Chapter 2 Move toward Overcoming Deflation and Points of Debate concerning Wages

Section 1 Sustainability of Price Growth

- Since the yen started to weaken in the autumn of 2012, prices have risen moderately. In line with the yen's weakness, import prices have risen, and the rise in import prices has gradually been transferred to domestic corporate goods prices and then to consumer prices.
- Excluding the direct impact of the consumption tax hike, the core-core CPI has continued to rise moderately. Price statistics show that certain progress has been made in the transfer of the consumption tax hike to sales prices.

Figure 2-1-1 Changes in major price-related indexes

(2) Change in major price-related indexes

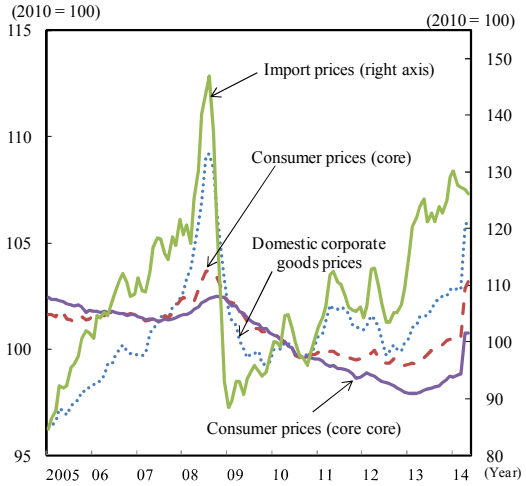


Table 2-1-2 Trend in transfer of consumption tax

(2) Consumer prices

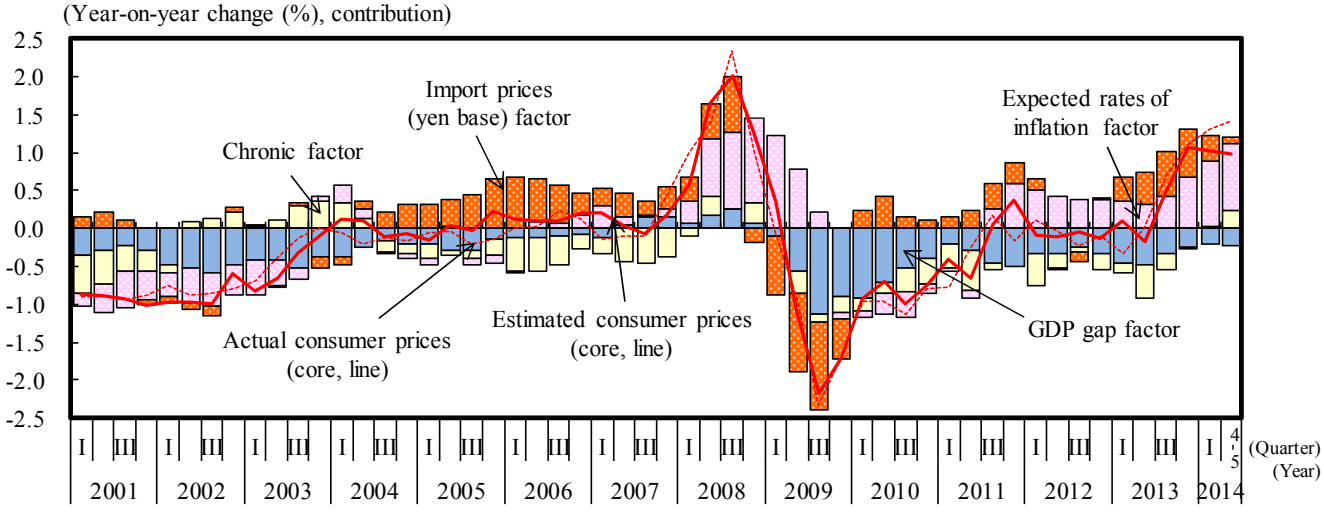
Month-on-month (seasonally adjusted)	April 2014			May		
	(i) Including tax	(ii) Consumption tax portion (Estimate)	Excluding tax (Estimate, (i)-(ii))	(iii) Including tax	(iv) Consumption tax portion (Estimate)	Excluding tax (Estimate, (iii)-(iv))
Core	2.3	1.7	0.6	0.3	0.2	0.1
Public service fees	2.9	0.6	2.2	1.4	1.1	0.4
General industrial and food products	3.0	2.9	0.1	0.0	0.0	0.0
Textiles	2.1	1.8	0.2	0.3	0.0	0.2
Durable goods	3.1	2.8	0.3	-0.5	0.0	-0.5
Other industrial products	3.3	2.6	0.7	-0.3	0.2	-0.5
Petroleum products	3.7	2.3	1.5	0.4	0.6	-0.1
Personal services	2.4	2.3	0.1	-0.2	0.1	-0.3
Food services	2.5	2.9	-0.3	0.1	0.0	0.1
Core core	1.9	1.8	0.1	0.0	0.1	-0.1

(Notes) 1. (Left) Compiled based on the Corporate Goods Price Index, the Bank of Japan; and the Consumer Price Index, the Ministry of Internal Affairs and Communications.
2. (Right) Compiled based on the Consumer Price Index, the Ministry of Internal Affairs and Communications. Figures in the "consumption tax portion (estimate)" column are estimates by the Cabinet Office.

- The upward pressure from import prices has subsided for the moment, while a rise in expected rates of inflation is contributing to consumer price growth. The negative contribution of the GDP gap has steadily become smaller.

Figure 2-1-5 Breakdown of consumer prices

(1) Breakdown of consumer prices



(Notes) 1. Compiled based on the System of National Accounts, and the Consumer Confidence Survey, the Cabinet Office; the Consumer Price Index, the Ministry of Internal Affairs and Communications; and the Corporate Goods Price Index, the Bank of Japan.
2. The GDP gap was estimated by the Cabinet Office.
3. Expected rates of inflation in and before the January-March period of 2004 were calculated through the Carlson-Parkin method based on the rational expectations hypothesis. Expected rates of inflation in and after the April-June period of 2004 were calculated by the weighted average of the ranges provided by respondents, with the deviation from the expected rates in and before the January-March period of 2004 adjusted.

- The ratio of companies which transfer a cost increase to their prices if the increase is 10% or higher has risen in both manufacturing and non-manufacturing industries compared with one year ago. There are signs of a change in companies' price-setting behavior at the time of a cost increase.
- Deflation in value added has been halted. Unit profit is making positive contributions to GDP deflator against the backdrop of a profitability improvement due to a shift to an economic environment in which companies find it easier to transfer a cost increase to prices as well as the yen's weakness.

Figure 2-1-6 Causes of sales price increases and changes in companies' price-setting behavior

(2) Transferring a cost increase to sales prices

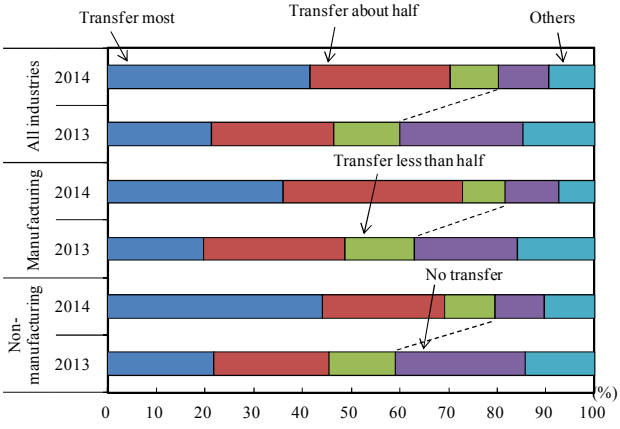
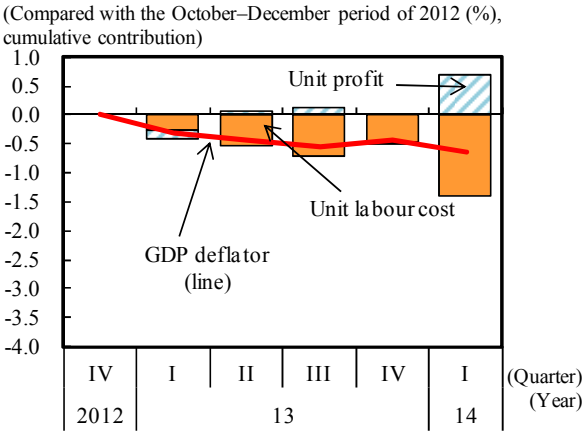


Figure 2-1-7 Breakdown of contributions to GDP deflator

(2) Breakdown of contributions of income-related factors

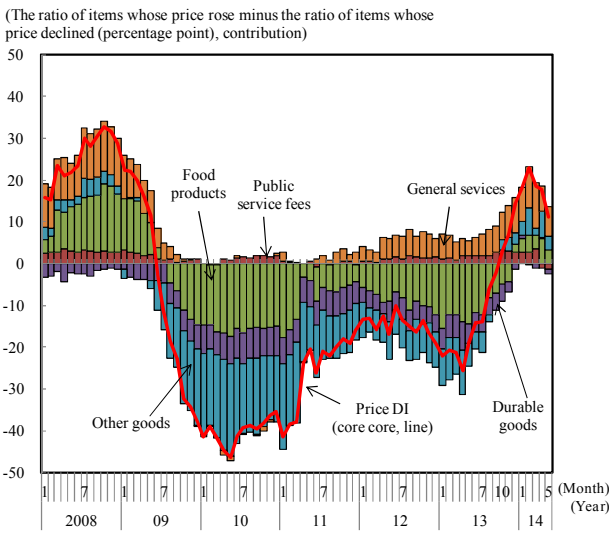


(Notes) 1. (Left) Compiled based on "Survey on Attitudes to Corporate Management," Cabinet Office. As companies polled in the 2013 survey and those polled in the 2014 survey are not completely the same, the results should be viewed with some qualifications.
2. (Right) Compiled based on the System of National Accounts, the Cabinet Office.

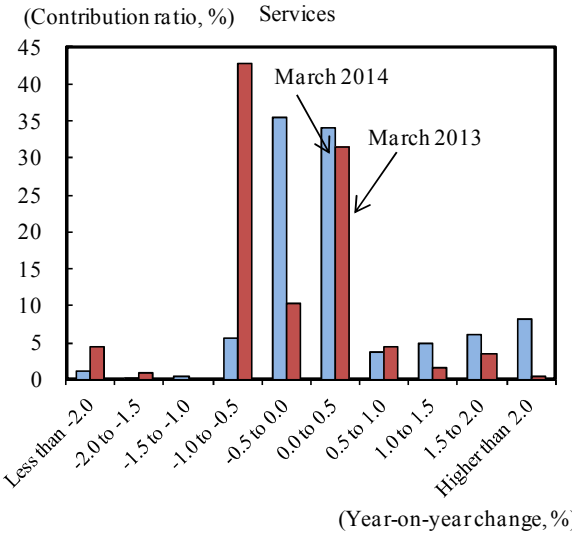
- The ratio of items whose prices are rising is steadily increasing. What is notable this time is that prices are increasing with regard to all types of goods and services, including durable consumer goods.
- While items whose price growth is in the range of minus 0.5% to 0.0% are making the most contributions, the distribution of price growth rates is shifting upward on the whole compared with one year ago.

Figure 2-1-8 Trend of consumer prices by item

(1) Consumer price (core core) DI



(2) Distribution of price growth rates of items covered by the consumer price index (core core)

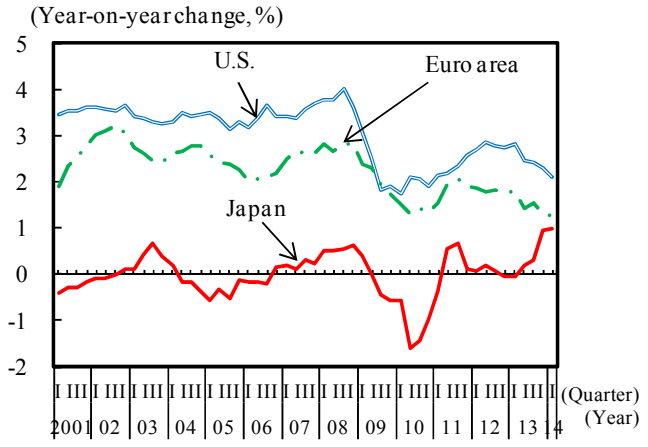


(Notes) 1. Compiled based on the Consumer Price Index, the Ministry of Internal Affairs and Communications.
2. The price DI is obtained by subtracting the ratio of items whose price recorded year-on-year declined to the component items of the consumer price index (core core) from the ratio of items whose price recorded year-on-year growth.

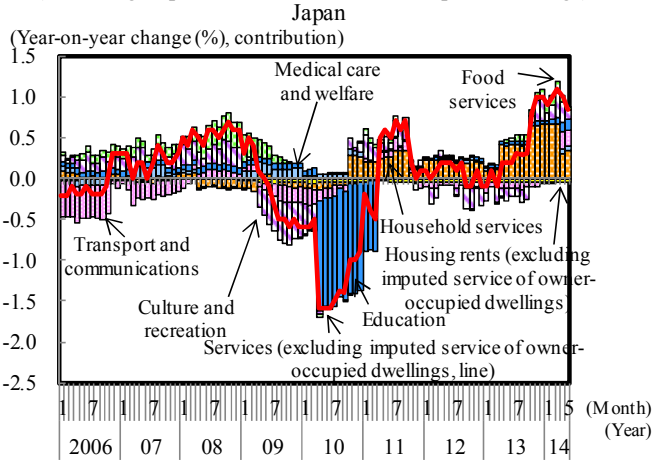
- Although the growth rate of service prices in Japan has been rising since the autumn of 2013, it still remains relatively low compared with the growth rate of 2% to 2.5% in the U.S. and of around 1.5% in the Euro area.
- Service prices, mainly for food services, construction (part of household services) and lodging (part of culture and recreation) have been rising due to the underlying strength of demand, against the backdrop of an increase in personnel and other costs.

Figure 2-1-9 Comparison of prices of goods and services in Japan, U.S. and Europe

(2) Changes in prices of services (excluding imputed service of owner-occupied dwellings)



(3) Breakdown of contributions to prices of services (excluding imputed service of owner-occupied dwellings)



(Notes) 1. (Left) Compiled based on the Consumer Price Index, the Ministry of Internal Affairs and Communications; the "Consumer Price Index," Bureau of Labour Statistics; Euro. Stat.
2. (Right) Compiled based on the Consumer Price Index, the Ministry of Internal Affairs and Communications.

- According to companies' supply and demand conditions DI, the supply-demand condition is at its most tight since 2000. By company size, the DI improved remarkably for small and medium-size enterprises, mainly in non-manufacturing industries.
- The deflation risk index has fallen to the same level as in 2007. However, improvements in indexes related to finance have remained moderate, as exemplified by the growth of less than 10% in outstanding bank loans. To overcome deflation, robust monetary policy measures will continue to be required.

Figure 2-1-11 Trend of supply and demand-related indexes

(2) Small and medium-size enterprises (SMEs)' supply-demand condition DI

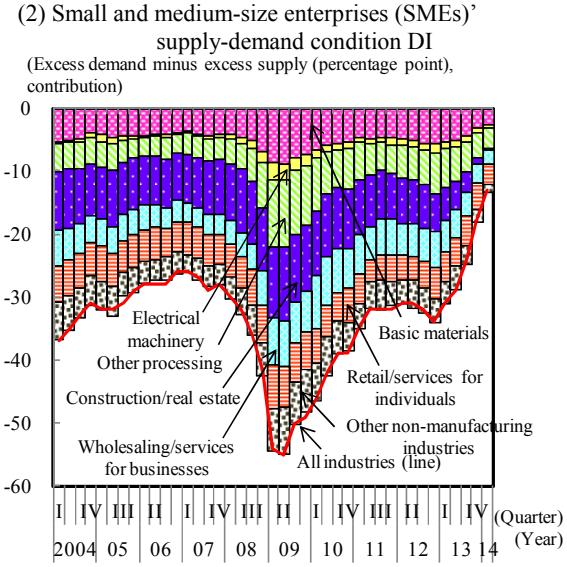
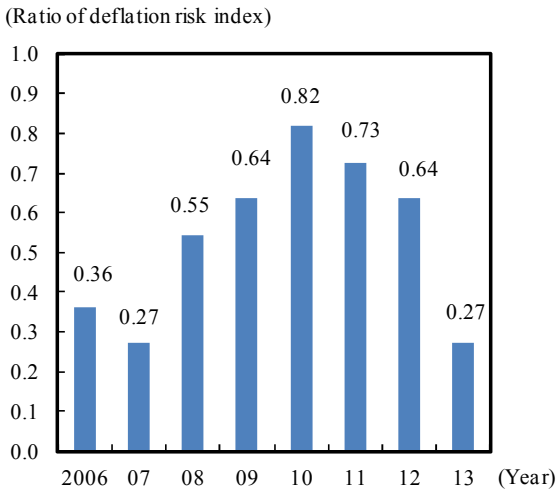


Table 2-1-13 Changes in the deflation risk index



(Notes) 1. (Left) Compiled based on the Tankan Survey, the Bank of Japan.
2. (Right) Compiled based on the Consumer Price Index, the Ministry of Internal Affairs and Communications; the System of National Accounts, the Cabinet Office; the Financial and Economic Statistics, the Bank of Japan; and Nikkei NEEDS-Financial QUEST. The deflation risk index is an index which was calculated based on the IMF (2003) and which represents the ratio of indexes—from among prices, GDP, stock prices, exchange rates, bank loans and money supply indexes—which do not meet prescribed criteria. Of the figures indicated in Table 2-1-13, only the deflation risk index is indicated above.

Section 2　Income and Wage Trends that Support the Virtuous Circle

- Against the backdrop of an increase in the number of employed people due to the economic recovery and improvement in scheduled earnings and special earnings, nominal compensation of employees in the whole of Japan has been growing moderately.
- In the current phase of economic expansion, nominal compensation of employees has been recovering steadily compared with in past such phases.

Figure 2-2-1 Breakdown of contributions to nominal compensation of employees

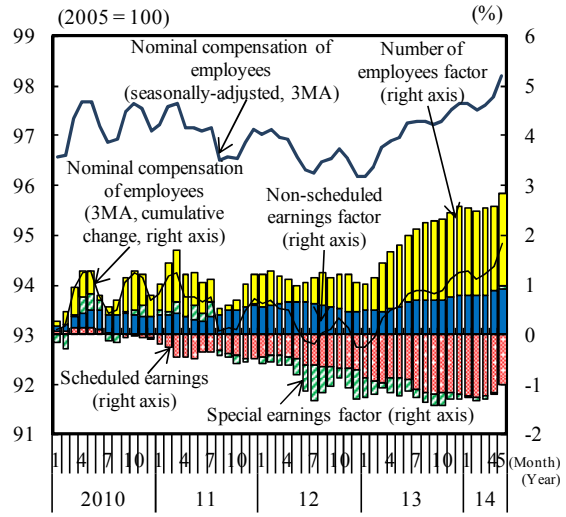
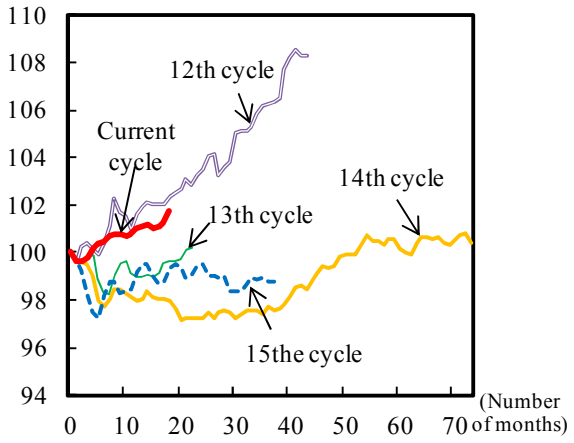


Figure 2-2-2 Past phases of economic expansion and nominal compensation of employees

(1) Nominal compensation of employees



(Notes) 1. Compiled based on the Monthly Labour Survey, the Ministry of Health, Labour and Welfare; and the Labour Force Survey, the Ministry of Internal Affairs and Communications.
2. The figure on the right shows changes in each economic cycle from the peak to the trough. The 12th cycle lasted from November 1993 to May 1997, the 13th cycle from February 1999 to November 2000, the 14th cycle from February 2002 to February 2008 and the 15th cycle from March 2009 to April 2012. As for the current cycle, the figure covers the period since November 2012.

- A major feature of the current phase of economic expansion is the fast pace of an increase in the number of employed people.
- The number of employed people is increasing amid the steady improvement in the employment situation as shown by the sustained decline in the unemployment rate. The perception of a labor shortage is growing in such industries as construction and real estate, mainly among small and medium-size enterprises.

Figure 2-2-2 Past phases of economic expansion and nominal compensation of employees

(4) Number of employees

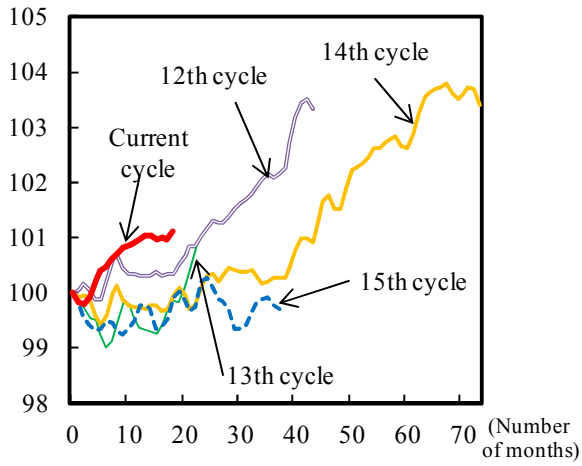
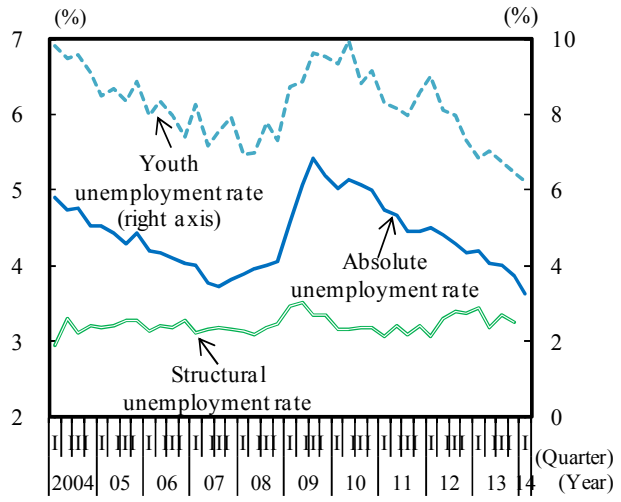


Figure 2-2-3 Employment situation and corporate activities

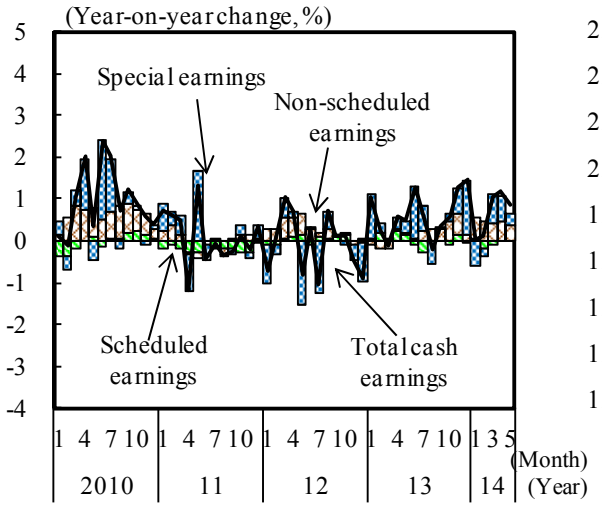
(1) Changes in the unemployment rate



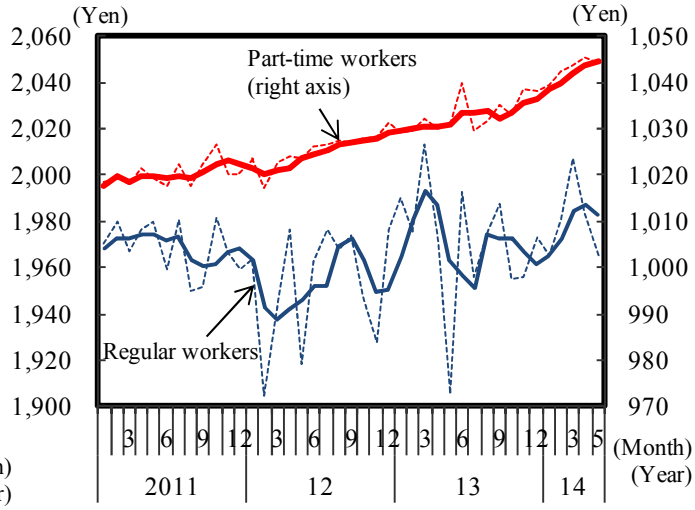
(Note) Compiled based on the Labour Force Survey, the Ministry of Internal Affairs and Communications.

- Against the backdrop of growth in special earnings and non-scheduled earnings due to an improvement in corporate profits and increased corporate activities, nominal wages per capita for regular workers has been growing moderately.
- Since the latter half of 2013, hourly wages for regular and part-time workers have been on an uptrend. It is important that hourly wages rise in tandem with an improvement in productivity while the government promotes a variety of working styles.

Figure 2-2-4 Breakdown of contributions to per-capita nominal wages for regular and part-time workers
(2) Per-capita nominal wages for regular workers (Total cash earnings)



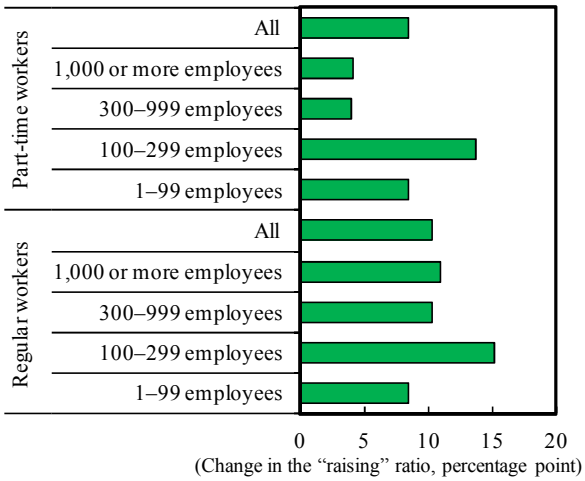
2-2-12 Comparison of per-capita hourly total scheduled earnings
(4) Changes in hourly scheduled earnings



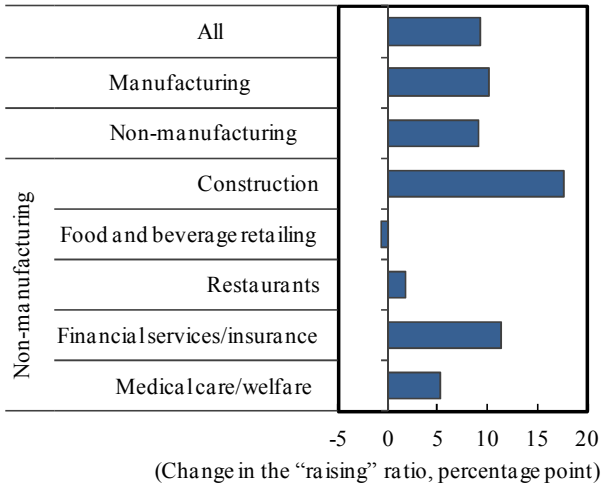
(Notes) 1. Compiled based on the Monthly Labour Survey, the Ministry of Health, Labour and Welfare.
2. (Right) Hourly wages are based on scheduled earnings. The dotted line indicates seasonally-adjusted figures and the solid line indicates the three-month average thereof.

- Regardless of company size, the ratio of companies expecting to raise salary scales in FY2014 from FY2013 has grown. Moves to raise salary scales are steadily spreading among small and medium-size enterprises as well.
- In the construction industry, the number of companies expecting to raise salary scales has increased significantly because of the tightening of the labor supply-demand balance due to the continuing recovery demand and institutional factors such as a rise in the unit labor cost regarding construction work and design.

Figure 2-2-8 Outlook on salary scale raises by companies
(1) Change in the outlook on salary scale raises by company size



(3) Changes in the outlook on salary scale raises by industry (Regular workers)



(Notes) 1. Compiled based on "Survey on Attitudes to Corporate Management," Cabinet Office.
2. A change in the "raising" ratio represents the difference between the ratio of companies which responded in the 2014 survey that they would raise wages and the ratio of those which gave the same response in the 2013 survey.

- Companies expecting to raise salary scales in FY2014 also place emphasis on securing and retaining labor force.
- Among large companies, there is a tendency that those with a long-term vision for growth are more likely to raise salary scales than those with a short-term vision for growth.

Figure 2-2-9 Reasons for companies' wage revisions

(2) Difference between companies which raised salary scales and those which did not (regular workers)

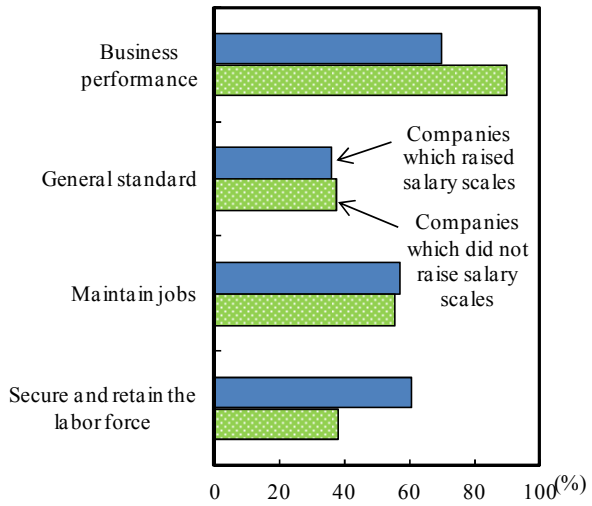
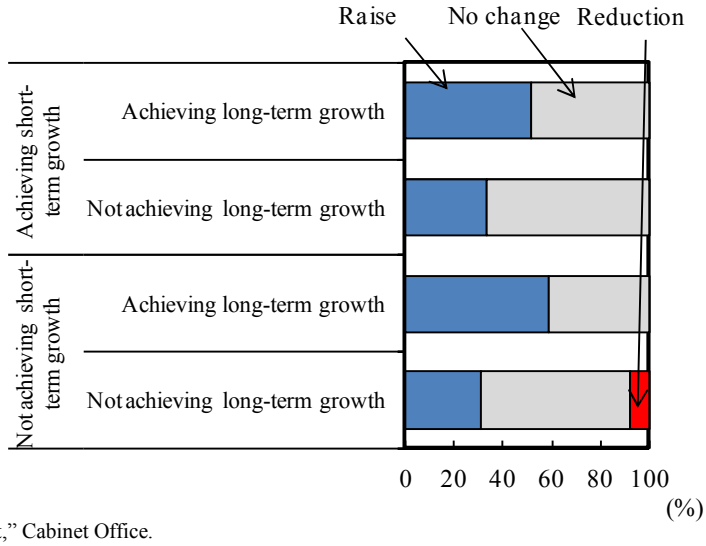


Figure 2-2-10 Long-term growth visions and salary scale raises

(1) Outlook on wage revisions in 2014 (large companies)



(Notes) 1. Compiled based on "Survey on Attitudes to Corporate Management," Cabinet Office.
2. The "short-term growth" in the figure on the right refers to companies which expect the domestic market to grow in 2014, and the "long-term growth" refers to companies which expect all markets (including overseas markets as well as potential markets) to grow over the next 10 years.

- In the long term, there is a positive correlation between labor productivity and real wages on an hourly basis.
- Growth in real wages has been weak due to a decline in labor's share of income and a deterioration in the terms of trade. Amid the improvement in corporate profits, it is important to ensure that the profits are appropriately distributed to employees and to improve the terms of trade by reducing resource and energy cost through energy conservation.

Figure 2-2-16 Hourly labour productivity and real compensation of employees

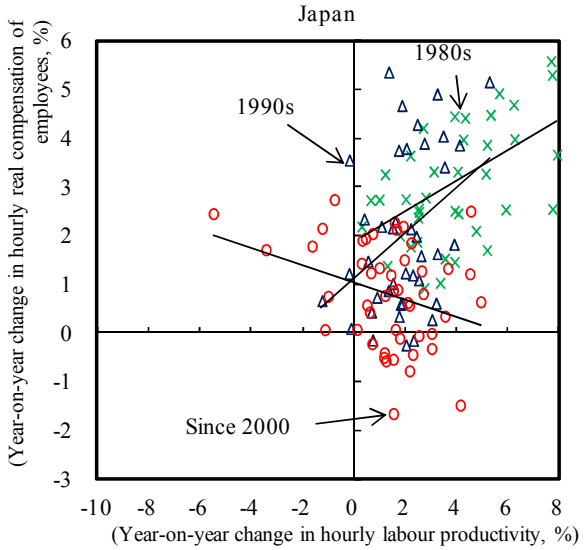
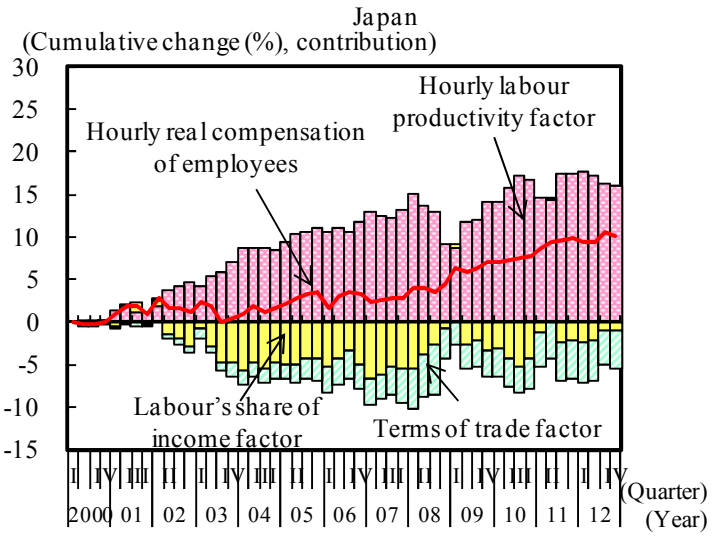


Figure 2-2-18 Breakdown of contributions to hourly real compensation of employees



(Notes) 1. (Left) Compiled based on OECD.Stat.
2. (Right) Compiled based on the System of National Accounts, Cabinet Office; and OECD.Stat.

Section 3　Challenges on the Road to Higher Real Wages and Labor Participation Ratio

- The relative importance of the quality of labor for higher labor productivity has grown. To raise labor productivity, it is essential to enhance the quality of labor in a sustained manner through the accumulation of skills.
- It is important to enhance the flexibility of working arrangements and employment mobility through the revision of the regulation on working hours and implementation of measures to support labor mobility, thereby improving labor productivity and raising real wages.

Figure 2-3-1 Breakdown of contributions factors to labour productivity

(1) Breakdown of contributions to labour productivity (overall)

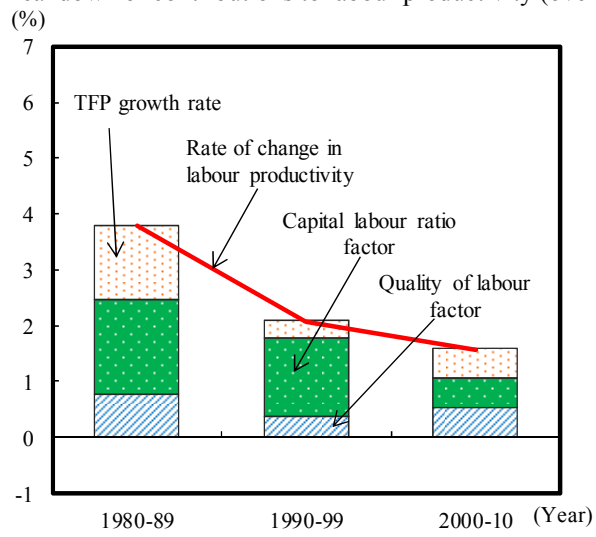
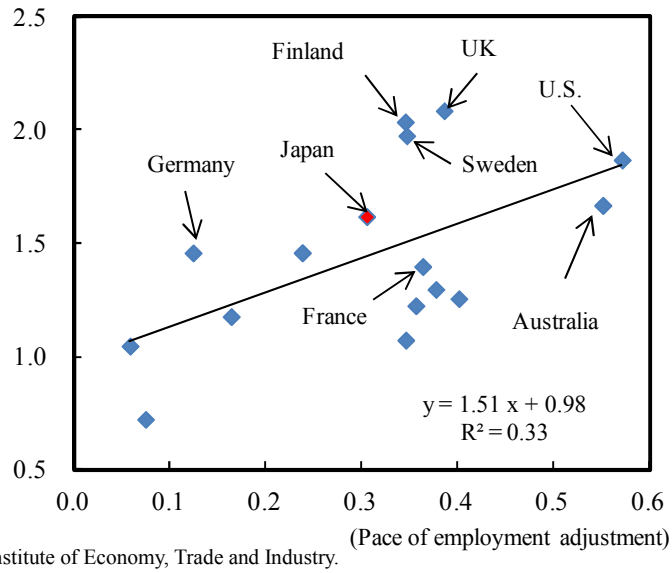


Figure 2-3-2 Labour productivity and the pace of employment adjustment

(Average growth rate of labour productivity, %)

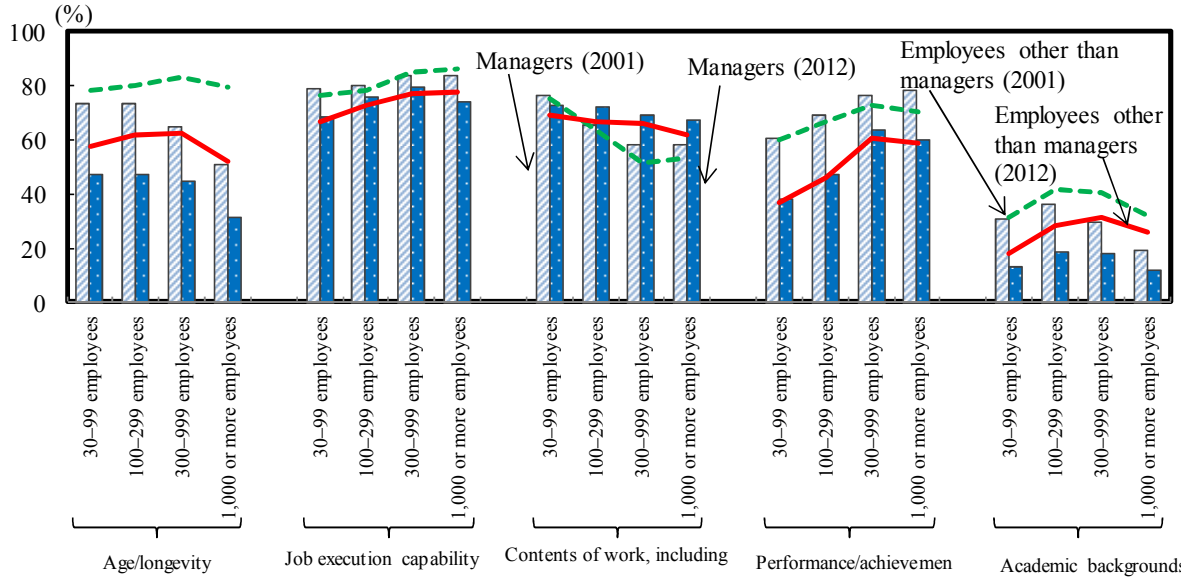


(Notes) 1. (Left) Compiled based on the JIP Database 2013, the Research Institute of Economy, Trade and Industry.
2. (Right) Compiled based on OECD.Stat. The pace of employment adjustment is an estimate based on data from 1991 to 2010. The growth rate of labour productivity is the average rate between 1991 and 2012.

- Many companies place emphasis on “job execution capability” as a determinant factor of basic pay. To realize a wage increase, it is necessary to enhance job execution capability through personnel training systems, etc.

Figure 2-3-4 Determinant factors of basic pay and bonuses

(1) Determinant factors of basic pay by company size



(Note) Compiled based on the General Survey on Working, the Ministry of Health, Labour and Welfare.

- Industries which retain personnel tend to have a steep wage curve.
- Industries which face difficulty retaining personnel tend to have a gentle wage curve. It is important to accumulate human capital by securing and retaining capable personnel while improving labor productivity.

Figure 2-3-6 Wage curve and personnel training by industry

(2) Rate of wage growth and personnel training by industry

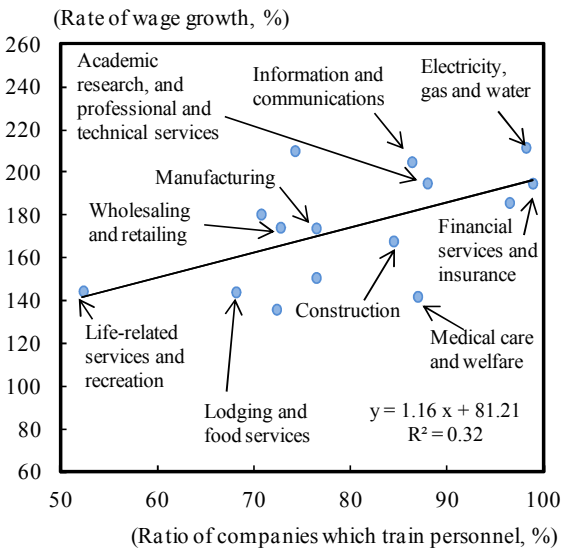
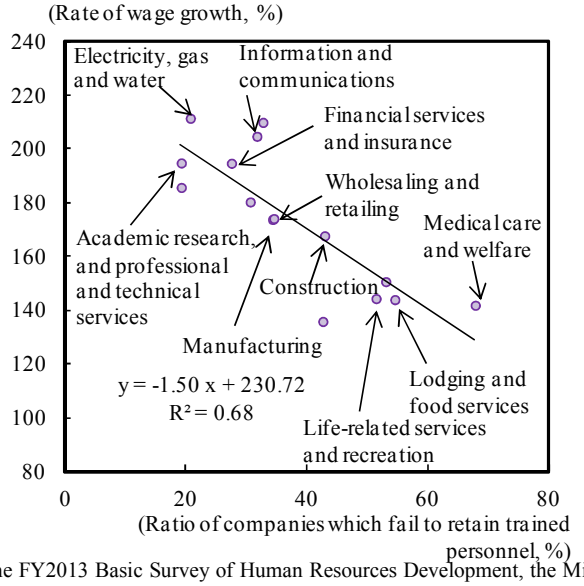


Figure 2-3-8 Rate of Wage growth and challenges for personnel training

(2) Rate of wage growth and retention of personnel



(Note) Compiled based on the FY2013 Basic Survey on Wage Structure and the FY2013 Basic Survey of Human Resources Development, the Ministry of Health, Labour and Welfare.

- The labor force participation rate among elderly people in Japan has stayed higher than the average rate for the OECD countries. While the labor force participation rate among women of child-rearing age has been rising, there is room for improvement compared with the levels in other major advanced countries and Nordic countries.
- In Nordic countries, more women are engaging in the fields of education and medical and nursing care than in Japan.

Figure 2-3-13 Labour force participation rate by age group in OECD countries

(2) Labour force participation rate of elderly people and women of child-rearing age

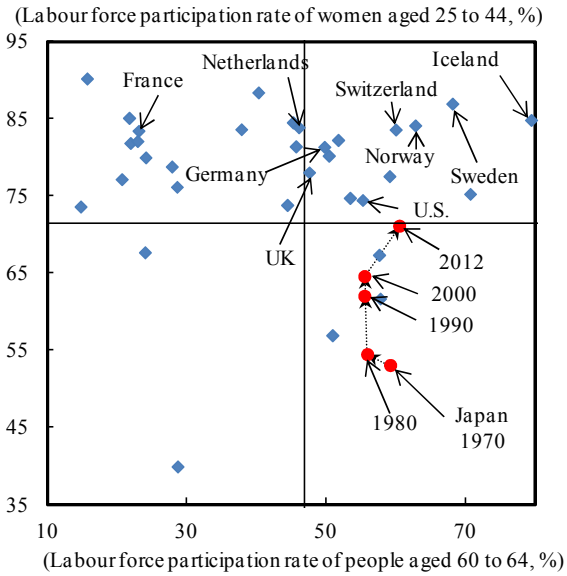
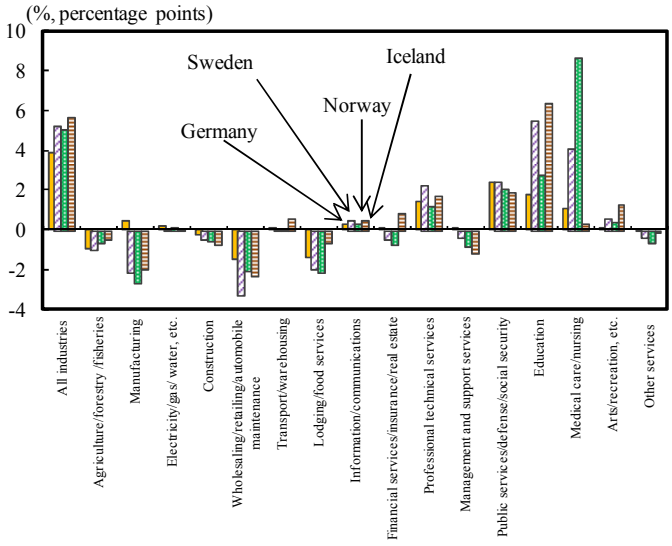


Figure 2-3-14 International comparison of the structure of employment of women by industry

(3) Difference between the ratio of women to employees in Japan and the ratios in other countries and contribution by industry (2012)

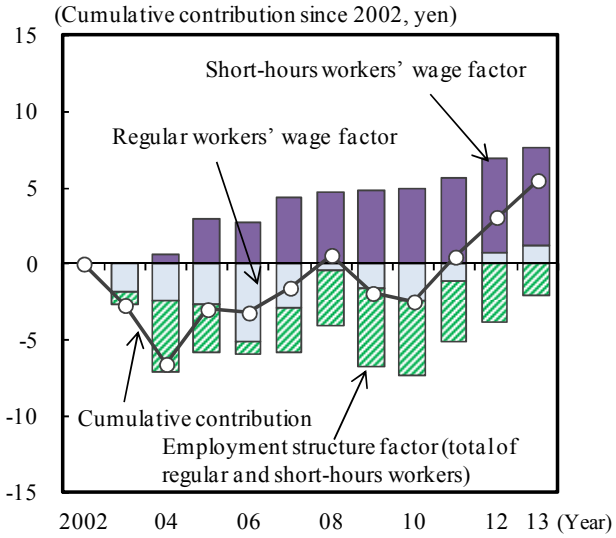


(Notes) 1. (Left) Compiled based on the Labour Force Survey, Ministry of Internal Affairs and Communications; and OECD.Stat.
2. (Right) Compiled based on OECD.Stat.
The Difference between the ratios of women employed in all industries to people employed in all industries in Japan and other countries and contribution by industry.

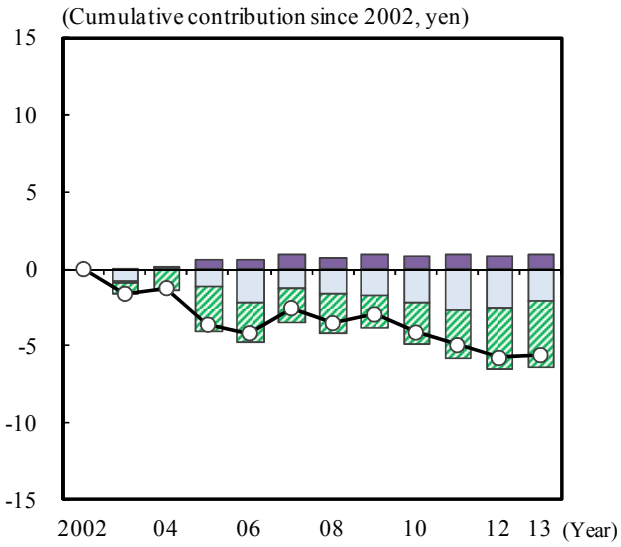
- Hourly wages for women of child-rearing age (aged 25 to 44), including both regular and short-hour workers, have risen, making positive contributions to the average wage for overall workers.
- Regarding elderly men (aged 60 or older), the challenge is raising their hourly wages.

Figure 2-3-16 Breakdown of contributions to hourly wages by gender and age

(2) Contribution of people of child-rearing age (aged 25 to 44)



(3) Contribution of elderly men (aged 60 or older)



(Note) Compiled based on the Basic Survey on Wage Structure, the Ministry of Health, Labour and Welfare.

- There is room to increase the labor force by one million people through child care support measures.
- A qualitative change in the appointment of female managers may result in thorough implementation of the approach of putting the right person in the right position, leading to an improvement in productivity in the long term and, ultimately, to a rise in real wages.

Figure 2-3-19 Changes in the potential labour force participation rate of women and the labour force

(2) Potential labour force participation rate of women and the potential labour force by age group (2013)

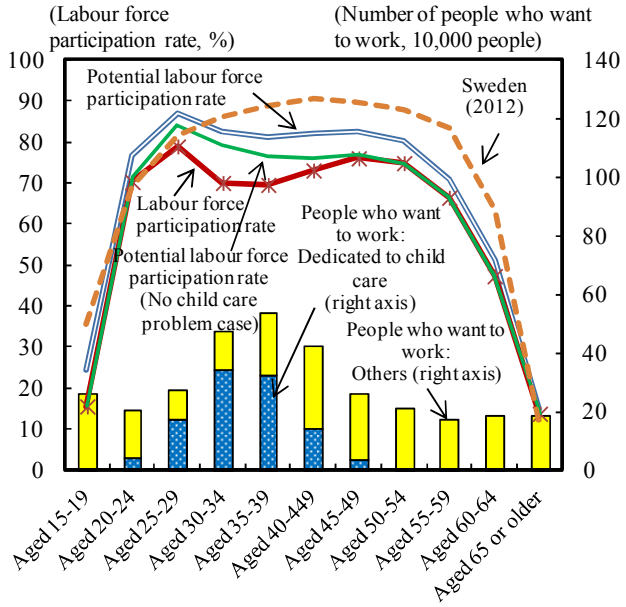
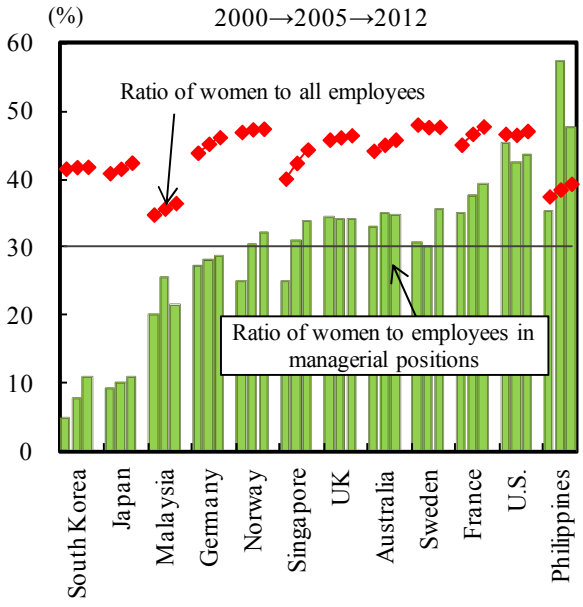


Figure 2-3-20 Ratio of women to employees engaging in managerial positions

(1) Ratio of women to all employees and employees in managerial positions



(Notes) 1. (Left) Compiled based on the Labour Force Survey, the Ministry of Internal Affairs and Communications; and OECD.Stat.
2. (Right) Compiled based on the Databook of International Labour Statistics, the Japan Institute for Labour Policy and Training.