

Structural Reform and Medium-Term Economic and Fiscal Perspectives – FY2003 Revision

January 19, 2004

Cabinet Decision

The Japanese economy shows promising signs for forward-looking movements mainly in the corporate sector, such as an improvement in corporate profits and an increase in business investment.

Behind this lies the fact that, in addition to a cyclical recovery of demand in the world economy, structural reforms have begun to bear fruit, as can be seen in the improvement of private-sector corporations' earnings structure brought about by their ceaseless reform efforts and active corporate/industry reorganizations prompted by establishment of corporate legal systems.

The government intends to step up policy efforts so that the promising signs will spread throughout the Japanese economy, from corporations to households and from cities to local regions, and thus to realize sustainable economic growth led by private-sector demand.

On the other hand, the Japanese economy still remains in a mild deflationary situation, although the rates of decline in Consumer Prices Index and Domestic Corporate Goods Prices Index have been getting smaller on the whole. In order to prevent deflation from impeding the fruits of corporate efforts, the government and the Bank of Japan will work together to promote measures aimed at overcoming deflation.

So that economic and fiscal management is always conducted with an approximately five-year medium-term basic policy and perspective in mind, the "Structural Reform and Medium-Term Economic and Fiscal Perspectives – FY2003 Revision" (hereafter referred to as "Revision") covers up to fiscal 2008, while a longer-term perspective is included with regard to a primary balance surplus in the early 2010s.

The "Revision" focuses on the basic policy for medium-term economic and fiscal management and the future economic and fiscal outlook, as well as on the acceleration of structural reforms from the standpoint of expanding private-sector demand¹ that is

¹ The role of the "Reform and Perspectives" is to ensure the consistency of short-term and medium-term economic and fiscal policies by presenting a medium-term economic and fiscal vision, to show medium- and long-term sustainability of public finance and social security, and to fulfill accountability about the reasonableness of economic and fiscal policies.

"The Revision" is based on the "Reform and Perspectives" and closely linked to the

closely linked to the role of the “Structural Reform and Medium-Term Economic and Fiscal Perspectives” (Cabinet Decision of January 25, 2002, hereafter referred to as “Reform and Perspectives”).

The policies incorporated in the “Reform and Perspectives” are those that should be implemented by the government. The targets concerning the government sector are those that the government should strive for to reach their realization, taking account of economic and fiscal conditions. Figures concerning the private sector are perspectives based on certain policies that the government will implement.

1. Economic and Fiscal Conditions

* Because of the continuing severe domestic and international economic conditions, the “Reform and Perspective-2002 Revision” (Cabinet Decision of January 24, 2003) estimated that the real growth rate would remain below 1% and that the nominal growth rate would go even lower during the intensive adjustment period to FY2004, or at least in the short-term.

* In view of the recent economic conditions, the real economic growth rate for FY2003 is likely to come to around 2.0% and nominal growth rate to around 0.1% due to the faster-than-expected recovery of the U.S. and other economies. The economy is picking up, as the employment situation, though still severe, shows movements of incipient recovery and the corporate sector shows forward-looking movements, such as improvement in profits. However, the recovery is seen mainly in large corporations and in the manufacturing industry, showing disparity between different sizes and categories of corporations. There is also a regional disparity in economic improvement.

* Aiming for the realization of sustainable growth led by private-sector demand, the government will improve environments to spread the economic recovery movements to small and medium corporations and non-manufacturing industries and to households and accelerate “From Public Sector to Private Sector” and “From Central Government to Local Government” reforms to spread the effects of the economic recovery from cities to local regions and to every corner of the Japanese economy. These efforts will also help the economy cope with risks concerning overseas economies and the movement of stock prices, exchange rates, and long-term interest rates.

* At present, both the Consumer Price Index and the Domestic Corporate Goods Price

“Basic Policies for Economic and Fiscal Management and Structural Reform 2003”(Cabinet Decision of June 27, 2003), and advances structural reform in combination with these.

Index move almost sideways on a month-to-month basis and their margins of decline have narrowed on a year-to-year basis, though they are continuing their decline on the whole. In addition, corporations' concerns about deflation have begun to show signs of improvement. Although the Japanese economy is in a mild deflationary situation, these movements, taken together, show signs of change.

* With regard to public finance, the government has been implementing stable economic and fiscal management in line with the "Reform and Perspectives" to establish sustainable public finance.

2. Basic Policy on Medium-term Economic and Fiscal Management

(Stable economic and fiscal management)

* Economic and fiscal policies will be administered in a stable manner during the stipulated period (up to FY2008), and due consideration will be given to the automatic stabilizer function of fiscal policy. In addition, under extremely severe economic conditions, policy management will be carried out boldly and flexibly.

(Intensive adjustment period and measures to overcome deflation)

* The intensive adjustment period is an important time of preparation for promoting reforms intensively and realizing medium-term economic growth led by private-sector demand. Until the end of the intensive adjustment period, the government will make policy efforts, such as acceleration and expansion of structural reform, in order to overcome deflation and realize sustainable economic growth led by private-sector demand.

* In order to overcome deflation and expand private sector demand continuously, an approach from a financial point of view is necessary, such as effective monetary policy and strengthening of its spillover mechanism.

* These efforts on the part of the government and the Bank of Japan are expected to shake off people's concerns about deflation.

* In accordance with this basic policy stance, the government will accelerate and expand structural reforms, while focusing on the expansion of private-sector demand and employment. Based on the achievements made so far, the government will accelerate disposal of non-performing loans, with the aim of resolving the non-performing loans issue by FY2004. These efforts are expected to contribute to overcoming deflation mainly through the following five effects.

(1) Under the philosophy of “from the public to the private sector,” the government will promote creative corporate activities and expand new demand by further promoting regulatory reforms, such as opening of administrative services in the private sector and creation of special zones for structural reform, and by developing corporate- and reorganization-related systems.

(2) The government will reduce unforeseeable factors and risks for the lives of the people and private economic activities by continuously carrying out measures to establish sustainable public finance and a sustainable social security system.

(3) The government will create an environment to improve the private sector’s profitability through such measures as reform toward the creation of a more robust financial system and promoting corporate and business revival and financial revival in an integral manner. These efforts are expected to have favorable effects on asset prices.

(4) The government will realize sustainable invigoration of the economy and society and ensure the confidence for the future by implementing a comprehensive and fundamental tax reform.

(5) By implementing the above measures (1) through (4), the government will increase the expected growth rate of the economy and expand money demand and, at the same time, facilitate money supply through recovery of the financial intermediary function and enhancement of the industrial financial function.

* The government and the Bank of Japan will act as one to overcome deflation and to turn the price growth rate to a positive figure as soon as possible.

The Bank of Japan has committed that it will maintain the quantitative easing policy until the Consumer Price Index (excluding fresh food, on a nationwide basis) registers stably a zero percent or an increase year on year. Moreover, in order to strengthen the transparency of its monetary policy, the Bank of Japan in October 2003 announced specific conditions concerning the continuation of quantitative easing, making its commitment clear². The Bank is expected to continue ample supply of money

² (Reference: “*Enhancement of Monetary Policy Transparency*” (summary) October 10, 2003; Bank of Japan)

Such commitment is underpinned by the following two conditions.

First, it requires not only that the most recently published core CPI should register zero percent or above, but also that such tendency should be confirmed over a few months.

Second, the Bank needs to be convinced that the prospective core CPI will not be expected to register below zero percent. This point will be described in such materials as the analysis and the forecasts of Policy Board members in the Outlook Report. To be more specific, many Policy Board members need to make the forecasts that the core CPI

in line with the commitment.

In addition, the structural reform toward the creation of a more robust financial system by the government and the efforts to strengthen the spillover mechanism of monetary policy by the Bank of Japan are expected to increase supply of money.

(Economic outlook)

* Since the deflationary pressure is expected to decrease gradually through the combined efforts of the government and the Bank of Japan, as noted above, and the Consumer Price Index (excluding fresh food, on a nationwide basis) is expected to post a positive growth, gradually bringing positive growth in other price indexes along with it, a steady progress toward overcoming deflation can be expected.

* In FY2004, the real growth rate is expected to come to about 1.8% and the nominal growth to about 0.5%. After the intensive adjustment period, the economy will go on a medium term growth path of 1.5% or higher in real terms, and will achieve a growth path of around 2% or higher in nominal terms from FY2006.

* When making a judgment on price movements, it is important to take price-related statistics, such as including the Consumer Price Index, into consideration in a comprehensive manner. In doing so, statistical properties of each statistic, such as the scope of items covered and calculation method, should be fully kept in mind.

(Targets for expenditure control and the primary balance)

* In the "Reform and Perspectives," the government aims at holding the size of government (ratio of general government expenditure to GDP) at or below its FY2002 level until FY2006. The government will also continue to consider the relationship between benefits and cost burdens. In the FY2004 budget, as in the FY2003 budget, the government set the goal of holding general account expenditures and general expenditures at levels lower than those of the previous fiscal year in substance. Local public finance is also in accordance with this policy.

* Fiscal soundness cannot be achieved without steady economic growth and appropriate fiscal structural reform. To ensure tangible improvement to the fiscal balance in the medium term, the government will accelerate structural reform to realize sustainable

will register above zero percent during the forecasting period.

The above conditions are necessary. There may be cases, however, that the Bank will judge it appropriate to continue with quantitative easing even if these two conditions are fulfilled.

economic growth led by private-sector demand and accelerate expenditure reform. Through this kind of action, the primary balance deficit and its ratio to GDP, which stood at 5.5% in FY 2002 and 2003, will be reduced gradually starting in FY2004.

* Additionally, by FY2006, with the continuing efforts of both central and local governments to reduce expenditure, based on assessment of necessary public services and expenditure levels, as well as on the status of economic revitalization and fiscal conditions, the government will judge what tax measures are required.

* Beyond FY2007, the government aims to achieve a surplus in the primary balance in the early 2010s through continuing the same level of effort as before to improve the fiscal balance and realization of sustainable economic growth led by private-sector demand.

* The economic and fiscal outlooks mentioned above should be interpreted with considerable range, since they are accompanied by various unforeseeable factors.

3. Acceleration and Expansion of Structural Reform

Amid the progress of structural reform, the Japanese economic and social structures have been undergoing a drastic change. The rapid spread in the use of information technology has been a drastically changing industry, as have the lives of the people. Business establishments in the field of the telecommunications-related service industry, software industry, and nursing care have increased sharply, leading to expanded employment. Special Zones for Structural reform that make the most of regional wisdom and ingenuity are making rapid progress, and efforts for the revitalization of unique cities are now being made in various parts of the country.

In order to expand these movements and ensure the economic and fiscal shapes described so far, the government will bring out a reform timetable and accelerate and expand structural reform under the following policies. Through these efforts, the government will overcome deflation, realize sustainable economic growth led by private-sector demand, and achieve a surplus in the primary balance of the central and local governments combined. In doing so, the government will realize the philosophy of “from the public sector to the private sector” as a systemic/regulatory reform and place emphasis on the idea of “from the Central Government to Local Government” and on creativity and ingenuity in the field.

Through structural reform, the government aims to create the following economic society in the medium term.

- (1) where every individual can contribute to the revitalization of the economy by

bringing his/her individuality and abilities into full play,

(2) where elderly people can become active and where young people can take opportunities through their efforts and studies,

(3) where anyone, regardless of age and gender, can find motivation in their work,

(4) where people can take an active part and contribute to the world not only in trade and investment but also in a wide-range of fields, such as research and development, culture and art, and sports,

(5) where local regions in the “spirit of the self and independence” can bring regional attraction and individuality into full play by utilizing their manpower, history and culture,

(6) where safety and security are ensured and where people can live without fear.

(1) Strengthening of economic growth led by the private sector toward the realization of a vigorous and dynamic economic society

Amid rapid progress toward globalization, the government, based on science and technology, intellectual creativity, diverse regional resources, and people’s potential demand, etc., will strengthen economic growth led by private demand by implementing measures to create new industries, building distinctive regional industries, and expanding diverse and high-quality employment opportunities.

(Settlement of the problem of non-performing loans and corporate/business revival in an integral manner)

* The government will dissolve the problem of non-performing loans by FY2004 through steady implementation of measures, such as “Program for Financial Revival.”

* The government will create a new public fund system for strengthening the financial function in order to revitalize the economy and stabilize and strengthen the financial system.

* The government will promote regional industrial and financial revival in an integral manner through creation of revival funds for regional small and medium corporations, in addition to strengthening the relationship banking function.

(Promotion of regulatory reform and special structural reform zones for “From Public to Private Sector”)

* Regulatory reform is to be pushed forward even more aggressively and policies to promote competition are to be strengthened.

* With regard to special zones for structural reform, the government will realize as

many regulatory reforms as possible, and, based on the assessment of the effects of exceptional measures in regulatory reform, implement regulatory reform on a nationwide basis starting in 2004.

* The government will reform the systems and regulations impeding the opening of public services to the private sector.

(Creation of new industries/businesses, promotion of investment, and strengthening of the industrial financial function, etc.)

* Through the formulation of strategies to create new industries and the promotion of strategies for intellectual property, the government will promote measures such as for creating new businesses, supporting the businesses of small and medium corporations attempting to make inroads into new fields, developing and promoting growth fields, and creating unique regional industrial clusters.

* Based on the Science and Technology Basic Plan, the government will place strategic importance on science and technology, continue to promote science and technology system reform, and realize a nation based on creativity of science and technology. In addition, the government will promote effective utilization of IT through promotion of the e-Japan Strategy II.

* Through strengthening the monitoring function in the securities market, reforming the securities settlement system, creating a trust system and so on, the government will make the money market more efficient and competitive and accelerate the flow of funds from savings to investment.

* The government will create a flow of diverse funds by promoting the establishment of framework for investment partnerships and introducing new leaders and methods to support securitization.

* The government will create a guarantee system (ex. posting system for transfer of movable assets) utilizing inventories, etc. instead of real estate and review the “comprehensive personal guarantee” that has been criticized for its excessiveness in order to improve personal guarantee practices.

(Strengthening of employment creation)

* The government will expand employment creation by steadily promoting the 5.3 Million Job Creating Program, mainly in the fields of elderly care-related services, information and communications, and the tourism industry.

* The government will focus on policies concerning elimination of labor demand-supply mismatch, manpower development and job training, and support for labor movement.

In doing so, the private sector will be actively utilized.

* By actively utilizing the private sector, the government will promote the Independence and Challenge Plan for Young People for job assistance for school graduates, enhancement of education and human resource development, and creation of employment opportunities.

(Promotion of economic partnerships, including free trade agreements)

* The government will accelerate the circulation/movement of goods, humans, and money by promoting economic partnerships, including free trade agreements, with East Asian countries, Mexico and other countries. Additionally, the government will strive to increase direct foreign investment in Japan and create an environment to double foreign visitors to Japan in order to realize a country built on tourism.

(2) Real Self-held and revitalization of local regions

Development of a country is impossible without diversified development of its regions. In order to make the most of the original idea of “balanced development,” the government will strive for the revitalization of regional economies, attaching importance to “development of unique regions” and “revitalization through competition in wisdom and ingenuity.”

(Strengthening measures for the revitalization of regional economies)

* Based on the “Basic Policies on the Revitalization,” the government formulated the “Program” in late February of 2004 and will strive to achieve prompt results based on it.

* The government will promote management innovation, such as change of business, in local key industries, such as the construction industry. The government will also promote creation of industries and businesses making the most of regional characteristics, such as tourism and food industries, revitalization of small and medium-sized enterprises, and symbiosis/convection of cities and rural districts. As for agriculture, the government will promote structural reforms, such as concentrated/focused support for “professional” farm management, the promotion of corporative management by joint stock companies/agricultural legal persons, including agricultural cooperative reform.

* The government will strengthen employment assistance according to the actual regional situations and extend support to local governments’ voluntary project for job creation. In doing so, the government will promote the establishment of a system that makes it possible for local governments to consign the project to the private sector.

(Implementation of the “ Reform of the Three Major Policies”)

* Based on the “Basic Policies 2003,” the government will eliminate or reduce state subsidy by 1 trillion yen. Also, based on the agreement of the “the Reform of the Three Major Policies” (for the allocation of financial resources, including state subsidies, local allocation taxes, and the transfer of tax sources to local government) reached at a meeting between the government and the governing parties, the government will realize a full-scale transfer of tax sources from central government to local governments by FY2006, and as a temporary measure until then, the government, in the tax reform for FY2004, will create an income transfer tax in order to transfer part of income tax to local governments. As for the reform of local allocation taxes, the government will reduce the size of the fiscal plans of local governments in order to curb the total amount of local allocation taxes.

* Based on the “Basic Policies 2003,” the government will eliminate or reduce state subsidies by about 4 trillion yen by FY2006, and eliminate and reduce the funding guarantee function of local allocation taxes. At the same time, with regard to the projects that are affected by the abolition of state subsidies but need to be carried out by local governments, the government will transfer tax sources by increasing the fundamental tax. The Council on Economic and Fiscal Policy will promote discussions on accelerating and strengthening the Reform Timetable for the “ Reform of the Three Major Policies” plan. The reform of the tax resource allocation, including transfer of tax resources to local governments, may result in creating a gap in financial capability among local governments. In such a case, the government will take appropriate measures to reduce the gap.

(3) Measures against declining birthrates and establishment of sustainable social security system)

The government will extensively strengthen the measures concerning support for fostering next generation people to change the tide of declining birthrates and develop a sustainable social security system to create a society that provides young people with a promising outlook for the future and older people with a sense of security.

* The government, with support of the whole people, will tackle the problem of declining birthrates based on promotion of the “strategy for no children waiting lists for day-care centers,” review of the maternity leave system, consideration for the child-care period in the public pension system, and the “Outline of Measures for Society with Fewer Children” that will be formulated in the near future.

* Social security services, such as pension, medical care, nursing, and livelihood protection, should be promoted in an integral manner and their system designs should be interrelated in order to provide high-quality, efficient services. While ensuring the security of the people by establishing a sustainable social security system, the government will restrain the growth of social security benefit expenditure.

(4) Establishment of sustainable public finance

With the aim of realizing a lean and efficient government, the government will establish sustainable public finance by continuously implementing expenditure reform and comprehensive, drastic tax reform.

(Expenditure reform aimed at realizing a lean and efficient government)

* Based on the "Reform and Perspectives," the government aims to hold the size of government at or below the FY2002 level until FY2006. Special accounts will also come under review without sanctuary for abolition/rationalization of projects and higher fiscal discipline.

* Also based on the "Reform and Perspectives," the government will promote more focused and efficient public investment until FY2006 and reduce costs to the level seen before substantial economy-boosting measures were additionally taken.

* While drastically lowering the ceiling of the Total Staff Number Law and appropriately assigning personnel to the sectors that are really necessary, such as for public security, the government will drastically rationalize the number of national government workers. Total staff costs will be reduced as much as possible. Local governments are also expected to take measures to restrain total personnel expenses in line with the central government's move.

* The government will give priorities to policies that utilize private-sector demand and private sector potentiality to the fullest extent and will continue to utilize multi-year projects.

(Continued implementation of comprehensive and fundamental tax reform)

* Based on the philosophy of the "Basic Policies 2003," the government will continue to implement comprehensive and fundamental tax reform centering on the following issues: 1) further reform toward sustained economic revitalization; 2) integrated study of tax burden and social security burden; and, 3) ideal allocation of financial resources, including state subsidies, local allocation taxes, and the transfer of tax sources to local government. In doing so, conducting a thorough review of expenditures, the government

will also examine what tax measures are required, while fully assessing economic and fiscal conditions.

(Reform of budget system)

* Under the above medium-term guidelines, the government will control the major areas of expenditure from the standpoint of a multiple-year budget.

* In addition to expanding the new budget formulation process as a model projects, the government will expand the budget formulation process based on “declaration, execution, and evaluation” to the whole budget.

(Management of public debt)

* The government will restrain government bond issuance as much as possible and manage various risks involved in public debt appropriately and specifically.