

## Economic Outlook for FY2004 and Basic Economic and Fiscal Management Measures

January 19<sup>th</sup>, 2004

Cabinet Decision

### 1. Economic and Fiscal Management in FY2003 and Our Nation's Economy

(Economic and Fiscal Management in FY2003)

In FY2003, the Government examined and evaluated the progress of structural reform and then decided the Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2003 (Cabinet Decision of June 27, 2003). Based on the Basic Policies, the Government has driven forward the Program for Financial Revival (October 30, 2002), aiming to terminate the non-performing loans (NPLs) problems in FY2004. As a result, NPLs ratio of major banks has fallen.

In April, the Law on Special Zones for Structural Reform took effect and 236 such zones have been approved up to now. In June, the Government complied the 5.3 Million Job Creation Program and the Independence and Challenge Plan for Young Workers (June 10, 2003 both) and has implemented related measures upon them. The Government has also implemented the Program for the Promotion of Foreign Direct Investment into Japan (March 27, 2003).

In May, responding to financial and economic situations, the Government formulated the Measures to Reform and Vitalize Securities Market (May 14, 2003). The Industrial Revitalization Corporation of Japan, which has started to operate in May, has decided its supports in eight cases. To prevent financial crisis, the Government decided to enhance the capital of Resona Bank (June 10, 2003) and to begin the special public management of the Ashikaga Bank (November 29, 2003).

(The Japanese Economy in FY2003)

In FY2003, it seems that the Japanese economy came to a halt at the beginning of the year. After that, while the US economy and the world economy are recovering, exports and industrial production will increase gradually again. At the same time, corporate profits will continue to improve and private non-residential investment will also increase, which means corporate sectors' recovery. Thus, it is expected that the Japanese economy will gradually recover mainly by private demand. With regard to deflation, although the rates of price declines are expected to be reduced, the deflationary trend will continue.

Consequently, as the yearly economy for FY2003, the real growth rate of Japan's gross domestic product (GDP) is expected to be approximately 2.0% (with the nominal growth rate of approximately 0.1%).

### 2. Basic Economic and Fiscal Management Measures for FY2004

While the reforms have yet to be accomplished and mild deflation continues, there are some positive signs such as increasing corporate profits and business investments. The results of the reforms are sprouting; the steady progress in the disposal of NPLs, the movement to establish Special Zones for Structural Reform, and vitalized entrepreneurship using the Minimum Capital Exception. In order to

grow these sprouts of the reforms into a big tree, that is, “Revitalized Japan”, it is required to accelerate and expand the reform efforts spreading further the fruits of the reforms.

Under the principles of “No growth without reforms,” “Leave to the private sector what can be done by the private sector,” and “Leave to local governments what can be done by local governments,” the Government, based on the Basic Policies, will carry out the structural reforms in regulation, financial system, tax system and government expenditures in an integrated and consistent manner, aiming to overcome deflation and to achieve the sustainable economic growth driven by private demand through the promotion of creative business and the revitalization of local economies. The Government, with the Bank of Japan (BOJ) will continue to take powerful and comprehensive actions to stabilize financial and capital markets, and to achieve positive price rate of change as soon as possible. Furthermore, the Government will continue to practice decisive and flexible policy managements in accordance with the economic situations.

### ***(1) Acceleration and Expansion of Structural Reforms***

In the area of regulation, the Government, starting from Special Zones for Structural Reform, will drive the reforms thoroughly in the fields directly related to daily lives or with substantial demand for businesses.

The Government will promptly implement required policies and formulate the new three-year program for promoting regulatory reform starting from FY2004 by the end of FY2003, while thinking highly of the specific policies mentioned in “the Third Report on the Promotion of Regulatory Reform” (December 22, 2003). The Council for Regulatory Reform is to disband at the end of FY2003, but the Government will set up the new council mainly consisting of members private sector from FY2004.

Concerning Special Zones for Structural Reform, the Government will work to increase licensed zones and will spread nation-wide the exceptional measures which have already been implemented that the Evaluation Committee recognizes to be without any problems; as soon as possible.

In the area of financial system, the Government, aiming to put an end to the NPLs problems in FY2004, will steadily implement policies based on the Financial Revitalization Program, which enable the financial intermediation function to be restored, and make a smooth transition of resources to new growth areas. Furthermore, the Government will never let financial crisis happen.

The Government will establish a new public funds scheme to contribute to vitalizing the economy, and to stabilizing and strengthening financial system.

The Government will continue to consider possible measures to enhance the capital adequacy of banks.

The Government will encourage private financial institutions to develop profitable business models, including interest rates setting corresponding to carefully assessed risk. As for small and medium-sized or regional financial institutions, the Government will, based on the Action Program concerning enhancement of Relationship Banking Functions (March 28, 2003), urging them to secure soundness and profitability, revitalize small and medium enterprises (SMEs) and activate regional

economies.

In addition, in order to solve both the NPLs problems and the excess debts problems in corporate sector, the Government will promote structural reforms in industrial sector through restructurings and reorganization, making active use of resources such as the Industrial Revitalization Corporation of Japan, with its newly enhanced functions, and the Law on Special Measures for Industrial Revitalization.

In the area of tax system, the Government will continue to consider “Desirable tax system,” which gives people reassurance in the future, aiming at sustainable invigoration of the Japanese economy and society.

FY2003 Tax Reform, which achieved reforms in a wide range of tax items comprehensively and drastically, has been effective in economic vitalization. And front-loaded tax cuts of 1.5 trillion yen are to be in effect during FY2004. In FY2004 Tax Reform, the Government will continue to carry out truly effectual measures, evaluating properly the results of FY2003 Tax Reform and taking fiscal order into consideration.

For example, the Government will take concrete measures as follows; reviewing the taxation of housing such as the extension of tax reductions corresponding to housing loans; reviewing the income tax for capital gains on land and housing contributing to vitalize real estate transactions; establishing the system of fixed property tax reduction by local ordinance; reduction; amplifying the taxation for SMEs and venture companies; reducing and simplifying the financial and securities taxation system contributing to facilitate reform that shifts the focus from savings to investments; extending carry-over period for tax deficit and abolishing the additional tax for corporations electing consolidated taxation, contributing to the structural reforms of financial and corporate sectors. A comprehensive revision of the Tax Treaty between Japan and the United States, and amendments of related systems, will be undertaken to realize economic vitalization through foreign investments. Furthermore, the Government will review pension benefit taxation, considering the viewpoint of contributing to reform of pension system, in order to secure fairness inter and in generations. In addition, as part of “the reform package of three issues,” the Government will introduce the income transfer tax (tentative) to transfer part of the revenue of income tax to the local governments, as a bridging measure until the full-fledged transfers of tax revenue sources from individual income tax to local inhabitant tax by FY2006.

In the area of government expenditure, by boldly focusing on the creation of private demand and building a sustainable fiscal structure with the reforms of the social security system and “the reform package of three issues,” the Government will eliminate people’s anxiety for the future and promote consumption and investment.

The Government will further promote the expenditure reform based on the Guidelines for Formulation of the FY2004 Budget (Cabinet Decision of December 5, 2003). As a part of innovation of budgeting process, the Government will provisionally introduce “Model Projects,” in

which it sets quantitative outcome targets, practices strict ex post evaluations, and facilitates multi-year projects by contract authorization correspondent to their characteristics, in order to achieve the policy goals more efficiently, and will apply the method of “Policy Packages”.

The scale of spending in the FY2004 budget is to be such that the budget’s general expenditures and total general account expenditures will be kept virtually at or below the FY2003 level. Concerning the special accounts, the Government will review their projects and make them more efficient and reasonable, while considering each account’s characteristic and situation of execution. In allocating budget, the Government will apply the method of “Policy Packages” and emphasize four priority areas aiming to the realization of a vibrant socio-economic milieu. These four areas are “Progress and utilization of human resource education, culture, science and technology, IT -,” “Attractive urban areas and local areas with their own ideas and characteristics,” “Measures to build a fair and secure aging society addressing the aging society and declining birthrate,” and “Creating an environment - friendly society and economy to deal with global environmental problems -”. Furthermore, the Government will employ the results of policy evaluations when reviewing expenditures.

As for “the reform package of three issues,” based on the Basic Policies, the Government will carry out “¥1 trillion” elimination and reduction in state subsidies, try to materialize the transfer of tax resources to local governments as mentioned above, and, concerning the reform of local allocation tax, scale down the Local Public Finance Program and the total amount of local allocation tax.

As for revenues, the Government will tightly control the amount of government bond issues to the utmost, considering the expanding deficit and debts. In issuing government bonds, the Government will practice appropriate public debt management including proper and professional risk control from the viewpoints of minimizing funding costs in the medium and long run and stabilizing the government bond markets.

As for local economies, there are noticeable differences in the extent to which economic recovery of each region has been achieved. Aiming to realize the potential advantages of each region, the Government will promote vitalization of the economy and job creation in each region based on its own eagerness and spontaneous activities, while further penetrating the results of structural reforms. In order to revitalize local economies, the Government will promote the regulatory reforms, including spread of Special Zones for Structural Reform, vitalize local industries, making best use of originality and distinctive features of each region, and execute employment and SMEs policies. Outsourcing of administration services will be actively promoted. The Headquarters for the Regional Revitalization will decide “the Program for the Promotion of the Regional Revitalization” by the latter part of February 2004, based on “Basic Policies on the Regional Revitalization,” realize required revisions in accordance with the Program, and promote one-stop supports of the Government for efforts of each region to revitalize itself in corporation with the Headquarters for the Promotion of Special Zones for Structural Reform. It will take supporting measures, for example, promotion of Special Zones for Structural Reform, delegation of administrative authorities, outsourcing of administration services, and tie-up and concentration of various measures, while cooperating with relative policies such as employment and SMEs policies. Through these measures, it will completely back up the plans for

regional renaissance including revitalization or restructuring of key regional industries and launch of new business with applying technologies, human resources, tourism resources, and natural environment.

The Government will promote the creation of new industries and businesses, the supports for SMEs' challenges, the development of growing sectors, and the accumulation of unique local industries, through measures such as New Industrial Promotion Strategy, e-Japan Strategy II and the Intellectual Property Strategy. Amid a severe employment situation, the Government will steadily promote the 5.3 Million Job Creation Program, and implement measures based on the Independence and Challenge Plan for Young Workers, while actively making use of private sector. Furthermore, the Government will strengthen industrial financial systems, such as arranging various flows of funds and finance which does not excessively depend upon mortgages and guarantors; and will facilitate financing to motivated and capable SMEs. The Government will also support the revitalization of SMEs making the best use of the SME Turnaround Support Committee. Through these actions, the Government will make doubly sure that there are safety nets for employment and SMEs.

In order to secure people's reassurance and safety in the future, the Government will continue the integrated reforms of social security services such as pension, medical, long-term care, and livelihood protection, and will take measures to build a fair and secure aging society and to address declining birth rate, aiming to construct a sustainable social security system. Furthermore, in order to revive "Japan, the safest country in the world", the Government will also secure people's safety and public peace.

In response to the needs of the times, the Government will review the role of administration and continue to promote its structural reforms, such as the downsizing and improvement of executive organs and the public corporation reform.

In addition, the Government will steadily promote and follow up various measures related to the Seven Reforms set forth in the Basic Policies, whose objectives are "revitalization of the economy," "ensuring security of the people" and "establishment of responsible fiscal balances for future generations."

In order to overcome deflation, actions on financial aspects are indispensable; building robust financial system by the Government in the process of policy efforts for acceleration and expansion of structural reforms, and strengthening the transmission mechanism by BOJ. These actions will be expected to enable the expansion of liquidity. BOJ's more effective monetary policy management aiming to overcome deflation as soon as possible will be anticipated.

## *(2) Contributions to the Sustainable Development of the World Economy*

In ever globalizing economy, the Government will carry out external economic policies integrated with domestic structural reforms.

In order to revitalize the Japanese economy, the Government will actively continue negotiations on the World Trade Organization (WTO) new round and promote economic partnership, including free trade agreements (FTAs) with Mexico, South Korea, ASEAN, and other countries or regions. The Government will promote regional ties, such as the Asia Pacific Economic Cooperation, the ASEAN +3 (Japan, China and South Korea). And the Government will contribute to the sustainable development of the world economy by strengthening the international financial system and carrying out strategic assistance to developing countries in a transparent and efficient manner.

### **3. Economic outlook for FY2004**

In FY2004 it is required to accelerate and expand reform efforts, spreading further the fruits of reforms. The Government will carry out structural reforms in various areas in an integrated and consistent manner aiming to overcome deflation and to achieve sustainable economic growth driven by private demand.

In FY2004, since the world economy continues to recover, industrial production and private non-residential investment are expected to continue to increase moderately. Because of these improvements in corporate sectors, it is anticipated that the employment and income situations, while still severe, move towards an incipient recovery, thus this improvement is expected to gradually spread also to household sectors. Accordingly, the Japanese economy will continue to follow a moderate growth path of recovery mainly by private demand. Although there is a concern that the deflationary trend will continue, it is expected that deflationary pressure will gradually diminish due to the recovery of demand and the measures by the government and BOJ.

As a result, the growth rate of real GDP is projected to be about 1.8% (with the nominal GDP growth rate of about 0.5%). Projections of other main economic indicators are shown in the attached table.

#### **(1) Real GDP**

##### **[1] Private Consumption**

Since employment and income situations, while still severe, move towards an incipient recovery, private consumption will begin to pick up gradually (approx.1.1% increase from the previous fiscal year).

##### **[2] Private Residential Investment**

The rate of the decline of private residential investment will be reduced, because employment and income situations, while still severe, move towards an incipient recovery (approx. 0.1% decrease).

##### **[3] Private Non-Residential Investment**

As corporate earnings continue to improve, private non-residential investment will keep on increasing (approx. 7.2% increase).

#### [4] Public Expenditure

Public expenditure will decrease, because public fixed investment will decline under the continued commitment of the government for fiscal discipline, “Budget Committed to Reform”, although the government consumption such as medical and elderly care insurance payments will rise (approx. 1.2% decrease).

#### [5] Net Exports

While the world economy continues to recover, net exports will keep on increasing (Net exports will contribute approx. 0.2% to the real GDP growth).

### **(2) Labor & Employment**

Due to the movement of an incipient recovery of employment and income situations in line with the improvement of corporate sectors, although severe as a whole, the unemployment rate will decrease compared with the previous year's level (approx. 5.1%).

### **(3) Industrial Production**

Because of the increase in exports and the incipient recovery of domestic demand, industrial production will continue to increase gradually (approx. 4.1% increase).

### **(4) Prices**

Prices will continue to fall. The rate of decline of Domestic Corporate Goods Prices will be reduced by an improvement in supply and demand conditions (approx. 0.4% decrease). The rate of decline of Consumer Prices will stay at the same level as in the previous fiscal year (approx. 0.2% decrease).

### **(5) Balance of payments**

Since imports as well as exports will increase because of the recovery of the world economy and the incipient recovery of domestic demand, current account as a percentage of GDP will remain roughly flat (Current account surplus will be approx. 3.2% of GDP).

Note: In light of the fact that private economic activity accounts for the main part of the Japanese economy and the fact that there are numerous unforeseeable factors, particularly in terms of changes in the international economic environment, it should be considered that some allowances exist for the projections of main economic indicators.

## Main Economic Indicators

	FY2002	FY2003	FY2004	Percentage changes over the previous fiscal year					
	(actual)	(estimate)	(forecast)	FY2002(actual)		FY2003(estimate)		FY2004(forecast)	
	trillion yen	trillion yen	trillion yen	%	%	%(approx.)	%(approx.)	%(approx.)	%(approx.)
	(approx.)	(approx.)	(approx.)	current prices	constant prices	current prices	constant prices	current prices	constant prices
Gross domestic product	497.6	497.9	500.6	-0.7	1.2	0.1	2.0	0.5	1.8
Private consumption expenditure	284.5	282.5	283.1	-0.2	1.0	-0.7	0.6	0.2	1.1
Private residential investment	17.9	17.8	17.8	-3.3	-2.1	-0.5	-0.2	-0.2	-0.1
Private non-residential investment	71.6	74.1	76.8	-5.8	-3.3	3.5	8.7	3.7	7.2
Increase in private inventory*	0.0	0.8	1.2	(0.3)	(0.4)	(0.2)	(0.2)	(0.1)	(0.1)
Government expenditure	117.4	114.7	113.0	-1.3	0.1	-2.3	-1.4	-1.5	-1.2
Final consumption expenditure	87.4	87.8	89.4	0.5	2.1	0.4	1.4	1.8	2.2
Fixed capital formation	30.0	26.9	23.6	-6.3	-5.0	-10.4	-9.1	-12.2	-11.4
Exports of goods & services	56.7	59.2	62.3	8.4	12.0	4.5	7.2	5.1	5.5
Less:Imports of goods & services	50.5	51.2	53.6	4.3	5.5	1.4	3.9	4.8	5.2
Contribution of domestic demand				-1.1	0.4	-0.3	1.5	0.4	1.6
Contribution of private demand				-0.8	0.4	0.2	1.9	0.8	1.9
Contribution of public demand				-0.3	0.0	-0.5	-0.3	-0.3	-0.3
Contribution of external demand				0.5	0.8	0.4	0.5	0.1	0.2
National Income	362.9	363.8	365.7	-1.3		0.2		0.5	
Compensation of employees	264.7	264.2	264.9	-2.6		-0.2		0.3	
Property income	7.6	7.2	6.8	-5.1		-5.4		-5.9	
Entrepreneurial income	90.5	92.3	94.1	3.1		2.0		1.8	
Labor & Employment	ten thousands	ten thousands	ten thousands		%		%(approx.)		%(approx.)
Total labor force	6,677	6,665	6,655		-0.9		-0.2		-0.1
Total employment	6,318	6,315	6,315		-1.1		-0.1		-0.0
Employees	5,329	5,335	5,345		-0.5		0.1		0.2
Unemployment rate	%	%(approx.)	%(approx.)						
	5.4	5.2	5.1						
Production	%	%(approx.)	%(approx.)						
Industrial production	2.8	2.9	4.1						
Prices	%	%(approx.)	%(approx.)						
Corporate Goods Price Index	-1.6	-0.7	-0.4						
Consumer Price Index	-0.6	-0.2	-0.2						
Balance of Payments	trillion yen	trillion yen	trillion yen		%		%(approx.)		%(approx.)
Balance of goods and services	6.4	8.3	8.6						
Trade balance	11.6	12.1	13.5						
Exports	50.1	52.0	54.6		8.5		3.7		5.2
Imports	38.5	39.9	41.1		3.6		3.5		3.0
Current account	13.4	15.8	16.2						
Current account as a percentage of GDP	%	%(approx.)	%(approx.)						
	2.7	3.2	3.2						

\*The figures in the parenthesis are contributions to GDP growth.

(Note) The main assumptions are as follows. These assumptions are not projections nor forecasts of government.

	FY2002	FY2003	FY2004
World GDP (excluding Japan)	2.6%	2.8%	3.8%
Exchange Rate (yen/dollar)	121.9	113.6	109.2
Crude Oil Prices (dollar/barrel)	27.4	28.5	28.3

(N.B.)

1. World GDP (excluding Japan) is calculated based on the outlook of international organizations and other institutions.
2. Exchange rate is assumed to be unchanged after December 1st at the one-month average (109.2 yen/dollar) from November 1st to 30th.
3. Crude oil prices are assumed to be unchanged after December 1st at the three-month average (28.3 dollar/barrel) from September 1st to November 30th.