

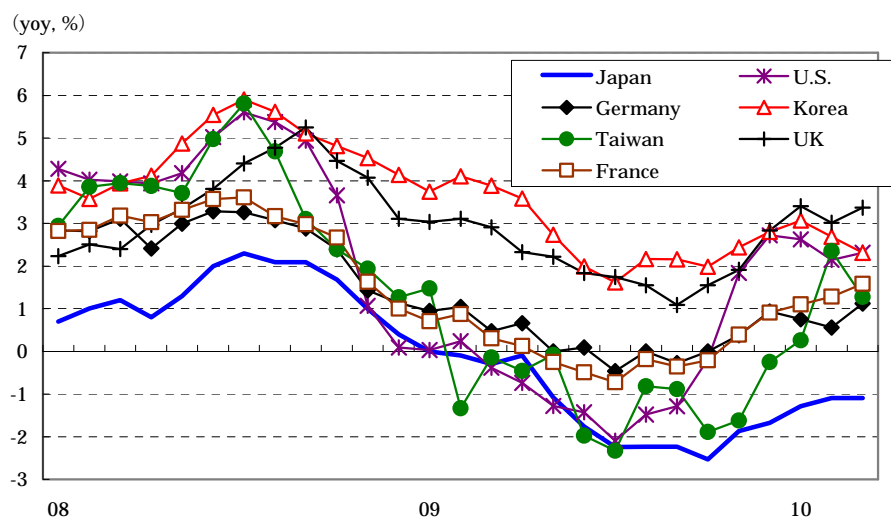
Will Escaping from Deflation Increase Growth Potential?

- The Real Issue for the Japanese Economy Is for Corporations to Create Value. -

By Tomomichi Akuta, Rei Tsuruta, Miki Ohata

The Japanese economy is showing improvement following a major deterioration in the wake of the collapse of Lehman Brothers Holdings. However, alone among the major countries, Japan's consumer prices even now are continuing to decline. In view of this situation, the government, the Bank of Japan (BOJ), and the ruling party have raised escaping from deflation as a major policy issue.

Chart1: Percentage changes in consumer prices in principal countries



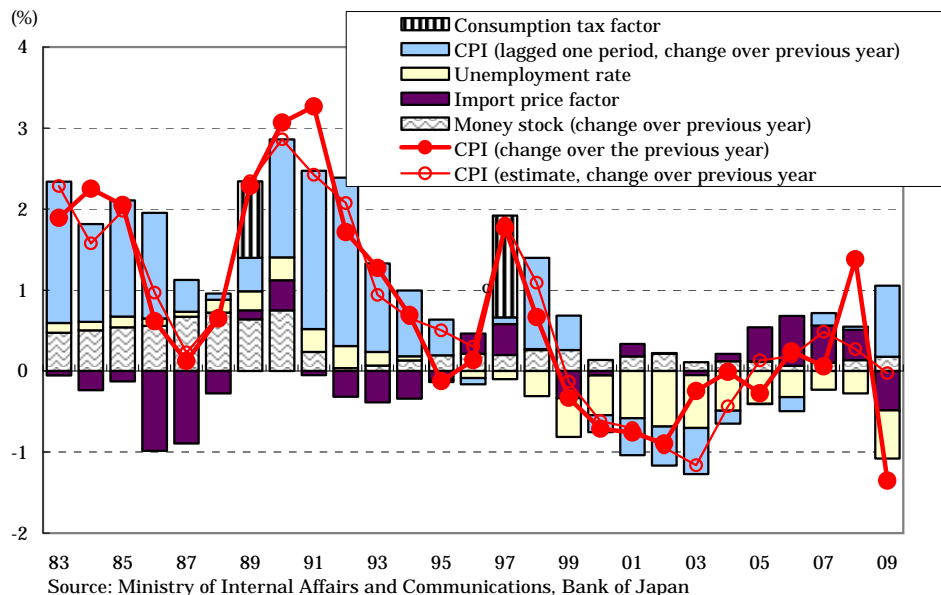
Source: Ministry of Internal Affairs and Communications, CEIC

Analyzing the distinguishing features of movements in Japan's price level from an income distribution perspective, we can point out the fact that wage costs have been a major factor pushing down the price level in Japan, and corporate incomes have been a relatively minor factor pushing it up. On the other hand, from the perspective of expenditures and products, the decline in the deflator for personal consumption and drop in the consumer price index (CPI), in particular the lack of increases in service prices, are major distinguishing features of price movements in

Japan. Service prices are closely linked to wages, and, in general, we can infer that deterioration in macroeconomic demand in Japan will restrain increases in prices and wages.

There are four points to make about the relationship between deflation and the real economy. The first is that the effects that fluctuations in prices have on the economy and on unemployment are not always clear. Second, provided the economy does not move into a deflationary spiral, deflation has both positive and negative effects, and, overall, the net effect is a zero sum. Third, at present, as a result of deflation, an unintended transfer of income from debtors to lenders would not result in deterioration in economic conditions. Fourth, unlike the 1990s, there is little likelihood at present of the emergence of debt deflation. As these four points suggest, it seems unlikely that deflation itself has been a direct cause of the stagnation in the Japanese economy.

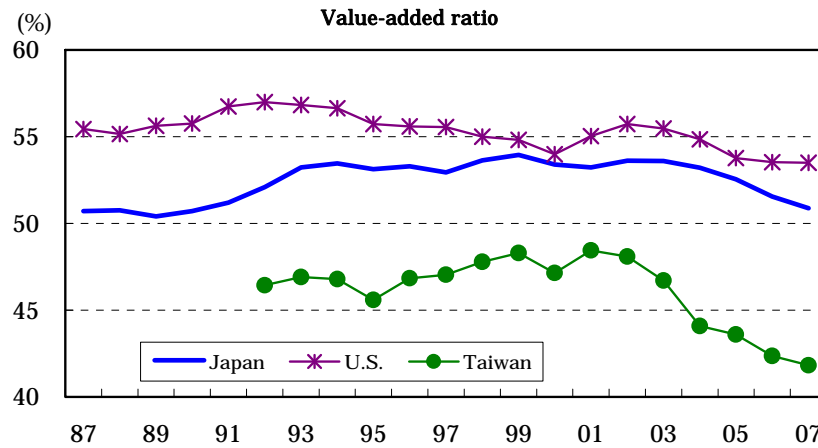
Chart2: Analysis of factors causing changes in Japan's consumer prices



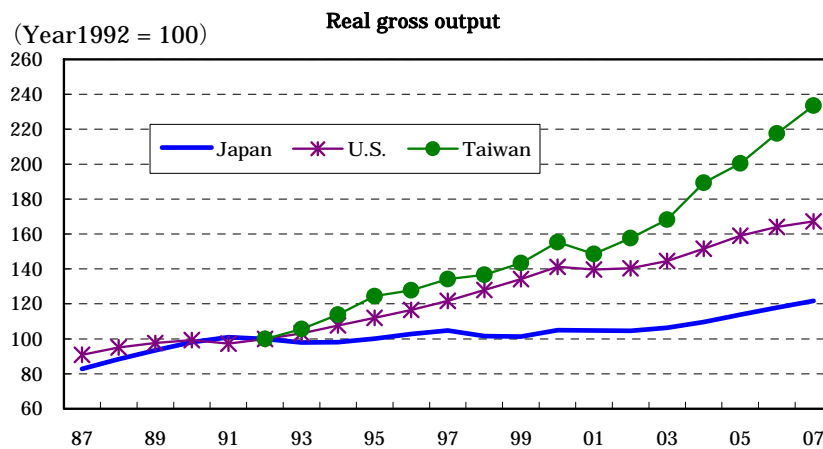
The real reason why the Japanese economy has been stagnant for a prolonged period is that corporations, because they have not been strong enough to expand their sales, have not been able to create sufficient value added. For Japanese companies to achieve stable expansion in their sales going forward, there are only two ways. One is to increase exports and the other is to raise the value of consumption on a per-capita basis in Japan. There is still sufficient leeway for expanding sales channels, mainly in the emerging economies. Moreover, there are also many service fields in Japan where corporations can expect to find latent demand. Just bringing inflation back to reasonable levels will not assure higher economic growth nor better labor market conditions. Continuing to focus persistently on shifting the industrial structure to meet

changes in (latent) demand will be indispensable for the Japanese economy to escape from stagnation.

Chart3: U.S. and Japanese value-added ratio and real gross output



Note: GDP deflators were used to calculate real gross output figures.
Source: Cabinet Office, U.S. Dept. of Commerce,
Taiwan Directorate-general of Budget



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*This is an English summary of a report originally published on May 25, 2010. The full report is available only in Japanese, but the author will answer questions regarding the topic by e-mail.

*The information and the views contained herein are subject to change without notice.