



27 January 2025

Economic Letter from Asia: On Japan

A HAVER ANALYTICS® publication

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Written by [Tian Yong Woon](#)

This week, we focus on Japan following last week's decision by the Bank of Japan (BoJ) to raise interest rates again. That decision brings Japan's central bank closer to policy normalization, supported by the latest inflation data. However, Japan still has a considerable distance to cover before fully exiting its accommodative monetary policy stance, with the real policy rate remaining deeply negative (Chart 1). A closer look at Japan's inflation dynamics reveals that the recent uptick in price pressures has been driven primarily by fresh food and energy, with specific food items seeing price surges due to supply issues and rising production costs. That said, non-"core core" inflation components continue to show inflation consistently above 2% (Chart 2).

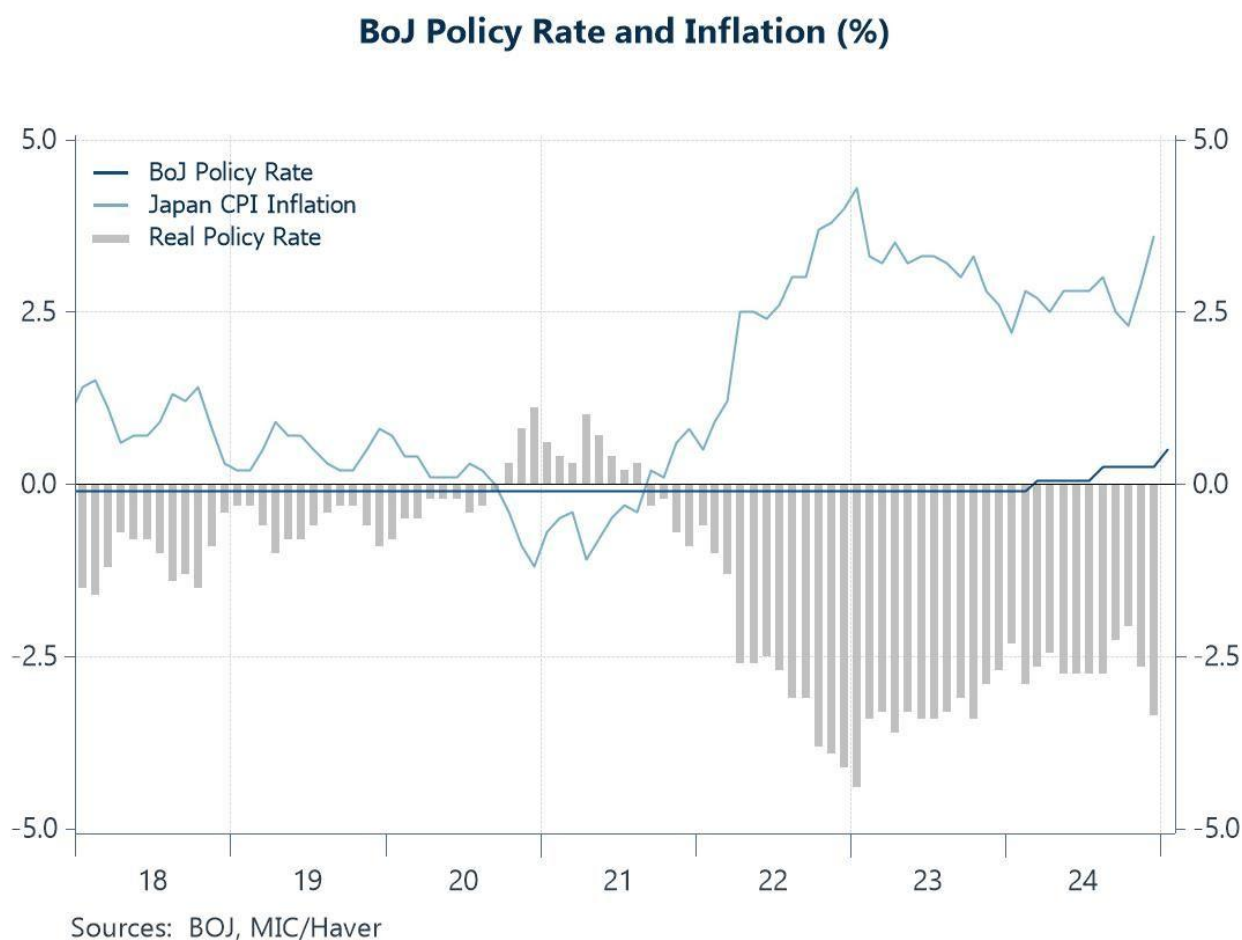
The outlook from here is increasingly supportive of BoJ tightening, including on the wage front. Annual spring wage negotiations have resulted in rising wage hikes in recent years, with the wage-price dynamic beginning to unfold as the BoJ desired (Chart 3). More recent wage data also shows a broad-based increase, though the manufacturing sector was a laggard in November, amid ongoing challenges (Chart 4). Externally, Japan still has considerable ground to cover in terms of monetary policy compared to its G10 peers. The wide yield differentials between Japan and other economies continue to weigh on the yen, creating unfavourable conditions that impact both locals and foreigners (Chart 5). Finally, like other net exporters to the US, Japan faces ongoing tariff risks, with added uncertainty surrounding its investments in the US (Chart 6).

The BoJ's January decision

Last Friday, the Bank of Japan (BoJ) raised its policy rate by 25 basis points to "around 0.5%," marking the highest interest rates in 17 years. Leading up to the decision, markets had already priced in the rate hike,

following signals from BoJ officials that further tightening was possible in January. In addition, the central bank released updated economic forecasts, now projecting slightly lower real GDP growth for fiscal year 2024 but higher CPI inflation for both fiscal years 2024 and 2025. The upward revision in inflation forecasts coincided with Japan's December CPI report, which showed a notable increase in price pressures, rising to 3.6% y/y, up from 2.9% previously. However, despite the BoJ's rate hike, Japan still has a long way to go before exiting its accommodative monetary policy stance, with the real policy rate remaining deep in negative territory, as illustrated in Chart 1.

Chart 1: BoJ policy rate and inflation

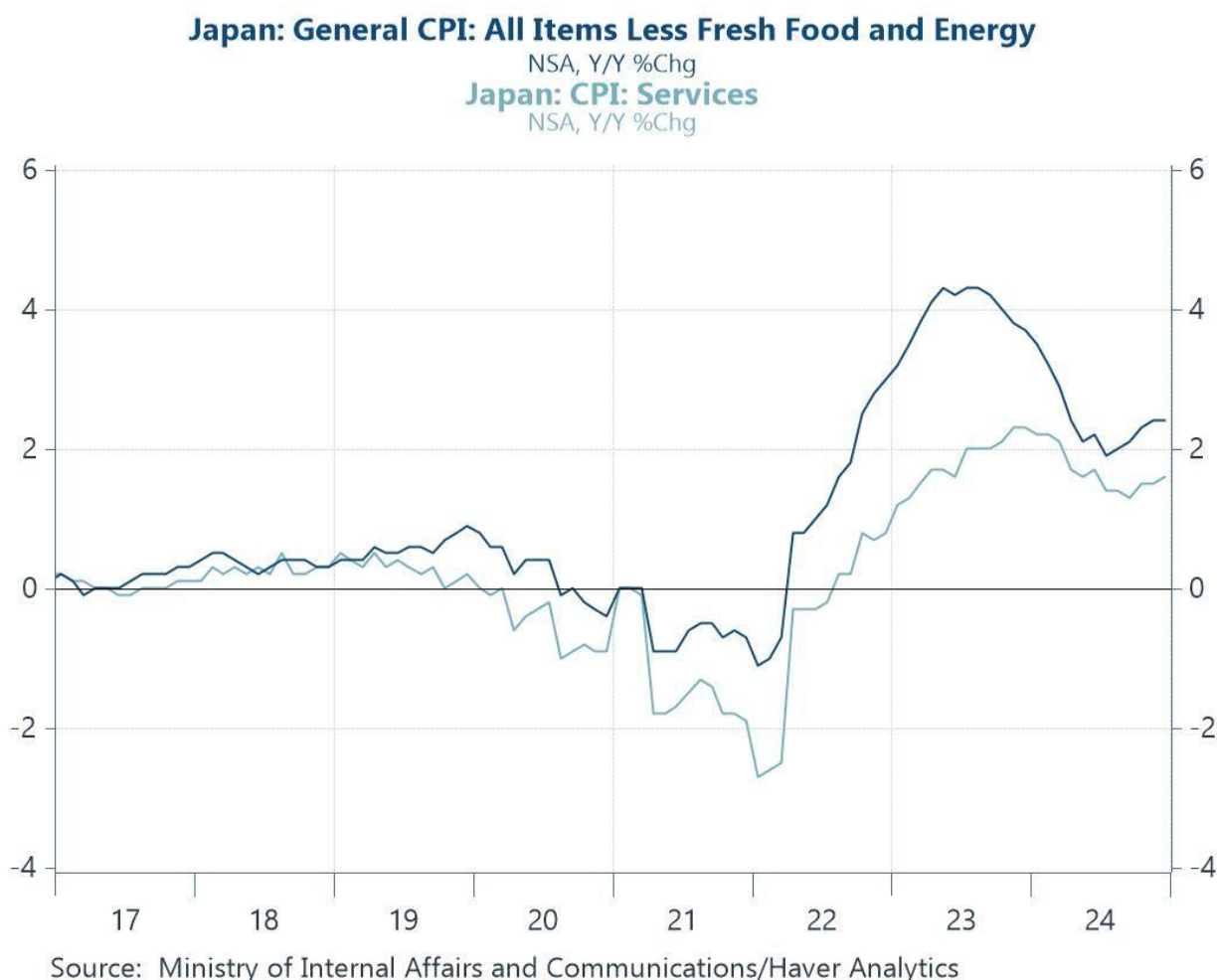


Price and wage developments

Digging deeper, the December uptick in Japan's inflation appears to have been driven by a few key factors, including fresh food and energy prices, which surged 17.3% y/y and 10.1% y/y, respectively. The spike in fresh food prices was broad-based, with notable increases in specific foods, such as cabbage. Meanwhile, the rise in energy prices was primarily due to the expiration of government subsidies for electricity and gas. When stripping away the effects of these items, Japan's "core core" inflation remained steady at 2.4% y/y, with services inflation still trailing behind (see Chart 2). Additionally, some non-fresh food items, such as rice, also

saw significant price increases, driven by a combination of reduced supply and rising production costs. In response, the Japanese government is now planning to release some of its emergency rice stockpile to help cool prices.

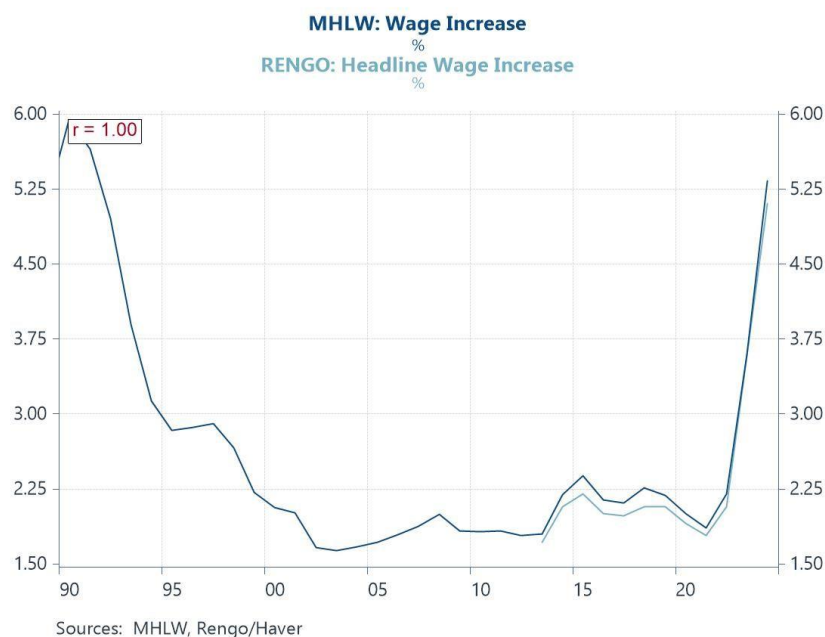
Chart 2: Japan core core CPI and services inflation



The persistence of some services inflation is a positive sign, even though that sector's price pressures remain relatively muted compared to other categories, as discussed above. This is still significant, particularly given the strong link between service costs and wages, as many service sectors are heavily reliant on labour inputs. Moreover, wage growth in Japan continues to be a key factor in the BoJ's decision-making process as it normalizes policy. The central bank sees wage growth as crucial to achieving its goal of establishing a "virtuous cycle" between wages and prices. With that in mind, investors are once again turning their attention to this year's major wage-related event: Japan's annual Spring wage negotiations, or "Shunto." There is growing evidence that such a cycle is beginning to play out in Japan, with wage developments becoming increasingly encouraging in recent years (see Chart 3). Notably, 2024 was particularly promising, as wage

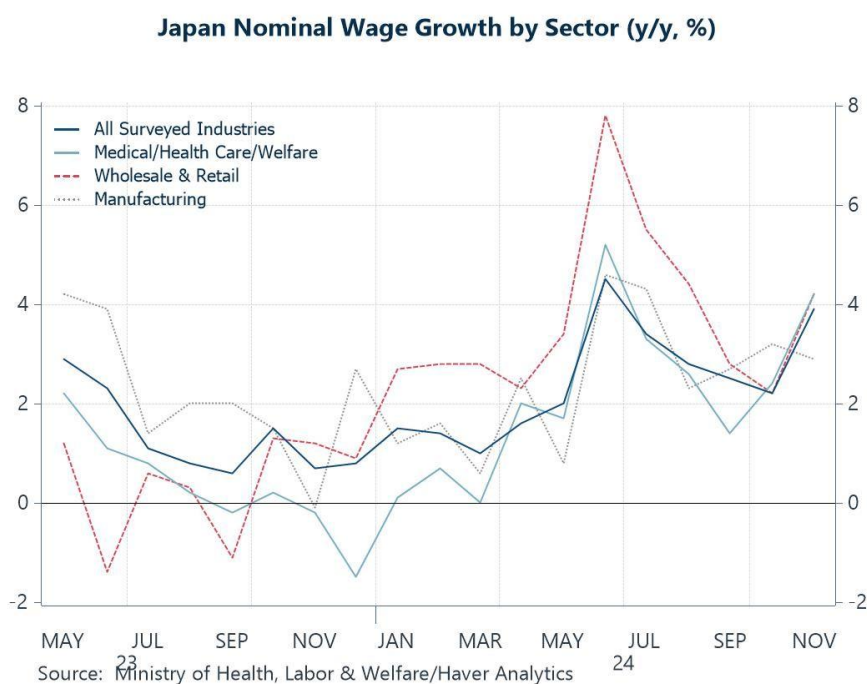
negotiations led to the first wage increase of over 5% since 1991. Ahead of the year's official figures, investors will likely look to leading indicators, such as wage increases reported by Rengo, Japan's largest labour union.

Chart 3: Japan wage increases from spring negotiations



Ahead of the spring wage negotiation results, we turn to more recent wage developments. As shown in Chart 4, wage growth in Japan, measured by total cash earnings, has remained robust over the past year, with the latest reading at 3.9% y/y in November. Nominal wage growth has been strong and broad-based across sectors, though wage growth in manufacturing lagged, as it faces ongoing challenges. Also, real wages are still struggling to maintain positive growth, despite significant gains in nominal wages, as inflation remains strong.

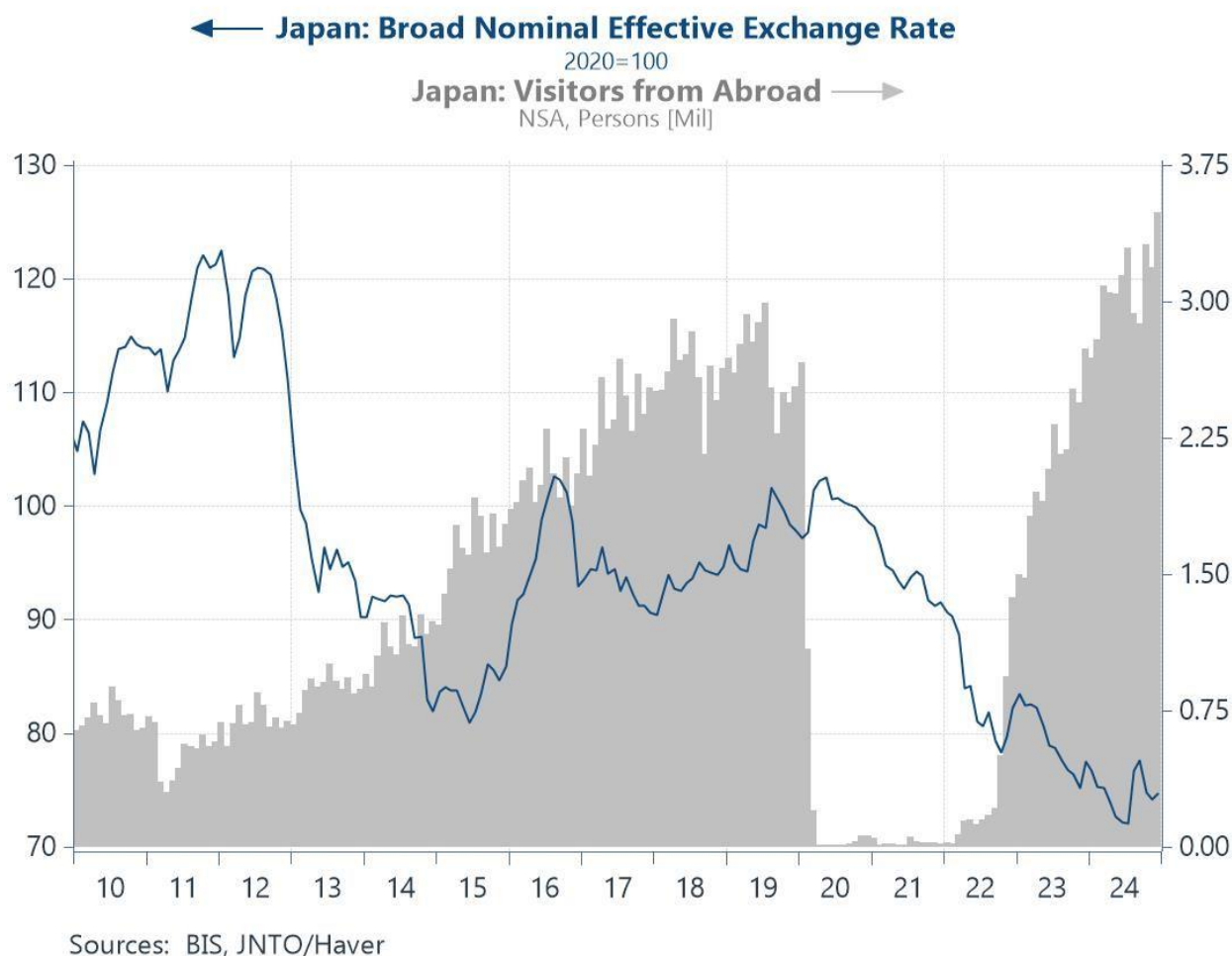
Chart 4: Japan nominal wage growth by sector



External developments

We turn next to external developments concerning Japan. As mentioned earlier, the BoJ still has a long way to go in its bid to normalize monetary policy. This is particularly evident when comparing the BoJ's current policy stance—still considered loose—to those of its G10 peers, who have already begun easing after completing their tightening cycles. As a result, Japan's yields remain very low compared to those of its peers (e.g., the US, UK, etc.), making yield differentials unfavourable to the yen and contributing to its depreciation. The effects of a weak yen are being felt by both locals and foreigners. A cheaper yen has been a key driver of the ongoing tourism boom in Japan (Chart 5), but it has also partially driven higher prices for goods in Japan due to imported inflation. While last Friday's BoJ decision triggered a mild bounce in the yen, it has yet to fully recover from the levels seen, for example, in September of last year.

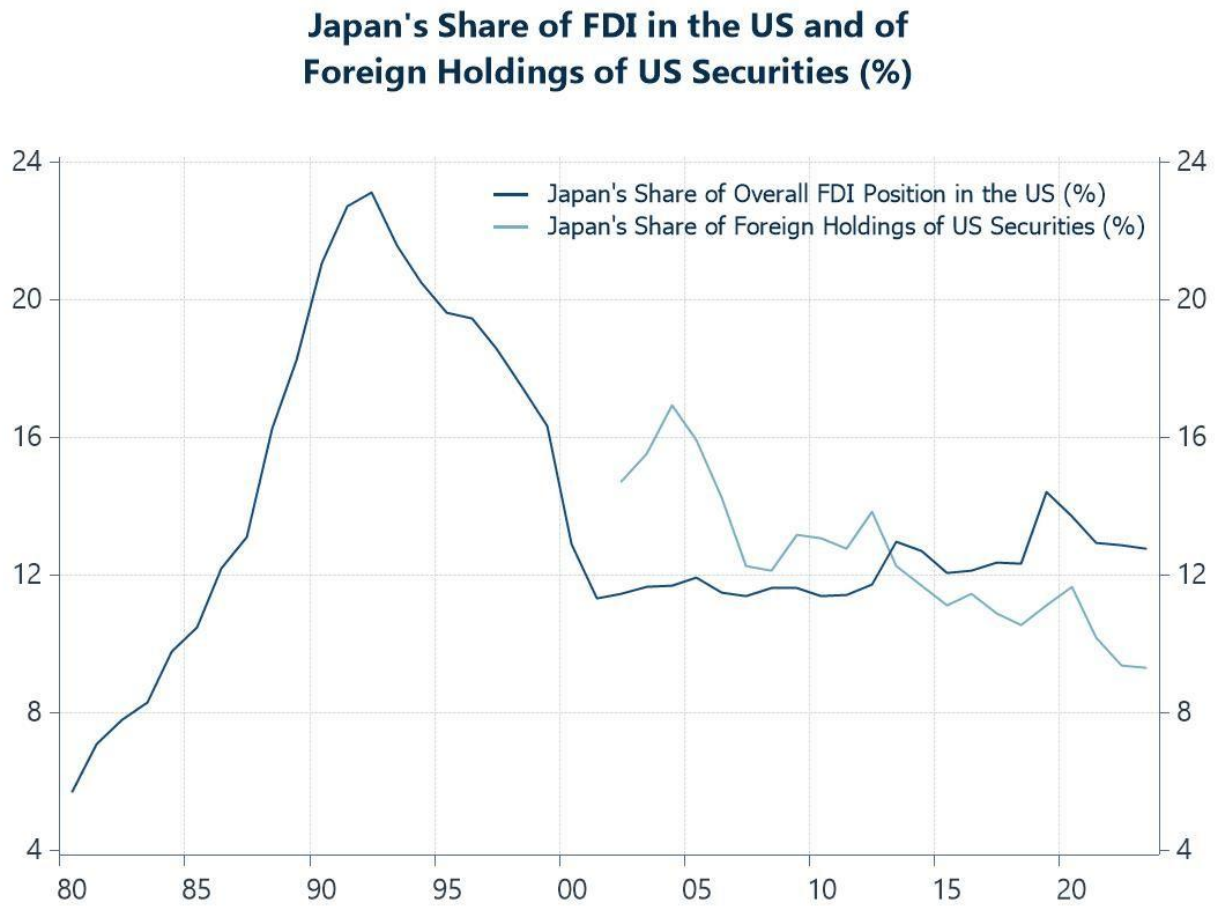
Chart 5: The Japanese yen and Japan tourist arrivals



Additionally, like many other major net exporters to the US, Japan faces risks related to trade actions under the hawkish stance of the new Trump administration. While no explicit trade actions have been announced regarding Japan, it remains uncertain whether President Trump will follow through on his repeated campaign proposal for blanket tariffs on all foreign imports. Beyond these potential tariff risks, other aspects

of US-Japan relations are still in limbo, particularly concerning Japan's direct investment in the US, where Japan already holds a significant position (Chart 6). Of recent note is the fate of Nippon Steel's attempted acquisition of US Steel, which was blocked by former President Biden.

Chart 6: Japan's share of FDI in the US and of foreign holdings of US securities



Source: BEA, US Treasury/Haver Analytics

About the author



Haver Analytics is pleased to bring [Tian Yong Woon's](#) commentaries on the state of the global economy to its clients.

Tian Yong joined Haver Analytics as an Economist in 2023. Previously, Tian Yong worked as an Economist with Deutsche Bank, covering Emerging Asian economies while also writing on thematic issues within the broader Asia region. Prior to his work with Deutsche Bank, he worked as an Economic Analyst with the International Monetary Fund, where he contributed to Article IV consultations with Singapore and Malaysia, and to the regular surveillance of financial stability issues in the Asia Pacific region. Tian Yong holds a Master of Science in Quantitative Finance from the Singapore Management University, and a Bachelor of Science in Banking and Finance from the University of London.

Data featured in this commentary:

Chart 1: BoJ policy rate and inflation

Series 1: [JPNRTARE@JAPAN](#)

JPNRTARE@JAPAN [Japan: Monetary Policy Rate [Spliced Series] (EOP, % p.a.)]

Series 2: [JYCIJ@JAPAN](#)

JYCIJ@JAPAN [Japan: Consumer Price Index: General (NSA, Y/Y %Chg)]

Series 3: ([JPNRTARE@JAPAN](#) - [JYCIJ@JAPAN](#))

JPNRTARE@JAPAN [Japan: Monetary Policy Rate [Spliced Series] (EOP, % p.a.)]

JYCIJ@JAPAN [Japan: Consumer Price Index: General (NSA, Y/Y %Chg)]

Chart 2: Japan core core CPI and services inflation

Series 1: [JPGCIJEF@JAPAN](#)

JPGCIJEF@JAPAN [Japan: General CPI: All Items Less Fresh Food and Energy (NSA, Y/Y %Chg)]

Series 2: [JYNC220@JAPAN](#)

JYNC220@JAPAN [Japan: CPI: Services (NSA, Y/Y %Chg)]

Chart 3: Japan wage increases from spring negotiations

Series 1: [WIRNO3@JAPAN](#)

WIRNO3@JAPAN [Japan: Spring Wage Increase: Non-Official Wage Increase Percentage (%)]

Series 2: [SHWIPA@JAPAN](#)

SHWIPA@JAPAN [Japan: Shunto: % Increase in Headline Wage (%)]

Chart 4: Japan nominal wage growth by sector

Series 1: [JPEYFT@JAPAN](#)

JPEYFT@JAPAN [Japan: Earnings Index [5+ Employees]: All Surveyed Industries (NSA, Y/Y%Chg)]

Series 2: [JPEYFMH@JAPAN](#)

JPEYFMH@JAPAN [Japan: Cash Earnings [5+ Employees]: Medical/Health Care/Welfare (NSA, Y/Y%Chg)]

Series 3: JPEYFWR@JAPAN

JPEYFWR@JAPAN [Japan: Cash Earnings [5 or More Employees]: Wholesale & Retail (NSA, Y/Y%Chg)]

Series 4: JPEYFM@JAPAN

JPEYFM@JAPAN [Japan: Earnings Index [5 or More Employees]: Manufacturing (NSA, Y/Y%Chg)]

Chart 5: The Japanese yen and Japan tourist arrivals

Series 1: X158DNB@INTDAILY

X158DNB@INTDAILY [Japan: Broad Nominal Effective Exchange Rate (2020=100)]

Series 2: JPNVA@JAPAN

JPNVA@JAPAN [Japan: Visitors from Abroad (NSA, Persons)]

Chart 6: Japan's share of FDI in the US and of foreign holdings of US securities

Series 1: (I158D@USINT % I001D@USINT)

I158D@USINT [Foreign Direct Investment Position in the US: Japan (Hist.Cost, Mil.\$)]

I001D@USINT [Foreign Direct Investment Position in the US (Hist.Cost, Mil.\$)]

Series 2: (FH158TDA@USINT % FH001TDA@USINT)

FH158TDA@USINT [Japan: Holdings of US Equity & Debt Securities (Mil.\$)]

FH001TDA@USINT [Foreign Holdings of US Equity & Debt Securities (Mil.\$)]

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