

**Economic Outlook for FY2005 and Basic Economic and Fiscal Management Measures**

January 21, 2005

Cabinet Decision

**1. Economic and Fiscal Management and the Japanese Economy in FY2004**

(Economic and Fiscal Management in FY2004)

In FY2004, the Government decided the “Basic Policies for Economic and Fiscal Management and Structural Reform 2004” (Cabinet Decision of June 4, 2004. Hereinafter, it is called; the “Basic Policies 2004”.) which contains the measures to get rid of problems caused by the negative legacy of the post-bubble period until the end of the Intensive Adjustment Period and to focus on consolidating the fundamentals for new growth in the Concentrated Consolidation Period. Through the continuous implementation of the “Program for Financial Revival” (October 30, 2002), the steady progress to normalize the non-performing loans(NPLs) problems has been accomplished; the NPLs ratio of major banks has fallen favorably by half as targeted.

In addition, in May, the Government formulated the “New Industrial Promotion Strategy” (May 17, 2004), the “Principles to promote Regulatory Reform and Opening up to the Private Sector”(May 25, 2004), and the “Direction and Strategy to promote Regional Revitalization”(May 27, 2004), and drives the measures based on these strategies. In November, based on the “Basic Policies 2004”, the Government made the agreement at the meeting of the Government and the ruling parties concerning the overall picture of the “Three-Part Reform Package” until FY2006(November 26, 2004). In December, the Government formulated the “Program for Further Financial Reform”(December 24, 2004) and the “Action Plan to Foster a Spirit of Independence and Challenge in Youth”(December 24, 2004).

(The Japanese Economy in FY2004)

Despite recent slack movements observed in certain areas, the Japanese economy throughout FY2004 will, sustained by a solid recovery of corporate sectors as shown in significant improvements in corporate profits for instance, expect a pickup in the employment situation and a continuing recovery led by private demand.

With regard to prices, although corporate goods prices have been rising due to soaring raw material prices including crude oil, consumer prices are expected to remain on a slightly declining trend on a year-on-year basis. Moreover, GDP deflator continues

falling mildly. Taken together, these movements show that the Japanese economy is in a mild deflationary phase.

In sum, the growth rate of real GDP in FY2004 is expected to be approximately 2.1% (with the growth rate of nominal GDP of approximately 0.8%).

## **2. Basic Economic and Fiscal Management Measures for FY2005**

Under the progress of the structural reforms, the Japanese economy has been recovering although it is in a mild deflation. For the revitalization and development of the Japanese economy, it is required to establish a system suitable in the 21<sup>st</sup> century, and to ensure a breakaway from deflation. While the reforms have yet to be accomplished, sprouts of the reforms have thriven, and it is required to grow these sprouts into a big tree.

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 will continue to carry out the structural reforms, in an integrated, consistent and swift manner, not only in the four fields of regulation, financial system, tax system, and government expenditures, but also in the privatization of the postal services, the Three-Part Reform Package, the social security system and so on, aiming to bring out eagerness for challenge of individuals and corporations and initiative of local governments, based on the “Basic Policies 2004”, and will achieve the sustainable economic growth driven by private demand. Moreover, the Government, in a body with the Bank of Japan (BOJ), will further strengthen its policy efforts to ensure a breakaway from deflation.

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***

(Positive Promotion of Regulatory Reform and Opening up to the Private Sector)

In the area of regulation, the Government will drive regulatory reform and opening up to the private sector in the fields directly relating to daily lives and contributing to create business chances.

The Government will implement necessary measures immediately, paying serious attention as much as possible to the “concrete measures” described in the “First Report on the Promotion of Regulatory Reform and Opening up to the Private Sector”(December 24, 2004, the Council for the Promotion of Regulatory Reform). For example, with regard to the Market Testing(government-and-private sector competitive bid system), the Government will study the system including the “Market Testing Law”

(tentative name) and implement “Model Projects” by way of trial, towards its full-scale introduction. Moreover, the Government will implement certainly the “Three-year Program for Promoting Regulatory Reform and Opening up to the Private Sector” to be reformed by the end of FY2004.

Concerning Special Zones for Structural Reform, which plays a roll as a breakthrough in the regulatory reform, the Government will implement measures for the further improvement based on the result of general review on unrealized proposals and will spread nationally the exceptional measures, as soon as possible, which have already been implemented and which are recognized as having no problems by the Evaluation Committee.

#### (Reform of Financial System)

Through enforcement of the measures based on the “Program for Further Financial Reform” as for the Concentrated Consolidation Period, the Government aims to achieve the financial system which satisfies users of financial services, is highly appreciated in the global market and contributes to the regional economy, not driven by the initiative of the "Government" but realized by the energy of the "private sector".

#### (Comprehensive and Drastic Tax Reform)

In the area of tax system, along with the “Basic Policies 2004”, based on the outlines of tax reform of the ruling parties already formulated, the Government will succeedingly advance comprehensive and drastic examination of the tax reform proposals relevant to each other, in order to reach the conclusion within the Concentrated Consolidation Period.

In FY2005 Tax Reform, in order to accomplish the “Desirable tax system” for realizing sustainable invigoration of the Japanese economy and society, the Government, based on the “Outline of the Tax Reform of the Ruling Parties”(December 15,2004), will take appropriate measures on the proportional across-the-board tax credit, the taxation of housing, the taxation of financial services and securities, the taxation of the international transactions, the taxation of small and medium enterprises(SMEs), the local transfer of income tax, the taxation of NPOs, the taxation for restructuring of corporation, the human investment tax credit, and so on.

#### (Expenditure Reform)

The Government will further promote the expenditure reform based on the “Basic Principles of FY2005 Budget Formulation”(Cabinet Decision on December 2, 2004). Concerning the FY2005 budget, the Government will continue the basic line of the

“Budget for Reform Resolution”, and stick to and strengthen the existing basic principle for expenditure reform under which the scale of the general expenditures and the general account expenditures has been controlled virtually less than the scale in the previous fiscal year. The Government will promote the budgetary system reforms in full-scale, such as a promotion of the “Model Projects”, the “Policy Packages” and reform of special accounts. As for revenues, the Government will reduce the amount of new government bond issues less than the amount in FY2004, tightly control it to the utmost, and practice appropriate public debt management including the promotion of the stable subscription of government bonds.

(The “Three-Part Reform Package”)

In accordance with the agreement reached at the meeting of the Government and the ruling parties concerning the overall picture of the “Three-Part Reform Package” until FY2006, the Government will implement necessary measures for the reform of state subsidy system, the transfer of tax sources and the reform of local allocation tax.

By expanding local government’s authority and responsibility and by increasing local discretion in both revenue and expenditure, the Government will give local governments wider authority to choose administrative services truly required by habitants independently and efficiently on their own responsibility, and construct the simpler and more efficient administrative and fiscal system at national and local level.

The Government will follow up these efforts appropriately on the Council on Economic and Fiscal Policy.

(The Social Security System)

Based on discussions on integrated reforms of the entire social security system in order to establish a sustainable system to the future, in FY2005, the Government will practice reforms of nursing care insurance, livelihood protection, and so on.

(Regional Revitalization)

The Government will promote efforts of the “Strategies on Maximizing the Capability of Regions” that combines various policy measures by preparing the full-fledged schemes for regional revitalization which expand authority and responsibility of local governments so that regions can collectively make use of the reformed measures, which are proposed by regions, including transfer of administrative authority, reform of state subsidy system and measures for inducement of private fund, by encouraging various actors to participate in regional revitalization and by introducing performance-based evaluation system.

(Creation of New Industries and Businesses, Steady Implementation of the “Action Plan to Foster a Spirit of Independence and Challenge in Youth”)

The Government will promote the creation of new industries and businesses, the strengthening of the research and development and the human resource cultivation, the supports for SMEs’ challenges, the development of growing sectors, and the accumulation of unique local industries, through measures such as the “New Industrial Promotion Strategy”, promotion of foreign direct investment into Japan, “e-Japan Strategy II”, the Intellectual Property Strategy, and strengthening of industrial financial systems. The Government will steadily practice “Action Plan to Foster a Spirit of Independence and Challenge in Youth” aiming to make youths’ will to work stronger, improve the youths’ ability development measures which enable youths to choose on their own needs, and to strengthen cooperation with regions.

(Innovation and Revitalization of SMEs)

The Government will ensure safety nets such as the smooth flow of funds to SMEs, and will make the best use of the SME Turnaround Support Committee, in order to support the innovation and revitalization of vigorous SMEs. Moreover, the Government will consistently and powerfully support new business efforts of start-up companies and intergroup “new partnership” by integrating three existing acts to support SMEs’ businesses.

(Efforts towards Overcoming Deflation)

The Government will accelerate and expand the structural reforms of each field in order to improve the GDP gap further. The Government expects that the BOJ continues aggressive monetary easing including measures which lead to effective money supply for ensuring the breakaway from deflation. Moreover, the Government also expects that the BOJ, considering stabilization of expectation of financial and capital markets, makes further efforts to improve the transparency about monetary policy management including showing a path to overcome deflation.

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

In ever globalizing economy, the Government will accelerate and expand external economic policies with domestic structural reforms in an integrated manner.

In order to vitalize the Japanese economy, the Government will make full efforts for the agreement on the World Trade Organization (WTO) new round.

Concerning Economic Partnership Agreement (EPA) including Free Trade Agreement (FTA), while the Government will realize the smooth implementation of the

concluded agreement, and practice positively towards early conclusion of the bilateral agreements with Asian countries, the agreement with ASEAN as a whole, and so on.

### **3. Economic outlook for FY2005**

In FY2005, under the ongoing recovery in the world economy and with the continuing improvement in domestic corporate sectors as shown in increasing industrial production and business investment, the economic recovery is expected to spread over to household sectors through the improvement in employment and income situations, and private consumption is expected to follow a steady growth path. As a consequence, the Japanese economy is expected to continue a moderate recovery led by private demand.

With regard to prices, by making joint efforts of the government and the BOJ, a steady progress towards overcoming deflation is expected.

In sum, the growth rate of real GDP in FY2005 is expected to be approximately 1.6% (with the growth rate of nominal GDP of approximately 1.3%).

#### (1) Real Gross Domestic Product

##### ① Private Consumption Expenditure

Stable improvement is expected in private consumption as employment and income situations are improved (approximately 0.9% of increase from the previous year)

##### ② Private Residential Investment

Although declining from FY2004 which posts a comparatively high growth, private residential investment will remain at a sound level (approximately 0.6% of decrease from the previous year).

##### ③ Private Non-residential Investment

With continuing improvement in corporate profits, private non-residential investment is expected to follow through on growth (approximately 3.3% of increase from the previous year).

##### ④ Public Expenditure

Public expenditure will, under continued efforts to restrain expenditure under the Budget for Reform Resolution, be around the same level with the previous year despite an imperative increase in payments of public medical and nursing care insurance, and the outlays for disaster-restoration works (approximately 0.4% of increase from the previous year).

##### ⑤ External Demand

As the world economy continues to recover, external demand is expected to continue growing (Net export contributes approximately 0.4% to the real GDP

growth rate).

#### (2) Labor and Employment

Employment and income situations will, while still severe, gradually improve and the unemployment rate will show a little improvement from the previous year (approximately 4.6%).

#### (3) Industrial Production

As both domestic and external demands increase, industrial production is expected to continue expansion (approximately 1.8% of increase from the previous year).

#### (4) Prices

Corporate goods prices continue to grow in a modest way (approximately 0.4% of increase from the previous year). Consumer prices move back into a positive territory while slight (approximately 0.1% of increase from the previous year). The rate of decline of GDP deflator will be narrowed (approximately 0.3% of decrease from the previous year).

#### (5) Balance of Payment

Due to a continuing growth of the world economy and domestic demand, both exports and imports will increase and the current account surplus as a percentage of GDP will be increased a little (current account surplus will be approximately 3.9% of GDP).

It should be noted that the future movements in crude oil prices and the world economy could have influence on the Japanese economy.

(Note 1) These economic trend and outlook premise the policies listed in the “2. Basic Economic and Fiscal Management Measures for FY2005.”

(Note 2) As the Japanese economy mainly consists of private activities, the above indicators should be recognized as being subject to upside and downside risks relating to market fluctuations and other changes in circumstances.

## Main Economic Indicators

|  | FY2003<br>(actual) | FY2004<br>(estimate)       | FY2005<br>(forecast)       | Percentage changes over the previous fiscal year |   |   |            |                  |            |
|--|--------------------|----------------------------|----------------------------|--|---|---|------------|------------------|------------|
|  |                    |                            |                            | FY2003(actual)                                   |   | FY2004(estimate)                            |            | FY2005(forecast) |            |
|  |                    |                            |                            | trillion yen<br>current prices                   | trillion yen<br>(approx.)<br>current prices | trillion yen<br>(approx.)<br>current prices | %          | %                | %(approx.) |
| Gross domestic product                 | 501.3              | 505.1                      | 511.5                      | 0.8  | 1.9   | 0.8   | 2.1        | 1.3              | 1.6        |
| Private consumption expenditure        | 283.5              | 286.7                      | 288.9                      | -0.2   | 0.5   | 1.1   | 1.7        | 0.8              | 0.9        |
| Private residential investment         | 17.8               | 18.3                       | 18.2                       | -0.4   | -0.5  | 2.6   | 1.7        | -0.2             | -0.6       |
| Private non-residential investment     | 75.2               | 78.7                       | 80.9                       | 5.3  | 8.2   | 4.6   | 5.6        | 2.8              | 3.3        |
| Increase in private inventory          | 0.3                | -0.4                       | 0.4                        | (0.1)  | (0.1)                                       | (-0.1)                                      | (-0.1)     | (0.1)            | (0.1)      |
| Government Expenditure                 | 115.2              | 112.7                      | 113.0                      | -2.0   | -1.5  | -2.2  | -1.8       | 0.3              | 0.4        |
| Government consumption                 | 88.0               | 88.9                       | 90.0                       | 0.5  | 1.1   | 1.1   | 1.9        | 1.2              | 1.5        |
| Public investment                      | 27.2               | 23.8                       | 23.0                       | -9.3   | -9.2  | -12.8                                       | -13.5      | -3.0             | -3.5       |
| Exports of goods & services            | 60.4               | 67.7                       | 72.6                       | 6.5  | 9.9   | 12.2  | 12.9       | 7.3              | 7.1        |
| Less:Imports of goods & services       | 51.2               | 58.6                       | 62.5                       | 1.4  | 3.4   | 14.5  | 9.0        | 6.7              | 5.6        |
| Contribution of domestic demand        |                    |                            |                            | (0.2)  | (1.1)                                       | (0.8)                                       | (1.4)      | (1.1)            | (1.2)      |
| Contribution of private demand         |                    |                            |                            | (0.7)  | (1.5)                                       | (1.3)                                       | (1.8)      | (1.0)            | (1.1)      |
| Contribution of public demand          |                    |                            |                            | (-0.5)   | (-0.4)                                      | (-0.5)                                      | (-0.4)     | (0.1)            | (0.1)      |
| Contribution of external demand        |                    |                            |                            | (0.6)  | (0.8)                                       | (-0.0)                                      | (0.7)      | (0.2)            | (0.4)      |
| National Income                        | 367.8              | 373.0                      | 377.4                      | 1.8  |   | 1.4   |            | 1.2              |            |
| Compensation of employees              | 263.5              | 264.0                      | 265.2                      | -1.0   |   |   |            | 0.5              |            |
| Property income                        | 8.7                | 8.0                        | 7.6                        | 1.3  |   | -7.9  |            | -5.0             |            |
| Entrepreneurial income                 | 95.7               | 101.0                      | 104.7                      | 10.2   |   | 5.6   |            | 3.6              |            |
| Labor & Employment                     | ten thousands      | ten thousands<br>(approx.) | ten thousands<br>(approx.) |  | %   |   | %(approx.) |                  | %(approx.) |
| Total labor force                      | 6,662              | 6,640                      | 6,625                      |  | -0.2  |   | -0.3       |                  | -0.3       |
| Total employment                       | 6,320              | 6,330                      | 6,325                      |  | 0.0   |   | 0.2        |                  | -0.1       |
| Employees                              | 5,340              | 5,360                      | 5,365                      |  | 0.2   |   | 0.4        |                  | 0.1        |
| Unemployment rate                      | 5.1                | 4.7                        | 4.6                        |  |   |   |            |                  |            |
| Production                             | %                  | %(approx.)                 | %(approx.)                 |  |   |   |            |                  |            |
| Industrial production                  | 3.5                | 4.0                        | 1.8                        |  |   |   |            |                  |            |
| Prices                                 | %                  | %(approx.)                 | %(approx.)                 |  |   |   |            |                  |            |
| Corporate goods price index            | -0.5               | 1.4                        | 0.4                        |  |   |   |            |                  |            |
| Consumer price index                   | -0.2               | -0.1                       | 0.1                        |  |   |   |            |                  |            |
| GDP deflator                           | -1.1               | -1.3                       | -0.3                       |  |   |   |            |                  |            |
| Balance of Payments                    | trillion yen       | trillion yen<br>(approx.)  | trillion yen<br>(approx.)  |  | %   |   | %(approx.) |                  | %(approx.) |
| Balance of goods and services          | 9.6                | 9.5                        | 10.1                       |  |   |   |            |                  |            |
| Trade balance                          | 13.3               | 13.4                       | 13.1                       |  |   |   |            |                  |            |
| Exports                                | 53.4               | 59.4                       | 63.0                       |  | 6.5   |   | 11.2       |                  | 6.2        |
| Imports                                | 40.1               | 46.0                       | 50.0                       |  | 4.0   |   | 14.8       |                  | 8.7        |
| Current balance                        | 17.3               | 18.4                       | 19.9                       |  |   |   |            |                  |            |
| Current balance as a percentage of GDP | 3.5                | 3.6                        | 3.9                        |  |   |   |            |                  |            |

\*The figures in the parentheses are the contribution to GDP growth.

(Note) Assumptions are as follows. These assumptions are not projections nor forecasts of the government.

|                                  | FY2003 | FY2004 | FY2005 |
|----------------------------------|--------|--------|--------|
| World GDP (excluding Japan)      | 3.0%   | 3.8%   | 3.2%   |
| Exchange Rate (yen/dollar)       | 113.0  | 107.7  | 104.9  |
| Crude Oil Prices (dollar/barrel) | 29.5   | 38.2   | 39.8   |

(N.B.)

1. World GDP (excluding Japan) is based on the outlook of international organizations and other institutions.
2. Exchange rate is assumed to stay constant after December 1st, 2004 at the one-month average (104.9 yen/dollar) from November 1st to 30th, 2004.
3. Crude oil prices are assumed to stay constant after December 1st, 2004 at the three-month average (39.8 dollar/barrel) from September 1st to November 30th, 2004.

(Note) As Japanese economy mainly consists of private activities, the above indicators should be recognized as being subject to upside and downside risks relating to market fluctuations and other changes in circumstances.