## INTRODUCTION

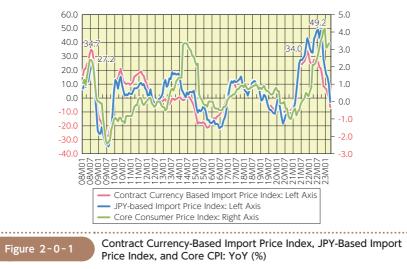
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The year 2022 was a historic year in which attention was focused on the virtuous cycle between prices and wages.

During the global financial crisis known as the Lehman Shock, both nominal and real wages fell due to the substantial expansion of the supply-demand gap, and the two did not diverge. During the recovery process after the COVID-19 pandemic, nominal wages rose only moderately, and the decline in real wages expanded due to the price hikes that exceeded them.

To clarify the situation during this period, Figure 2-0-1 shows the movements of the Core CPI and the import price index (in both contract currency and JPY terms) during the Lehman shock period and after the COVID-19 pandemic.

In both periods, the surge in crude oil prices led to a sharp increase in import prices. During the Lehman shock period, the import price index in contract currency terms peaked in July 2008 (+34.7% YoY), while the import price index in JPY terms peaked in August 2008 (+27.2% YoY). However, due to the rapid appreciation of the JPY in the exchange rate, the Core CPI turned downward in January 2009. During the recovery process after the COVID-19 pandemic, on the other hand, the import price index in contract currency terms peaked in November 2021 (+34.0%), while the import price index in JPY terms



Source: Author's calculations based on the Bank of Japan's "Domestic corporate goods price index" and the Ministry of Internal Affairs and Communications' "National Consumer Price Index"

peaked in July 2022 (+49.2%). During this period, the ven depreciated rapidly against the U.S. dollar from 114.13 yen to 136.63 yen, so the peak of the yenbased import price index was delayed by eight months relative to the contract currency-based index. With a time lag, import price inflation propagated to domestic corporate prices (peak in December 2022) and was passed on to consumer prices (peak in January 2023). As a result, real wages in Q1 2023 declined YoY for the fourth consecutive quarter. This rapid deterioration in the income environment drew national attention to the need for wage increases and to the virtuous cycle between prices and wages. Chapter 2, Section 1 presents the theoretical and empirical frames of the price-wage virtuous cycle. First, in order for wages to rise sustainably, it is fundamental to first increase the level of activity in the economy as a whole before raising prices. For this to happen, strong growth in private demand, mainly household consumption and private capital investment, is indispensable. Second, an increase in labor productivity is essential for wages to rise, the key to which is the expansion of production facilities through capital investment.

Japan's capital equipment growth has lacked momentum. However, supported by the accommodative financial environment that has prevailed over the past decade, the performance of large companies in particular has improved, and capital investment has remained strong. The key will be for this to spread to small and medium-sized enterprises (SMEs), leading to a further increase in capital equipment and productivity in the macroeconomy as a whole. The source of robust capital investment will be sustained growth in household consumption. Wage increases are indispensable for this purpose.

A virtuous cycle between prices and wages is a mechanism by which the demand and supply sides of the macroeconomy mutually exert a positive influence on each other. In Japan, capital investment is currently growing against the backdrop of a labor shortage and the digital transformation (DX) accompanying improvements in artificial intelligence (AI). This situation, coupled with a recovery in consumption following the COVID-19 pandemic, should continue to generate sustained increases in productivity and wages, creating a virtuous cycle between prices and wages. In addition, the creation of high-value-added products and the premiumization of value-added products are important when considering the improvement of productivity.