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Will Japan escape its deflationary trap? Ongoing capex boom holds the key

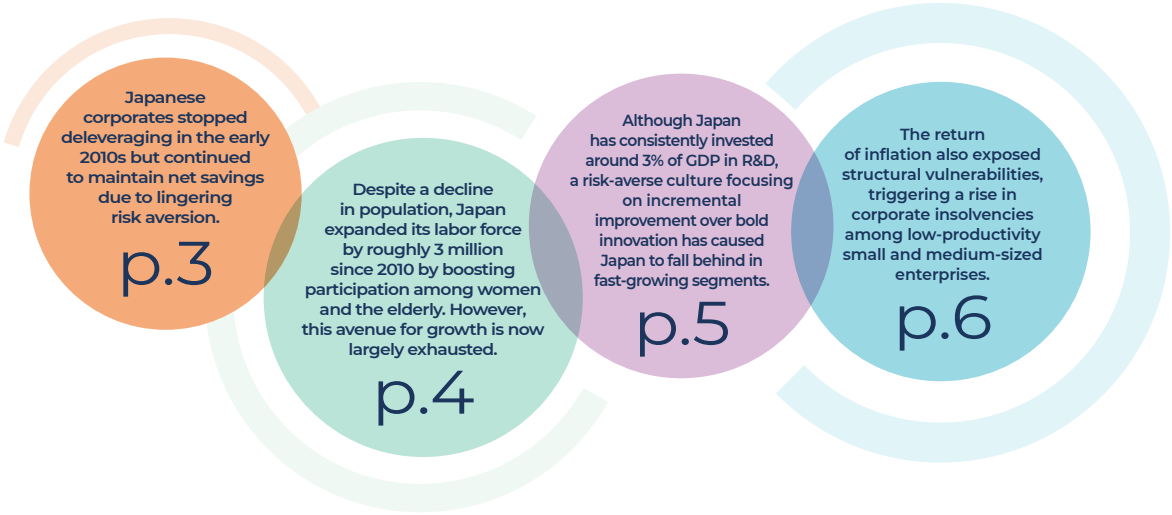
EXECUTIVE SUMMARY

How did inflation return to Japan? Since 2022, Japan has undergone a notable inflationary shift, with headline inflation consistently surpassing the Bank of Japan's 2% target. Initially driven by cost-push factors like high commodity prices and a weak yen, this inflationary pressure has gradually evolved into a more demand-led phenomenon. Domestically focused service firms, facing margin squeeze with limited offset from higher yen-denominated overseas revenues, began passing higher costs onto consumers. Rising living expenses, combined with structural labor shortages, has led to multi-decade-high wage hikes for three consecutive years. These developments are fueling hopes of a potential regime shift in Japan's deeply entrenched deflationary mindset, shaped during the post-asset bubble "balance sheet recession."

Is it sustainable? The sustainability of this inflationary trend hinges on continued wage growth, which itself depends on sustained corporate profit growth through productivity-enhancing investment. Encouragingly, Japanese firms are beginning to shift away from a decades-long focus on cash hoarding toward proactive investment in automation and R&D. This pivot is supported by stronger earnings, structural labor market pressures, and targeted government incentives. However, the critical question remains whether these investments will generate the productivity gains necessary to sustain a virtuous cycle of profit growth, wage increases, and positive inflation.

The emerging winners and losers. Japan's reflationary environment has so far broadly supported corporate earnings. Manufacturers—particularly in the automotive and electric machinery sectors—have benefited from higher yen-denominated overseas revenues, though this momentum may be challenged by rising U.S. tariffs and improving yen strength. Non-manufacturers, especially in accommodation and catering and transport, have gained from robust domestic consumption, booming inbound tourism, and enhanced pricing power. In contrast, low-productivity price-taker SMEs now face mounting pressures from rising labor costs and weaker earnings growth, contributing to a rise in bankruptcies. While painful, this cleanout may ultimately foster a more efficient corporate landscape by reallocating capital and labor to more productive firms.

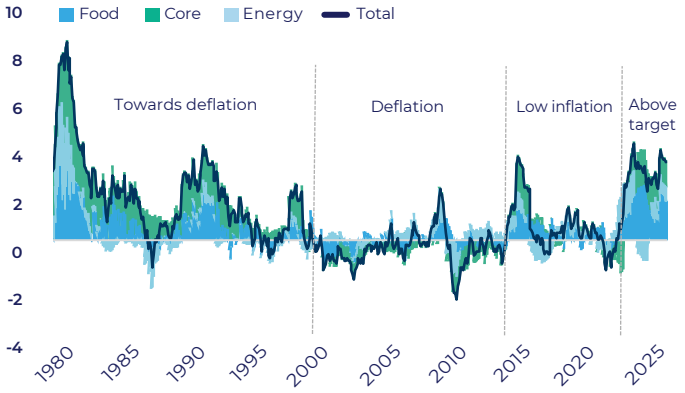
SOME OF THE THINGS YOU'LL LEARN...



Since the early 1990s, the Japanese economy has been experiencing a long period of near-zero or even negative inflation, following the collapse of the asset price bubble in stocks and land. The economy technically entered deflation in 1998, triggered by a surge in non-performing loans (NPLs) stemming from the sharp decline in land prices. This deflationary environment has persisted for nearly three decades. During this period, Japan's headline inflation only inched up modestly amid temporary spikes in oil prices and currency fluctuations. Core inflation remained remarkably low and stable, with only a few brief periods of noticeable increases—such as in the mid-2010s, driven by the launch of ultra-loose monetary policy and consumption tax hikes, rather than sustained demand-side pressures **(Chart 1)**. Services prices, which are more influenced by domestic factors than global developments, remained largely flat.

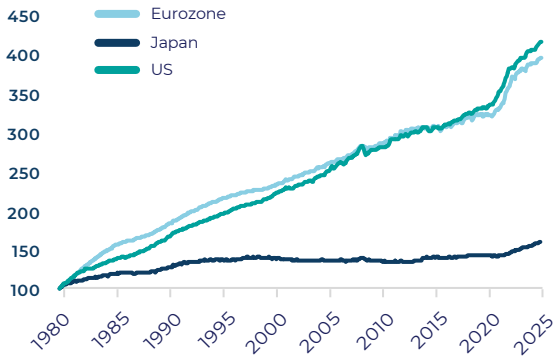
However, signs of inflation began to emerge in 2022, driven by a combination of surging food and energy prices and structural tightening in the labor market. These developments have begun to challenge Japan's long-standing stagnancy in pricing and wage-setting, fueling hopes of a potential regime shift in Japan's long-lasting deflationary environment.

Chart 1 - Japan's consumer price index (CPI) *(% y-o-y)*



Source: JSB, Coface

Chart 2 - Consumer price index *(1980 Jan = 100)*



Source: Macrobond, Coface

How did Japan fall into prolonged deflation?

To evaluate the likelihood of a potential regime shift, it is crucial to first understand the deflationary forces that have shaped Japan's economy over the past three decades. In fact, Japan's slide into deflation in the late 1990s stemmed from both supply and demand shocks, with the former playing a temporary role in the initial stages and the latter proving more persistent.

On the supply side, several factors—including cheaper imports and efficiency gains—contributed to price declines, but these should not have inevitably resulted in entrenched deflationary pressures. One key driver was the sharp appreciation of the yen, which rose from above ¥200 per U.S. dollar before the signing of the Plaza Accord[1] to a peak of ¥80 in 1995 (**Chart 3 next page**). This currency strength accelerated the inflow of low-cost goods, particularly from China and emerging Asian economies. At the same time, the offshoring of production to these countries reduced labor demand in Japan and exerted downward pressure on wages, especially for low-skilled workers. However, the subsequent depreciation of the yen to around ¥140 per dollar by 1998 should have alleviated some of the import-driven deflationary pressures.

In parallel, IT-driven productivity gains also played a role in suppressing inflation by improving efficiency. For example, enhanced price transparency enabled by IT advancements helped streamline Japan's traditionally high-margin distribution system. While such gains are inherently deflationary, they were largely concentrated in the tech and manufacturing sectors. Therefore, they may not have been sufficient to drive broad-based price declines—especially if inflationary pressures in areas like services with less productivity gains provided a meaningful offset. This dynamic is reflected in the continued rise of CPI in the U.S. and Eurozone during the early 2000s **(Chart 2)**, despite similar technological progress. Over the longer term, these advancements can also become inflationary if productivity gains are broadly shared through higher wages, leading to increased demand.

1 - The Plaza Accord was a 1985 agreement signed among the G5 nations, aimed at depreciating the U.S. dollar to address its large trade imbalances, particularly with Japan and Germany. The agreement led to a sharp appreciation of the Japanese yen, which significantly hurt Japan's export growth, and in turn, prompted the Bank of Japan to implement aggressive monetary easing. These policies, combined with speculative behavior, contributed to the formation of an asset bubble in equities and real estate. When the BOJ later reversed its easing stance in the early 1990s to rein in speculation and cool the economy, the bubble burst and triggered a prolonged period of economic stagnation.

On the demand side, Japan experienced a textbook case of debt deflation loop, where falling asset prices, rising real debt burdens, and weak demand reinforced a deflationary spiral. As land prices collapsed **(Chart 3)**, the value of collateral held by borrowers eventually fell below the value of debt by a widespread manner around 1998. This triggered a so-called "balance sheet recession" where households and firms had to prioritize debt repayment over consumption and investment to repair their balance sheets. This deleveraging suppressed aggregate demand, leading to further price declines and an increase in the real value of debt. This has in turn deepened the need to deleverage, reinforcing deflationary pressures.

By early 2010s, the technical constraints of Japan's balance sheet recession had largely dissipated, but the deflationary mindset persisted. After nearly two decades of corporate and household deleveraging, many firms had repaired their balance sheets. Some had resumed borrowing, as reflected in the renewed rise of interest-bearing financial liabilities **(Chart 4)** and the uptick in non-financial corporate debt **(Chart 5)**. Although stronger financial positions and historically low interest rates encouraged Japanese firms to re-leverage, most still preferred to hoard cash out of caution and maintained net savings. This persistent conservatism has prevented them from investing in production, upgrading technology, or raising wages. Meanwhile, it not only weakened aggregate demand and suppressed demand-pull inflation, but also dampened potential cost-push inflation, as firms became hesitant to raise prices for fear of losing customers.

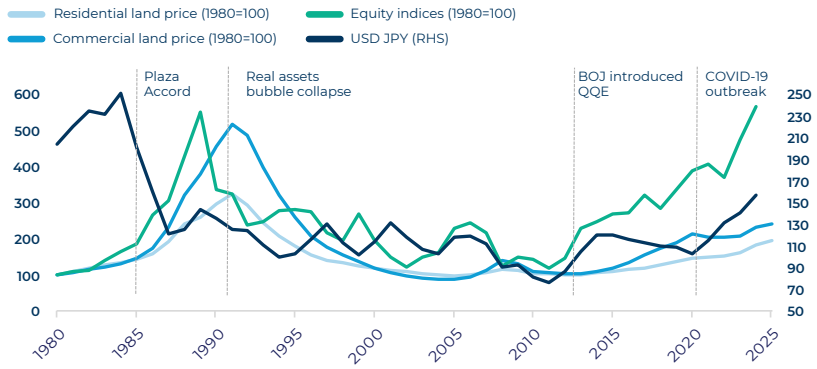
Why did policy stimulus hardly boost inflation? On the monetary side, the inflationary effects of ultra-loose policies were undermined by a liquidity trap. The persistent preference among households and corporates to hoard cash rather than spend or invest has led to both an excess of savings and a lack of borrowing. This dynamic has exerted downward pressure on interest rates and made rate cuts largely ineffective. On the fiscal side, Japan's ability to pursue sustained expansion was constrained by its high government debt – one of the highest globally at 235% GDP – as well as rising government funding costs. Importantly, this debt accumulation was not primarily due to excessive spending that is potentially inflationary, but rather chronic revenue shortfalls driven by a combination of public resistance to tax hikes, deflationary pressures on taxable income, and an aging population. In fact, Japan's public expenditures have remained modest, consistently below the OECD average as a share of GDP.

Is the current uptick temporary or sustained?

Having established the deep-rooted behavioral drivers behind Japan's prolonged deflationary equilibrium, the next critical question is whether the current inflationary uptick marks a temporary deviation or a decisive break from this entrenched pattern.

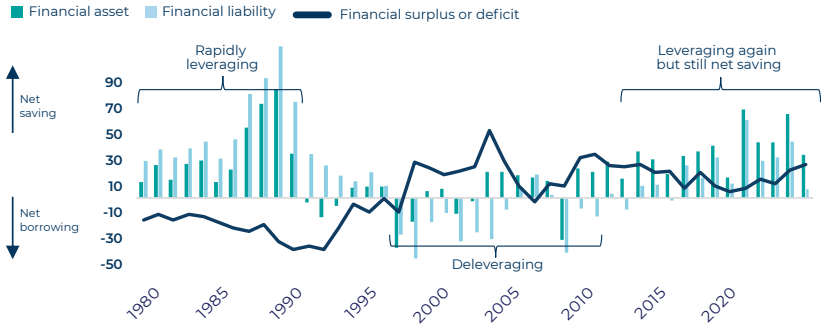
Japan's recent departure from its decades-long low-inflation equilibrium was initially driven by cost-push factors amid a combination of higher energy prices and a weaker yen. Since 2022, this pressure emerged amid pandemic-induced supply chain disruptions and soaring food and energy prices following Russia's invasion of Ukraine. The cost burden was amplified by yen depreciation, driven by a widening monetary policy gap between Japan and other major economies. That said, yen weakness and elevated commodity prices alone may not be sufficient to durably lift Japan out of its low-inflation equilibrium, as these trends could reverse—and previous episodes of exogenous price shocks have typically proven transitory.

Chart 3 - Japanese asset prices



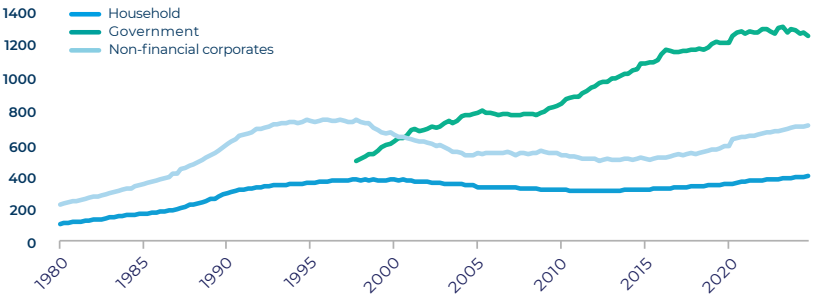
Source: Ministry of Land, Macrobond, Coface

Chart 4 - Japanese corporates flow of funds *(JPY trn)*



Note: In BOJ's Flow of Funds data, financial assets include liquid instruments such as cash, demand deposits, and time deposits, while financial liabilities primarily consist of interest-bearing debt, including loans and bonds.
Source: BOJ, Coface

Chart 5 - Japan's stock of debt by sector *(JPY trn)*



Source: BIS, Coface

But the inflation dynamics have increasingly reflected a growing demand-led component, as price increases have broadened from goods into services, in particular dining and recreation. Unlike export-oriented manufacturers, domestically focused service firms have seen limited benefit from higher yen-denominated overseas revenues, but have faced margin pressures from rising input costs. This has compelled service firms to accelerate the pace of cost pass-through to consumers, raising prices even faster than manufacturers **(Chart 6 next page).**

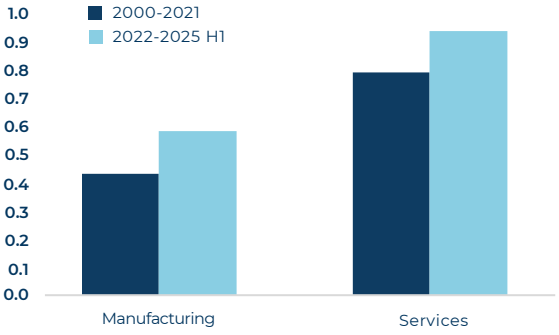
The higher living expenses, in turn, have emboldened labor unions to demand higher wages growth consistent with price increases. From 2023 to 2025, average wage increases for workers affiliated with Rengo—Japan's largest labor union—reached 3.6%, 5.1%, and 5.3% respectively, marking the largest gains in three

decades **(Chart 7)**. Smaller firms, which employ about 70% of Japanese workers, followed suit with an average 2% increase in base pay during the same period. While these wage hikes remain moderate relative to headline inflation growth and may not fully offset rising living costs, they reflect a notable shift in labor union priorities—from a focus on job security under long-term employment[2] to wage growth.

Structural wage pressures could reinforce Japan's shift toward demand-led inflation. Even after the immediate impact of rising living costs subsides, sustained wage hike demands are likely to persist. This can be driven by structural shifts in the labor market and increased bargaining power amid a steepening population decline, a reduction in irregular employment, and a more fluid labor market. Although Japan's potential labor pool of population aged above 15 peaked around 2010, the labor force has since expanded by approximately 3 million **(Chart 8)**. This growth was supported by Abenomics, which promoted greater participation among women and older workers through policies such as expanded childcare services and incentives for senior employment[3]. However, the size of labor force now reached record highs, suggesting limited room for further labor supply expansion —unless the Japanese government intensifies efforts to attract immigration, which is currently hindered by language barriers and cultural resistance. At the same time, there has been a gradual shift from irregular[4] to regular employment—a trend that began even before the pandemic **(Chart 9)**. Since regular jobs typically offer higher wages and greater job security, this transition is contributing to a rise in overall labor income. Additionally, rising job mobility and an increasing number of workers switching jobs are pressuring companies to raise wages to retain talent. This trend is challenging Japan's traditionally rigid employment practices, which have long been characterized by lifetime employment and seniority-based pay structures.

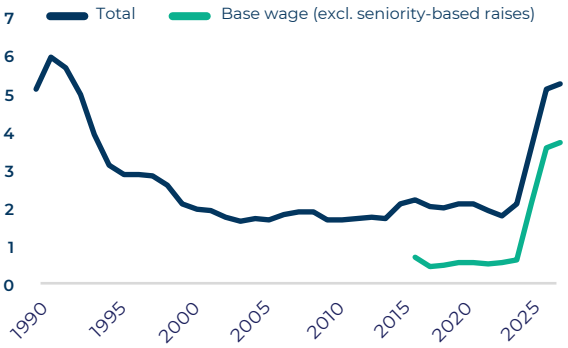
For wage growth to be sustainable without hurting profitability, it must be underpinned by productivity-enhancing investment. Encouragingly, firms are beginning to respond amid a structural tightening labor market and corporate governance reforms, which marks a meaningful shift from their long-standing focus on saving and deleveraging. Corporate capital expenditure has turned aggressive since 2022, averaging a 9.1% increase over FY22–24, and is projected to rise by 6.7% in the current fiscal year **(Chart 10 next page)**. This marks a sharp contrast to an average of 0.6% decline per year seen during FY92–19 amid balance sheet recovery and rising overseas investment. Key areas of investment boom include software that can substitute for labor due to both its shortage and rising costs. Meanwhile, R&D spending is also becoming robust, in particular in growth sectors such as digital transformation (DX) and green energy. This momentum has been supported by tax credit and pressure from Tokyo Stock Exchange (TSE) that has urged low valuation listed companies to improve capital efficiency[5].

Chart 6 - Japanese firms cost passthrough
(Beta of outprices to input prices)



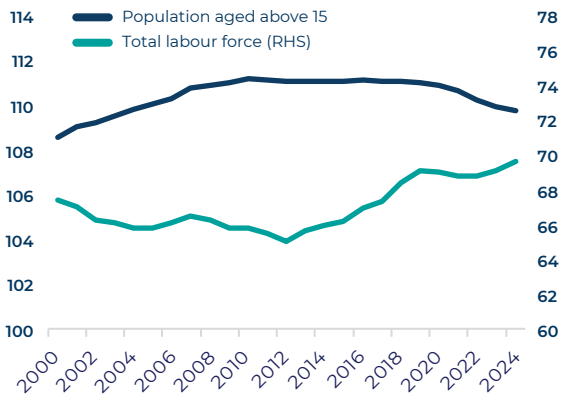
Source: BOJ, Coface

Chart 7 - Nominal wage growth for spring wage negotiations *(% y-o-y)*



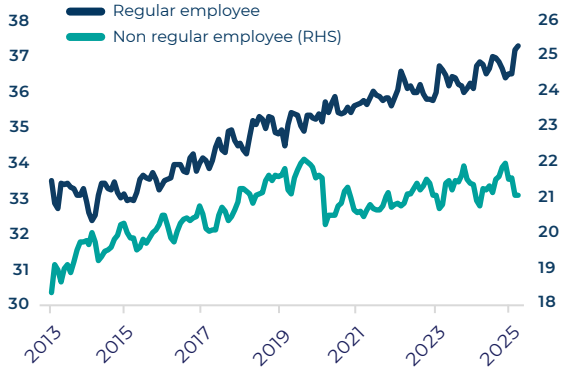
Source: Rengo, Coface

Chart 8 - Japan labor force *(ppl mn)*



Source: JSB, Coface

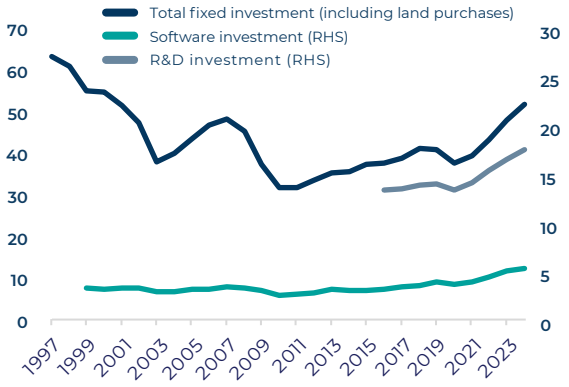
Chart 9 - Japan total employment by type *(ppl mn, sa)*



N.B. Total employment excludes company executives.
Source: JSB, Coface

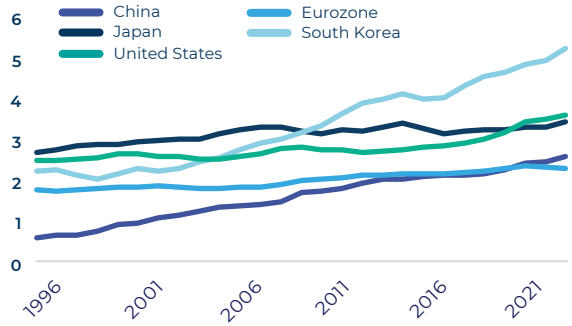
2 - In 2009, in the aftermath of the global financial crisis, Japan's Business Federation (Keidanren) and the Trade Union Confederation (Rengo) issued a joint statement emphasizing employment stability under the long-standing lifetime employment model. The statement prioritized job stability over wage increases, which prevented labor unions from demanding significant base wage hikes in subsequent years.
3 - To support working women, the Abe administration expanded childcare services by increasing public daycare capacity, subsidizing private childcare providers, and encouraging corporate-sponsored childcare facilities. For older workers, the government introduced incentives such as subsidies for companies that retained senior employees, raised the mandatory retirement age, and gradually increased the pension eligibility age to encourage continued employment beyond 65.
4 - Non-regular employees include part-time, temporary and contract workers.
5 - Under Japan's 2021 Tax Reform, companies can choose between a tax credit of up to 5% or 30% special depreciation for approved DX investments, capped at JPY 30 billion. For carbon neutrality initiatives, firms are eligible for up to 10% tax credit or 50% special depreciation, with a maximum investment limit of JPY 50 billion. Since March 2023, the Tokyo Stock Exchange (TSE) has urged all companies listed on the Prime and Standard Markets to enhance disclosure regarding their cost of capital and to reassess their capital expenditure strategies. Beginning in 2024, the TSE started publishing a monthly list of companies that have disclosed such actions.

Chart 10 - Corporate capital expenditure *(JPY tr)*



Source: BOJ Tankan Survey, Coface

Chart 11 - R&D investment *(% of GDP)*



N.B. These include both capital and current expenditures across four main sectors: business enterprise, government, higher education and private non-profit
Source: World Bank, Coface

However, the critical question remains whether these investments will generate the productivity gains necessary to sustain a virtuous cycle of profit growth, wage increases, and stable inflation. To achieve this, manufacturing firms should reorient R&D efforts toward high-growth domains to enhance the efficiency of capital allocation. Although Japan maintains relatively high R&D spending at around 3% of GDP **(Chart 11)**, it has paradoxically lost its edge in innovation over time. This decline is largely due to a decades-long risk-averse corporate culture that favors incremental improvements over disruptive breakthroughs—for example, refining internal combustion engines rather than pursuing new energy vehicles. This cautious approach has led Japan to fall behind regional peers such as South Korea and China in next-generation technologies like semiconductors and electric vehicles where demand is rapidly expanding. Meanwhile, non-manufacturing firms must prioritize investment in automation – such as AI-powered logistics and robotics – to counter an increasingly scarce labor supply. These technologies could potentially boost productivity, while free up resources that can be redirected toward wage growth. Without such investments, labor shortages will continue to act as a bottleneck on revenue growth, ultimately suppressing wage growth despite strong demand for labor.

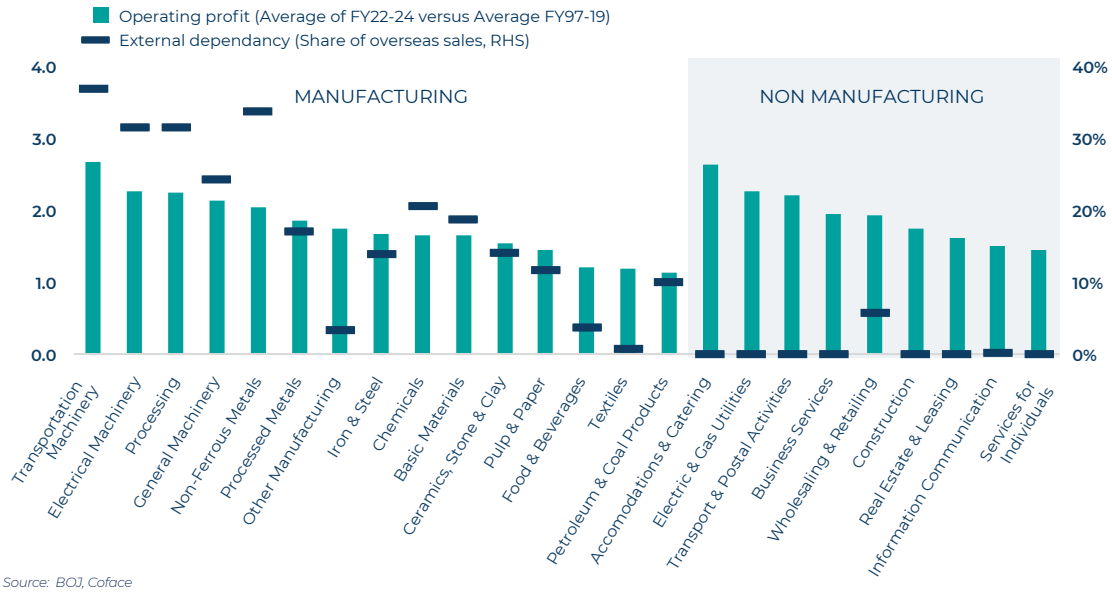
The emerging winners and losers from reflation

Regardless of the sustainability of the current reflationary cycle, its impact is already creating clear winners and losers across the Japanese corporate landscape, redistributing profits and exposing new vulnerabilities. Exporters have benefited from higher yen-denominated overseas revenues, while domestically oriented sectors like catering and transport have gained from consumption recovery and improved pricing power. In contrast, low-productivity SMEs now face mounting pressures from rising labor costs and weaker earnings growth, contributing to a rise in bankruptcies.

Overall, the reflationary environment has thus far been broadly supportive of corporate earnings. Since FY2022, corporate operating income has consistently exceeded ¥70 trillion, well above the ¥44 trillion average from FY1997–2019. This earning boom reflects a combination of improved household purchasing power, stronger cost pass-through, and higher yen-denominated overseas earnings.

Sector-wise **(Chart 12)**, the strength of yen appears to be a key determinant of profit growth among manufacturing firms - those with greater exposure to overseas revenues

Chart 12 - Japanese corporates profits



Source: BOJ, Coface

have led profit expansion, while those more reliant on imported inputs have lagged. Transport and electrical machinery have seen their profits more than double from pre-COVID levels, buoyed by strong global demand for hybrid vehicles and production reshoring, respectively. However, a significant portion of these gains has been amplified by yen weakness, which inflated overseas earnings in yen terms. At the other end of the spectrum, food & beverage and petroleum & coal producers have seen more modest profit growth, constrained by higher input costs linked to the weaker yen.

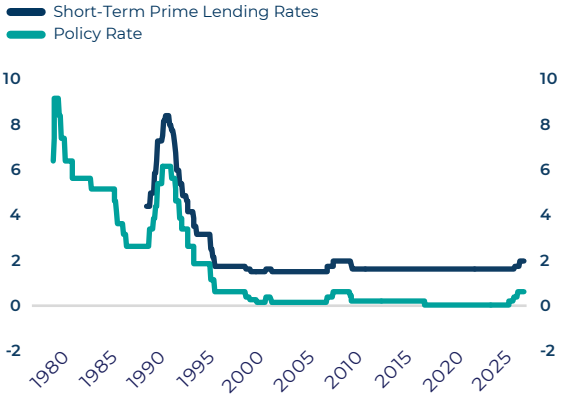
However, this trend could reverse if a sustained inflationary environment prompts further monetary policy normalization by the BOJ **(Chart 13)**, potentially strengthening the yen. This would erode some of the forex-driven profit gains and reduce the cost competitiveness of exporters, while easing input cost pressures for importers. Furthermore, from this August, Japanese exports face an average 14% tariff increase in the U.S.[6] **(Chart 14)**—Japan's top export market—which, combined with stronger yen, could put pressure on the sales performance of Japanese manufactured goods in America and force exporters to lower prices to maintain market shares.

Non-manufacturing sectors have also posted strong profit growth, with earnings nearly doubling from pre-pandemic levels. Accommodation and catering have led the improvement, thanks to a combination of rising domestic consumption fueled by wage growth and booming inbound tourism driven by a weak yen. For similar reasons, the transport sector also recorded solid growth in profits. Meanwhile, a virtuous wage-price cycle has allowed service providers to raise prices without losing demand, helping them offset rising labor costs and preserve margins. Electricity and gas suppliers have also seen pronounced profit improvements, likely supported by government subsidies that facilitated cost pass-through.

By firm size, the benefits of reflation have been unevenly distributed, with profitability gains disproportionately concentrated among large corporates. Since FY2022, earnings for large corporates[7] have more than doubled from pre-pandemic levels, supported by stronger pricing power and global exposure. In contrast, small and medium-sized enterprises (SMEs) have seen more modest profit growth due to narrower margins **(Chart 15).**

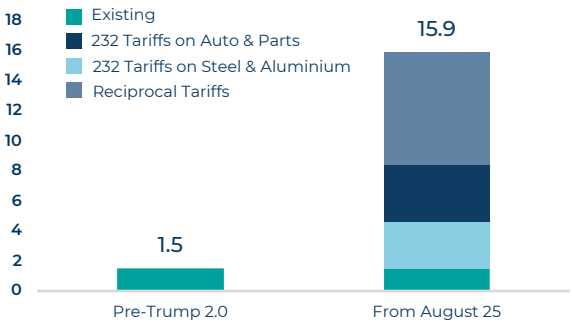
The weaker earnings growth among SMEs, compounded by more severe labor shortages and shifting macroeconomic policies, has led to a rise in corporate insolvency. While the number of bankruptcies has not reached the levels seen during the aftermath of the Asian Financial Crisis or the Global Financial Crisis, it has risen noticeably since 2H2022 **(Chart 16)**. Tightening labor markets and upward wage pressure have made it increasingly difficult for SMEs—typically offering lower wages—to attract and retain workers. Moreover, low-productivity SMEs that survived under prolonged monetary easing and fiscal support may face increased pressures as policy normalizes. The rise in interest rates, albeit modest, could redirect capital toward more profitable firms, while fiscal support and subsidies for SMEs may decline overtime due to rising fiscal constraints. These pressures could lead to a further uptick in bankruptcies in the short term. But over the longer term, this clean-up may support a shift toward a more efficient corporate landscape through restructuring and reallocating resources to more productive uses.

Chart 13 - Japan interest rate *(%)*



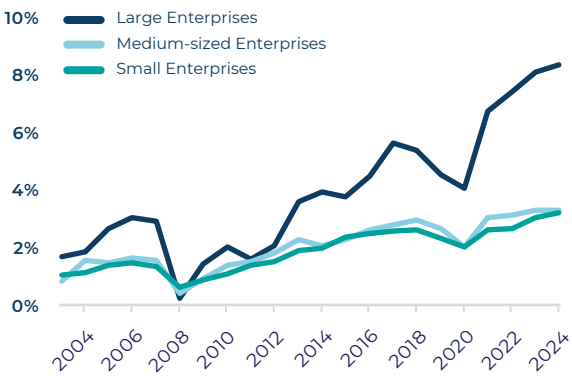
Source: BOJ, Coface

Chart 14 - Estimated U.S. effective tariff rate on Japan *(%)*



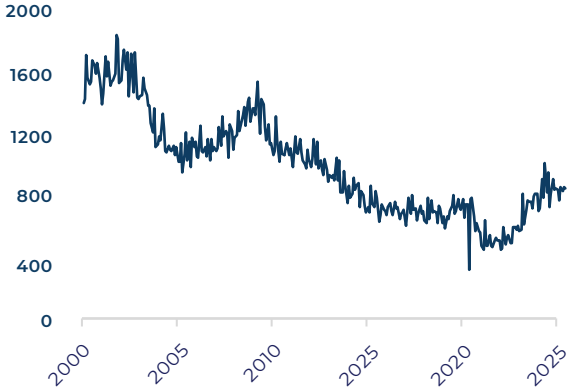
Source: Coface based on White House and U.S. Census Bureau data

Chart 15 - Net profit margin



Source: BOJ, Coface

Chart 16 - Number of corporate bankcruptcies



Source: Japan Teikodu Databank, Coface

6 - See Coface Brief: US-Japan trade deal averts worse outcomes but implementation hurdles remain.
7 - According to BOJ's Tankan survey, large companies are defined as those with capital of 1 billion yen or more, medium-sized companies as those with capital between 100 million and 1 billion yen, and small companies as those with capital between 20 million and 100 million yen.

Conclusion

Japan's long-awaited escape from its deflationary trap is gaining momentum. What initially began as a cost-push phenomenon driven by external factors is now increasingly underpinned by domestic demand, evidenced by strong wage growth and a broad-based rise in service prices. While some inflationary forces may ease due to softer commodity prices and a potential yen rebound—amid a mix of BOJ tightening and Fed easing—sustained inflation ultimately hinges on a deeper shift in corporate behavior: from cash hoarding to proactive productivity-enhancing investment.

This transition is creating clear winners, such as automotive and electric machinery manufacturers, as well as domestic catering and transport service providers. At the same time, it is exposing vulnerabilities among low-productivity, price-taking SMEs, contributing to a rise in bankruptcies. Though painful, this restructuring is necessary to more efficiently reallocate capital through monetary policy normalization and labor via greater job market mobility. Together, these shifts pave the way for a more dynamic corporate landscape and could finally unlock higher potential growth for Japan.

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