

Fiscal 2006 Economic Outlook and Basic Stance for Economic and Fiscal Management

January 20, 2006

Cabinet Decision

1. Economic and Fiscal Management and the Japanese Economy in FY2005

(Economic and Fiscal Management in FY2004)

In FY2005, the government decided the “Basic Policies for Economic and Fiscal Management and Structural Reform 2005” (Cabinet Decision of June 21, 2005, hereinafter: “Basic Policies 2005”). Through the continuous implementation of the “Program for Financial Revival” (October 30, 2002), the target for March 2005 to reduce the non-performing loans (NPLs) of major banks has been achieved.

Moreover, the following represent some major basic economic and fiscal management measures formulated by the government.

—May—

- “The Basic Policy for the Promotion of Regulatory Reform and the Opening Up of Government-driven Markets for Entry into the Private Sector” (May 11, 2005, Headquarters for the Promotion of Regulatory Reform)

—June—

- “New Industrial Promotion Strategy 2005” (June 8, 2005)

—November—

- “Basic Policy Direction for Total Personnel Expenses Reform” (November 14, 2005, Council on Economic and Fiscal Policy)
- “Basic Policy on the Reform of Policy-based Finance” (November 29, 2005, Council on Economic and Fiscal Policy)
- “On the Reform of Policy-based Finance” (November 29, 2005, the Meeting of the Government and the Ruling Parties on the Reform of Policy-based Finance)
- “Basic Policies for the Reform of Government Assets and Debts” (November 29, 2005, Council on Economic and Fiscal Policy)
- “The Agreement Between the Government and the Ruling Parties” on the reform package of three issues up to FY2006 (November 30, 2005)

—December—

- “Outline of Medical Care System Reform” (December 1, 2005, Meeting of the Government and the Ruling Parties on the Reform of Medical Care)
- “Important Policy of Administrative Reform” (Cabinet Decision of December 24, 2005)
- “Plan of Support for Women's Renewed Challenge” (December 26, 2005, Conference on Support Measures for Women's Renewed Challenges)
- "Science and Technology Basic Policy Report" (December 27, 2005, Council for Science and Technology Policy)

—January, 2006—

- “Independence and Challenge Plan for Young Workers” (revised edition) (January 17, 2006, Strategy Council to Foster a Spirit of Independence and Challenge in Youth)
- “IT New Reform Strategy” (January 19, 2006, the IT Strategic Headquarters)

(The Japanese Economy in FY2005)

The Japanese economy continues its moderate recovery in FY2005, after picking up from the slack movements observed in exports and industrial production by mid-2005.

As the robust performances in the corporate sector spread to households through improvements in the employment and income situations, the moderate economic recovery led by private demand is expected to continue.

With regard to prices, the Japanese economy—despite some progress toward eradicating deflation—is still in a deflationary phase. Although the real economy has been recovering at a moderate pace and the rate of decline of the consumer price index (CPI) is narrowing by the easing of deflationary pressures, the GDP deflator still continues to fall; it is being dragged down by the rising import prices due to the surge in crude oil prices.

In sum, the growth rate of real GDP in FY2005 is expected to be approximately 2.7 percent (with the growth rate of nominal GDP at approximately 1.6 percent).

2. Basic Economic and Fiscal Management Measures for FY2006

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,” on the basis of “Basic Policies 2005” and the like, the government will resolutely carry out structural reforms in every field, such as regulation, financial system, tax system, and government expenditures. It will also realize a “small and efficient government” through the steady enforcement of the privatization of the Japan Post, the reform of policy-based finance, the reform of total personnel expenses for public employees, the reform of strengthening the management of

government assets and debts, and the regulatory reform and opening up to private sector by “Market Testing.” Through promoting these policies, the government will revitalize the economy and achieve sustainable economic growth driven by private demand. Moreover, the government, together with the Bank of Japan, will further strengthen and expand policy efforts to secure the eradication of deflation.

Furthermore, the government will continue to practice decisive and flexible policy management in accordance with the economic situation.

(1) Acceleration and Expansion of Structural Reforms

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

The government will drive regulatory reform and open up to the private sector, paying serious attention to the “concrete measures” described in the “Second Report on the Promotion of Regulatory Reform and Opening up to the Private Sector”(December 21, 2005, the Council for the Promotion of Regulatory Reform). Moreover, the government will implement the “Three-year Program for Promoting Regulatory Reform and Opening up to the Private Sector,” which will be revised again by the end of FY2005.

With regard to the full scale introduction of “Market Testing” from FY 2006, the government will submit its “Improvement of Public Services Efficiency Bill (or Market Testing Bill) (provisional title)” to the 164th session of the Diet in the early stages.

Concerning Special Zones for Structural Reform, it plays roles as a breakthrough in the regulatory reform and a means to revitalize regions. On the basis of “Government Policy Based on the Opinion Expressed by Advisory Councils for Special Zones for Structural Reform” (October 21, 2005), the government will realize the prior proposals which were, on the basis of the result of general review, selected out of unrealized proposals. Furthermore, the government 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)

The government will carry out measures steadily to establish a “financial service nation,” that satisfies users of financial services, that is highly appreciated in the global market, and that contributes to regional economies. For example, the government will make efforts to swiftly legislate the “Investment Services Law (provisional title)” as a universal law of financial and investment services, on the bases of “Legislation for the Investment Services Law (provisional title)” made by the Financial System Council.

(Fiscal structure reform from both the aspect of expenditure and revenue)

Toward the sound public finance, the government first aims to achieve a surplus in the primary balance of the central and local governments combined in the early 2010s, continuously suppressing the size of government.

Concerning concrete measures, the government will continuously advance the examination following the three principles: “small and efficient government,” Principle of Vitality, and Principle of Transparency, and will clarify options for the direction and the process of the reform in the middle of 2006.

Through such efforts, the government will reach the conclusion on the fiscal structure reform from both the aspect of expenditure and revenue within FY2006.

(Expenditure Reform)

On the basis of the “Basic Principles of FY2006 Budget Formulation” (Cabinet Decision on December 6, 2005), the government will stick to and strengthen the basic line of the “Budget for Reform Resolution,” to work toward the realization of small and efficient government. Concerning the FY2006 budget, the government will thoroughly review expenditures in toto, reduce the scale of the general expenditures and the general account expenditures from the previous fiscal year, and make sharp cuts in the amount of new government bond issues from the previous fiscal year, to below 30 trillion yen. Moreover, the government will work on the drastic reform of special accounts.

(Comprehensive and Drastic Tax Reform)

Concerning the tax system, on the basis of the “Basic Policies 2005” and the outlines of the existing tax reform of the ruling parties, the government will continue to advance comprehensive and drastic examination of the tax reform proposals and to reach a conclusion within the Concentrated Consolidation Period.

In FY2006 Tax Reform, to accomplish a “desirable tax system” for realizing the sustainable invigoration of the Japanese economy and society, the government will take appropriate measures on personal income taxation such as the proportional across-the-board tax credit, the taxation related to corporation, the taxation of land and housing, the taxation of international transactions, liquor taxes, and tobacco taxes.

(The “Three-Part Reform Package”)

In accordance with the “Agreement Between the Government and the Ruling Parties” on the reform package of three issues up to FY2006 and the four “Basic Policies” formulated since FY 2001, the government will steadily realize the reform of state subsidies over four trillion yen, the transfer of tax revenue resources of approximately three trillion yen, and the reform of local

allocation taxes. To further promote decentralization and the administrative and fiscal reform at the national and local levels, on the basis of the results of the reform until FY2006, the government will take measures to establish the self-reliance and responsibility of regions in a true sense.

(The Social Security System)

In accordance with discussions on integrated reforms of the entire social security system to establish a sustainable system to the future, in FY2006 the government will practice the reforms of medical care, nursing care and other health-related areas. Concerning the medical care system, to firmly maintain universal care and to establish a sustainable system for the future, the government will promote structural reform along with basic ideas of “securing medical care for safety and trust and valuing of prevention,” “comprehensively promoting a proper system of medical expenses,” “achieving a new medical insurance system for the super-aging society,” all on the basis of the “Outline of Medical Care System Reform” formulated by the Meeting of the Government and the Ruling Parties on the Reform of Medical Care.

(Reinforcement of Japan’s International Competitiveness and Creation of New Industries and Businesses)

The government will examine the direction of a new development strategy that aims at the reinforcement of Japan’s international competitiveness, the improvement of productivity, and the vitalization of regional economy and SMEs. It will also promote the creation of new industries and businesses, the strengthening of the research and development and the human resource cultivation, the supports for the many challenges facing SMEs, the help develop growing sectors, the support of the growth of unique local industries, and the realization of an efficient distribution system, through measures such as the “New Industry Promotion Strategy 2005,” the third science and technology basic plan, promotion of foreign direct investment into Japan, “IT New Reform Strategy (provisional title),” the intellectual property strategy, strengthening of industrial financial systems, and “Outline of General Policies of the Distribution System from 2005 to 2009.” The government will steadily carry out its “Independence and Challenge Plan for Young Workers (revised edition)” aiming to convert “freeters” to regular employees, support the independence of “NEETs,” promote the systematic development of human resources in cooperation with regions and industries, and promote intermediation between youths and jobs.

Moreover, to cope with the change of the environment around the corporate management such as globalization, the Government will provide the basic legislation of civil and criminal affairs, developing the law for consolidation of companies, reconsidering trust legislation and insurance legislation, developing a new framework regarding electronic credit, and taking measures for ensuring compliance in corporate activities.

(Innovation and Revitalization of SMEs)

The government will promote the smooth flow of funds to SMEs, and will make the best use of the SME Revitalization Support Councils to support the innovation and revitalization of vigorous SMEs.

Moreover, the government will develop a new framework to intensively support SMEs which has the basic technology of manufacturing.

(Regional Revitalization)

The government will promote regional revitalization measures, such as human resource development and construction of a human resource network for regional revitalization, the expansion of local government discretion by subsidies reform, and the promotion of utilization of the funds and expertise of the private sector, aiming at vitalization of regional economies by wisdom and device. Especially, to support regional voluntary actions in cooperation with universities, the government will promote its “Program to Revitalize Bases of Knowledge in Regions,” which contains support measures coordinated among ministries.

(Efforts Directed Toward Ending Deflation)

The government will promote the structural reforms of various areas to further reduce the GDP gap. Together with the Bank of Japan, the government will further strengthen and expand policy efforts aimed at eradicating deflation. The government expects that the BOJ will implement effective monetary policy management, which will be consistent with the government’s efforts and economic perspectives, and will promote proper formation of expectations in financial markets.

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

In today’s ever-globalizing economy, the government will accelerate and strengthen external economic policies with domestic structural reforms in an integrated manner.

To vitalize the Japanese economy, the government will make energetic efforts for the final agreement on the World Trade Organization (WTO) Doha round by the end of CY2006.

Concerning the Economic Partnership Agreement (EPA), including the Free Trade Agreement (FTA), on the basis of the “Basic Policy Toward Further Promotion of Economic Partnership Agreements” (December 21, 2004), the government will realize the smooth implementation of the concluded agreements, and will endeavor toward early conclusion of the bilateral agreements with Asian countries, the agreement with ASEAN as a whole, and so on.

3. Economic Outlook for FY2006

As private consumption and business investment continue to grow, the Japanese economy in FY2006 is expected to continue a moderate recovery led by private demands.

With regard to prices, joint efforts by the government and the Bank of Japan will give a decent prospect to end deflation, turning year-on-year CPI and the GDP deflator into positive territory by a narrow margin in FY2006. When making a judgment regarding the end of deflation, it is critical to make comprehensive and cautious consideration on the trend and the backgrounds of price movements.

In sum, the economic outlook for FY2006 is shown in the attachment, and the growth rate of real GDP in FY2006 is expected to be approximately 1.9 percent (with the growth rate of nominal GDP at approximately 2.0 percent).

(1) Real Gross Domestic Product

① Private Consumption Expenditure

As the employment and income situations improve, private consumption is expected to continue growing (an approximate 1.6 percent increase from the previous year).

② Private Residential Investment

As the employment and income situations improve, private residential investment is expected to remain at a sound level (an approximate 0.4 percent increase from the previous year).

③ Private Non-residential Investment

Supported by the improvement in corporate profits, private non-residential investment is expected to continue growing (an approximate 5.0 percent increase from the previous year).

④ Public Expenditure

As the government sticks to and strengthens the basic line of the “Budget for Reform Resolution,” which will reduce public investment and restrain the natural increase of public medical and nursing care insurance payments through the reforms in medical and nursing care systems, public expenditure is expected to be reduced (an approximate 0.9 percent decrease from the previous year).

⑤ External Demand

As the world economy expands, external demand is expected to continue growing (net export contributes approximately 0.4 percent to the real GDP growth rate).

(2) Labor and Employment

Japan’s labor and employment situations are still severe, but are expected to show improvements on a broader basis and the unemployment rate is expected to show a little

improvement from the previous year (approximately 4.1 percent).

(3) Industrial Production

As both domestic and external demands increase, industrial production is expected to continue its expansion (an approximate 2.9 percent increase from the previous year).

(4) Prices

Domestic corporate goods price index is expected to continue growing (an approximate 0.9 percent increase from the previous year). CPI (an approximate 0.5 percent increase from the previous year) and the GDP deflator (an approximate 0.1 percent increase from the previous year) are expected to turn into positive territory by a narrow margin.

(5) Balance of Payment

As both exports and imports will increase due to the continuing growth of the world economy and domestic demand, the current account surplus, along with the large income account surplus, is expected to increase slightly (the current account surplus will represent approximately 4.0 percent of nominal GDP).

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

(Note 1) These economic trends and outlook are premised on the policies listed in “Basic Economic and Fiscal Management Measures for FY2006.”

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

Main Economic Indicators

	FY2004 (actual)	FY2005 (estimate)	FY2006 (forecast)	Percentage changes over the previous fiscal year					
				FY2004 (actual)		FY2005 (estimate)		FY2006 (forecast)	
				trillion yen (approx.) current prices	trillion yen (approx.) current prices	trillion yen (approx.) current prices	%	%	% (approx.)
Gross domestic product	496.2	503.9	513.9	0.5	1.7	1.6	2.7	2.0	1.9
Private consumption expenditure	285.2	289.1	294.3	1.0	1.7	1.3	1.9	1.8	1.6
Private residential investment	18.3	18.3	18.5	2.3	1.7	0.0	-0.7	1.0	0.4
Private non-residential investment	71.1	75.9	79.6	4.4	5.4	6.8	7.7	4.8	5.0
Increase in private inventory	-1.0	-0.4	0.3	(-0.3)	(-0.3)	(0.1)	(0.1)	(0.1)	(0.1)
Government expenditure	113.6	114.3	113.2	-1.9	-1.4	0.6	0.5	-1.0	-0.9
Government consumption	89.3	90.7	91.0	0.9	1.8	1.6	1.7	0.3	0.6
Public investment	24.0	23.5	22.2	-11.4	-12.4	-2.3	-3.4	-5.4	-6.2
Exports of goods & services	67.0	73.8	81.1	11.0	11.4	10.0	7.7	9.9	7.3
Less: Imports of goods & services	58.1	67.1	73.1	13.5	8.7	15.5	7.2	8.9	5.1
Contribution of domestic demand				(0.6)	(1.3)	(2.0)	(2.5)	(1.7)	(1.5)
Contribution of private demand				(1.0)	(1.6)	(1.9)	(2.4)	(1.9)	(1.7)
Contribution of public demand				(-0.4)	(-0.3)	(0.1)	(0.1)	(-0.2)	(-0.2)
Contribution of external demand				(-0.1)	(0.5)	(-0.5)	(0.2)	(0.3)	(0.4)
National income	361.0	367.7	375.6	0.7		1.8		2.2	
Compensation of employees	255.4	259.6	264.3	-0.3		1.6		1.8	
Property income	10.1	11.2	12.7	31.8		10.8		13.3	
Entrepreneurial income	95.5	96.8	98.6	1.0		1.3		1.8	
Labor & Employment	ten thousands	ten thousands	ten thousands			% (approx.)		% (approx.)	
Total labor force	6,639	6,660	6,660		-0.3		0.3		0.0
Total employment	6,332	6,370	6,385		0.2		0.6		0.2
Employees	5,355	5,410	5,440		0.3		1.0		0.5
Unemployment rate	%	% (approx.)	% (approx.)						
	4.6	4.3	4.1						
Production	%	% (approx.)	% (approx.)						
Industrial production	4.1	1.8	2.9						
Prices	%	% (approx.)	% (approx.)						
Domestic corporate goods price index	1.5	1.7	0.9						
Consumer price index	-0.1	-0.1	0.5						
GDP deflator	-1.2	-1.1	0.1						
Balance of payments	trillion yen	trillion yen	trillion yen			%	% (approx.)	% (approx.)	
		(approx.)	(approx.)						
Balance of goods and services	9.6	7.0	8.5						
Trade balance	13.2	9.8	11.5						
Exports	58.8	64.3	71.2		10.2		9.3		10.8
Imports	45.7	54.5	59.8		13.2		19.3		9.6
Current balance	18.2	18.4	20.7						
Current balance as a percentage of GDP	%	% (approx.)	% (approx.)						
	3.7	3.7	4.0						

*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.

	FY2004	FY2005	FY2006
World GDP (excluding Japan)	3.7%	3.3%	3.4%
Exchange rate (yen/dollar)	107.5	113.6	118.4
Crude oil prices (dollar/barrel)	38.7	54.6	56.5

(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, 2005 at the one-month average (118.4 yen/dollar) from November 1st to 30th, 2005.
3. Crude oil prices are assumed to stay constant after December 1st, 2005 at the three-month average (56.5 dollar/barrel) from September 1st to November 30th, 2005.