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Government plays the waiting game as inflation slows

Key takeaways

- Real wages fell again in FY 2023, but inflation data, combined with wage negotiation results, could point to income gains soon.
- Prime Minister Kishida Fumio needs wage gains to make the case for his government, but his near-term policy options are limited.

The Kishida government and the Bank of Japan (BOJ) face a dilemma as new data presents a mixed picture for incomes and prices, complicating Prime Minister Kishida Fumio's desire to highlight his government's achievements in boosting household incomes and delivering broad prosperity and improve his prospects for political survival.

On the one hand, the Ministry of Health, Labor, and Welfare (MHLW) reported on Thursday, 23 May that real wages declined 2.2% in FY 2023, the largest decrease since FY 2014, when real incomes were squeezed by that year's consumption tax increase. It was the second consecutive year of a year-over-year decline in real wages, which, with the yen at multi-decade lows against other major currencies, has likely contributed to the pessimism captured by the Cabinet Office's Economy Watchers survey and other measures of economic sentiment.

At the same time, however, it is possible that households could begin seeing monthly increases in their real wages after twenty-four consecutive months of decline. Not only will unionized laborers at large companies see their biggest pay increase since 1991 – in its first aggregated results this week, Keidanren reported that large companies increased pay by an average of 5.58% – but inflation data released by the Ministry of Internal Affairs and Communications on Friday, 24 May showed that while inflation remained above the BOJ's 2% target in April, core CPI stripping out fresh food rose by only 2.2%, the second consecutive month in which the rate of increase slowed. Slower inflation, rising pay, and the pending income tax cut could all translate into an improved outlook for real wages.

The upshot is that the Kishida government and the BOJ must find the right policy mix that eases the inflationary pressures on household incomes (and consumption) without acting so aggressively that it undermines business and household economic activity. The result could be a more cautious approach to interest rates by the BOJ, given both slowing inflation and speculation that it could reduce its asset purchases driving interest rates on new long-term Japanese government bonds over 1% for the first time since 2013. If the BOJ opts for a slower approach to interest rate hikes and other monetary policy changes, it will likely mean that the government will continue use foreign exchange intervention to keep the yen from testing JPY 160/USD, not because the prime minister's office and the finance ministry expect that they can shift the underlying fundamentals but to afford both the government and the BOJ more time for real income gains.

Ultimately Kishida and the Liberal Democratic Party (LDP) are in the uncomfortable position of having to play a waiting game. They have already introduced a broad tax cut, and big wage hikes have been announced for core workers. Now they have to see how large pay increases will be for the more than 80% of the workforce that does not belong to unions involved in the *shuntō* wage negotiations and hope that the monetary and exchange rate policies can find a sweet spot limit the risk of currency weakness that undercuts wage gains.

Of course, even if the government and BOJ can successfully navigate these challenges, the results may come too late to save Kishida's job.