A Tough Path to a Virtuous Price-Wage Circle

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Wage increases are attracting intense attention as a touchstone for the future course of the Japanese economy. The Japanese government and the Bank of Japan are closely watching how the forthcoming *shunto* spring wage negotiations will play out. There are signs of a shift in the long-entrenched norm that prices and wages simply do not rise, which has permeated the nation throughout the long period of deflation, and now is the time to aim for an increasing, virtuous circle between prices and wages. This article will examine whether such a virtuous circle can become sustainable.

First, when assessing the *shunto* wage increase, it is important to understand that it usually consists of two portions—the regular annual pay increase that company employees receive, and the increase in the base pay. It is important to understand that the increase in the base pay is the determining factor in the economy-wide wage trend, and by extension, the rate of inflation.

The periodic pay increase determines the wage curve, which represents the relationship between the number of years worked and wages, and it is a critical element in Japan's traditional seniority-based wage system. However, if the rate of increase remains the same year after year, the periodic pay increase does not change the total amount of wages that employers pay unless the demographics of the workforce change, because higher-paid senior employees retire and are replaced by new recruits with low wages.

In this case, on an economy-wide basis as well, the total amount of wages paid remains constant. In other words, companies that utilize the membership-type employment system can achieve the almost magical feat of raising wages every year for each and every member (employee) without sustaining any additional financial burden.

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My understanding is that in order to fundamentally adapt to major changes in the surrounding environment from the 1990s onward, labor and management, particularly at large companies, were forced in the late 1990s through the early 2000s to curb recruitment of new graduates, increase the proportion of non-regular employees in the workforce, and hold down the increase in the base pay in exchange for retaining middle-age and elderly regular employees. While the curb on the base pay increase has been reflected in the more moderate wage curve than was previously the case, the seniority-based wage system, which constitutes the core of the membership-type employment system, has been maintained. As long as inflation remains minimal, workers at companies with membership-type employment systems, who are automatically granted an annual pay increase, can lead relatively comfortable lives.

Maintaining employment is not the only reason why a lack of growth in the base pay has become the norm. As membership-type companies default to retaining regular employees until they reach retirement age personnel costs need to be thought of in terms of the cumulative total amount of wages paid until retirement. This is a fixed cost, rather than a variable one, and is essentially more of an investment in nature.

If the base pay continues to increase into the future, the fixed cost of wages naturally grows accordingly. In this era of uncertainty when high economic growth is not expected and unforeseen events occur regularly, it is no wonder that personnel costs, which have a strong element of investment, are curbed.

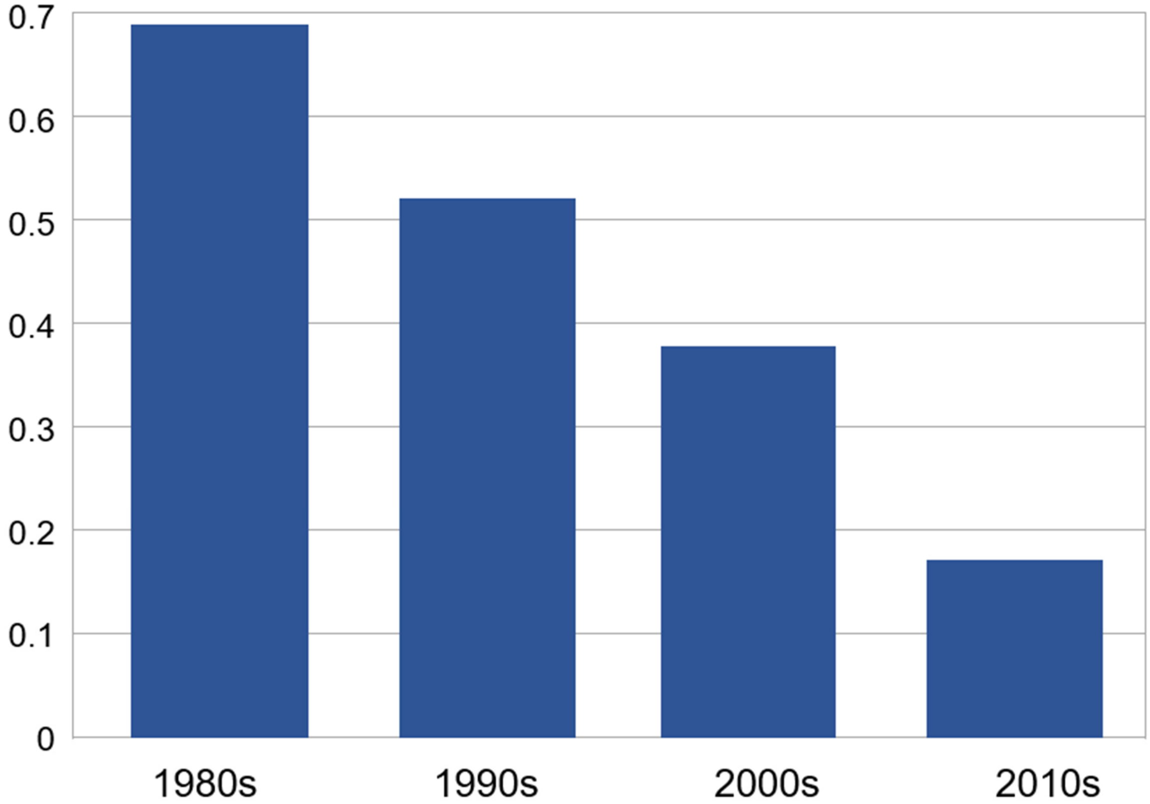
In that sense, the fact that in 2023, the base pay was raised by around 2% after some 20 years of little pay increase was epoch-making. Moreover, that increase is attributable to the highest inflation in several decades, which was triggered by a shock from overseas that came in the form of energy and food price upsurges. If the shock is recognized as a temporary phenomenon, the possibility cannot be ruled out that the uptrend in the base pay will prove to be short-lived given that the fundamental factors behind the inclination to hold down the base pay that were mentioned earlier have remained unchanged.

One factor in whether to raise wages is the concept that wages should be to keep the labor share of income constant, which is mentioned in *Watashiga Mitekita Nihon Keizai* (The Japanese Economy as I Have Watched), a recent book by Komine Takao. In the past, this was a very basic idea for economists at government organizations. In order to increase wages while keeping the labor share of income constant, real wages should be raised to the degree commensurate with the increase in labor productivity. Under this concept, when the terms of trade deteriorate due to import-driven inflation, a commensurate decline in real wages should be expected.

The lesson of the 1970s was that once inflation has arisen due to an overseas factor, any excessive increase in the labor share of income should be held down by accepting a decline in real wages. At times of high inflation, the combination of increasing wages and rising prices is referred to as a negative spiral, while it is called a virtuous circle when deflation is the problem. However, in either case, if the labor share of income grows rapidly along with increasing wages and rising prices, negative effects on the economy, such as the risk of a fall in capital investment, cannot be disregarded.

It is also possible that it has in effect become more difficult than it was previously to create a virtuous price-wage circle. A study conducted jointly by this author and other researchers, titled *Nihon No Makuro Keizai Bunseki* (Macroeconomic Analysis of Japan) found that since the 1980s, the correlation co-efficient between the rates of increase in prices and wages has become smaller over time (see the figure below). A recent study by the Bank of Japan (BOJ) also pointed out that while the reaction of prices to an external shock that spread through changes in nominal wages had extensive spillover effects in the 1970s and 1980s, few such effects have been observed since the 1990s.

Relationship between the rates of wage increase and inflation



Note: The vertical axis represents the correlation coefficient between the rate of increase in total amount of cash earnings and the rate of increase in the all-item CPI

Source: *Nihon Keizai No Makuro Bunseki-Teion Keizai No Pazuru Wo Toku* (Macro Analysis of the Japanese Economy—Solving the Question of Why the Economy Has Remained Lukewarm) (Tsuru Kotaro, Maeda Saeko, and Murata Keiko, 2019, Nihon Keizai Shimbun Publication)

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Wage increases typically are not accompanied by rising prices, but what is the reason for this phenomenon? One hypothesis states that we should focus on companies' price-setting behavior and the competitive environment in the marketplace.

Let us consider a case in which all companies competing in a market want to raise prices because of rising costs. None of the companies would experience a loss of market share if all other competitor companies universally raise their prices. However, if one company alone raises their prices while others don't, it will usually lose a large market share. In this case, the optimal behavior is for each and every company to leave prices unchanged.

This situation is akin to the prisoner's dilemma (coordination failure) as referred to in game theory. A BOJ researcher, using company-by-company data obtained through the BOJ's Tankan short-term economic sentiment survey, reported that when Japanese companies set prices, they tend to behave similarly to their competitors—that is, a strategic complementarity can be observed.

Furthermore, the possibility cannot be disregarded that the increasingly severe competitive environment surrounding Japanese companies may be tilting them further toward that price-setting behavior. Professor Kosuke Aoki of the University of Tokyo and others measured the price markup rate, or the rate of disparity between the sales price and the marginal cost, at a broad range of companies and showed that since the beginning of the 2000s, there has been a clear downtrend. At non-manufacturing companies and small and medium-size enterprises (SMEs) in particular, not only is the level of the markup rate low, but the margin of decline in the rate is also becoming larger and larger, according to their research.

In addition, at companies that record a steeper decline in the markup rate, the margin of increase in the wage markdown rate, which represents the disparity between the income per unit of labor input and the wage level, is larger. At the macro level, this can be interpreted to indicate that a decline in value added due to a fall in the markup rate has been offset by the wage-curbing pressure, resulting in a stable trend in the labor share of income.

The above research findings may indicate that the present market situation is that of a price-reducing competition known as Bertrand competition—a situation that tends to result in a price reduction spiral among competitors. In competition between products of the same quality, companies cannot escape this price competition trap even by attempting to cut costs. The only viable option for exiting the situation is to pursue a product differentiation strategy by providing goods and services that are different in quality from those available from other companies. This is a critical challenge, particularly for non-manufacturing companies and SMEs, for which markup rates are in steep decline.

If the change in the structural factors that have been mentioned in this article does not materialize, creating a virtuous price-wage circle will not be achievable. Even if a virtuous price-wage circle is ultimately created, there is no guarantee that real wages will rise. Ultimately, the challenges for the Japanese economy boil down to reconsidering the membership-type employment system and the homogenous corporate strategies based on a herd mentality that are strongly associated with the system.

Translated by the Research Institute of Economy, Trade and Industry (RIETI).* The article first appeared in the "*Keizai kyoshitsu*" column of The Nikkei newspaper on 15 January 2024 under the title, "*Bukka to Chingin no Kojunkan, michi kewashi* (*A Tough Path to a Virtuous Price-Wage Circle*)." *The Nikkei*, 15 January 2024. (Courtesy of the author)

*RIETI: http://www.rieti.go.jp/en/index.html

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