Provisional translation

The First Report by the Ministerial Council on Exiting Deflation

July 10, 2012

Introduction: Current State of Deflation and Its Background

Deflation has remained unresolved for more than past ten years in Japan[1][2]. The nominal GDP for FY2011 (around 470 trillion yen) has decreased by around 6% compared to a decade ago (around 502 trillion yen for FY2001). While real GDP has increased by 8%, GDP deflator has continued to decrease by 13% during the last ten years (at an annual rate of 1.4%). Consumer price has also continued to drop, although it rose for a short period.

Behind such long-term deflation lie three major factors including (i) negative output gap, (ii) falling growth expectation by business sectors and consumers, and (iii) persistent deflationary expectation. Negative output gap and price drop have pushed down income, leading to lower expectation for inflation and growth, which in turn have caused further downward pressure on both demand and price. In recent years, the rapid yen appreciation has also been a deflationary pressure and deflation reversely has caused yen appreciation.

Against this background, firms could not raise the prices of their goods and services which face fierce competition against emerging economies although their input costs rose due to the hike in import prices including oil, suppressing wages and corporate profits. The growth of real Gross National Income, an indicator of real national purchasing power, has been reduced by annually 0.6% due to the deterioration of the terms of trade, i.e. the ratio of export price to import price, from FY2006 to FY2011.

In order to realise the exit from deflation, reform to address structural factors inhibiting healthy cycle of economy among output, income and expenditure are essential, together with the appropriate macroeconomic policies. Given that the pace of price fall is getting moderate mainly due to reduced negative output gap, now it is the window of opportunity for ending longstanding issue of deflation by the utmost effort. With these policy efforts, the Government aims at the desirable growth for the nation as a whole, which accompanies wage and profit increase.

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[1] The Government assessed that "the Japanese economy is in a mild deflationary phase in that the decline in prices is continuing" in 2001 April Monthly Economic Report. While the Report did not describe "deflation" from July 2006 to October 2009, it again describes that the Japanese economy has been "in a mild deflationary phase" since November 2009.

[2] As whether or not being in a deflationary phase should be judged comprehensively with a wide range of indicators, the Monthly Economic Report emphasises consumer price index (CPI) which is most relevant to households, especially, on so-called "Core-core" base, i.e. general index excluding fresh food, petroleum products and other specific components (estimation by Cabinet Office). The Bank of Japan also assesses the price trend based on a wide range of indicators, while the inflation rate that the Bank aims to achieve is the year-on-year rate of increase in CPI.

I. Basic Policy Direction and Important Policy Areas toward the Exit from Deflation and Economic Revitalisation

1. Basic Policy Direction: Appropriate Macroeconomic Policies and Reform of Economic Structure

The Government and the Bank of Japan agree on that exiting deflation is a crucially important challenge. To swiftly realise the exit from deflation, reforming the economic structure predisposed to deflation is essential as well as appropriate macroeconomic policy management.

The Government, focusing especially on FY2012 and 2013 and considering shifts in the economic trend, will mobilise optimal policy measures including regulatory and institutional reforms, budget, fiscal investment and loan, and tax in the areas that are important for realising exiting deflation as specified in the following section, and will embody them in FY2013 budget formation and other processes. Particularly, regulatory and institutional reforms should be promoted more rigorously, since they are essential in order to realise economic revitalisation through changing the economic structure and promote competition. By strongly promoting policies to dynamically mobilise “goods”, “people”, and “money,” the Government will realise the virtuous economic cycle among output, income and expenditure and the growth accompanying increase in income, thereby achieving the early exit from deflation. Private sectors are also expected to enhance their value added by rethinking deflationary practices.

The Bank of Japan decided to pursue powerful monetary easing, with the aim of achieving the goal of 1% in terms of the year-on-year rate of increase in CPI for the time being. The Government expects the Bank of Japan to continue powerful monetary easing until the exit from deflation is ensured.

2. Important Policy Fields toward the Exit from Deflation

(1) Mobilise Goods

The Government will enhance the value of assets through making the housing stocks, infrastructures and other stocks quake-resistant, while revitalising real estate transaction. Also in terms of goods and services, the Government aims to capture the growing demand of emerging economies including Asia and realise latent domestic demand, thereby contributing to closing of negative output gap.

(i)Housing and Real Estate: Promoting spacious, quakeproof and eco-houses and enhancing the value of assets

While over seven million empty houses exist in Japan, the housing stocks are not optimally utilised with the share of second-hand housing in the total housing market being only one sixth of those in the U.S. and European countries. On the other hand, the demand of child-rearing households for spacious houses is unmet, and the needs for quakeproof and eco-houses has risen since the Great East Japan Earthquake. Hence, the following policies are to be taken;

- Accelerate to make the housing stocks quake-resistant and eco-friendly, aiming to raise the share of quake-resistant houses in the total stocks from around 80% in 2008 to 90% as early as possible. Take comprehensive measures to facilitate smooth rebuilding and renovation of aged apartment buildings.
- Undertake the fundamental reform of real estate market within FY2012, thereby revitalising the second-hand housing transactions. The specific measures include better informing consumers, clarifying function and quality of houses, improving pricing mechanism, and fostering necessary human resources.
- Promote changing dwellings by matching housing demand and supply and by donation from the elderly to their children and grandchildren, thereby contributing to increase in demand for durable goods.
- From the viewpoint of establishing the urban structure resilient against disasters, encourage check-up of the important buildings built before 1981 (the year in which the current quake-resistance standard was introduced), clearly indicate their quake-resistance, and promote necessary renovations, via broad range of measures.

(ii) Infrastructure: promoting investment in infrastructure by using private finance

Given the ageing of the infrastructures built in the past high growth era, the needs for their renovation and quakeproofing are heightened. In order to meet such needs under the severe fiscal constraint, infrastructure investments using Private Finance Initiatives (PFI) and fiscal investment and loan are to be promoted. As for PFI, the following measures will be taken;

- Promote self-funding and other form of PFI which are expected to contribute to major reduction in fiscal resource input, through the discussions in both the ministerial council and advisory body for PFI promotion. In so doing, promote discovering and embodying projects by demonstrating the models based on project categories and other measures.
- Work through to pass the amended PFI bill which stipulates the establishment of the public the private partnership infrastructure fund. At the same time, strengthen the function for funding and risk sharing to the PFI through partnership with the government-affiliated financial institutions and regional financial institutions.
- Consider introducing a new system judging in the first place whether PFI is possible or not for each public project which is executed by the central and local governments and others.

- Use Public Private Partnership scheme to promote regional development adjusted to population ageing.
- Promote private investments to renew the function of urban area by quake-resistant reinforcement of buildings through amended bill for the Real Estate Specified Joint Enterprise.

(iii) Service and Good I: capturing the growing demand in Asian and other economies

To capture the growths in Asian and other economies, it is essential to (i) strengthen non-price competitiveness of manufacturing sector, (ii) promote business reconversion from the areas exposed to fierce price cut competition against emerging economies, and (iii) enhance overseas expansion of service industries with internationally strong competitiveness. Also important is to promote so-called “packaged export,” which combines the overseas infrastructure building projects, the export of domestic products, and the service supply including distribution and consumer credits. Most services, unlike goods, are unable to be physically exported, and are possible to capture growth in foreign demands only through enhancing overseas activities. Also, in contrast to manufacturing sector, overseas expansion of service sectors is unlikely to lead to “hollowing-out,” but can create jobs not only in the destination countries but also within the border. As such, along with promoting infrastructure export and “Cool Japan” strategy, it is essential to strengthen cross-governmental measures for service industries, including strategic negotiation toward deregulation in the destination countries, cooperation toward establishing a legal system to protect consumer interests therein, fostering relevant human resources, provide information on regulations and needs which are necessary to expand business, and establish one-stop service” scheme supporting the firms operating abroad.

(iv) Service and Good II: realise latent domestic demand

Health care and welfare sector has created about 2 million jobs over the last ten years, and is expected to be growth area in the future as well. The Government will promote business expansion in healthcare and long-term care among others to realise latent domestic demand as well as foreign demand. Specifically, the following measures are to be taken;

- Accelerate the examination process of new medicine through amendment of the Pharmaceutical Affairs Act, promote integration of medicine and engineering, enhance developing innovative medical equipment and support overseas expansion of medical industry.
- Promote the supply of the at-home services and the houses with care services for aged person.

Also, the Government will enhance making the public sector database open and promote their use by private sectors.

It is expected that the Comprehensive Reform of Social Security and Tax, which will strengthen and stabilise social security system, contributes to growth by stimulating consumption, through ensuring sense of security for all generations. In addition, the Government will strengthen the measures to establish the goods and services market reliable to consumers, as enhancing safety and security of consumers is important condition for the expansion of consumption demand.

(2) Mobilise People

The importance of "human resources" as a main engine for economic growth has enhanced in the context that the growth of net capital stock is getting moderate in recent years and working age population has continued to decline. Accumulation of human capital, however, has stagnated because both firms and households have less and less leeway. In addition, the opportunities and workplaces to make the best use of talents and abilities of workers are insufficient. In order to achieve the growth led by increase in income, fostering human resources and expanding opportunities are urgently needed. The Government also aims the revival of the broad middle class through addressing these issues.

(i) Increase in Income I: support fostering human resources of the next generations

In order for working people to acquire the abilities to produce higher values, the Government will make utmost efforts to promote the supports for fostering human resources from medium- and long-term perspectives. Specifically, the Government will promote human capital investment by firms and encourage self-development (e.g. for improving professional skills and/or acquiring degrees and qualifications) by workers themselves. Also, it will enhance the investment and donation for fostering human resources in the next generations by promoting the use of tax incentive, planned giving scheme and others, thereby encouraging "the supports with the faces of supported visible" via non-profit organisations and others.

(ii) Increase in Income II: create new employment and business opportunities

In order to realise higher income, it is important to ensure the environment where the working people can move to the industry or workplace in which they can demonstrate their abilities to the fullest, in addition to the promotion of human capital investment. To this end, the policy focus should shift from "defensive mode" for crisis management taken after the Lehman Shock to "offensive mode" for enhancing new business and employment. Specifically, the following policies are to be pursued;

- Promote business start-ups, especially establish the "Hometown Investment Platform" using the comprehensive special zone scheme in FY2012 to support new business by youth and female.

- Promote job creation (especially in the growing areas) in the regions with severe employment conditions, collaborating with industrial development measures. Promote new business and incorporation in the agricultural sector as a growth area, which contributes to increase in income.
- Reduce mismatch between unemployment and vacancy through mitigating information asymmetry by promoting internship and other measures.
- The crisis management measures taken after the Lehman Shock should be withdrawn and shifted to the next stage, considering economic and employment conditions.
  - ✓ Restore the operation of the Employment Adjustment Subsidy to its normal status, considering the discussion with employers and employees. Promote job training, education and matching services for fostering human resources in growing sectors.
  - ✓ Enhance comprehensive support for restructuring of the small- and medium-sized enterprises, in the context of the final extension of the Act of Facilitating Finance for Small and Medium-sized Enterprise (SME) until the end of FY2012.
  - ✓ Closely watching the business condition, decide the category of designated industries for credit guarantee to SMEs (item (v) of the Safety-net Guarantee Program) for the second half of FY2012, while in principle all industries are continuously designated in the first half of FY2012.
- Promote the use of institutions for corporate realignment. Review the self-guarantee system aiming for helping entrepreneurs to restart.

iii. Increase in Income III: facilitating fair and rewarding working environment

- Strengthen the effectiveness of equal treatment among regular and non-regular employees and support fostering working career and moving to regular employment, all of which contribute to improvement in income.
- Accelerate the measures to empower female to participate in economic activities, which contribute to increase in income of families.
- Improve business and living environment for people from abroad, based on the Program for Promoting Japan as an Asian Business Centre and Direct Investment into Japan.

(3) Mobilise Money

Private asset has not been invested in growth areas, which partly causes the long-term deflation in Japan. For example, more than half of personal financial assets (amounting to about 1,500 trillion) have been held as cash and deposits. Accordingly, it is essential to establish the mechanism where the flow of money, including that held by elderly people who owns more than half of personal financial assets, be facilitated, and thereby leads to consumption and investment.

The following measures, based on the Report of "Council on Promotion of Growth Finance (released on July 9, 2012)," are to be taken; (i) Facilitating the use of and enhancing Defined Contribution Private Pensions, and promoting asset accumulation by diverse households through long-term and diversified investment both in domestic and foreign markets, (ii) revitalising real estate investment market by diversifying the financing methods and other measures, (iii) cooperating toward the establishment of well-functioning financial and capital markets in emerging countries including Asia, thereby promoting economic growth through stabilising foreign exchange and financial markets.

The Ministerial Council on Exiting Deflation will continue to consider materialising and promoting the policies abovementioned toward exiting deflation and economic revitalisation.

II. The Path toward the Exit from Deflation

1. Looking back the Previous Phase of Price Increase

While the Japanese economy has been unable to overcome deflation for more than a decade, there was a period during which consumer prices (general base) underwent a continuous rise lasting more than a year between 2006 and 2008. Behind such development was the improvement in the output gap amid sustained economic recovery, and the increase rate of CPI excluding energy and others (so-called "core-core") became positive for a short period of time. However, in the context of the worldwide recession triggered by the Lehman Shock, prices subsequently fell considerably.

The reasons why stable rise in prices was not sustained include (i) the fact that, as stated above, the economy retained a structure that easily fell into deflation, particularly the fact that, although exports and production grew as a result of overseas economic expansion, it was unable to link this development to sufficient improvement in domestic wages and corporate profits due to fierce competition against emerging economies; and (ii) the fact that external demand was not sustainable since the overseas economic expansion took place against the background of the housing bubbles among others. As a result, the sustainable growth accompanied by rise in income could not be achieved.

2. Prospect toward the Exit from Deflation

Although the economy is on the way to recovery at a moderate pace, the Japanese economy is still in a mild deflationary phase. Moreover, against the background of a reduction in the effect of reconstruction measures during the latter half of FY2012 compared with the first half of the fiscal year, there are many who forecast that growth rate will become moderate on quarter-over-quarter basis. Furthermore, there are various downside risks to the economy, such as a downturn in overseas economies due to the rekindling of the Eurozone government debt crisis, as well as the sharp fluctuation in the financial and capital markets, and the constraints of electric power supply.

Amidst this situation, it is essential, in addition to making utmost efforts to promote reconstruction measures, that policies mobilising "goods", "people" and "money" be promoted rigorously as stated above, in order to make a swift transition to economic growth driven by private demand and ensure overcoming deflation as soon as possible. As private investments are planned through to FY2013 in fields such as effective uses of radio waves and stable supply of energy under the Government's New Growth Strategy, such investments should be strongly promoted. Moreover, the Government will implement flexible and prompt policy actions if necessary in light of economic conditions. In addition, excessive volatility including rapid yen appreciation in the foreign exchange markets has negative impact on the economic and financial stability, the Government will continue to watch its development with a sense of vigilance and take decisive actions if necessary.

The comparison between the current economic condition and the previous phase leading to the rise in prices shows that, at present, a more desirable situation is developing as follows; (i) domestic demand driven growth is expected for the time being as the reconstruction measures are supporting the economy; (ii) the wage development is somewhat stronger in light of the improvement of labour market; and (iii) inflation expectation by households shows steady movement. It is necessary to take this opportunity to ensure the step toward exiting deflation, while making appropriate dissemination of information on price development.

Due to the growing domestic demand, the output gap has shrunk from around 3% in the previous fiscal year to around 2% in the first quarter of this year, and is expected to continue shrinking toward FY2013 as private demands including consumption and investment support the steady economic growth due to the improvement of employment, income and corporate profit. Furthermore, as the desirable economic cycle among output, income and expenditure gradually revives, it is anticipated that inflation and growth expectation will gradually rise, contributing to further improvement toward the exit from deflation.

3. Medium- to Long-term Economic and Fiscal Management: Achieving both Economic Growth and Fiscal Consolidation

Given that population decline and ageing will continuously constrain the growth in terms of labour input, achieving an average nominal growth rate of about 3% and real growth rate of about 2% until FY2020 is a challenge with considerable difficulties even after overcoming deflation.

In order to achieve those targets, it is necessary, besides ensuring the exit from deflation, to implement the measures aimed at "rebirth of Japan," thereby (i) making the maximum use of the benefits of globalisation, (ii) enhancing the dynamism of the domestic economic activities, and (iii) reviving broad middle class, and realising the virtuous cycle among them. By working on these issues, the Government will aim at achieving sustainable growth accompanying a rise in income and an increase in value-added productivity.

More specifically, in order to make maximum use of the benefits of globalisation, the Government will seek an improvement in the terms of trade by such means as promoting a shift away from businesses facing severe price competition with emerging economies, fostering the areas with strong non-price competition, as well as promoting high-level economic partnerships in order to develop an environment in which a broad range of industries finds it easier to enhance overseas activities that allows them to make higher profits in overseas markets. Moreover, in order to strengthen the dynamism of the domestic economic activities, the Government will expand the supply of financial resources to growth areas and promote regulatory reforms, which will develop an environment encouraging entries and changes of business, thereby fostering an environment in which innovation takes place on a broad scale across society. Furthermore, with a view to revitalising broad middle class, the Government will strive to promote the development of human resources that will lead Japanese economy and society, ensuring fair treatment between regular and non-regular employment, and the social participation of diverse human capitals, including female and elderly, in diversified manners of working.

Securing stable fiscal resources and sustainable base for social security system through the Comprehensive Reform of Social Security and Tax will support the growth by enhancing consumptions by reducing people's anxiety about the future and expanding economic activities. Moreover, it is anticipated that the creation of employment via the enhancement of healthcare and nursing care services will also contribute to economic growth. The Government will deal appropriately with the effect of surge in demand prior to the consumption tax rate hikes planned to take place in April 2014 and October 2015 and the subsequent repercussions in terms of reduced demand, and will work together with the Bank of Japan to assure the exit from deflation, and aiming continuously at achieving sustained stable price rises. In so doing, the Government will simultaneously push ahead economic growth and fiscal consolidation in a compatible manner.

Through the above initiatives, the Government will swiftly get the economy close to the desirable economic growth path that aims at an average nominal growth rate of about 3% and an average real growth rate of about 2% by FY2020.

The level of nominal GNI (Gross National Income), which reflects factor income (net income receivable), such as return on overseas investment, is about 3% higher than the level of nominal GDP (Gross Domestic Product) as of FY2011. However, the trading loss resulting from a deterioration in the terms of trade is just below 4% of GDP compared with FY2005 (i.e. the base year of the current national accounts); accordingly, the growth rate of real GNI (an indicator of real purchasing power of the nations), which takes this trading loss into account, has been reduced by 0.6% on average over that six-year period since FY2005. Through the aforementioned initiatives that make maximum use of the benefits of globalisation, the Government will promote an improvement in the terms of trade and an increase in income received from overseas which contributes to the increase in real GNI, thereby aiming at the growth with improvement of real affluence.

The risks posed to medium- to long-term growth include power and energy constraints restricting economic activity, further rise in resource prices putting downward pressure on the economy in the form of income outflows, and large-scale disasters such as those caused by earthquakes. Reinforcing the measures for strengthening growth potential and disaster prevention and others, the Government will take precautionary actions against such risks.

III. Framework for Reviewing the Economic Conditions including Prices

Toward the exit from deflation and economic revitalisation, the Ministerial Council on Exiting Deflation will review the economic conditions including deflation and economic policy management twice a year (at the beginning of the year and mid-year).

Through the review, the Government will clarify its judgment on economic conditions including prices and economic policy management, thereby mitigating uncertainty about the economic prospect as well as ensuring appropriate macroeconomic policy management.

In conducting the review, the Government will not only monitor economic indicators such as the nominal and real economic growth rates and price trends, but also check the indicators concerning the mobility of goods, people and money.

Moreover, the review needs to consider the economic outlook and prospect which take the effects by the implementation of the comprehensive measures into account. Accordingly, the review is to be conducted, taking into consideration the Government's Economic Outlook, the Mid-year Economic Projection, the Economic and Fiscal Projections for Medium- to Long-Term, and its mid-year revisions.