

Structural Reform and Medium-Term Economic and Fiscal Perspectives - FY2004 Revision

January 21, 2005
Cabinet Decision

1. About FY2004 Revision¹

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

The government, in a body with the Bank of Japan, will further strengthen its policy efforts aimed at overcoming deflation. Additionally, the government will accelerate and expand structural reforms to realize sustainable economic growth led by private-sector demand.

By positioning the two years of FY2005 and FY2006 as the "Concentrated Consolidation Period," the government will make further efforts to promote structural reforms, ensuring the breakaway from deflation, and focus on consolidating fundamentals for new growth.

Based on these standpoints, the role of the "Structural Reform and Medium-Term Economic and Fiscal Perspectives - FY2004 Revision" 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 rationality of economic and fiscal policies.

Concerning the medium-term policy plans to be dealt with in the future, not mentioned in the "Revision", the "Reform and Perspectives" and its revisions will be the basis for policy management. Additionally, the "Revision" is closely linked to the "Basic Policies for Economic and Fiscal Management and Structural Reform - FY2004 (Cabinet Decision of June 4, 2004, hereafter referred to as the "Basic Policies 2004"), and the government will promote structural reform in combination with these.

The "Revision" covers up to FY2009. It envisages the achievement of a primary balance² surplus in the early 2010s.

The method for actualization³ used to estimate the National Accounts was changed, making the method of estimating the real economic growth rate and GDP deflator⁴ more reflecting the economic realities, while having no direct influence on the nominal growth rate and the primary balance.

¹ The "Structural Reform and Medium-Term Economic and Fiscal Perspectives" (Cabinet Decision of January 25, 2002, hereafter referred to as "Reform and Perspectives") specifies that it should be revised every fiscal year to correspond appropriately to economic conditions. The FY2004 revision (hereafter referred to as the "Revision") is the third revision.

² The primary balance refers to the fiscal balance of the "tax and other revenue excluding borrowing" minus the "expenditure excluding principal and interest payments for the existent debts".

³ The estimation method of real GDP was changed from the method that fixes base year (based on 1995) to the present chain-linking method.

⁴ The real growth rate is calculated by reducing the nominal growth rate from the percentage change of the GDP deflator.

2. Economic and Fiscal Conditions

The "Intensive Adjustment Period" (FY2002 - FY2004) started in the grim economic conditions shown by enormous non-performing loans and negative growth, both in nominal and real terms, in FY2001. However, through the policy efforts in the past three years, Japan has been making a steady progress in bringing an end to the non-performing loan problems and Japanese economy has been shifting from prolonged stagnation to economic growth led by private-sector demand.

* The "Reform and Perspectives" and the "Structural Reform and Medium-Term Economic and Fiscal Perspectives - FY2002 Revision" (Cabinet Decision of January 24, 2003) expected that "the real growth rate will remain below 1% and nominal growth rate will go even lower during the intensive adjustment period, or at least in the near-term." However, on account of the improvements in the corporate sector, the economic growth rate for FY2004 is expected to be about 2.1 percent in real terms and 0.8 percent in nominal terms. In employment, the unemployment rate that deteriorated to 5.5 percent in January, 2003, is now hovering around 4 percent, and the overall situation, although still grim, has been improving.

While the per capita wage remains stagnant, with high unemployment rate for the younger generation persisting, the current economic recovery varies greatly from region to region. Besides, it should be noted that the future movements of exchange rates, oil prices and the world economy could have influence on the Japanese economy.

* With respect to prices, Domestic Corporate Goods Prices has been rising from 2004 mainly due to an increase in raw material prices such as for oil, but Consumer Prices still shows a slight downward trend compared to the previous year. The GDP deflator has also been declining moderately. Considering these price movements in a comprehensive manner, it can be seen that the Japanese economy is in a mild deflationary situation and measures to overcome deflation are still our key policy issue.

* With respect to public finance, the government, in view of promoting public expenditure reform, has maintained stable fiscal management since the FY2002 budget by holding general account expenditures and general expenditures at levels lower than those of the previous fiscal year in substance. Local government expenditures have also been under intense review in accordance with the national policy. Meanwhile, tax revenue has been on the increase against a background of rising corporate profits. Taking these factors into account, the primary balance deficit (its ratio to GDP) were stood at 5.5 percent for both FY2002 and FY2003, are expected to be around 4.4 percent for FY2004.

* With regard to structural reform, there has been a steady progress toward normalizing the problem of non-performing loans as exemplified by the steady decline in the major banks' non-performing loans ratio in accordance with the target of halving the ratio as set by the "Program for Financial Revival". With the corporate and industrial revival and financial revival in an integral manner, the activation of creating new businesses and the progress of deregulation, economic resources have been shifting from stagnant industries to new industries and growth industries have been showing strong business expansion. All these indicate that the dynamism of the Japanese economy is now being regenerated.

Under the above-noted economic and fiscal conditions, the government is expected to maintain proper economic and fiscal management by applying the current medium-term basic policy and perspectives.

3. Basic Policy for Medium-Term Economic and Fiscal Management

During the Concentrated Consolidation Period, the government will step up the structural reform programs including the "From Public Sector to Private Sector" and "From State to Regions" reforms, in order to establish the path for sustainable economic growth led by private-sector demand and to focus on consolidating the fundamentals for new growth. Additionally, the government intends to stay firmly on the path of public expenditure reform.

The government is now required to start examination to clarify the basic policy for the medium-term economic and fiscal management that will be introduced after the Concentrated Consolidation Period.

(1) Measures to overcome deflation

In order to ensure the breakaway from deflation, the government in a body with the Bank of Japan (BOJ) will further strengthen its policy efforts.

To further improve the supply and demand gap, the government will accelerate and expand the structural reforms aimed at each sector of regulations, financing, tax and public expenditure.

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) Stable Economic and Fiscal Management

Economic and fiscal management during the stipulated period (up to FY2009) will be implemented in a stable manner based on the "Revision", and due consideration will be given to the automatic stabilizer function of fiscal policy.

In addition, giving consideration to the economic situation, policy management will be carried out boldly and flexibly under extremely severe economic conditions.

(3) Economic Outlook⁵

* The deflationary pressure has been gradually weakened through the combined efforts of the government and the Bank of Japan. While the Domestic Corporate Goods Prices Index is on the rise, the Consumer Prices Index (excluding fresh food, on a nationwide basis) is expected to post a positive growth after the intensive adjustment period, gradually bringing positive growth in GDP deflator along with it. Thus, a steady progress toward overcoming deflation can be expected.

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

* With the recovering productivity of the corporate sector on the one hand and the decreasing working population on the other, promoting structural reforms for maintaining

⁵ The economic and fiscal outlooks mentioned above should be interpreted with considerable range, since they are accompanied by various unforeseeable factors.

and improving Japanese economic vitality will enhance the potential for medium-term growth. In addition to these programs, it is likely that strategic investment aimed at creating new businesses and strengthening competitive power will expand and lessening insecurity about employment through improvement in the employment situation will lead to a stable increase in household consumption. In view of these factors, the real growth rate is expected to come about 1.6 percent and nominal growth to about 1.3 percent FY2005. In FY2006 and thereafter, the economy will go on a growth path of around 1.5 percent or higher in real terms and around 2.0 percent or higher in nominal terms.

(4) Targets for Expenditure Control and Primary Balance

Fiscal soundness cannot be achieved without steady economic growth and appropriate fiscal structural reform. The government aims to ensure the size of government (ratio of general government expenditure to GDP) does not exceed the FY2002 level until FY2006, and stays firmly⁶ on the path of public expenditure reform in accordance with local governments.

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 progress of economic revitalization and fiscal conditions, the government will judge required measures for taxation.

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 government starts examining the combined reform of revenue and expenditure concerning the above efforts to improve the fiscal balance beyond FY2007 and reach a conclusion within the concentrated consolidation period.

4. Further Efforts for Structural Reform

(Further efforts for structural reform)

The government will make further efforts to promote structural reform in order to 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.

Specifically, the government will make more serious efforts toward reforms based on the "From Public Sector to Private Sector" and "From State to Regions" policy, including the privatization of the postal services, regulatory reforms and the "Three-Part Reform Package".

The government will perform full-scale reform of the government sector, such as the reform of budgetary system and administrative structure, creating a lean and efficient government. Additionally, the government will examine comprehensive and drastic reforms of the tax system.

In order to draw upon the dynamism of the private sector and regional economies the government will advance corporate reorganization, develop market rules, create a vigorous and dynamic financial system as well as revitalize and strengthen local key industries and the medium and small companies that support them, raise the competitive edge of the agriculture, forestry and fisheries-related industries, and promote urban renaissance. The expansion of growth areas will be ensured by creating new industries

⁶ The "Reform and Perspectives" states, as part of the reform of the expenditure, "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" and "Total staff costs will be reduced as much as possible by the efforts such as downsizing the number of government workers. Also, the other items of general expenditures will be reduced strictly by addressing comprehensive review without sanctuary and focused budget allocation."

and strengthening R&D and human resource development through implementation of Strategies toward Sustainable and Competitive Industrial Structure and the Intellectual Property Strategy. The government will also advance IT strategies so that the majority of the public can take the advantage of fruits in this key area and realize a nation based on creativity of science and technology, in accordance with the Science and Technology Basic Plan. In view of globalization, the government will also promote economic partnerships. Direct foreign investment in Japan as well as efforts for Japan Tourism will be also encouraged.

To enhance the human resources at all age levels fundamentally, the government will promote structural reforms in the point of employment and education as well as enhance our cultural potential.

The government will improve systems and infrastructure for creating a society where people can live without fear. This will include the integrated reforms of entire social security system, improvement of measures against declining birthrate, promotion of health and care prevention, security and safety assurance, creation of a recycling-base society and maintenance of the Earth environment through measures aimed at achieving the targets of the Kyoto Protocol, and promotion of the judicial system reform.

With regard to the above structural reform, the following matters will be promoted based on deliberations at the Council on Economic and Fiscal Policy after the "Basic Policies 2004" from the following viewpoints.

In addition, regarding the form of economic society to be realized as achievement of the structural reform, the Council on Economic and Fiscal Policy will issue "Japan's 21st Century Vision".

(Regulatory reform and Special Zones for Structural Reform)

With respect to the regulatory reform, the Government will push forward examination focusing on the key issues presented by the Council for the Promotion of Regulatory Reform. Especially, in order to promote cross-sectional market opening to the private sector in those areas where the government itself is a service provider, the government will implement "Model Projects" concerning the Market Testing (government-and-private sector competitive bid system) and study at the same time the system including the "Market Testing Law" (tentative name).

Concerning the Special Zones for Structural Reform, the government will aim to achieve as much regulatory reform as possible by implementing measures to invite new proposals and to realize nationwide regulatory reforms by evaluating the Special Zones. Additionally the government will make efforts to enhance the effectiveness of the system by implementing measures for further improvement based on the result of comprehensive evaluation on unrealized proposals that clarify their relevant points including structural factors.

(Consolidation of the financial system)

By implementing various measures based on the "Program for Further Financial Reform" targeted for Concentrated Consolidation Period, the government will establish a financial system, led not by the "public sector" but by the effort of the "private sector", which can satisfy the needs of financial service users, attract high commendation internationally and contribute to regional economies.

(Comprehensive and drastic reform of the tax system)

In line with the "Basic Policies 2004" and based on the "Outline of FY2004 Tax Reform of the Ruling Coalition" (December 17, 2003) and the "Outline of FY2005 Tax Reform of the Ruling Coalition" (December 15, 2004), the government will examine mutually relevant reform proposals of tax system in a comprehensive and drastic manner and reach a

conclusion within Concentrated Consolidation Period.

(Full-fledged reform of budget system)

In order to improve the quality of the budget, the government will implement budget system reform, promoting the clarification of performance goals and thorough ex-post evaluation and achieving efficient allocation of the budget. For this purpose, the system of policy evaluation will be reviewed and linkage between the evaluation and the budget will be strengthened.

With respect to the special accounts, the government, based on the reform plans made by the related ministries and agencies, will continue to promote the reform in accordance with the discussion made by the Council on Economic and Fiscal Policy and the recommendations by the Fiscal System Council on the individual account.

(Promotion of the "State to Regions" reform)

In accordance with the agreement reached at the meeting of the government and the ruling parties on the overall picture of the "Three-Part Reform Package" (November 26, 2004), the government will work on the state subsidy reform, the transfer of tax sources and the reform of the local allocation tax, and review participation and regulations by the state. Additionally, the Council on Economic and Fiscal Policy will adequately follow up these efforts.

(Regional revitalization)

In order to utilize various institutional reforms collectively, such as the transfer of authority and the governmental subsidy reform requested by local government and measures to attract private investment, the government will prepare full-fledged schemes as soon as possible, encourage the participation of various actors in regional revitalization, and will aim to activate local economies through competition in wisdom and ingenuity by introducing a performance-based evaluation system.

(Integrated reforms of entire social security system)

In order to create an economically and fiscally well-balanced system that is sustainable in the future with the ageing population and the declining birthrate, the government will advance an integrated reforms of the social security programs inclusive of pensions, medical care, nursing care, public assistance, etc. and reach a conclusion concerning the issues cited in the "Basic Policies 2004" within Concentrated Consolidation Period.

It is necessary to make benefits more efficient and concentrated and restrain the growth of social security benefit expenditure by promoting measures for lifestyle-related diseases and care prevention and encouraging sharing and coordination among the various systems while ensuring the security of the people.

Based on these views, the government will consider as soon as possible the cross-sectional issues, such as the medium-term goal of social benefit expenditures, what the burdens, including taxes and insurance, and benefits should be.