

**The First Report by
the Ministerial Council on Exiting Deflation**
Reference materials

July, 2012
Cabinet Office

Executive Summary

<<Background of the long-term deflation>>

- (i) negative output gap, (ii) falling growth expectation, (iii) persistent deflationary expectation
 - Sluggish real income growth (suppressed wages and corporate profits) due to the long-term deterioration of the terms of trade
- ↓
- Now it is the window of opportunity for ending deflation, as the pace of price decline is getting moderate along with shrinkage of negative output gap.
 - In addition to appropriate macroeconomic policies, reform should be conducted to remedy structural factors inhibiting healthy cycle of the economy, i.e., output, income and expenditure.

Exiting Deflation and Economic Revitalisation

Embodying important policy areas in the First Report by the Ministerial Council on Exiting Deflation [FY2012-2013]



"The Strategies for Rebirth of Japan"

Implementing based on the Roadmap [Until FY2020]

Path to the Exit from Deflation

The negative output gap is expected to continue shrinking toward FY2013 and the virtuous cycle of economy among output, income and expenditure will be gradually reviving, thereby improving toward the exit from deflation.

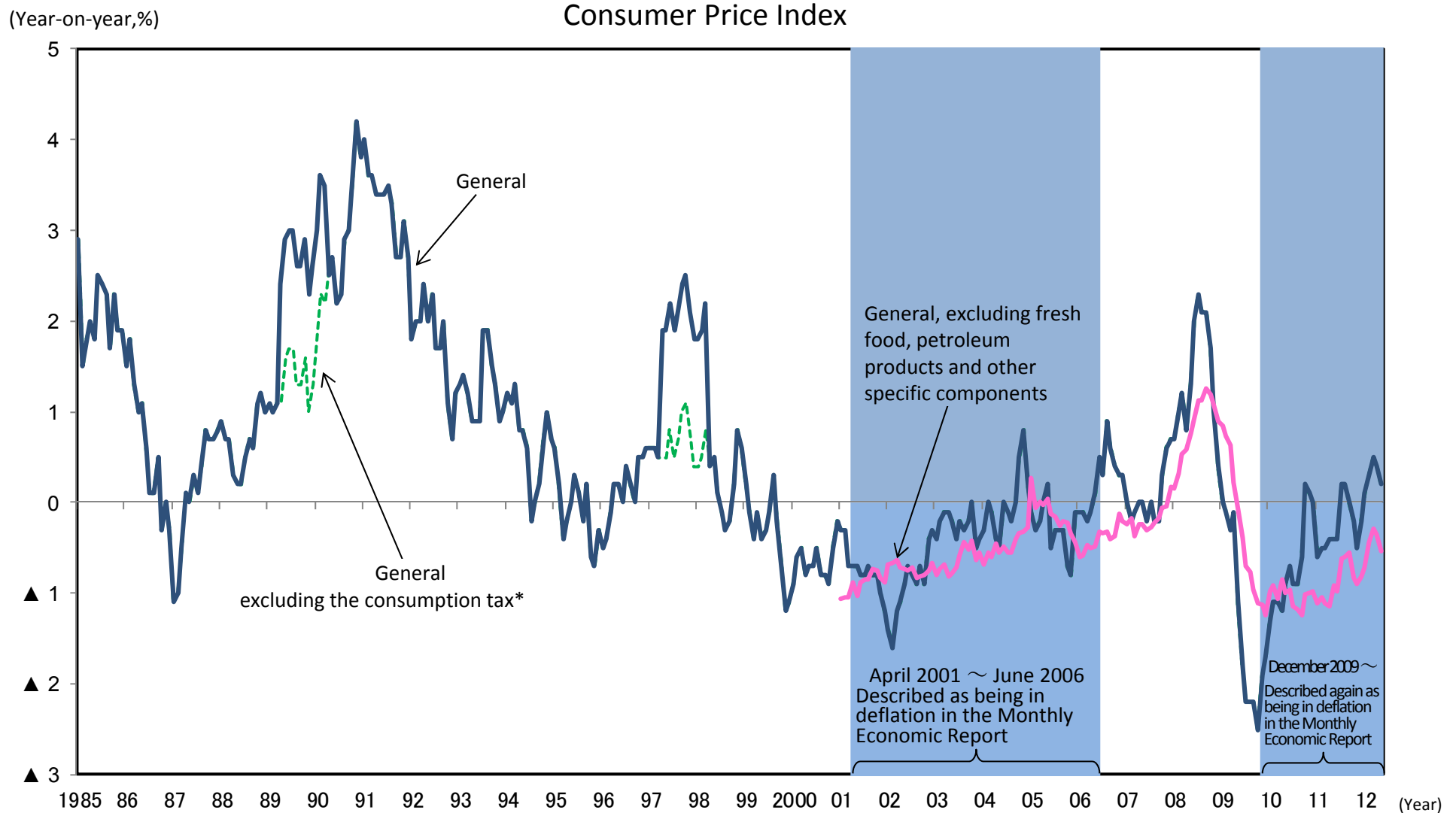
The Medium to Long Term Prospect

The Government aims at swiftly getting the economy close to the desirable growth, i.e., the nominal growth rate of about 3% and the real growth rate of about 2% on average from FY2011 to FY2020.

Reviewing Economic Conditions Including Prices

The Ministerial Council on Exiting Deflation will review economic conditions including deflation and economic management twice a year (early and mid-year) on a regular basis.

The Exit from Deflation Has Been the Challenge for More than 10 years



* Excluding the rise by the introduction of consumption tax and raising it (1.3% point is subtracted from April 1989 to March figures and 1.4% point from April 1997 to March 1998 figures).

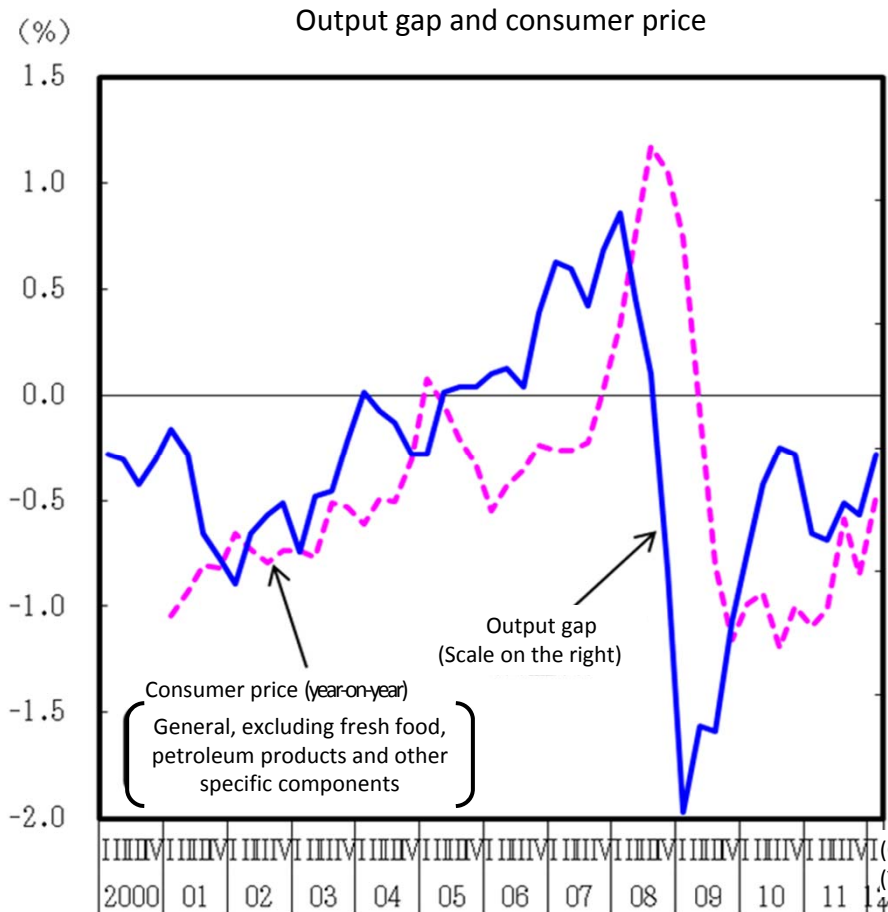
(Source) Ministry of Internal Affairs and Communications, "Consumer Price Index" (fixed 2010-base Laspeyres).

"General, excluding fresh food, petroleum products and other specific components" is estimated by the Cabinet Office. "Other specific components" consists of Electricity, Gas (manufactured & piped), Rice, Cut flowers, Hen eggs, Telephone charges, Medical treatment, Charges for nursing care, Tobacco and High school fees (public and private).

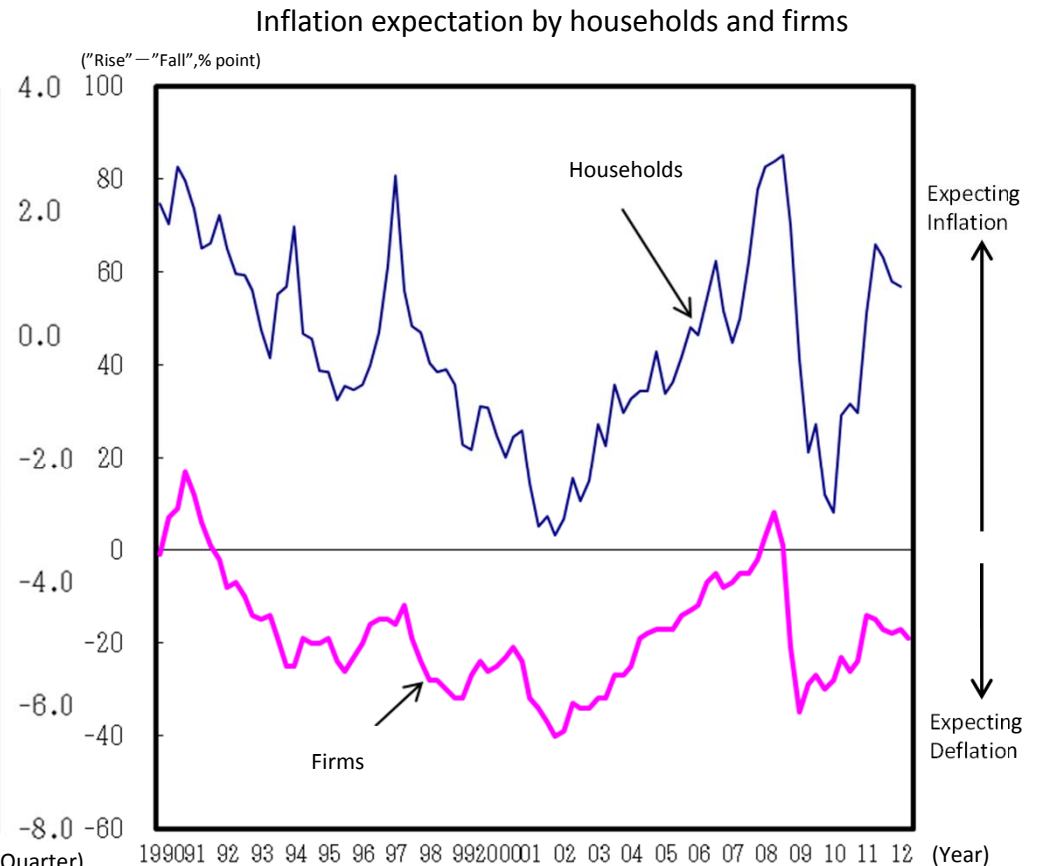
Background of Deflation (1)

- Deflationary pressure stemming from the negative output gap

- Deflationary expectation causes persistent deflation



- (Source) Cabinet Office, "National Accounts" and "Gross Capital Stock of Private Enterprises," Ministry of Economy, Trade and Industry, "Indices of Industrial Production" and Ministry of Internal Affairs and Communications, "Consumer Price Index" and others.
- (Notes)
1. Output gap = (Actual GDP - Potential GDP) / Potential GDP
 2. "General, excluding fresh food, petroleum products and other specific components" is estimated by the Cabinet Office. "Other specific components" consists of Electricity, Gas (manufactured & piped), Rice, Cut flowers, Hen eggs, Telephone charges, Medical treatment, Charges for nursing care, Tobacco and High school fees (public and private).



(Source) Cabinet Office, "Monthly Consumer Confidence Survey" and Bank of Japan, "Explanation of the Short-Term Economic Survey of Enterprises."

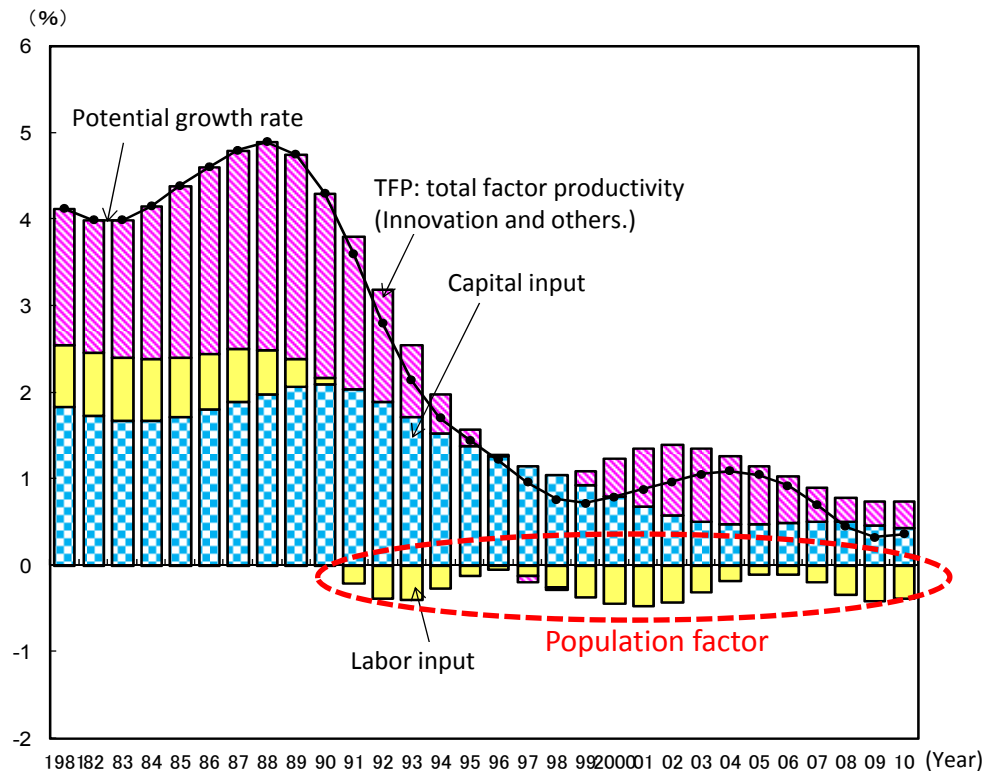
- (Notes)
1. Inflation rates expected by households are computed as the share of consumers answering "Rise" minus the share of consumers answering "Fall" to the following question: "Do you think how much the price of goods that you often purchase will rise or fall one year later compared to now?" Until March 2004, the quarterly series is used because the survey was conducted once a quarter. Since April 2004, the quarterly values are computed by the simple average of monthly data.
 2. Inflation rates expected by firms are computed as the share of firms answering "Rise" minus the share of firms answering "Fall" about the change of the selling price in the future (up to 3 months after).

Background of Deflation (2)

- Reduction of labor force stemming from population decline puts downward pressure on the potential growth rate.

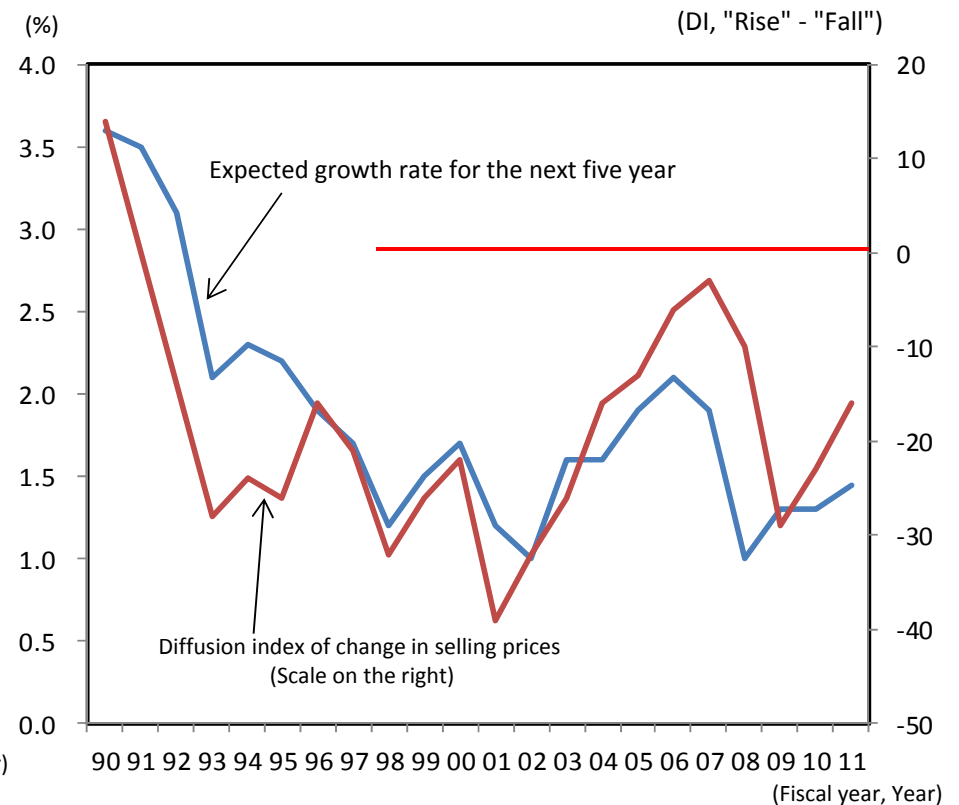
- Declining expected growth rate by firms partly explains deflationary expectation

Decomposition of potential GDP growth rate (Calendar year)



(Note) Estimated by Cabinet Office.

Expected growth rate and deflationary expectation by firms

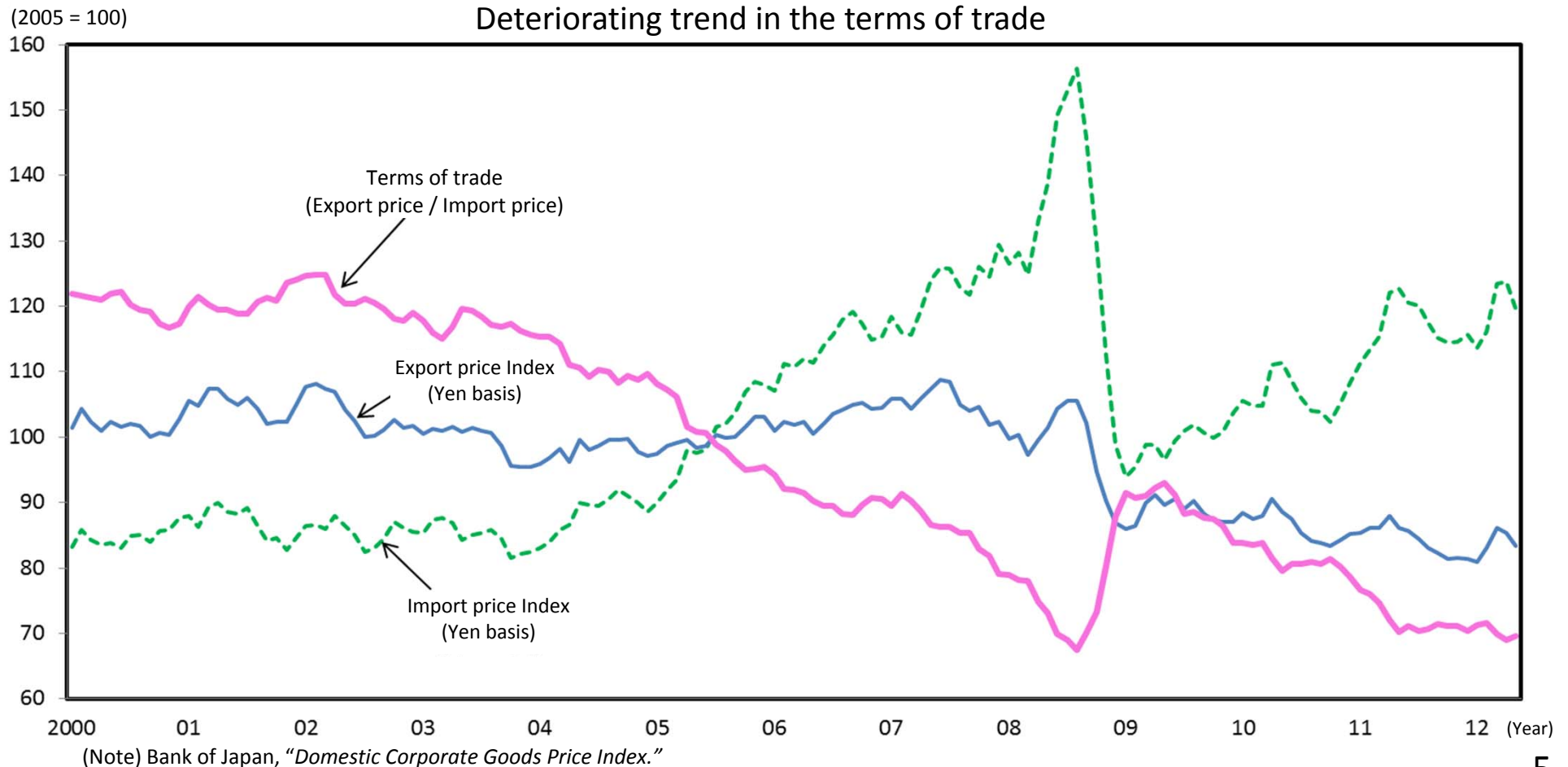


(Source) Expected growth rate: Cabinet Office, "Annual Survey of Corporate Behavior."

Diffusion index of change in selling prices: Bank of Japan, "Explanation of the Short-Term Economic Survey of Enterprises" (values from November survey is used for each year).

Background of Deflation (3)

- Firms could not raise the prices of their goods and services in fields facing fierce competition against emerging countries even if costs rose due to higher import prices including oil.
 - Suppressing wages and corporate profits.
 - Deterioration of the terms of trade, i.e. the ratio of export price to import price
- } → The growth of real Gross National Income which indicates real national purchasing power has been reduced



From immiserising growth to sustainable growth with increasing income

- For the past ten years (2001-2011), not only the growth of domestic production (GDP) but also the real income / purchasing power has been reduced due to the deterioration of the terms of trade (immiserising growth).
- To shift from the immiserising the growth to growth with increasing income, it is essential to increase real income (real GNI) by improving the terms of trade through cultivating fields with strong non-price competitiveness and shifting businesses from the fields facing severe price competition with emerging economies, in addition to increase in domestic product (GDP) and net income received from overseas. These measures will also contribute to revival of the broad middle class is aimed by doing these.

Real GNI(Gross National Income)

The indicator of real purchasing power of the nation

Real GNI(Gross National Income)

= Real GDP (Gross Domestic Product)

+ Net income received from overseas

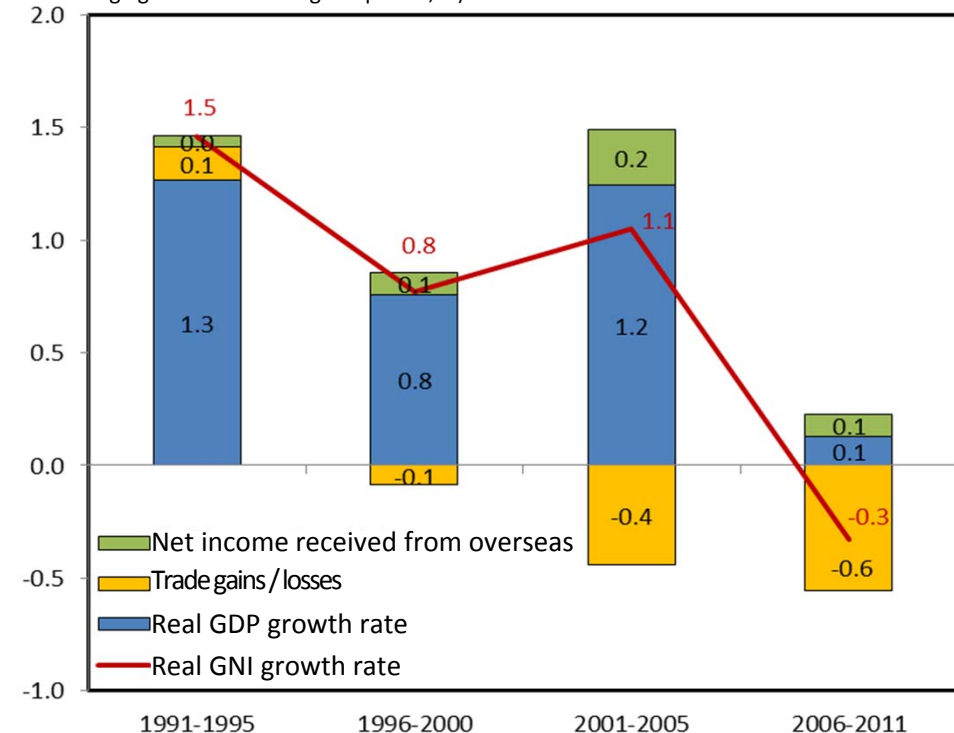
(e.g. Investment income)

+ Trading gains / losses generated

by change of the terms of trade

Deterioration in the terms of trade reduces the real GNI growth rate

(Annual average growth rate during the period, %)

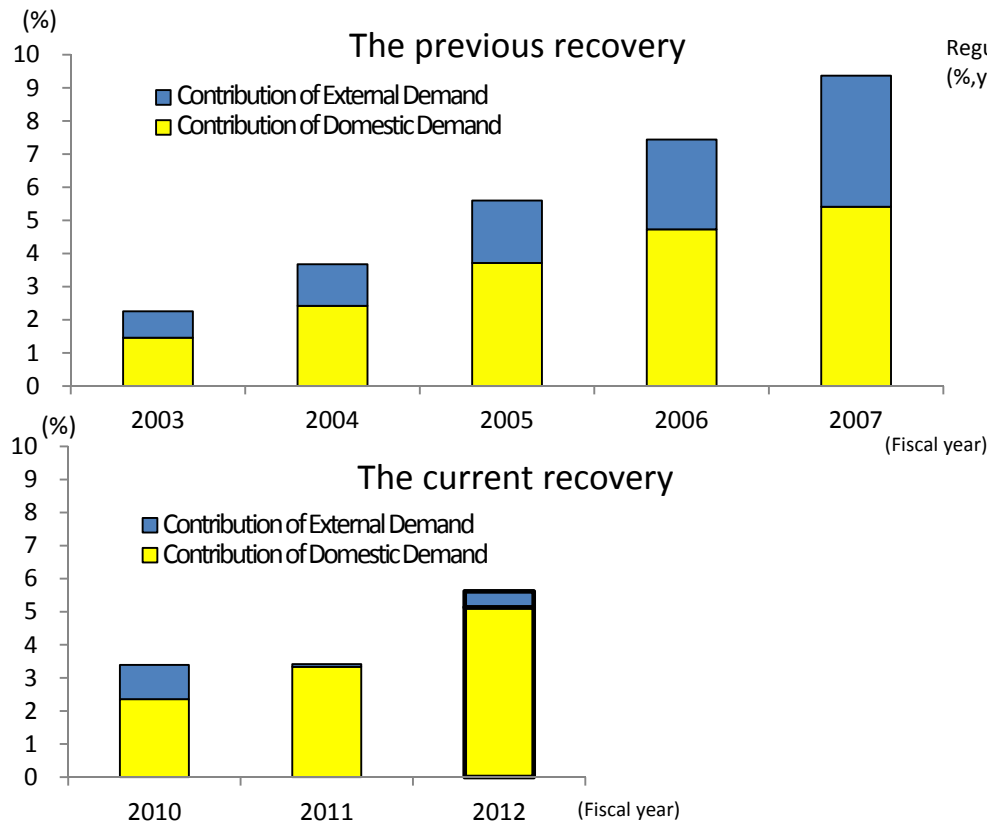


(Source) Cabinet Office, "National Accounts (Chained 2000)" for 1991-1995 and "Quarterly Estimates of GDP: Jan-Mar 2012 (The 2nd Preliminary Estimates)" for 1996-

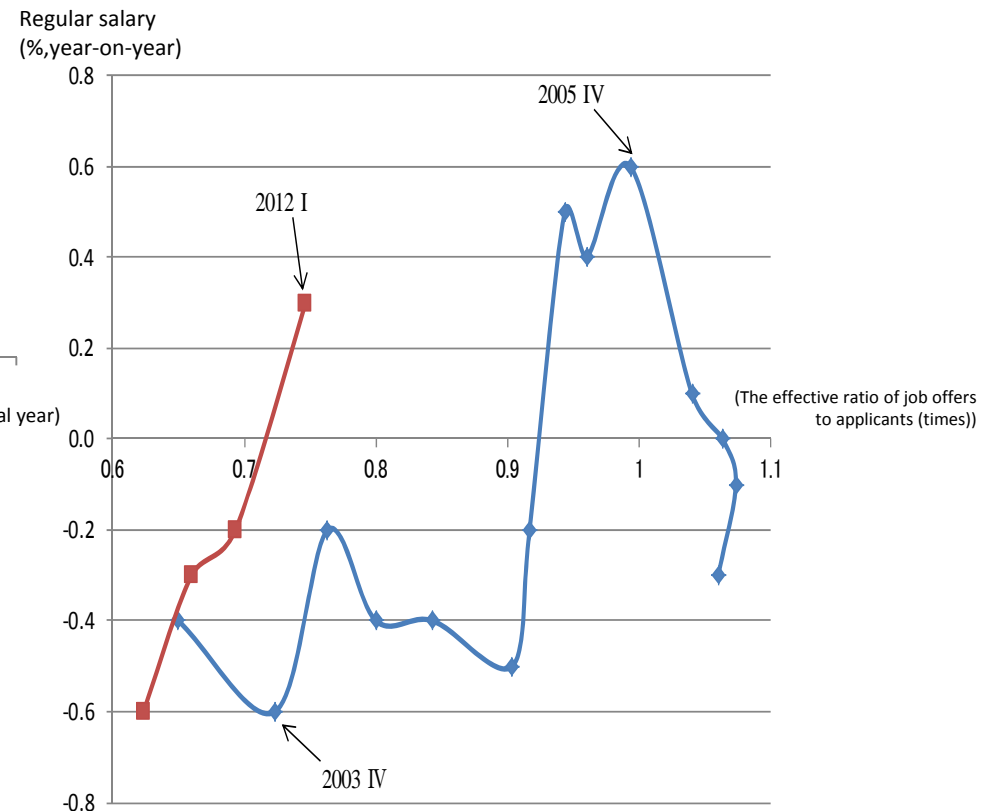
Now is the golden opportunity to exit from deflation

- Compared to the previous economic recovery, in the current phase (i) growth is led by the domestic demand, (ii) wages improve a little more strongly, and (iii) inflation expectation is steadier.
- Wages are stronger than during the previous recovery, as they are already increasing at the stage the balance of supply and demand has still more room to improve.

Cumulative increase of GDP from the economic trough



Phase of the business cycle and wage growth



(Source) Cabinet Office, "National Accounts" and "Fiscal 2012 Economic Outlook and Basic Stance for Economic and Fiscal Management".

- (Notes) 1. Decomposed by cumulative contribution of external and domestic demand starting from the economic trough (the previous is 2002 and the current is 2009).
2. The value for FY 2012 is based on "Fiscal 2012 Economic Outlook."

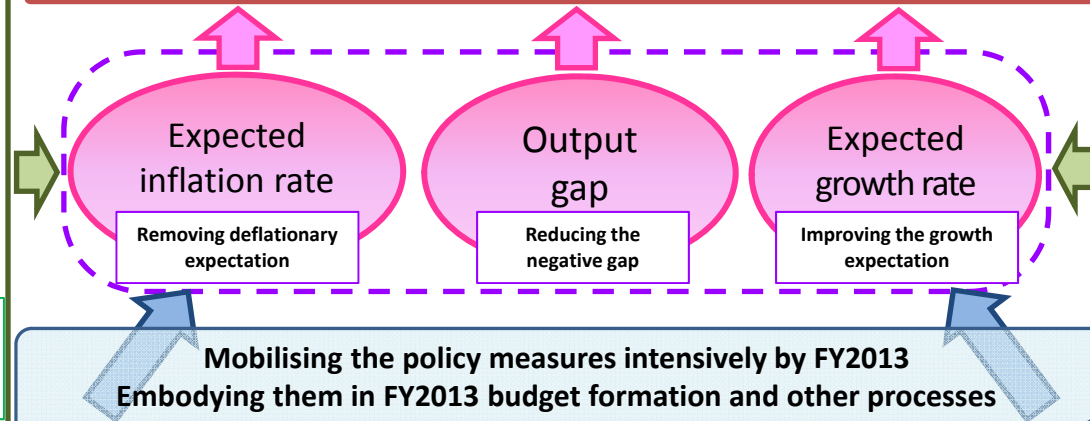
(Notes) Ministry of Health, Labour and Welfare, "Employment Referrals for General Workers" and "Monthly Labour Survey" (establishments with 5 or more regular employees).

Exit from deflation

Monetary policy

The Government expects the Bank of Japan to continue powerful monetary easing until the exit from deflation is ensured.

Aiming at achieving the goal of 1% of increase in CPI for the time being



Implementation of "the Strategies for Rebirth of Japan"

Under the Government's "New Growth Strategy", private investments are planned to take place through to FY2013 (the effective utilization of radio waves, the stable supply of energy and others).

Mobilise Goods

- **Housing and Real Estate: Promoting spacious, quakeproof and eco-houses and enhancing the value of assets**
 - Accelerate to make the housing stocks quake-resistant and eco-friendly (aiming to raise the share of quake-resistant houses to 90% as soon as possible)
 - Promoting changing dwellings by donation from the elderly to their children and grandchildren and others
 - Undertaking the fundamental reform of real estate market (within FY2012)
 - Encouraging check-up of the important buildings, clarify their quake-resistance and promote necessary renovations
- **Infrastructure: promoting investment to infrastructure by utilising private finance**
 - Promoting Strongly PFI and using fiscal investment and loan
 - Considering introducing a system judging in the first place whether PFI is possible or not for each project which is executed by the central and local governments and others
- **Services and Goods I: capture the broad demand among Asian countries**
 - Enhancing overseas activities expansion of service industries and establishing promotion system
- **Services and Goods II: realise latent domestic demand**
 - promote to business expansion in healthcare and long-term care sector

Mobilise People

- **Income growth I: support fostering human resources in next generation**
 - Promoting human capital investment by firms and encouraging self-development by workers themselves
 - Enhancing the investment and donation for fostering human resources in the next generations
- **Income growth II: create new business chances**
 - Establishing "Hometown Investment Platform" in FY2012 to support new business by youth and female
 - Promoting new business and incorporation in the agricultural sector
 - Reducing mismatch in labour markets (Youth Employment Strategy)
 - Shifting the crisis management measures taken after the Lehman Shock to the next stage
 - Enhancing support for restructuring of the small- and medium-sized enterprises (SMEs), in the context of the final extension of the Act of Facilitating Finance for SMEs
 - Restoring 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
 - Closely watching the business condition and deciding the category of designated industries for credit guarantee to SMEs (item (v) of the Safety-net Guarantee Program) for the second half of FY2012
- **Income growth III: facilitating fair and rewarding working environment**
 - Strengthening the effectiveness of equal treatment among regular and non-regular employees
 - Accelerating the measures to empower female

Mobilise Money

- Revitalising real estate investment market by diversifying the financing method of J-REIT and others
- Promoting asset accumulation by diverse households through long-term and diversified investment both in domestic and foreign markets

Toward the virtuous cycle of economy

