

Letter from SuMi TRUST - Wage Increases in Japan

Written by Hiroyuki Ueno

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Executive Summary

- Wage increases are gaining momentum in Japanese companies, particularly in large enterprises (LEs). If wages rise sufficiently and sustainably, consumer spending is also expected to increase, leading to a virtuous circle in the Japanese economy.
- In the meantime, it is challenging for small and medium-sized enterprises (SMEs), which account for about 60% of the total number of employees in Japan, to increase wages by as large an amount as the LEs have. It is because SMEs have not passed through higher costs to their customers, despite soaring import prices.
- The government has started to strengthen support for SMEs to pass on prices. In addition, material prices are now gradually coming down. As a result, SMEs have more room to get back their margin and realise wage increases going forward.

Trends in wage increases observed in Japanese companies

Japanese companies are increasingly moving towards higher wages in line with the high level of inflation and the economic recovery from COVID-19, which lagged behind other developed countries. According to the Ministry of Health, Labour and Welfare's Monthly Survey of Labour Statistics, nominal wages are rising due to special salaries and lump-sum payments in response to the price hikes, but they are not catching up with price increases, and real wage growth remains negative. During "Shunto" (annual wage negotiations between labour unions and companies every spring), the labour unions at many companies requested significant rises, and the outcome of this year is a bit different from the usual year, especially in the LEs such as Toyota Motor Corporation, which has agreed with its labour union to accept the wage increase request, which is the highest level in the last 20 years. Toyota's new CEO, Koji Sato, made a decision at the first negotiation to fully admit the request from the union, and this decision is a strong message for the industry. The government has also appealed to companies to raise wages above the rate of inflation, and social momentum is steadily growing.

Small and medium-sized enterprises have little room for wage increases

While labour unions' demands for higher wages have been fully accepted by many LEs, the situation in SMEs appears to be different. SMEs, defined as companies with capital of less than JPY 100 million (approximately USD 750 to 800 thousand), account for 58.1% of Japan's share of employment and have a significant influence on wages in Japan (Fig. 1). A comparison of the 2011-2013 period, which includes the beginning of Abenomics, and the average for the most recent three years, 2019-2021, shows that the wage increase rate for both manufacturing and non-manufacturing industries was lower for SMEs than for LEs, with the non-manufacturing sector displaying a negative rate of wage growth (Fig. 2). Among the three components: (a) change in labour share, (b) change in labour productivity or value-added per capita and (c) change in price, (b) was the largest negative contributor for SMEs in the non-manufacturing sector. A further breakdown of the labour productivity

into sales per capita and change in the value-added ratio (value added per sales) shows that the value-added ratio significantly impacts the difference in the labour productivity between LEs and SMEs. The labour productivity can be represented in the following formula.

$$\text{Labour Productivity} = 1 - \frac{\text{External Purchase Costs}}{\text{Sales}}$$

Figure 1. Share of permanent employees by the size of company's capital (2021)

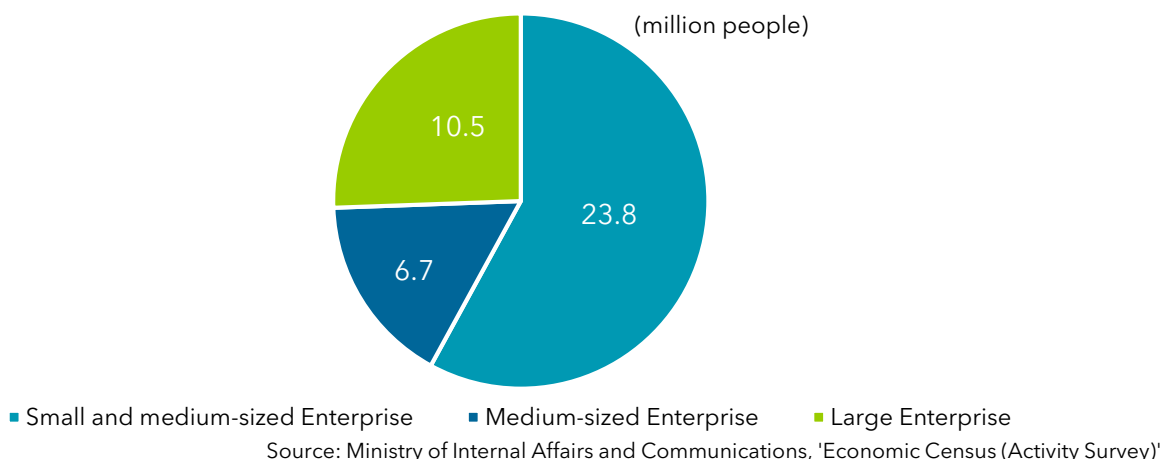
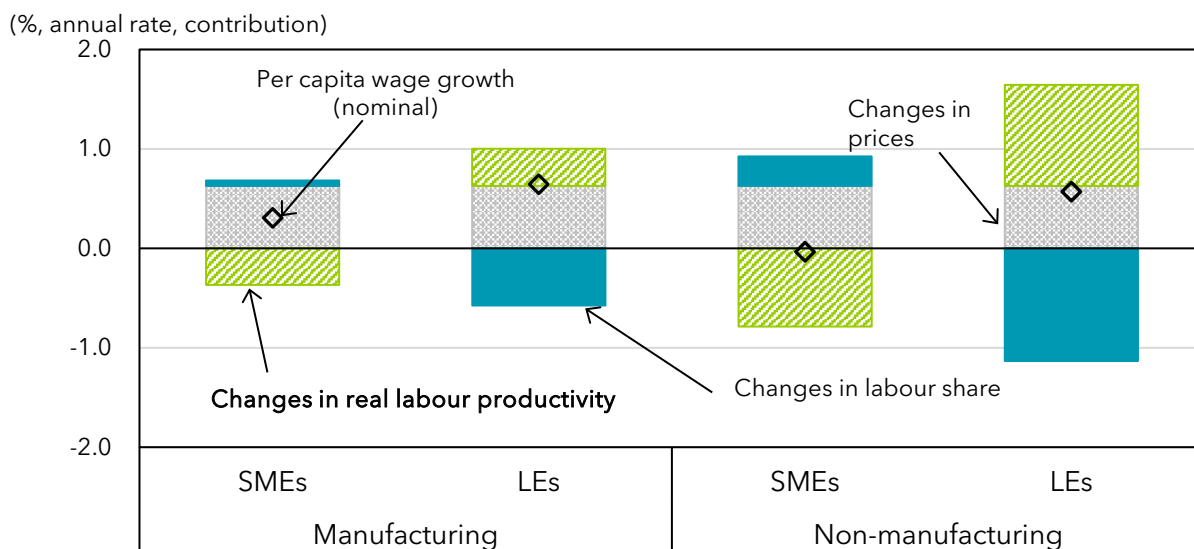


Figure 2. Factor breakdown of nominal wage growth



Note: The changes (annualised) in the FY2011-2013 average and the FY2019-2021 average are reviewed from the perspective of confirming the trend from the global financial crisis to the present day, while limiting the impact of single-year fluctuations.

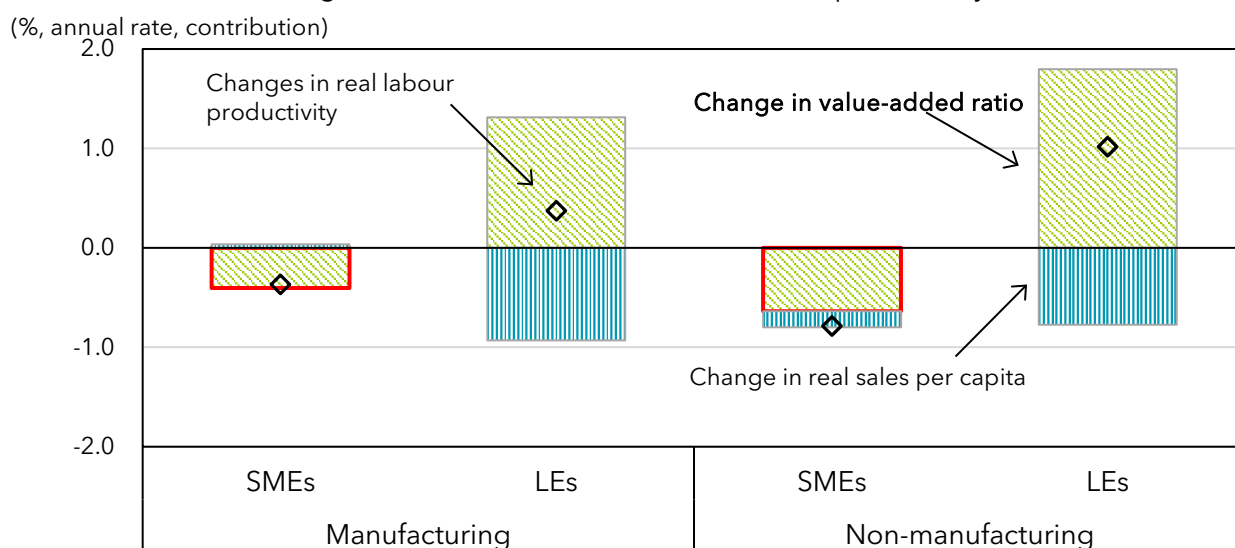
Computed using the following formula for factor breakdowns.

Nominal wage growth ≈ Changes in labour share + Change in real labour productivity + Price inflation (GDP deflator)

Source: Ministry of Internal Affairs and Communications, 'Annual Report on Statistics of Corporate Enterprises', Cabinet Office, 'National Accounts'.

To increase labour productivity, it is required to lower external purchase costs, such as materials, logistics and outsourcing costs, or to increase sales. Most of the external purchase costs are variable costs, which closely link to sales, and thus purchase/sales price is more important than the amount of sales. While SMEs hesitated to increase their sales price, the higher external purchase costs caused by global inflation and the Japanese Yen's depreciation have lowered labour productivity (Fig. 3).

Figure 3. Factor breakdown of real labour productivity



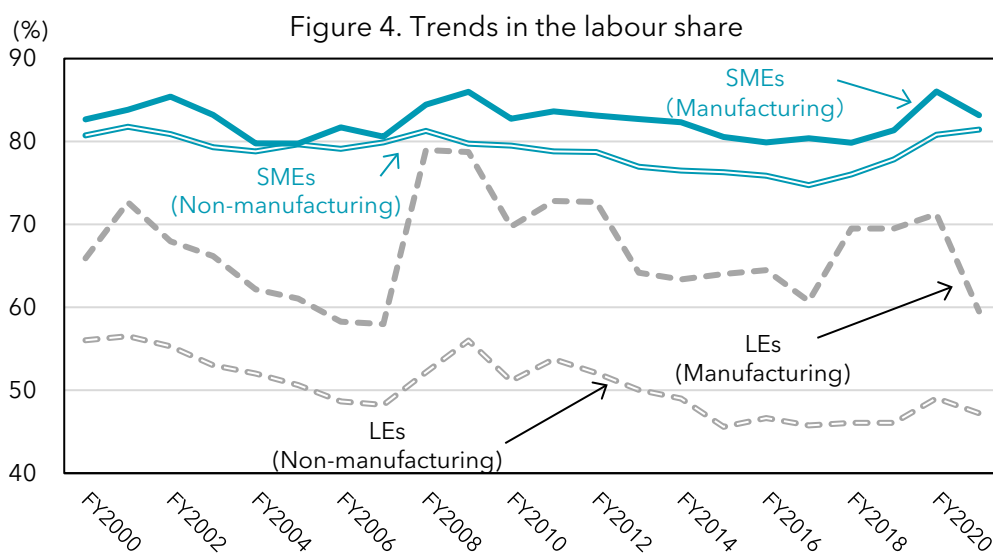
Note: The changes (annualised) in the FY2011-2013 average and the FY2019-2021 average are reviewed from the perspective of confirming the trend from the global financial crisis to the present day, while limiting the impact of single-year fluctuations.

Computed using the following formula for factor breakdowns.

Changes in real labour productivity ≈ Changes in value-added ratio + Change in real sales per capita

Source: Ministry of Internal Affairs and Communications, 'Annual Report on Statistics of Corporate Enterprises', Cabinet Office, 'National Accounts'.

Additionally other differences were found in the change in the labour share (labour costs per value added) between LEs and SMEs. While the labour share fell in LEs, it remains high or even rising in SMEs. In SMEs, the labour share increased because the amount of value added decreased more than that of labour costs. In other words, the labour share of SMEs rose because value added fell more than during the normal phase of economic expansion due to a lack of price pass-through. In addition to the fact that SMEs originally had less room to increase their labour costs due to their higher labour share compared to LEs, they have further lost their capacity to raise labour costs due to the increase in labour share over the last decade (Fig. 4).

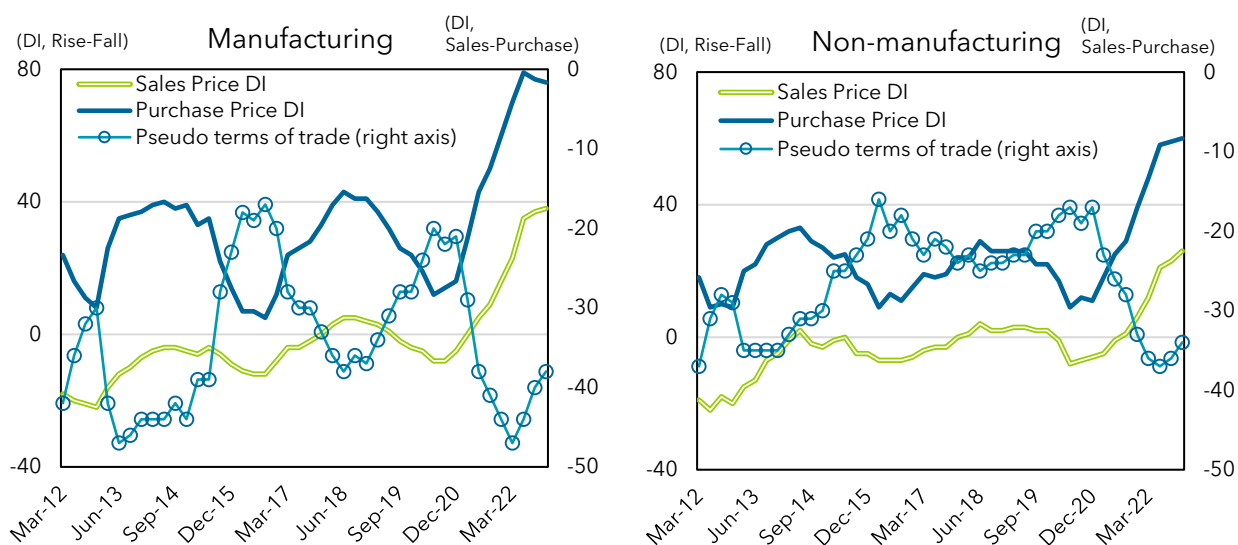


Source: Ministry of Internal Affairs and Communications, 'Annual Report on Statistics of Corporate Enterprises', Cabinet Office, 'National Accounts'.

Prospects for wage increases

Although SMEs were facing challenges to raise wages, the environment is changing. The pseudo terms of trade (sales price DI - purchase price DI) has bottomed out in early 2022 and it is continuously improving (Fig. 5).

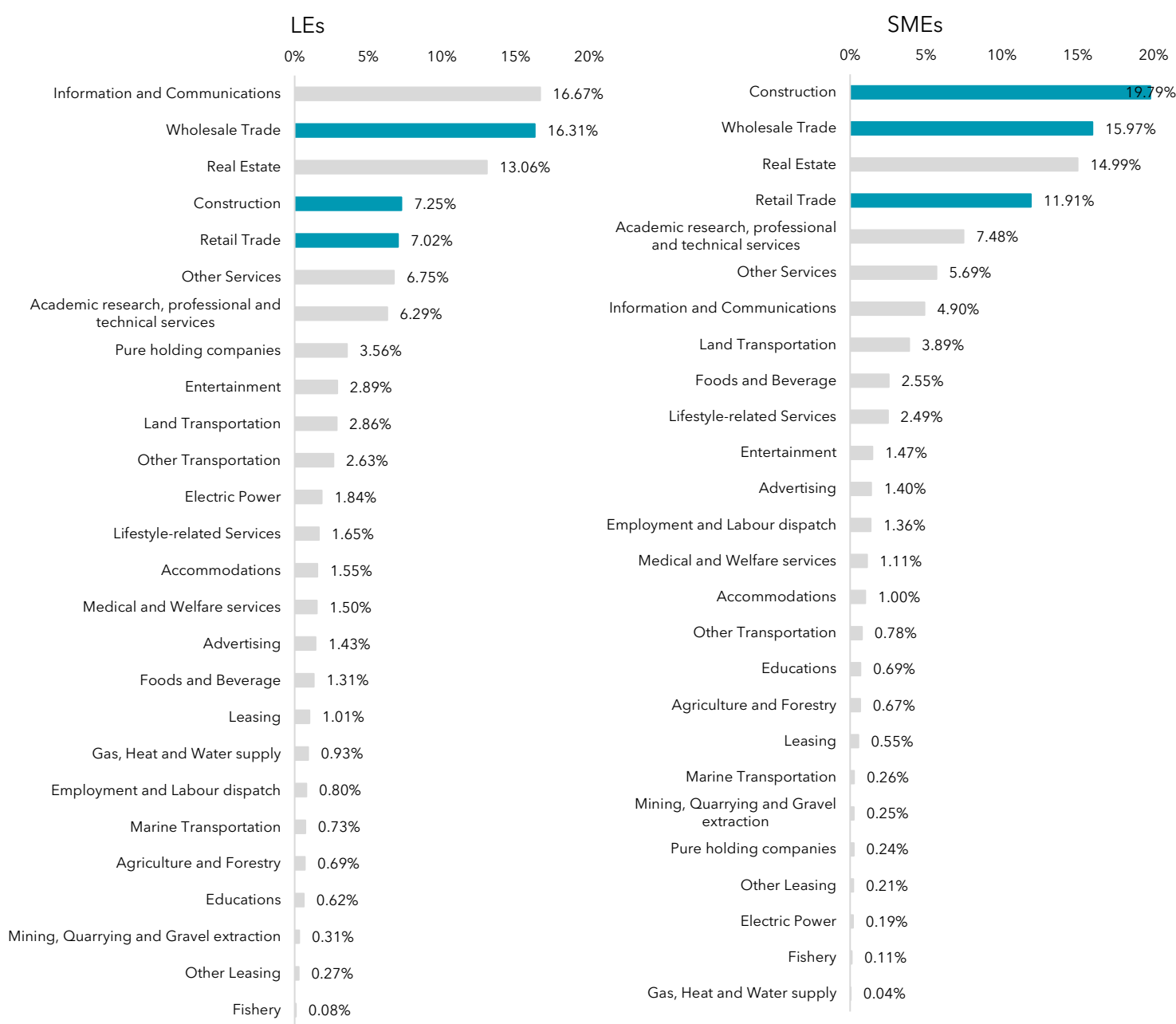
Figure 5. Pseudo terms of trade (SMEs)



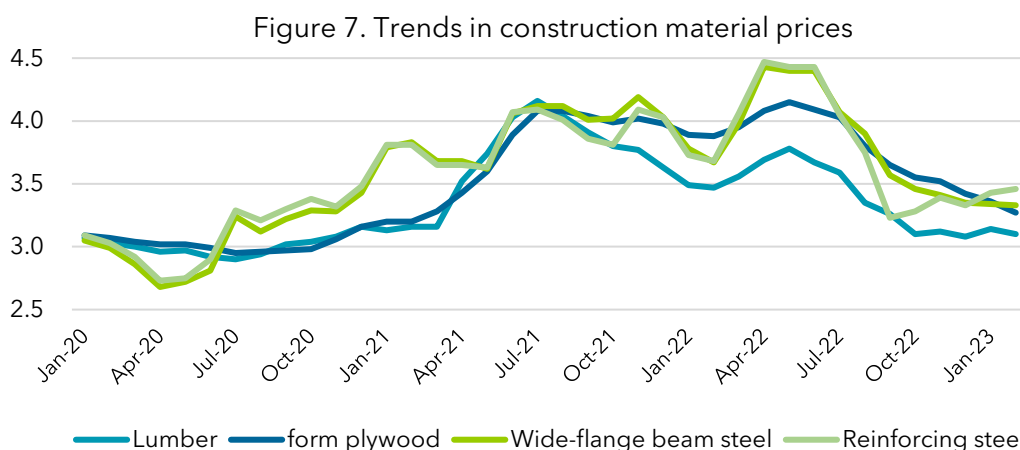
Source: Bank of Japan, 'Tankan Survey', Period: Mar 2012-Dec 2022

Moreover, SMEs in the non-manufacturing sector, where real labour productivity has declined the most, include many firms in the three sectors that are negatively impacted by price hikes: construction, wholesale, and retail (Fig. 6). While many industries are recovering from the stagnation caused by COVID-19, the increase in costs has taken away the capacity for wage increases, particularly in the construction industry, where material prices have risen significantly. However, price levels have gradually started to fall since the second half of 2022, and the price hikes of the past few years are coming to a halt (Fig. 7).

Figure 6. Breakdown of non-manufacturing sectors



Source: Ministry of Finance, 'Financial Statements Statistics of Corporations by Industry', as of the end of December 2022

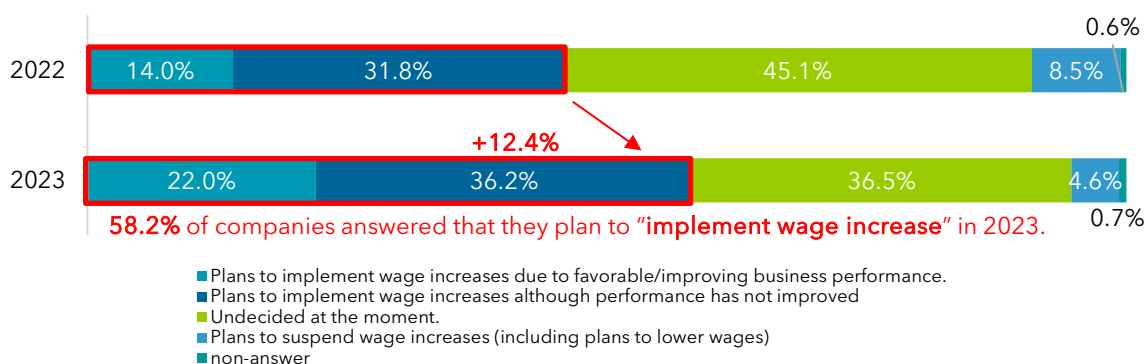


Source: Ministry of Land, Infrastructure, Transport and Tourism, Period: Jan 2020-Feb 2023
 Note: The data is calculated from the average of the responses from each monitor for each prefecture, with the current price trend as 1 (falling), 2 (falling slightly), 3 (remaining unchanged), 4 (rising slightly) and 5 (rising).

The labour shortage also pushes the SMEs to increase their wages. According to the results of a survey on wage increases among SMEs by the Japan Chamber of Commerce and Industry, 64.3% of SMEs answered that they are facing labour shortages, and 66.3% of SMEs have increased the wage/proposed wage for recruiting in order to attract employees.

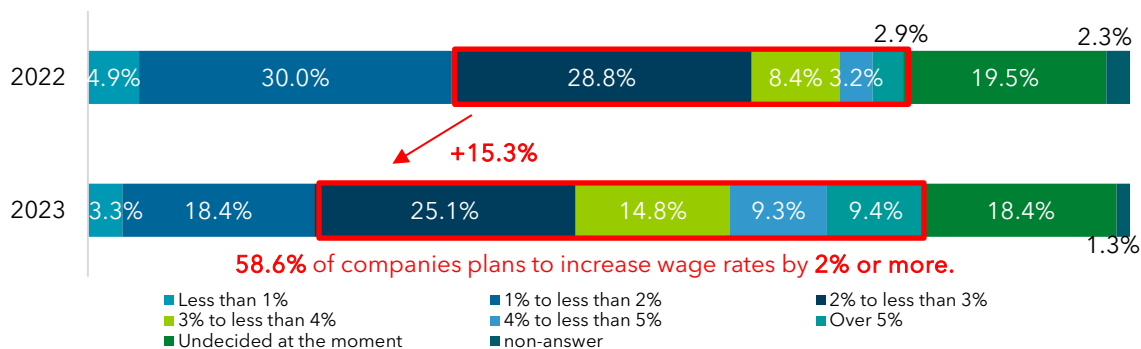
In the same survey, 58.2% of SMEs answered that they have decided to increase their wages, which is 12.4% points larger than the last year (Fig. 8). Out of the SMEs that have decided to increase wages, 58.6% will increase wages more than 2.0% and 18.7% will increase wages more than 4.0% (Fig. 9).

Figure 8. Japanese companies' plans for wage increases



Source: Japan Chamber of Commerce and Industry (JCCI), Period: 1st Feb 2023-28th Feb 2023

Figure 9. Prospects for the rate of wage increases



Source: Japan Chamber of Commerce and Industry (JCCI), Period: 1st Feb 2023-28th Feb 2023.
 Note: 100% = Companies that answered that they decided to increase wage.

The government is also supporting SMEs that increase wages. Tax reduction is one of the major measures. A maximum of 40% of the amount increase in payroll will be deducted from the corporate tax. The government also encourages SMEs to pass on prices. At the end of last year, the government announced the names of 13 companies that refused to discuss with their subcontractors about reflecting cost increases, such as raw fuel and labour costs, in their transaction prices. Furthermore, in February, the government announced a plan to investigate subcontractors to check whether their suppliers agreed to negotiations and to what extent they were able to pass on costs to prices, and if the LEs' actions were unfair, the government would issue documented warnings to the companies. In this way, the government aims to stabilise the management of SMEs and help them raise wages and invest in growth.

Sustainable wage increases are the key factor for Japan to get on the path to tackle deflationary pressure. More and more LEs, which have more capacity to increase wages, have aggressively decided to increase wages taking inflation pressure into account, while many of the SMEs are struggling to increase wages. In the meantime, the SMEs are under pressure to increase wages to retain employees due to labour shortages. As the global inflation pressure weakens, SMEs will have more room for wage increases. We expect that not only the LEs but also SMEs will contribute to creating a virtuous cycle of economic growth by increasing wages sustainably.

Figures 1 to 5 and related descriptions are quoted from a report published by The Research Department of Sumitomo Mitsui Trust Bank. Click [here](#) to read it. (Only in Japanese)

About Writer

Hiroyuki Ueno, Chief Strategist

Hiroyuki joined SuMi TRUST in 2002 and has been Chief Strategist since October 2017.

Through over 20 years of experience working in the investment industry, he is well-versed in the investment management business and has a strong network in the industry as well as financial authorities. Hiroyuki's primary focus is macroeconomy and financial market analysis. His insights based on his own analysis combined with information gathered from his broad network are widely acclaimed. Hiroyuki is a Certified Member Analyst of the Securities Analysts Association of Japan (CMA).



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Any enquiries regarding the products should be made to:

Hirofumi Hayashi

Head of Investment Management Department

Sumitomo Mitsui Trust International Limited

155 Bishopsgate, London EC2M 3XU, United Kingdom

Direct: +44 (0)20 7562 8405

Email: imd@smtil.com

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