CAPITAL MARKETS ECONOMICS

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Special Report:
Japan's Bogus End To Deflation

- **Upsides to inflation are being achieved the wrong way.**

Is Japan exiting deflation? CPI figures for June and July are being cited as evidence that Japan is doing so. We think that this interpretation confuses a relative price shock for a generalized lift in inflation. The economic consequences of a rise in energy costs — as compared to an increase in the price level due to wage growth — are different from what the BoJ ultimately needs to deliver.

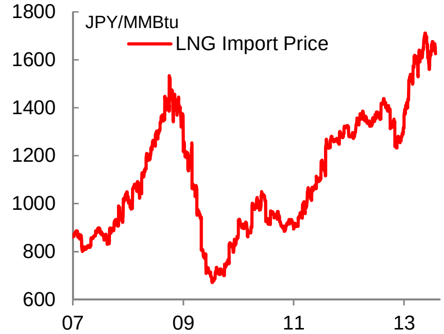
CPI Increases are all Due to Energy Prices

Japan's higher headline inflation is being driven by a large surge in energy costs (+6.9% y/y in the CPI numbers). This is reflected in a large 5.7% y/y rise in utilities prices (fuel, light and water charges) largely traceable to a 9.9% y/y rise in electricity prices, a 2.8% y/y rise in gas prices, and a 6.2% y/y rise in 'other fuel and light' prices. Higher energy prices are also showing up in higher prices in the transportation and communication category (+1.8% y/y) due to higher gasoline prices. Note that LNG prices are at all-time highs in JPY at the moment (see chart 1).

There are two main causes of this increase: a) electricity prices are surging because Japan took huge amounts of supply off the market when it shut down nuclear reactors in the wake of the Tōhoku tragedy, and b) Japan has had to therefore transition to imported fuels, which get more costly as the JPY depreciates (see chart 2), which magnifies the consequences of generally higher global market prices for energy inputs.

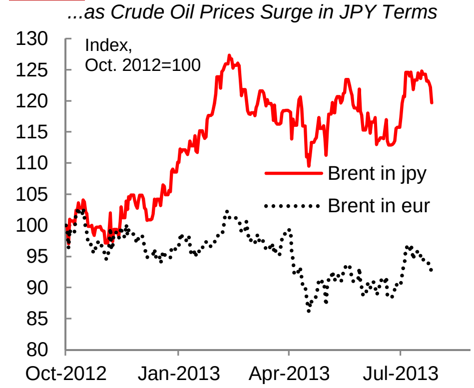
In short, energy is the only real type of upward price pressure in Japan today (see chart 3). Forget the anecdotes of some companies trying to pass through higher wage bills that ignore the anecdotes that go the other way. As economists, we want data, and the data continues to point toward widespread price deflation. In the June national print, falling prices persisted in categories like housing (-0.5% y/y), food (-0.9% y/y), household goods (-2.4% y/y), medical care (-0.6% y/y) and entertainment (-1.2% y/y). That's why upon removing food and energy, the rest of the CPI basket is still slightly falling (-0.2% y/y). Fresher data is available for the city of Tokyo and yet July Tokyo CPI showed much the same outcome with utilities prices up a stronger 9.0%, while prices are falling for housing (-0.7% y/y), household goods (-2.5% y/y), medical care (-0.8%), and entertainment (-1% y/y). Tokyo's July CPI excluding food and energy is down 0.4% y/y.

Chart 1 **Japan: LNG Prices**
Abenomics Fuelling Energy Price Spike...



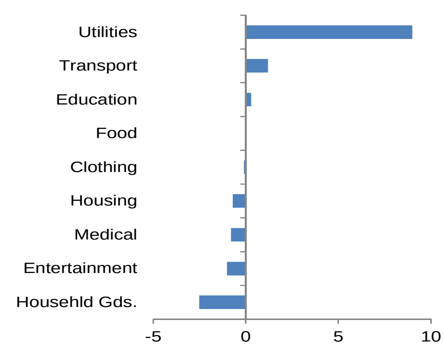
Source: Bloomberg, Scotiabank Economics

Chart 2 **Japan Oil Prices**
...as Crude Oil Prices Surge in JPY Terms



Source: Bloomberg, Scotiabank Economics

Chart 3 **Tokyo July CPI, Y/Y % Change:**
What End to Deflation?



Source: MIAC, Scotiabank Economics

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This type of energy cost-driven price shock is what we expected would occur when we wrote our thematic piece on Abenomics back in April titled *Challenges Confronting The Bank of Japan's Attempted Reflation.* The dynamics of a relative price shock then need to be evaluated very differently from the dynamics of generalized inflation.

Second Order Effects of Energy Price Spike

While energy prices are clearly up, wages are not (chart 4). Thus, subject to a household budget constraint that remains very tight, what are Japanese consumers to do in response to higher energy prices? Textbook economics says that they will spend less on other items in order to make a binding wage constraint balance out. That, in turn, is likely to aggravate disinflationary forces and keep non-energy prices falling.

Now, there are at least three counter-arguments to the views expressed thus far. One is that Japanese consumers could spend more upon a broader array of items without thereby feeding broad deflation by allowing the saving rate to drop. As chart 5 illustrates, there is no room for doing so without entertaining outright dissaving, as Japan's household saving rate was a paltry 0.8% in 2012 and the OECD forecasts it to remain around this level over 2013-14.

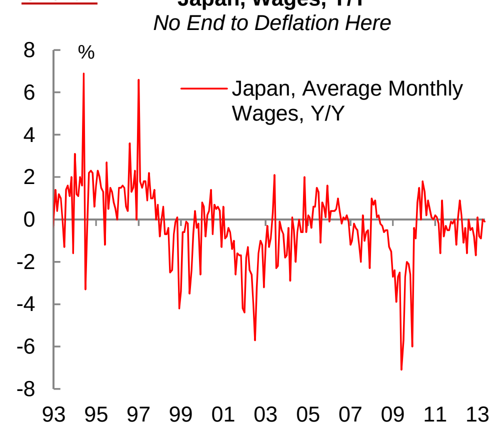
Which raises the argument over whether consumers can borrow more. More borrowing would drive the already low saving rate lower. As well, household debt accumulation is apparently not an option in Japan's banking system: Money multipliers continue to fall as does velocity (chart 6), and household debt growth is weak as Japan's cash-hoarding banking system is not playing along with Abe's inducements to take risks.

The third argument is that inflation could be more widely passed through the economy if businesses begin to incorporate higher inflation expectations. Here too, however, it depends what type of higher inflation they anticipate. If they anticipate just higher energy prices then they will adjust future plans to mitigate the effects as much as possible while still cutting back on other items in their budget. This is where the dangers of deflation persist. If businesses expect other non-energy prices to continue falling then they will only persist in postponing consumption in anticipation of securing lower prices in future and this is why economic weakness stemming from persistent deflation is so dangerous to an economy. The same logic holds for consumers.

Wrong Type of 2% CPI Target

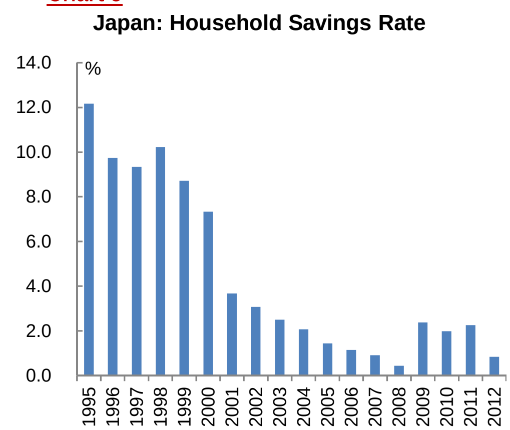
Last but not least, we fear that the planned April 2014 sales tax increase is likely to operate against the backdrop of still-weak wages further squeezing consumers. The second-round effect after consumers deal with the tax hike will be that they spend even less. Japan should have learned that lesson in the 1990s when it last raised the sales tax, but a sharp deterioration in public finances since then (debt to GDP stands near 250%) is giving the country little hope of avoiding tax increases. The net is that Japan might ultimately hit 2% y/y CPI due to energy costs and a hike in the VAT — the wrong type of inflation. While that might satisfy the BoJ's inflation target, it won't spur consumer and business spending. Good luck 'ending deflation now.'

Chart 4



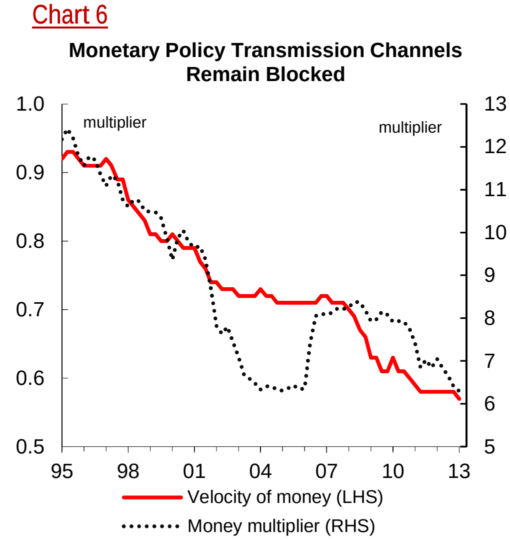
Source: Japan MHLW, Scotiabank Economics

Chart 5



Source: Scotiabank Economics, OECD

Chart 6



Source: Bloomberg, Scotiabank Economics.