Annual Report on
the Japanese Economy and Public Finance
2004

—No Gains Without Reforms IV —

Summary

July 2004

Cabinet Office
Government of Japan

Contents

Chapter 1 Reform and Recovery in the Japanese Economy

Section 1 Toward Economic Growth based on Private Demand

(Emergence of a recovery led by private demand)

The current economic recovery possesses the three following characteristics:

1) With government spending restrained, private demand is driving the recovery.
2) The management of the business sector is being strengthened with reduction of its excessive debts and employment.
3) Japanese companies are demonstrating their strength backed by their originality in such areas as digital electronics.

(Broadening of recovery in the business sector)

- In the previous cycle (2000), the recovery was narrowly based on the IT industry, but the recovery this time extends to the materials industry and non-manufacturing.
- The broadening of economic recovery reflects, to some extent, the underlying strength of private consumption.

(Lagging recovery in jobs and income)

- Compared to previous recoveries, growth in the employment figures is modest.
- On the other hand, the unemployment rate has begun to decline for the first time in 13 years.
- Income growth is flat, but with a modest decline in saving rate, consumption is maintaining its underlying strength.

(Continued mild deflation)

- Reflecting the worldwide economic recovery, the international commodity market has been tightened and Domestic Corporate Goods Prices have risen slightly as a result of an increase in material prices.
- However, as the higher price of raw materials has not been fully reflected in prices of the final products or consumer prices, mild deflation continues.

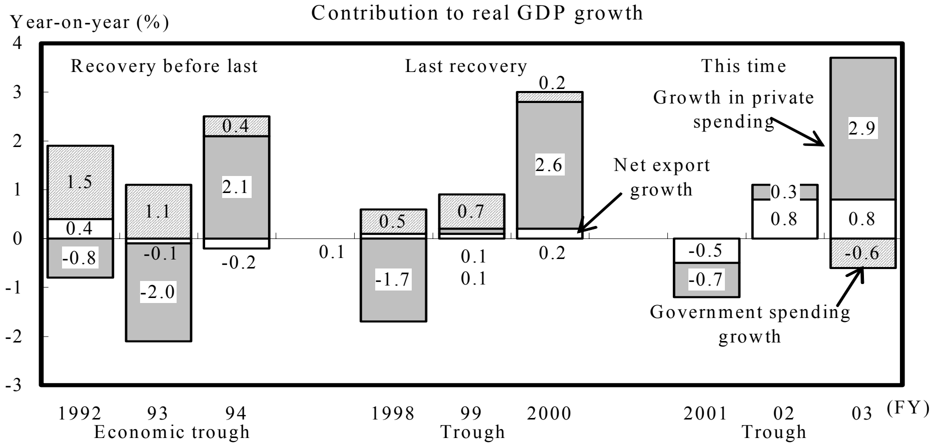
(Rising share prices reflecting economic recovery)

- The yen strengthened against the dollar over 2003.
- Reflecting the economic recovery, share prices have been rising since March 2003. Long-term interest rates rose in the middle of 2003.

(Increased current account surplus)

- The current account surplus increased by nearly 30% in FY2003 compared to the previous year. This reflects a higher surplus in trade, and a lower deficit in the service account, which was caused by the decrease in overseas travel due to SARS.

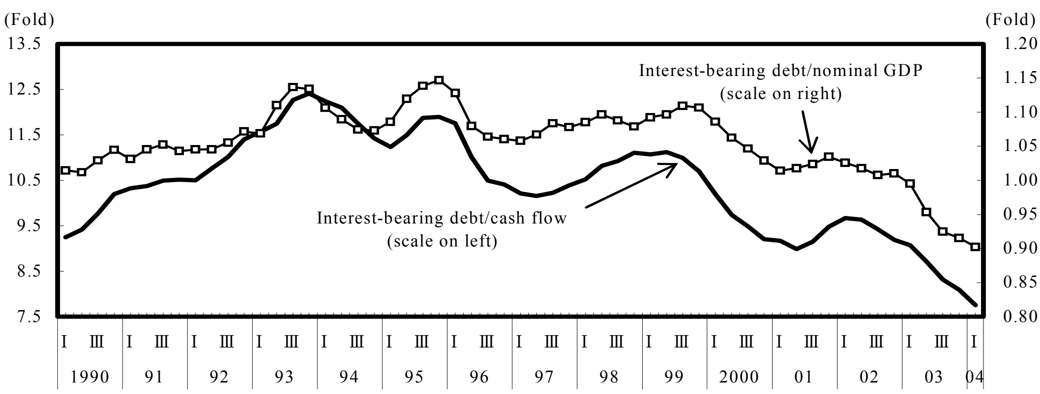
Fig. 1-1-1 Private sector demand leads recovery



Notes: 1. From *National Accounts*, Cabinet Office.

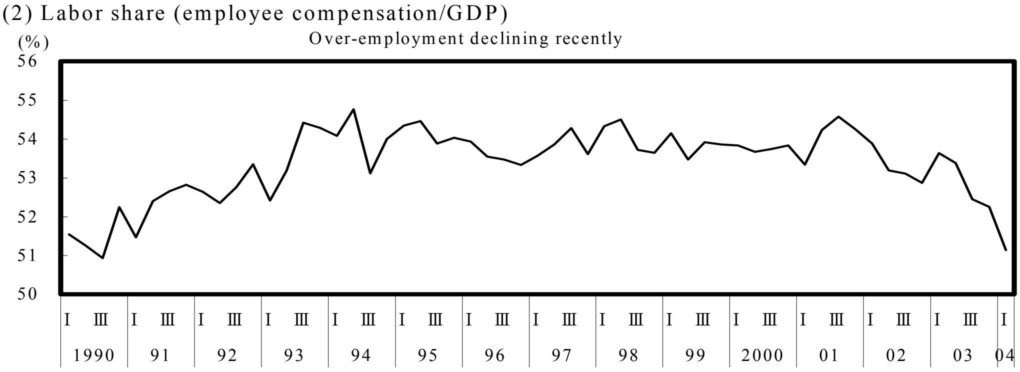
Fig. 1-1-2 Business sector trends in employment and debt

(1) Substantial decrease in private sector debt



Sources: 1. From *Statistics of Corporations by Industry Quarterly*, Ministry of Finance and *National Accounts*, Cabinet Office.
2. Interest-bearing debt = long-term loans + short-term loans + bonds (from *Statistics of Corporations by Industry*)
3. Cash flow = operating profit × 1/2 + depreciation (from *Statistics of Corporations by Industry*)

(2) Labor share (employee compensation/GDP)



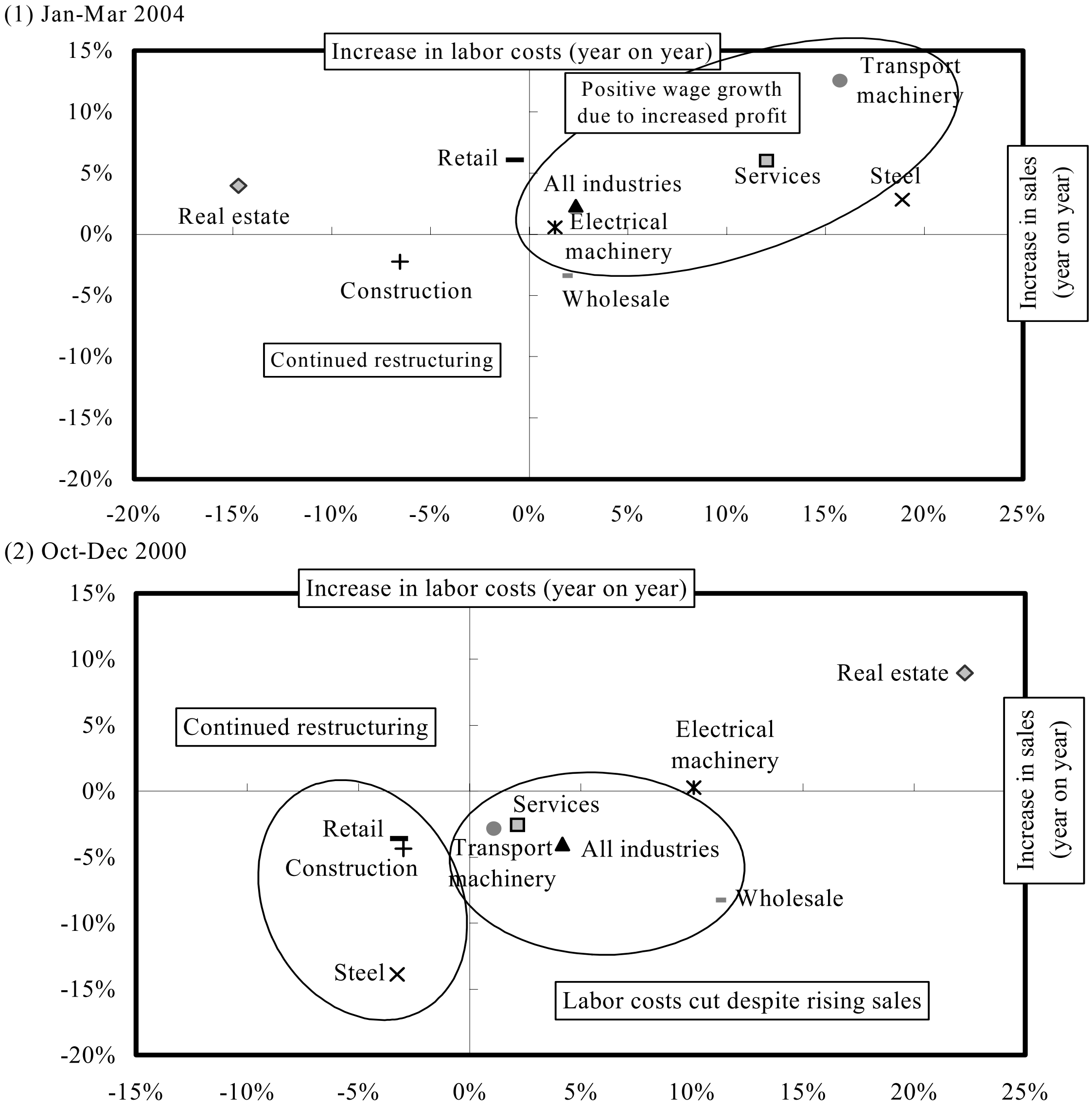
Source: From *National Accounts*, Cabinet Office.

Section 2 Business Sector benefiting from Reform

(Corporate profits: higher revenue, higher profits)

- The source of corporate profit has shifted from corporate restructuring aimed at lower labor costs, to higher demand, which allows firms to gain higher profits through higher revenue.
- In the previous recovery phase (2000), labor costs continued to be restrained as a result of harsh restructuring regardless of sales growth, but in this recovery phase, labor costs are rising in line with increased sales in some industries.
- There are some concerns over the impact of rising raw materials costs on corporate profits, but rising sales are canceling out the impact of deteriorating terms of trade.

Fig. 1-2-2 Corporate earnings and restructuring

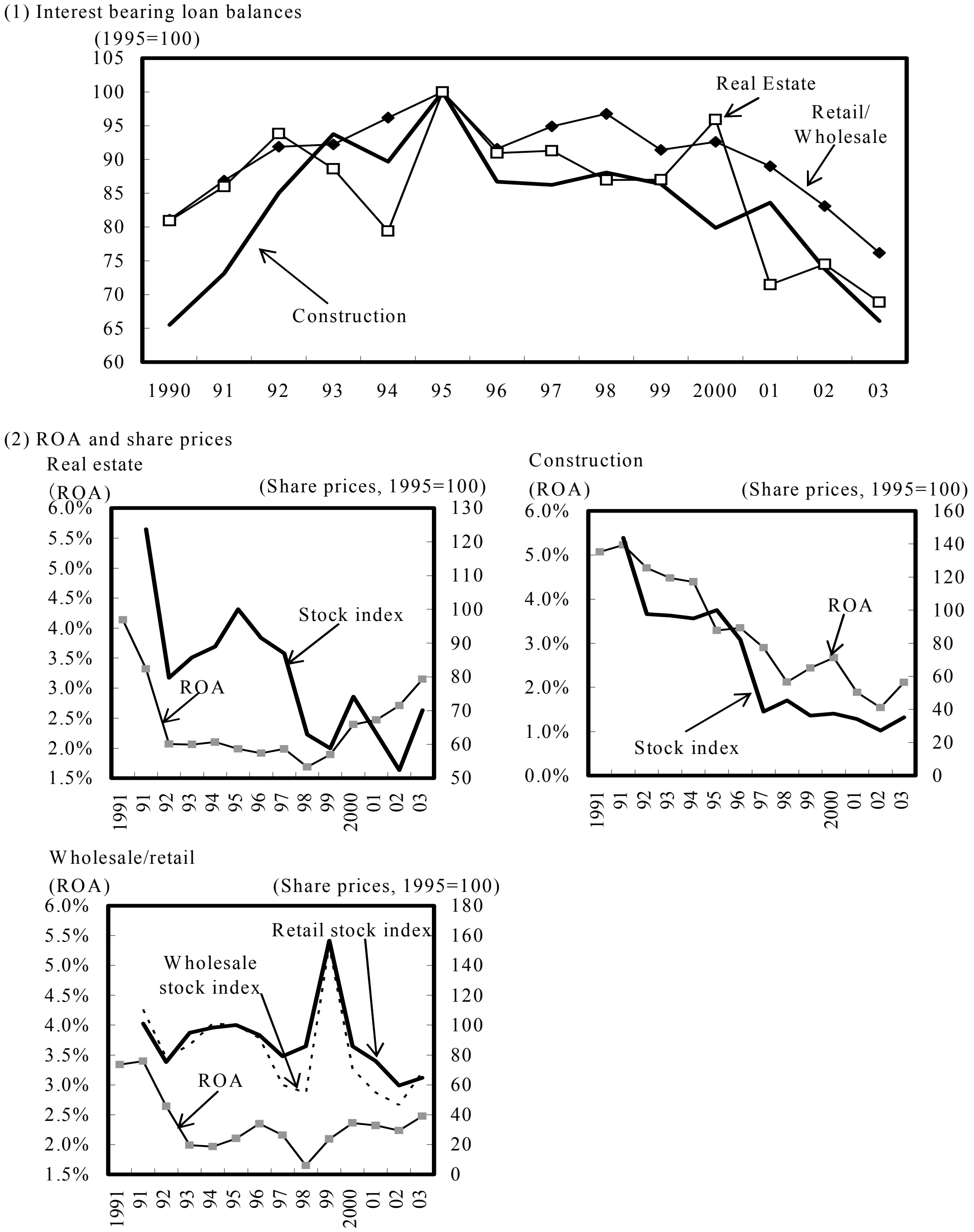


Source: *Statistics of Corporations by Industry Quarterly*, Ministry of Finance.

(Reduction of debts with disposal of non-performing loans)

- With the progress on non-performing loan disposal by banks, non-performing loans decreased considerably even in those sectors, such as real estate, wholesale and retail, and construction industries which suffered from a high proportion of such loans.
- With the reduction in non-performing loans, some improvement in profitability was seen in these industries.

Fig. 1-2-5 Three industries cut their non-performing loans and increase their profitability

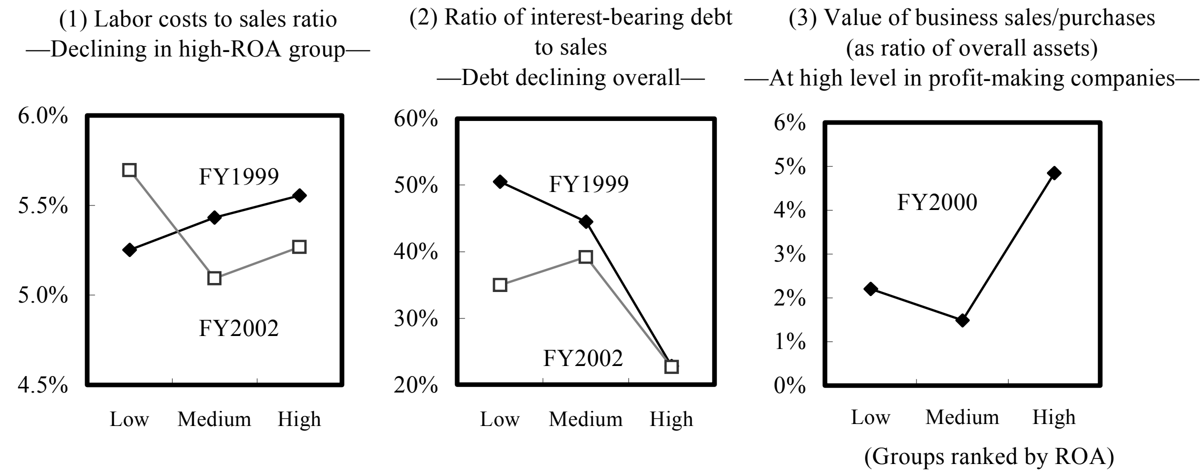


Notes: 1. Interest-bearing debt balances and ROA from *Statistics of Corporations by Industry Quarterly*, Ministry of Finance.
2. Stock indices from the Tokyo Stock Exchange industrials index.

(Effect of corporate restructuring)

- According to an estimate based on the individual data of around 1,000 companies, profitability tends to rise in companies that bought or sold operations, reduced labor costs and cut debt.
- Thanks to improved financial health resulting from corporate restructuring, the breakeven point has come down. As a result, a drop in sales or an interest rate hike tends to have less impact on profits.

Fig. 1-2-7 Relationship between restructuring and corporate earnings (listed manufacturers)



Notes: 1. From *Development Bank of Japan's Corporate Financial Databank*, Japan Economic Research Institute. Analysis of consolidated financial data of listed companies.
2. See Note 1-1 for further details.
3. For FY1999 and FY2002, the sample is split into roughly equal size by ROA rank for the purposes creating the graphs.
4. Graph 3, based on ROA ranks in FY2002, shows M&A ratios two years before (in 2000). M&A ratio is the proportion of overall assets to the total value of business purchases or sales.

Table 1-2-8 Impact of changing sales and interest rates on profits

Simulation 1:
Impact on ordinary profits in FY99 and FY02 if sales had been 10% lower
Simulation 2:
Impact on ordinary profits in FY99 and FY02 if debt interest change rate had been 1% higher

Rate of change in ordinary profits with changes to sales and interest rates

	1999	2002
Sales 10% lower	-41.0%	-33.6%
Interest 1% higher	-9.2%	-6.0%

Reference: Amount per company, unit 100 million yen

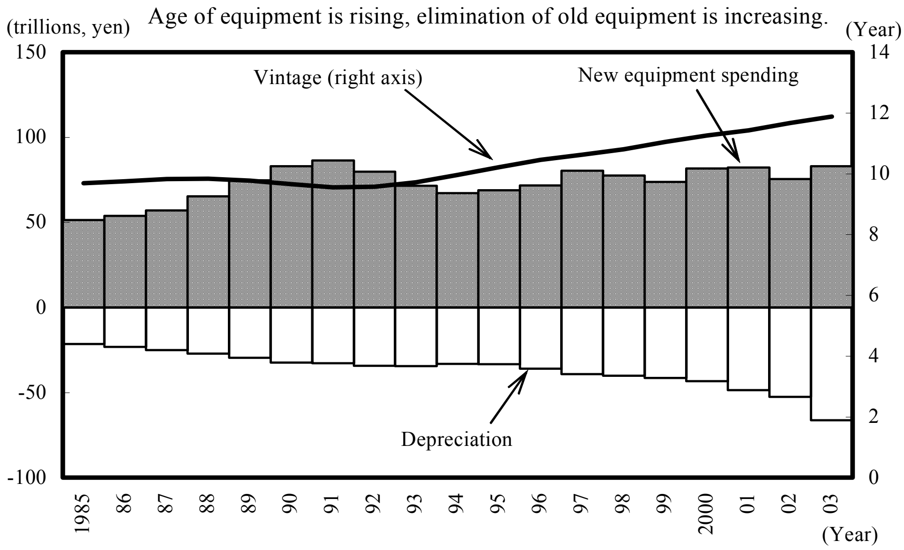
	1999	2002	FY99 comparison	
Sales	1,676	1,792	6.9%	
Operating profit	64	86	33.8%	
Sales breakeven point	75.6%	70.2%	-5.4%	(FY99 comp.)
Interest-bearing debts	574	494	-14.0%	

Sources: 1. From the *Development Bank of Japan's Corporate Financial Databank*, Japan Economic Research Institute. Analysis of 1,094 listed manufacturers with consecutive group net results data available.
2. See Note 1-2 for detailed analysis.

(Sustainability of capital investment)

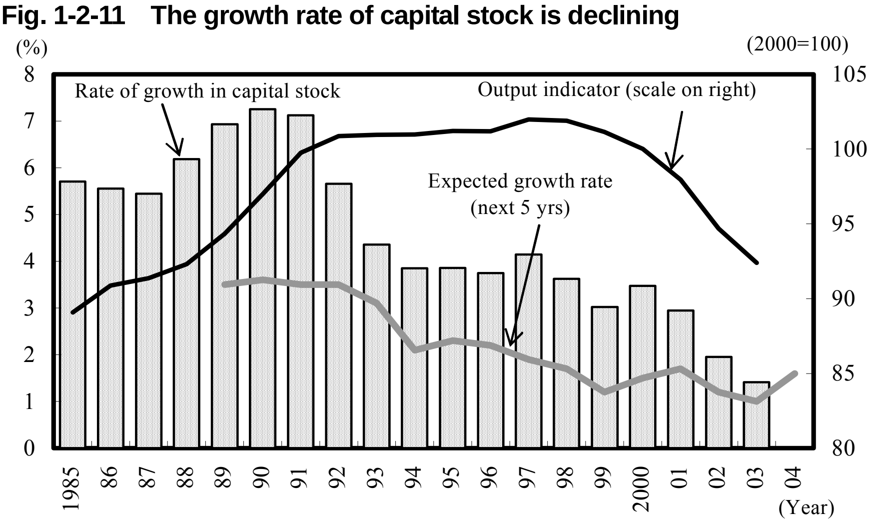
- A distinctive feature of capital investment in this recovery phase is that companies are making new investment, while they are also keen on elimination of old equipment. In the past, companies have postponed new investment, allowing the increase in the working life of their equipment. Hence, companies are increasingly scraping their old equipment. As a result, capital stock is growing at an extremely low rate.
- Capital investment is expected to maintain a momentum for the time being, based on i) the limited probability that capital stock adjustment could be induced by a temporary fall in demand and ii) the higher possibility that technological innovation could drive new investment.

Fig. 1-2-10 Trends in equipment investment and elimination



Source: From *Private Sector Capital Stock Statistics and National Wealth Survey*, Cabinet Office.

Fig. 1-2-11 The growth rate of capital stock is declining



Sources: *Private Sector Capital Stock Statistics and Questionnaire Survey on Corporate Activities and Behavior*, Ministry of Economy, Trade and Industry and *Index of Industrial Production*, Ministry of Finance.

Section 3 Improvement in a Labor Market and Household Sector

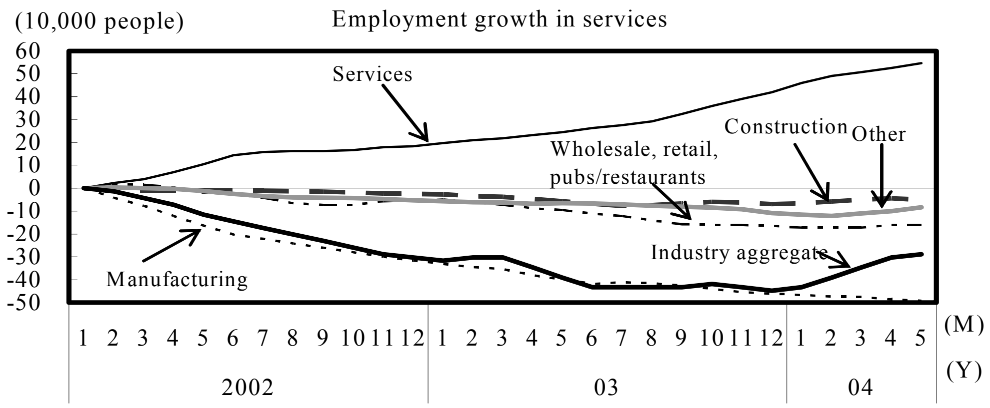
1. Improvement in a Labor Market despite remaining difficulties

(Development of employment by industry, gender and employment status)

- In terms of business sector, employment in the services sector including health and welfare is growing. Employment is falling significantly in the manufacturing and construction sectors. Employment for women and part-time workers is growing across the board. Male and full-time employment had been decreasing, but that trend has recently come to a halt.

Fig. 1-3-1 Cumulative change in employment since the beginning of the recovery

(1) By industry

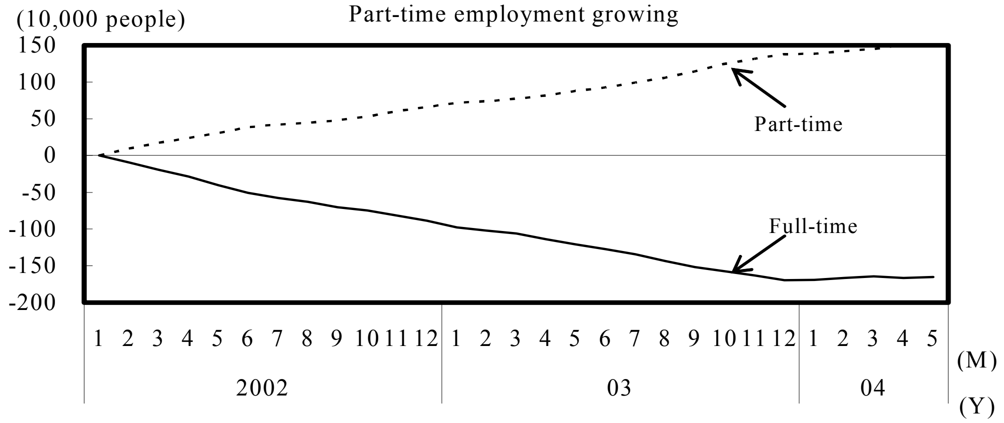


Source: *Monthly Labor Survey*, Ministry of Labour, Health and Welfare. Three-month moving average.

(2) By gender

Source: *Labour Force Survey*, Ministry of Labour, Health and Welfare. Three-month moving average.

(3) Part-time vs. full-time



Source: *Monthly Labor Survey*, Ministry of Labour, Health and Welfare. Three-month moving average.

(Business cycle, start-ups and closure of business, and employment)

- There is no apparent correlation between the business cycle and rise or fall in employment in each industry. Sectors such as manufacturing and construction, where employment declines regardless of the state of the economy, represent around 40% of overall employment.
- With regard to job creation and destruction, manufacturing industry suffers from job losses as employment growth through the increase in start-ups and that in existing businesses is slowing as a result of restructuring. Likewise, job losses are increasing in construction and finance as a result of company closures. On the other hand, job creation through start-ups leads to net increase in employment in wholesale/retail, pubs/restaurants and service industry.

Fig. 1-3-2 Change in employment by industry and the business cycle

40% of employment is in industries where employment is falling regardless the business cycle.

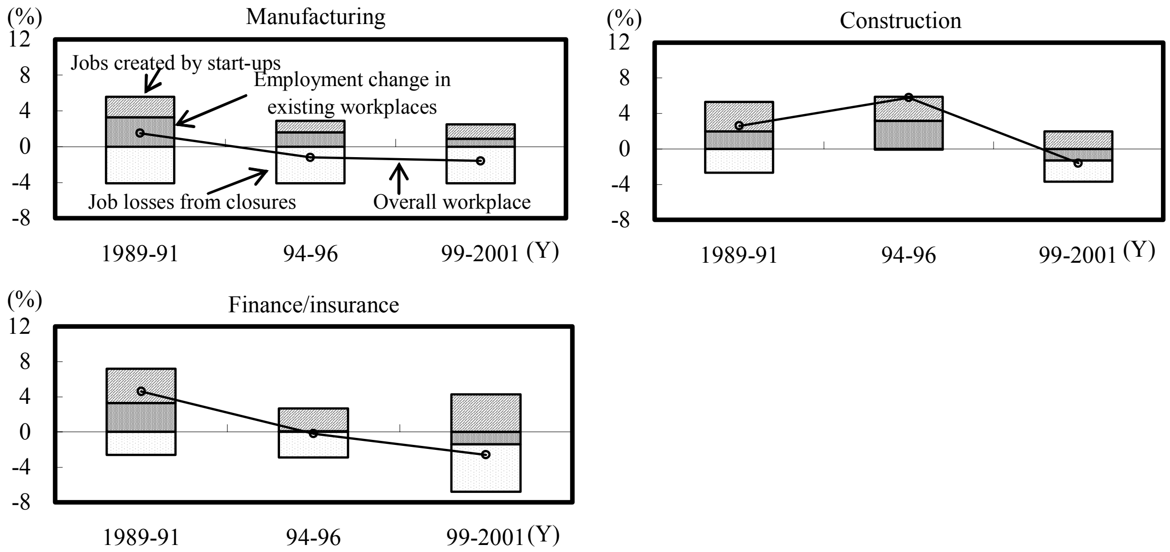
Change in employment by industry (+ for growth, - for decline)

	Recession	Expansion	Recession	Expansion	
	97.6～98.12	99.1～00.10	00.11～01.12	02.1～04.5	
Services	+	+	+	+	Structurally growing industry (33.1% share)
Construction	−	−	−	−	Structurally declining industries (39.3% share)
Manufacturing	−	−	−	−	
Transport/communications	−	−	−	−	
Finance/insurance	−	−	−	−	
Wholesale, retail, pubs and restaurants	+	+	+	−	Other (unrelated to business cycle) (27.6% share)

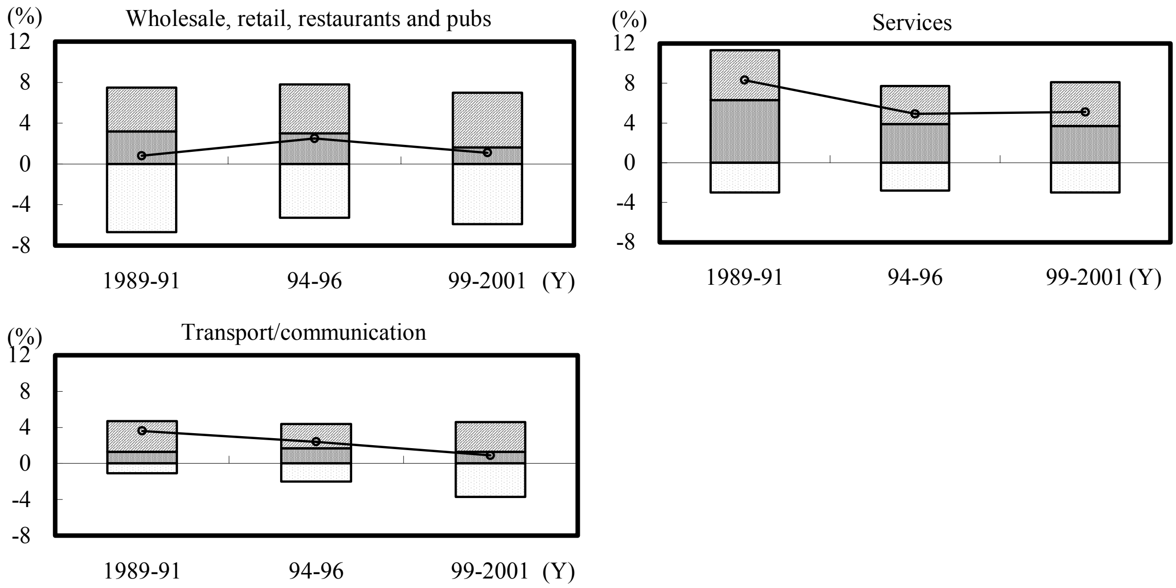
Sources: 1. From *Monthly Labor Survey*, Ministry of Labour, Health and Welfare.
2. "Share" refers to the share of regular fulltime employees overall in an industry as of May 2004.

Fig. 1-3-3 Job creation/destruction resulting from business startups/closures and employment change at existing businesses

(1) Industries where employment has turned into decline



(2) Industries of continuing employment growth



Notes: 1. From Ministry of Public Management, Home Affairs, Posts and Telecommunications, based on *Policy Effect Analysis Report No. 3*, "*Trends in Employment Reallocation in Areas Affected by Regulatory Reform*," Cabinet Office. Period extended by the Establishment and Enterprise Census and the *Workplace Roster Adjustment Survey*.

2. Methods of tabulation were as follows:

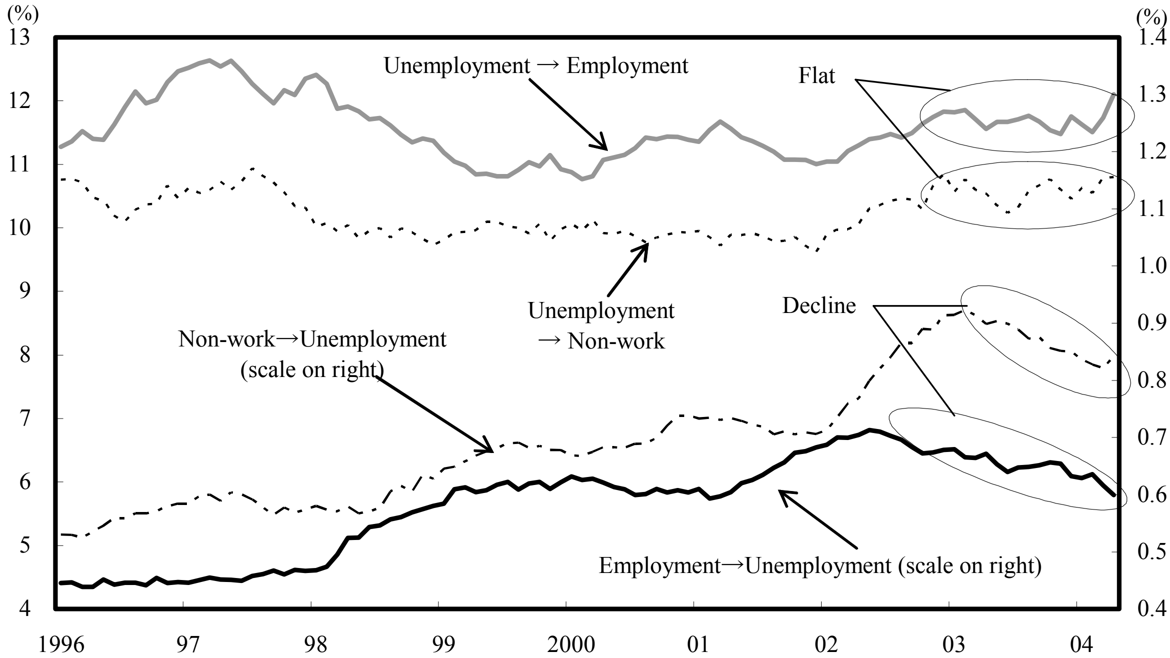
Job creation: Increase in number of workers resulting from business start-ups over the period between the last survey and this survey/no. of years

Job loss: Number of business closed over the period between the last survey and this survey × (average no. of workers in one business at time of last survey + average no. of workers in one business at time of this survey)/2/no. of years

(Background of declining unemployment rate)

- The decline of the unemployment rate in a soft employment environment reflects the lower chance of entering into unemployment rather than higher probability of exit from unemployment. This results from a halt in restructuring and a decline in housewives who move from non-employment to unemployment.

Fig. 1-3-4 Workforce flow (transition rate)



Notes: 1. From *Labour Force Survey*, Ministry of Public Management, Home Affairs, Posts and Telecommunications.
2. Flow data is edited for consistency with the numerical values of the stock base.
(Edited by same method as *Analysis of the Labour Economy 1985*)
3. Flow data 12-month aggregate value. Male and female aggregated value.
4. $\text{Transition rate} = \dfrac{\text{t months flow data (12-month aggregate)}}{\text{t-1 month stock data (12-month aggregate)}}$

ex.

$$\text{Employment}\rightarrow\text{Unemployment} = \frac{\text{t months work}\rightarrow\text{unemployment (12-month aggregate)}}{\text{workers (12-month aggregate)}}$$

(Youth unemployment remaining at high level)

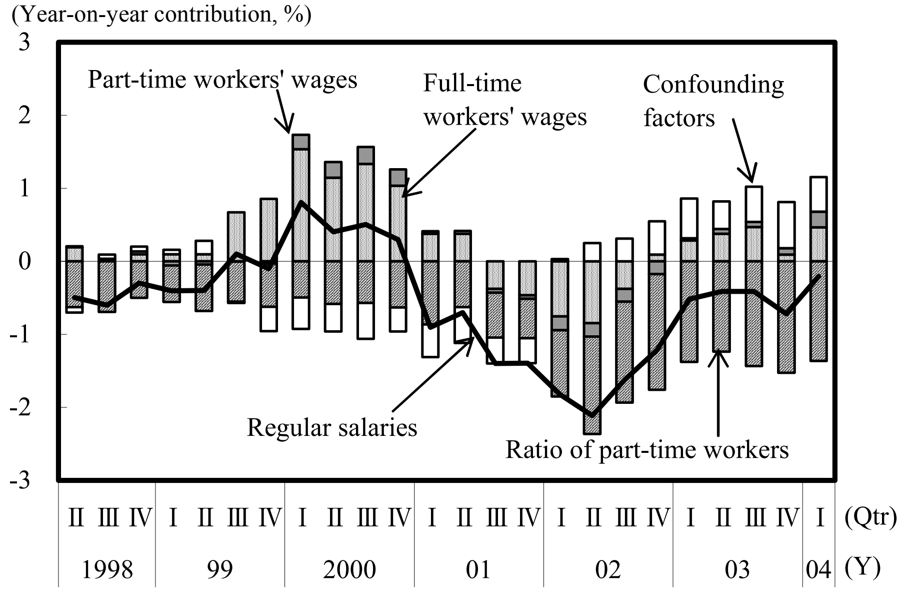
- Young people make up a large proportion of the long-term unemployed who are out of work for more than a year. The share of youth in long-term unemployed is still rising.
- Youth unemployment is exacerbated by fewer chances for recruitment by companies and the mismatch of young people to working conditions. On the young jobseekers' side, those living with their parents are less effective in job search.

(Effect of improved company profits on wages)

- There is no change to companies' basic stance of restraining basic salaries, but pay is expected to rise gradually via overtime pay and bonuses. In fact, in an increasing number of sectors, real wages are increasing with higher productivity.
- Meanwhile, as part-time workers account for an increasing proportion of employment, the expected rise in wages is likely to be modest on a macro level.

Fig. 1-3-7 Breakdown of factors of regular salaries

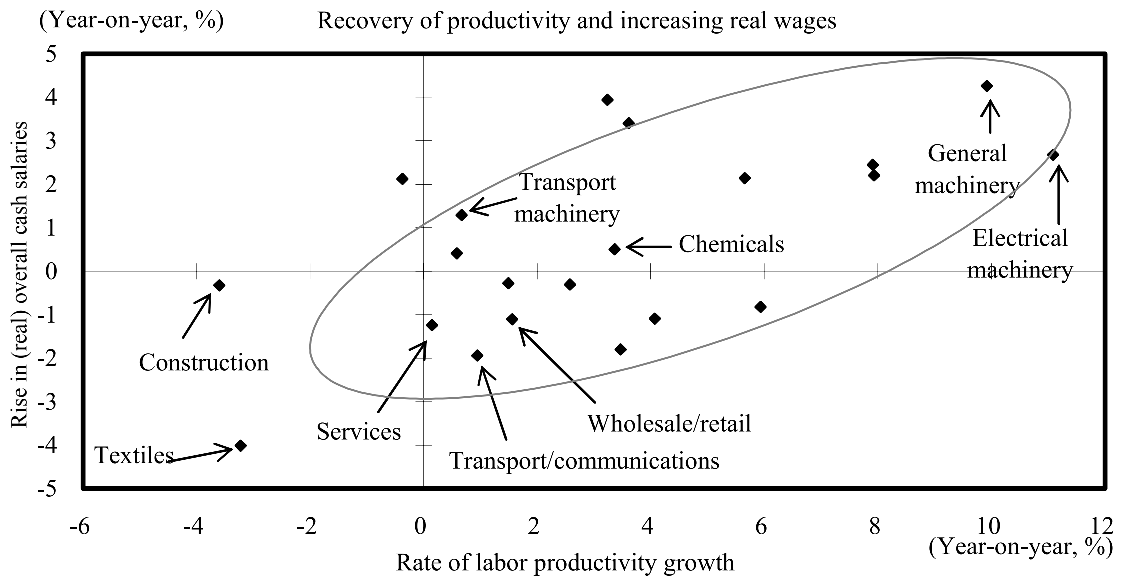
The increase in part-time workers is restricting salary growth.



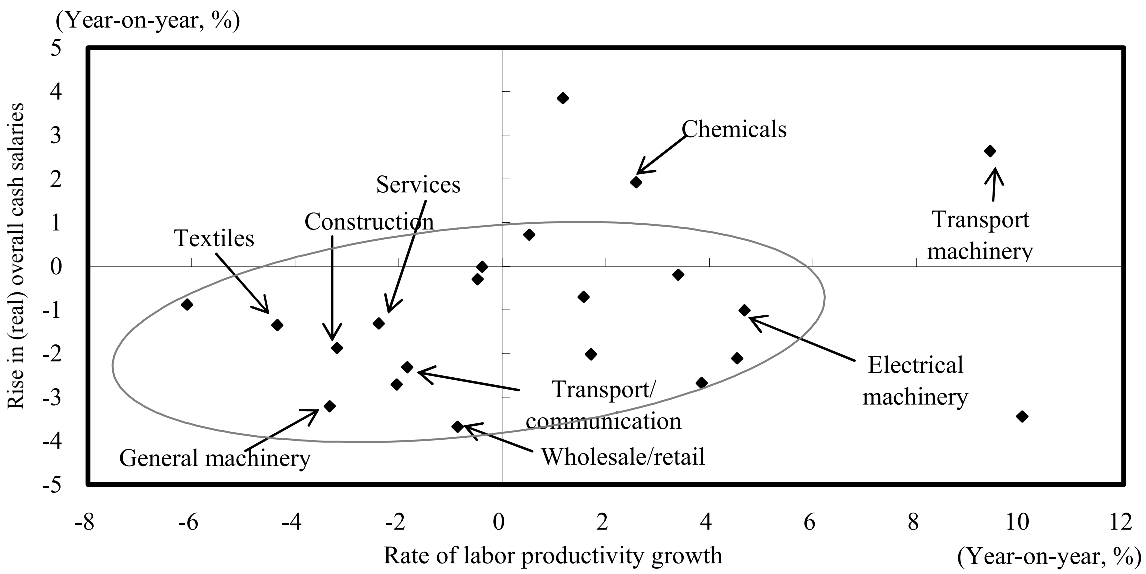
Source: *Monthly Labor Survey*, Ministry of Labour, Health and Welfare.

Fig. 1-3-8 Relationship between labor productivity growth by industry and real wage growth

(1) 2003



(2) 2002



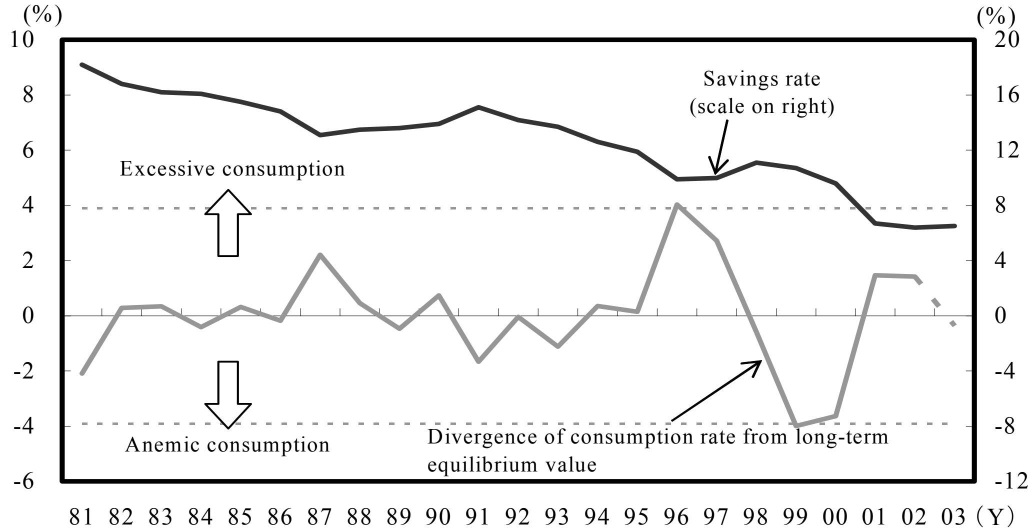
Sources: *Monthly Labor Survey*, Ministry of Health, Labour and Welfare and the *Industrial Produce Index, Indices of Tertiary Industry Activity and Indices of All Industry Activity*, Ministry of Economy, Trade and Industry.

2. Stable demand in Household Sector

(Modest recovery in private consumption)

- Over the past few years, household income has been weak, but consumption has maintained modest increase as a result of declining saving rate. Although the decline in saving rate was particularly large in 2001, this served to secure consumption growth to some extent. The boost in consumption in and after 2001 was also regarded as a rebound from excessively weak consumption in the previous period.
- The decline in saving rate moderated in 2002 and 2003. However, the relatively stronger consumption seen since the end of 2003 suggests the possibility of a further drop in saving rate.

Fig. 1-3-9 Trends in consumption, savings rates and income



1. Long-term equilibrium consumption is calculated with the assumption that it depends on long-term disposable income, financial asset balance and the proportion of the population over 60 years old.
   (Formula)
   Long-term equilibrium private consumption =
   3.725 + 0.569 × disposable income+ 0.029 × financial assets balance + 2.878×proportion of population over 60
   (0.33) (10.37) (2.47) (4.62)
2. The error correction model is estimated to see how rapid the return to equilibrium is, if the consumption becomes apart from the long-term equilibrium in a short-term.
   (Error correction model formula)
   Year-on-year increase in private consumption =
   – 1.963 + 0.399 × On-year disposable income change + 0.136 × on-year change in financial assets balance
   (– 1.76) (3.75) (2.99)
   + 0.981 × year change in ratio of population over 60 + 0.222 × error correction item
   (2.60) (2.51)

Notes: 1. From *Flow of Funds Account Statistics*, Bank of Japan, *Population Estimates*, Ministry of Public Management, Home Affairs, Posts and Telecommunications and *System of National Accounts*, Cabinet Office.
2. 2003 figures are forecasts.
3. The dotted lines are 95% confidence intervals.
4. Values in brackets are t values. The error correction items are diversions of actual consumption from the long-term consumption equilibrium formula above.

(Recovery of consumer confidence through improved employment situation)

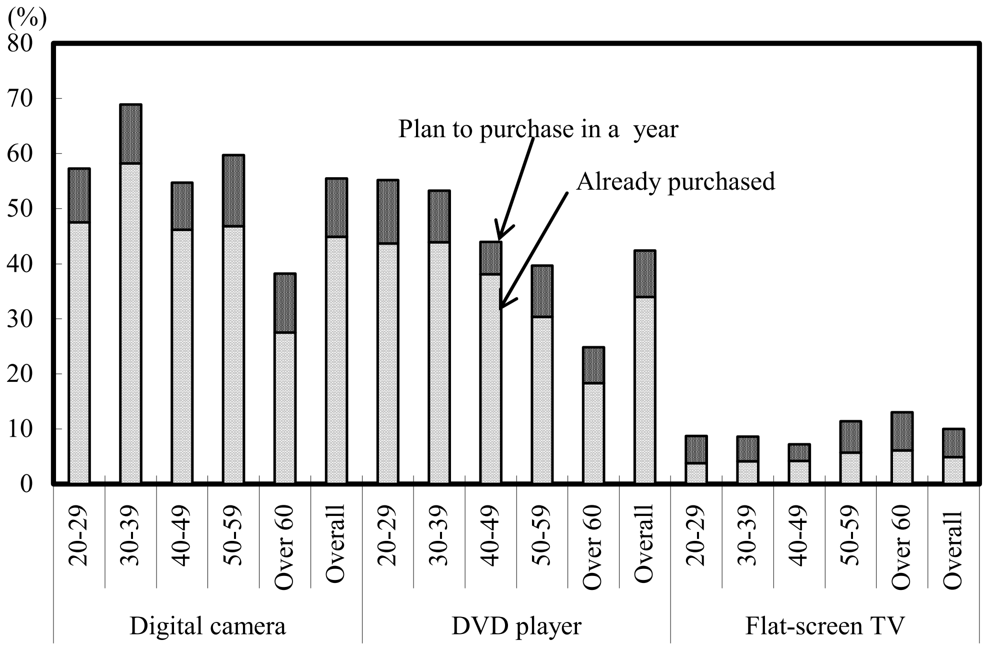
- The slight acceleration in consumption growth since the end of 2003 has reflected the recovery in consumer confidence backed by the improved employment situation as a result of a halt in corporate restructuring.

(New products contributing to creating new demand for consumption)

- Stimulation of consumption demand by new products such as digital electronics would be another factor supporting consumption growth.
- According to an original survey conducted by the Cabinet Office, consumers of digital electronics are spreading over a relatively wide range of ages. Flat-screen televisions have sold particularly well among older consumers.
- 60-80% of digital electronics consumers brought them either ahead of usual replacement cycle or with the intension to add to their existing ones. There are few cases where the purchase of digital electronics can be seen to have resulted in reducing other consumption. Therefore, they appear to have created new demand.

Fig. 1-3-12 Digital electronics purchase by age

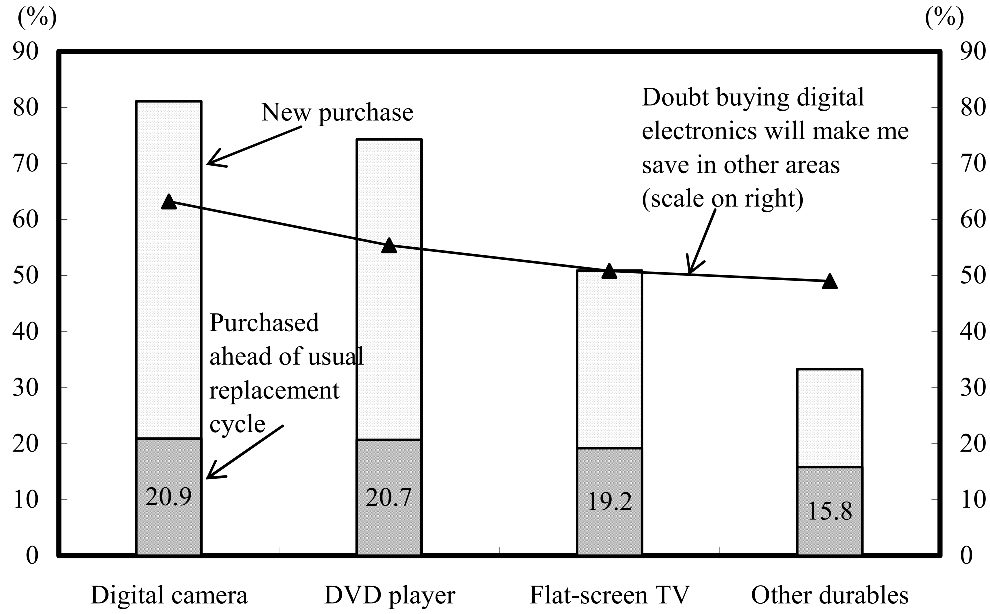
Answers to the question, "Have you already bought digital electronics for your home, or do you intend to over the next year or so?"



Note: The three answer options provided were “already bought,” “plan to buy over next year or so” and “no plan to buy.”

Fig. 1-3-13 Net Effect on demand created by digital electronics

Answers to questions, "Did the launch of digital electronics cause you to replace your existing products earlier than your usual replacement cycle?" and "Did purchasing digital electronics affect your other spending?"



Notes: 1. For the bar graph, each respondent was asked for each digital electronics items they had bought, "Did you buy it ahead of the usual replacement cycle?" They chose from the answers, "Bought a new one in addition to an existing one, or bought an entirely new one I did not own before," "Could still use the old one, but bought a new one earlier than I would have," and "Bought a new one because I was due to buy a new one anyway."

2. "New purchase" is a proportion of the "Bought a new one in addition to an existing one, or bought an entirely new one I did not own before, "while "purchased ahead of usual replacement cycle" is a proportion of the "could still use the old one, but bought a new one earlier than I would have" answers.

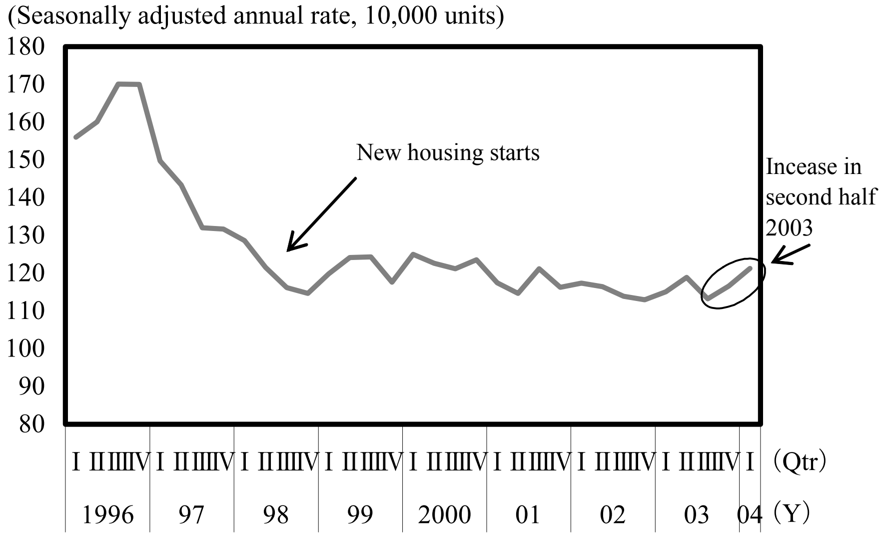
3. The line graph is the proportion of people who, asked "Will buying digital electronics affect your spending in other areas?" answered "Doubt buying digital electronics will make me save in other areas" from the options, "Think that I will save on discretionary spending (durables, travel, eating out, leisure, etc.)", "Think that I will save on general spending (food, utilities, clothes, etc.)" and "Do not think I will make any special effort to save."

(Modest increase in housing investment)

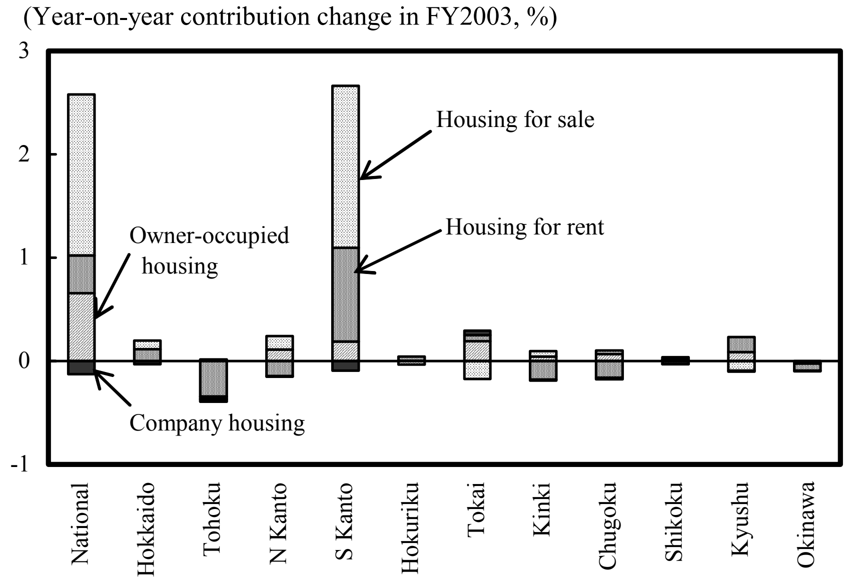
- There was a slight 2.5% increase in housing construction starts in FY2003. However, the regional breakdown reveals that the rise was largely driven by the southern Kanto region including Tokyo, and those at other regions either stayed flat or declined mildly.
- The price of land in inner city Tokyo stopped falling, but the decline continued in other regions.

Fig. 1-3-15 New housing starts

(1) Housing construction is relatively firm



(2) Growth in housing construction in FY2003 driven largely by growth in houses for sale and houses for rent in southern Kanto

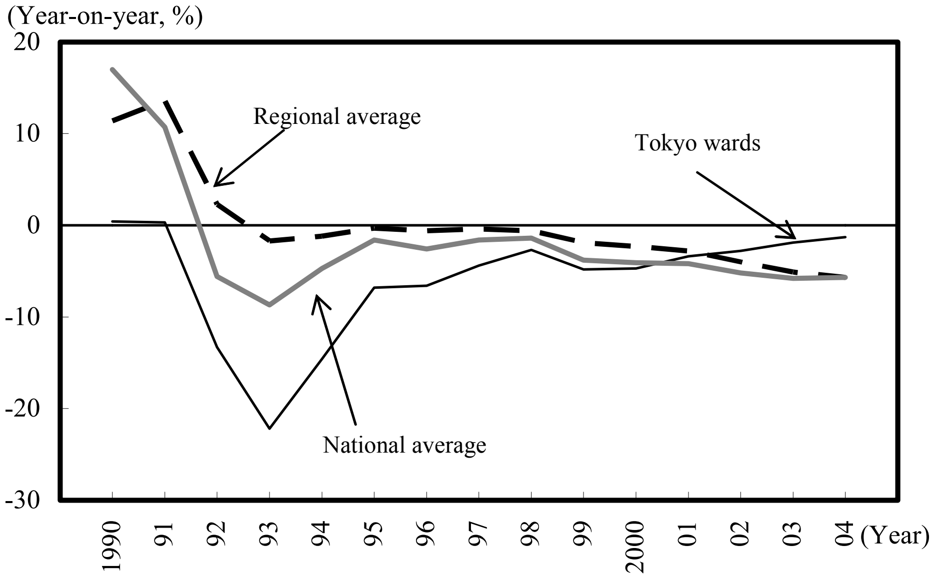


Notes: 1. From *Building Construction Starts,* Ministry of Land, Infrastructure and Transport.

2. (2) is the on-year growth rate in FY2003 in the total new housing starts nationwide, broken down into contribution by region and usage.

Fig. 1-3-16 Official land price (residential)

Decline continuing in Tokyo ward districts but less steeply now.



Source: *Land Price Publication*, Ministry of Land, Infrastructure and Transport.

Section 4　Prospect for Overcoming Deflation

1. General Prices staying flat

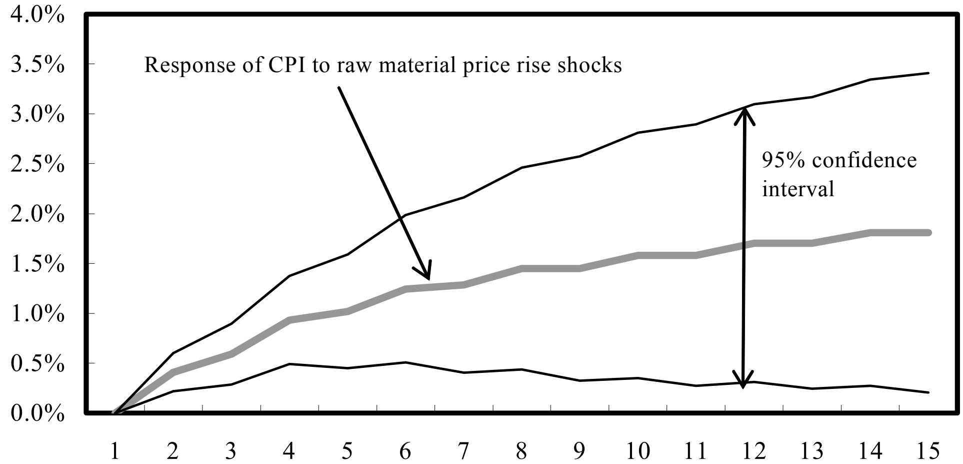
(Slight increase in price of domestic corporate goods as a result of higher raw material prices)

- The rising cost of raw materials is pushing up the price of intermediary goods, but the price of the downstream final products is still falling. 70 to 80 percent of companies in industries close to the consumer such as automotive and electronics have not been able to raise their prices.
- The estimated impact of rising raw material prices on consumer prices (excluding services) was significant when the data in the 1970s and ’80s was used, but it was insignificant when the data in 1990s was used.

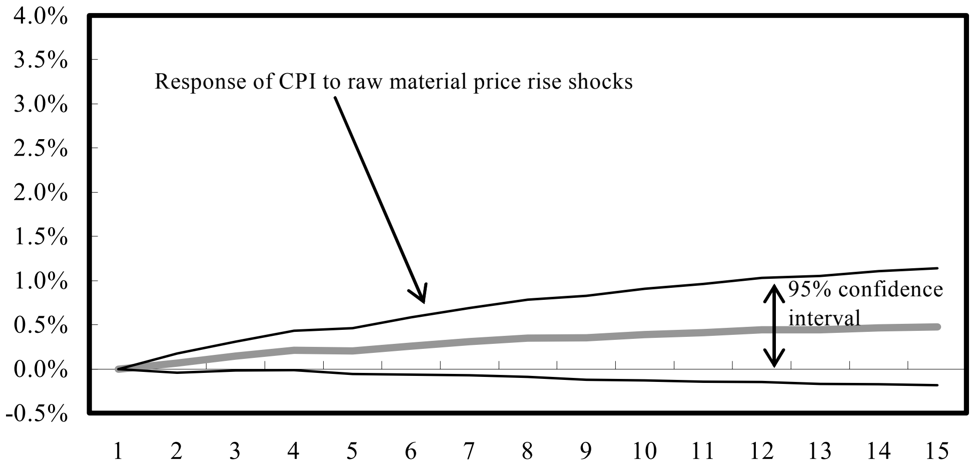
Fig. 1-4-3　VAR analysis of raw material prices and consumer price index (impulse response)

Consumer price index (CPI) sensitivity to raw material price rise shocks have lessened.

(1) From 1970 to 1989



(2) After 1990



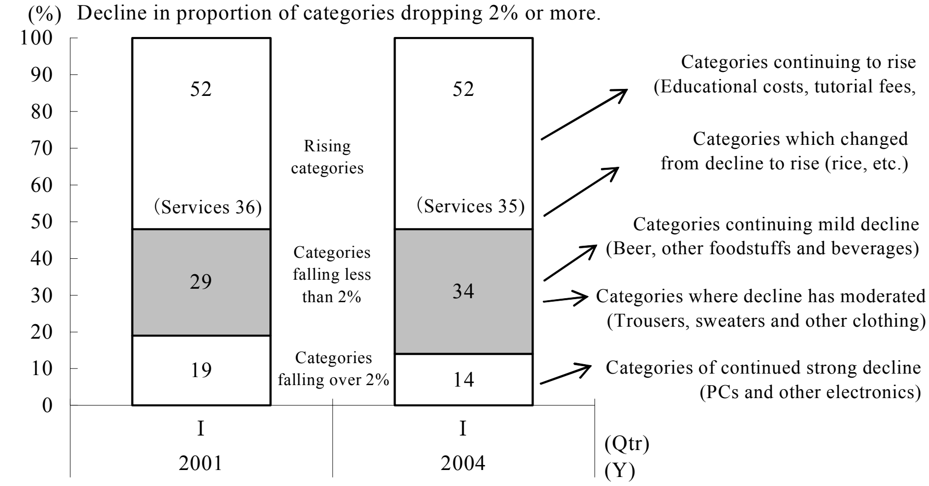
Notes:　1. From *Corporate Goods Price Index*, Bank of Japan and *Consumer Price Index*, Ministry of Public Management, Home Affairs, Posts and Telecommunications.

2. See Note 1-4 for estimation method, etc. Aggregate impulse response function.

(Consumer price staying flat)

- Consumer prices are flat. Comparison between early 2004 and the period experiencing more significant deflation such as in 2001 shows that there is no change in proportion of the items rising and falling—52 versus 48. But the share of items falling by over 2% lessened, reducing the overall decline in early 2004.

Fig. 1-4-4 Relative weight of categories rising/falling in CPI index

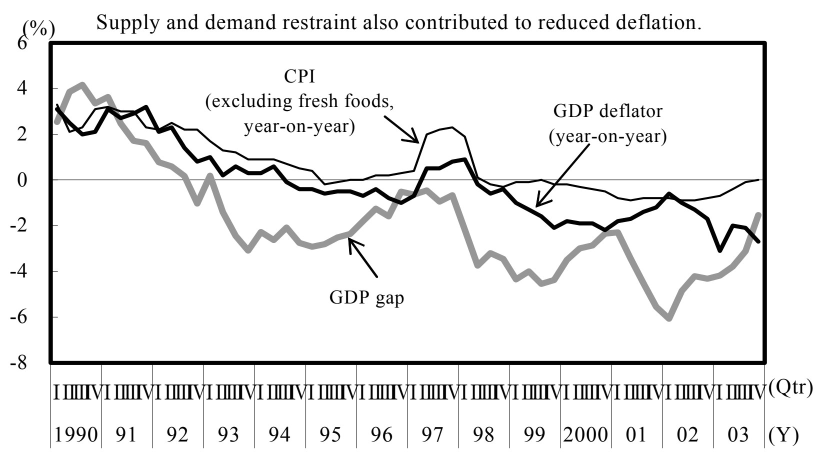


Source: *Consumer Price Index*, Ministry of Public Management, Home Affairs, Posts and Telecommunications.

(Demand factors contributing to easing deflation)

- Calculations based on historical data show that there is a positive correlation between the GDP gap and consumer prices in the long run.
- In fact, in the current economic recovery phase, the narrowing of the GDP gap from the beginning of 2002 to the beginning of 2004 reduced the extent of deflation in consumer prices by 0.8 percentage point. Although temporary factors such as the rise in rice price have pushed up the overall prices, the tightening in demand and supply condition resulting from the economic recovery is likely to have contributed to the milder deflation to some extent.

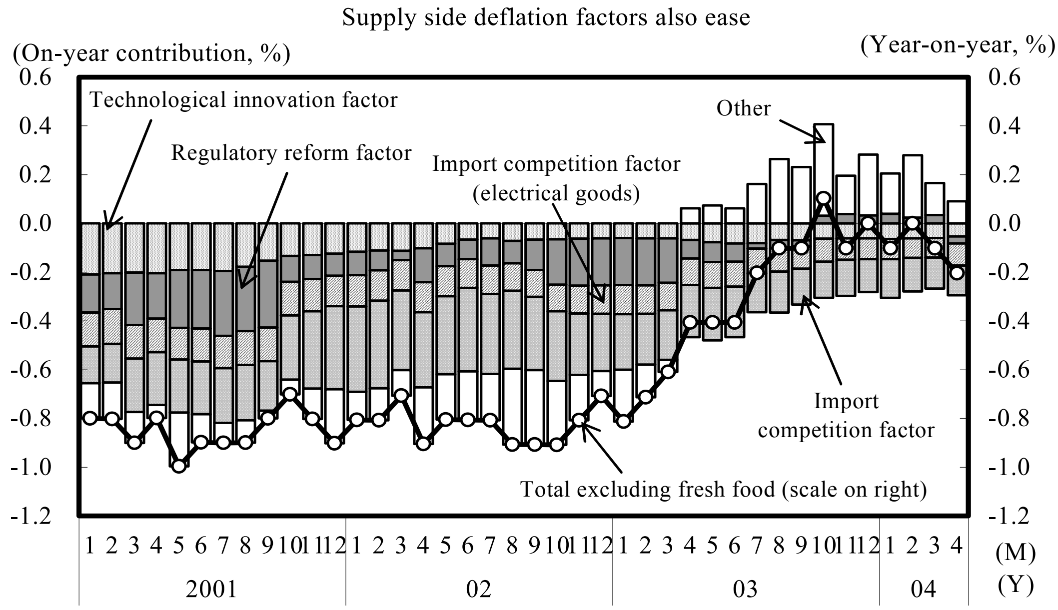
Fig. 1-4-5 Demand factors and CPI, GDP deflators



(Deflation factors ease on supply side also)

- To look at the contribution of different factors in consumer price categories, all the items in CPI are broken down into categories that changed because of technological innovation factor, those that changed because of deregulation factor and those that changed due to import competition factor (with electronics in a separate category).
- The total contribution of the four supply side factors above shrank to -0.2% in early 2004 from -0.7% to -0.8% in 2001.
- Of these, the deregulation factor has turned positive with the recent air transport cost increases; and in categories competing with imports, the decline has moderated in goods such as clothing. On the other hand, the technological innovation factor continues to fall.

Fig. 1-4-6 Impact on supply side prices



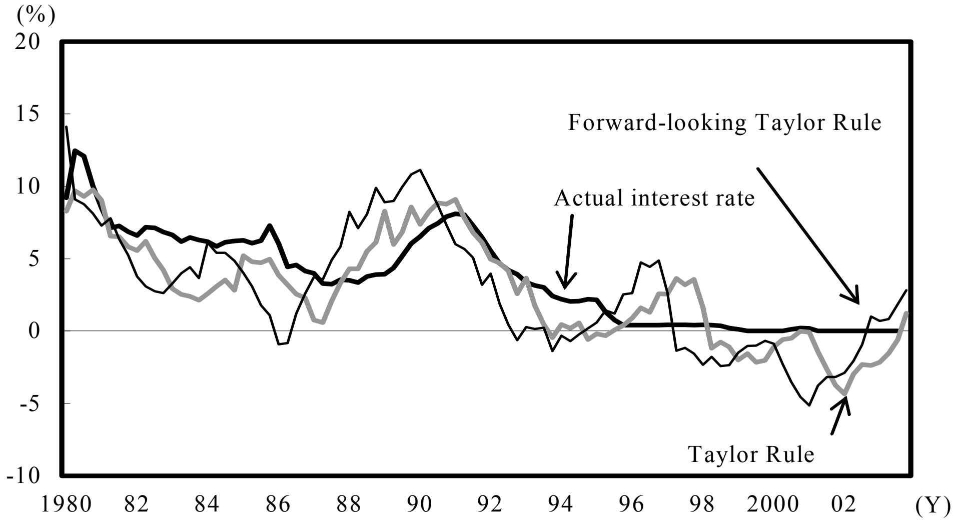
Notes: 1. From *Consumer Price Index*, Ministry of Public Management, Home Affairs, Posts and Telecommunications.
2. The factors are defined as follows:
Technological innovation factor: the contribution of hedonic items (PCs (laptop, desktop), cameras) to total excluding fresh foods.
Regulatory reform factor: the contribution of regulatory reform items from past price reports, etc. and to total excluding fresh foods.
Specifically, taxi fares, airfares, vehicle maintenance, (regular inspection), fixed line telephone bills, mobile phone bills, electricity and gas bills.
Import competition factor: the contribution of categories that are common to the import price index and the CPI to total excluding fresh foods, defined as import competition categories. Some categories are added even if they are not included in the import price index, because they are deemed to be competing with imports.
Import competition factor (electronics): the contribution of technological innovation-related categories such as electronics, apart from the import competitive factor (other) above, to total excluding fresh foods.
Other: Contributors to the total excluding fresh food other than the above. Includes medical fees, cigarettes, low-malt ale, rice, etc.

2. Deflation and Monetary Policy

(Quantitative easing continues with persistent deflation)

- Short-term interest rates remain stable as a result of quantitative easing. The appreciation of the yen had a slight tightening effect in 2003.
- Generally, the monetary authorities take into account the GDP gap, expected inflation rate and other factors when they set interest rates (the Taylor Rule). According to an estimate of this type of policy reaction function, it is suggested that, when the Bank of Japan clarified the conditions of continued quantitative easing in October 2003, the implied target interest rate may have well exceeded the level seen in 2000 when the zero interest rates were lifted. Hence, the BOJ's commitment in October 2003 is thought to have served to calm down expectations of higher interest rates going forward.

Fig. 1-4-9 Target interest rate derived from the Taylor Rule



Notes: 1. The Taylor Rule is a principle for adjustment when a) the actual inflation rate deviates from the desired inflation rate or when b) the growth rate deviates from the potential growth rate (GDP gap). Here, the target interest rate was calculated from the CPI (exc. fresh food) and Cabinet Office GDP gap estimates. The following methods of calculation were used.

(1) Taylor Rule

Calculated by OLS according to the following formula:

$r_t = \rho r_{t-1} + (1-\rho)\ [\mu_0 + \mu_y Yt + \mu_\pi \Pi_t]$

(2) Forward-looking Taylor Rule

Calculated by the instrumental variable of this formula:

$r_t = \rho r_{t-1} + (1-\rho)\ [\mu_0 + \mu_y\ E_t\ (Y_{t+4}) + \mu_\pi E_t\ (\Pi_{t+4})\ ]$

r_t: Secured overnight call rate

Y_t: GDP gap

Π_t: inflation rate

The secured call rate is used as the explanatory variable. That is because the BOJ website only discloses non-secured call rates since 1985.

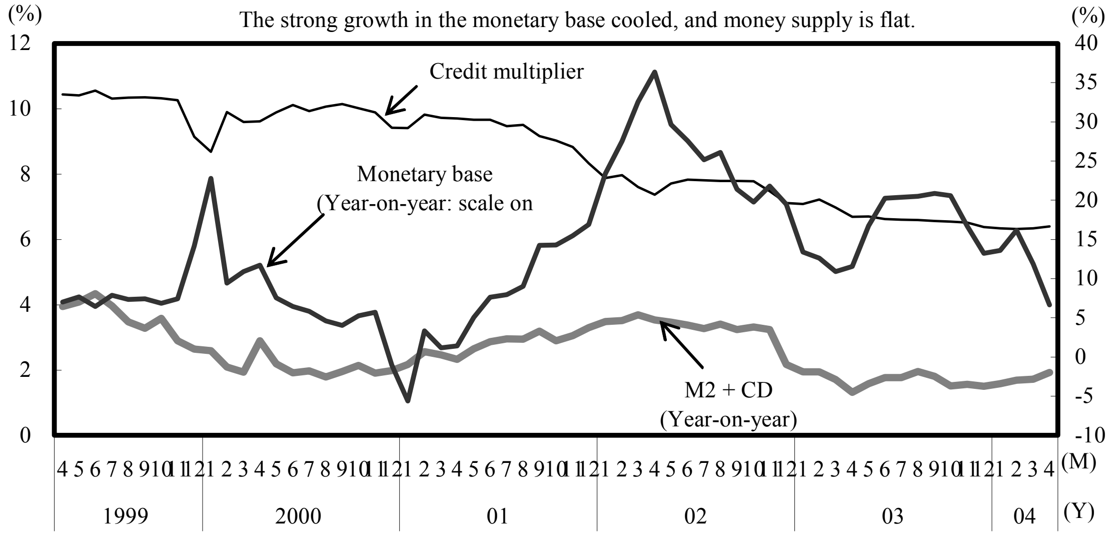
2. The FY2004 GDP gap and inflation rate calculated as the median of the April 2004 BOJ Policy Board Forecast is used in the calculation of FY2003 forward-looking Taylor Rule target interest rate.

3. Taylor Rule estimates use Q1 1980-Q4 1998.

(Background to declining money supply)

- The growth rate in the money supply slowed over 2002 and 2003 with the growth in the supply of BOJ notes declining as a result of increasing security in financial system. The declining trend in the credit multiplier (M2+CD/ monetary base) comes to a halt, bringing the first signs of normalization in financial system.

Fig. 1-4-10 Trends in monetary base and money supply

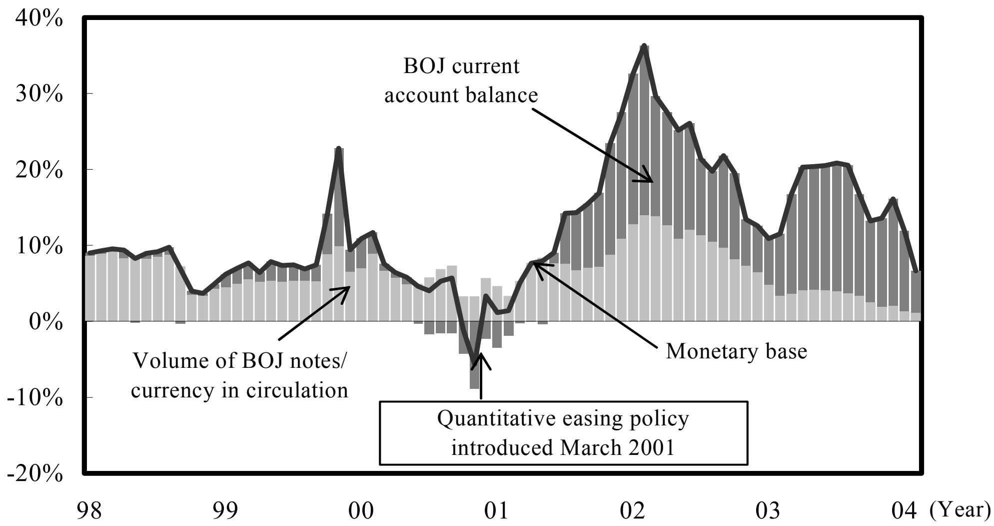


Source: *Financial and Economic Statistics*, *Monetary Base and Monetary Supply,* Bank of Japan (BOJ).

$$\text{Credit multiplier} = \frac{\text{M2 + CD}}{\text{Monetary base}}$$

Fig. 1-4-11 Breakdown of contributions to the monetary base

Since the introduction of the quantitative easing policy, the contribution of BOJ current account balance to changes in the monetary base has been significant.



Source: *Financial and Economic Statistics*, *Monetary Base,* BOJ.

3. Synthetic Judgment of Deflation and Future Policy

(Synthetic judgment of deflation)

Three factors must be considered when judging deflation risk.

(1) From the macroeconomic perspective, the most important price index to look at is consumer prices. Consumer price index serves as a reference when household decides labor supply. It also represents prices of final demand product and service prices for companies.

(2) Lower risk of deflation will not be secured merely by above-zero inflation rate. The economy needs to be in a state where deflation will not come back even in the event of external shocks.

(3) It is important that the financial system recovers to a fully sound condition.

Reflecting the above, the deflation risk has still remained because it will take some time before economic recovery drives up prices to a level high enough to eliminate the deflation risk. Moreover, the financial sector has not fully recovered to a sound condition, with weak growth of money and lending limiting the effectiveness of monetary policy.

(Policy to overcome the risk of deflation)

- Overcoming deflation requires effective monetary policy management so that it could lead to sufficient supply of credit. Structural reform conducted by the government could support the recovery and reduce the GDP gap.
- Issues to face in exiting deflation include i) possibility of a hike in long-term interest rates due to speculation, ii) risk of large latent losses in government bonds held by private financial institutions and its possible impact on their capital, and iii) possible increase in interest payment by the government.
- To prevent overshoot in long-term interest rates, the basic stance of monetary policy needs to be announced to get credibility of the market. More specifically, to stabilize the market expectation, it is crucial to announce to what extent monetary condition will be eased even after CPI inflation turns to slight positive, and how long such easing will continue. Some argue that indicating conditions such as certain rate of inflation or price level could serve to identify the duration and the extent of monetary easing, though broader options need to be considered.

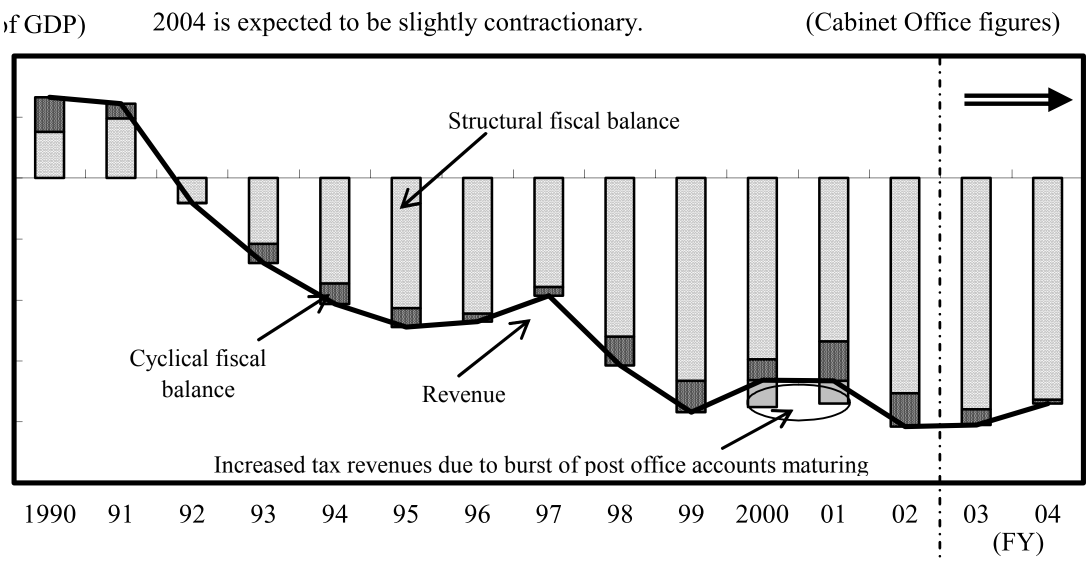
Section 5 The Progress in structural reform in fiscal policy and financial system

1. Trends in Government Finances and Outlook

(Government budget balance forecast to improve in FY2004)

- The government is aimed at restraining the size of general government expenditure so that its ratio to GDP could stay below that in FY2002. The deficit of central and local government as well as that of general government is projected to decline by 0.7 to 0.8 percentage point of GDP in FY2004.
- A calculation of structural budget balance, which is calculated by excluding the "cyclical" components from the actual balance, shows that the structural deficit is expected to shrink in FY2004 after it expanded slightly in FY2002 and stayed flat in FY2003.

Fig. 1-5-4 General government cyclical and structural budget balance



Notes: 1. It does not include the National Railway and Forestry debts inherited in FY1998 (around 27 trillion yen).

2. Method for calculating the cyclical/structural fiscal balance from *Annual Report on the Japanese Economy and Public Finance (FY2001)*.
See Note 3-1.

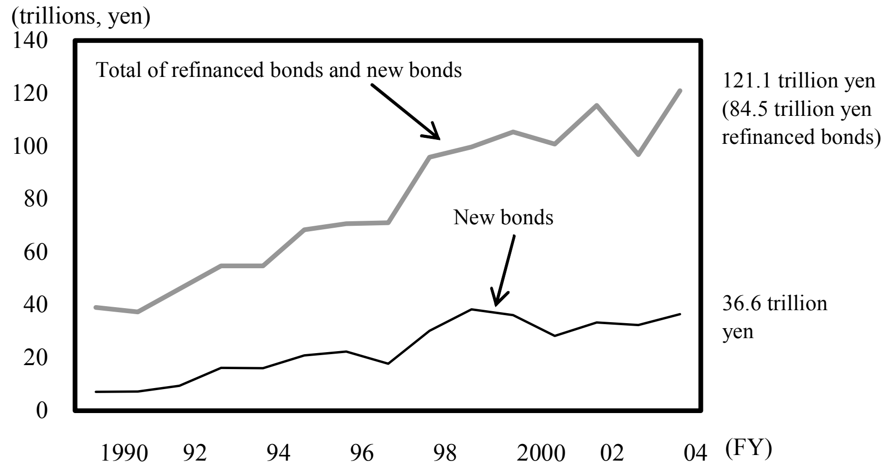
3. Since FY2003, *Structural Reform and Medium-Term Economic and Fiscal Perspectives - FY2003 ed., etc.* has served as reference for the estimate.

4. Postal account maturity-related tax revenue increases were around 4.5 trillion yen and 3.7 trillion yen in 2000 and 2001.

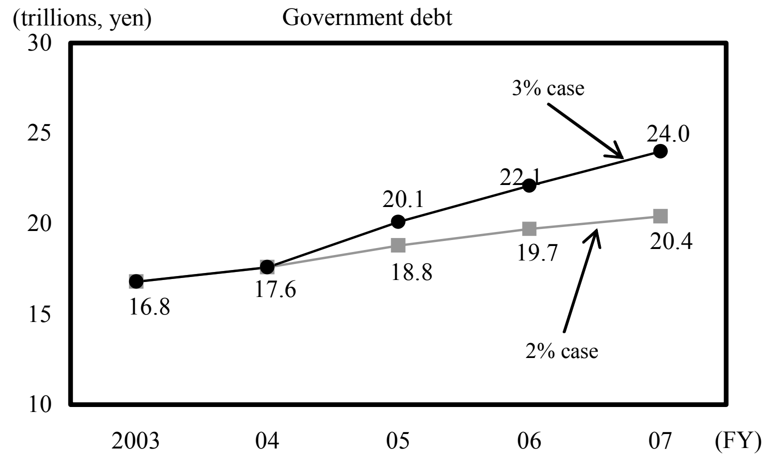
(Coming risks to public finances)

- If long-term interest rates did rise, the pace of improvement in budget balance could be delayed due to the expected increase in interest payments. According to an estimate, an increase in interest of 1% would increase interest payments by 3.6 trillion yen over the next three years.

Fig. 1-5-5 Amount of government bond issues



(2) Impact of rising interest (from 2% to 3%)



Source: *Impact on Revenue and Expenditure in Post-FY2004 Budgets*, Ministry of Finance.

2. Expenditure Reform

(Steady progress of expenditure reform)

- The various initiatives currently underway on expenditure reform are largely in the same class as those of other developed countries. The wide-ranging actions include the establishment of fiscal rules, budget system reform, the application of policy/project evaluation, consolidation of public finance systems, results-oriented budget execution, and the introduction of competitive principles in public services.

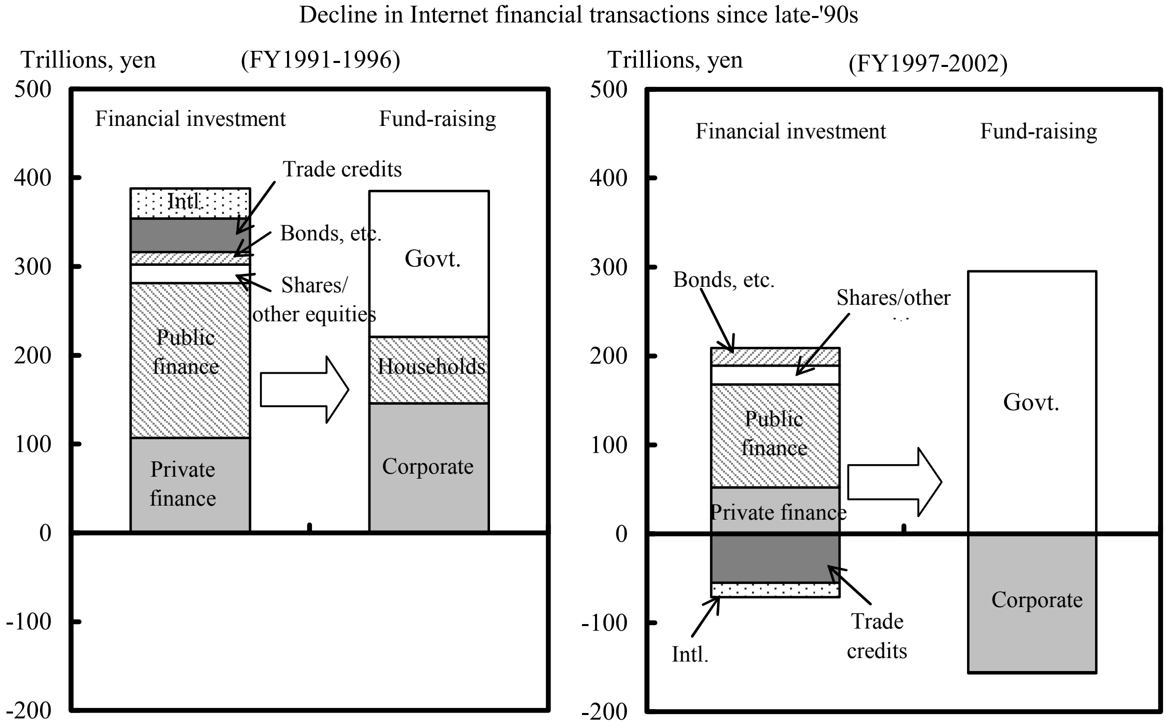
3. The Problem of Domestic Funds Flow and the Progress of Financial Reform

(Change in the domestic funds flow)

- Household and business funds are accumulated by the national government via financial institutions.

  → The financial intermediary function of the private sector is weakening due to the issue of non-performing loans and excess debt.

Fig. 1-5-10 Changes in financial transactions in Japan



Notes: 1. From *Flow of Funds Statistics*, BOJ.

2. Shows the financial investment through the various sectors of the finance system and the fund-raising by nonfinancial sector respectively.

3. Public finance institutions: Insurance, government loans and government-related financial institutions apart from the central bank, postal savings and private life insurance and mutuals.

Private financial institution: Banks, etc., collectively managed trusts, private life insurers, mutuals, pension funds, investment trusts, non-bank, brokers, noncollectively managed trusts, financial institutions other than intermediaries.

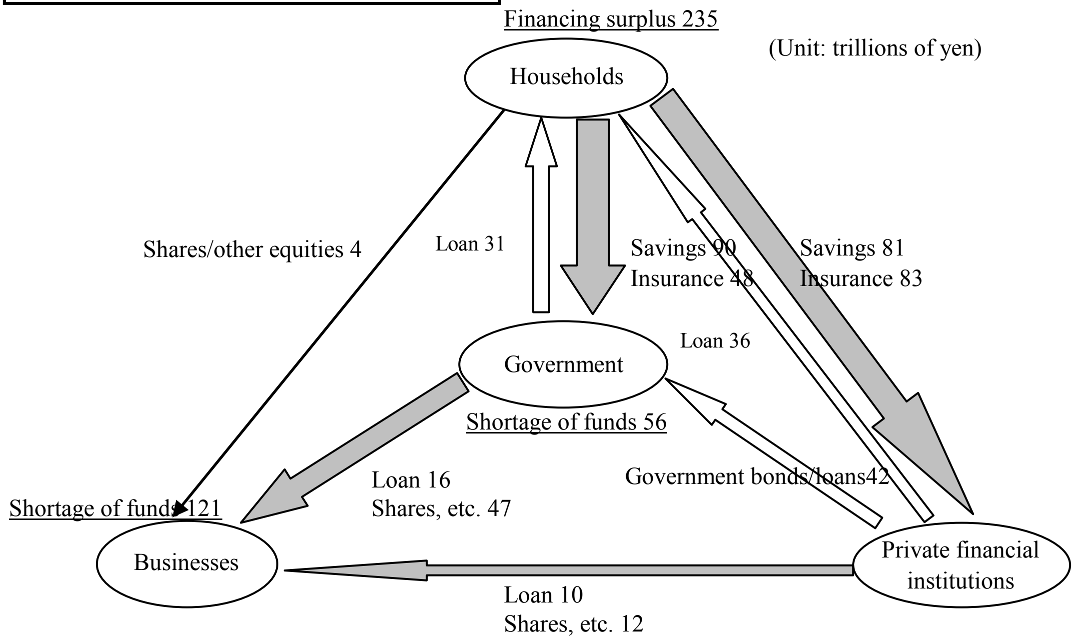
Government: Central government, local government, social security funds.

Corporate: Private nonfinancial corporations, public nonfinancial corporations.

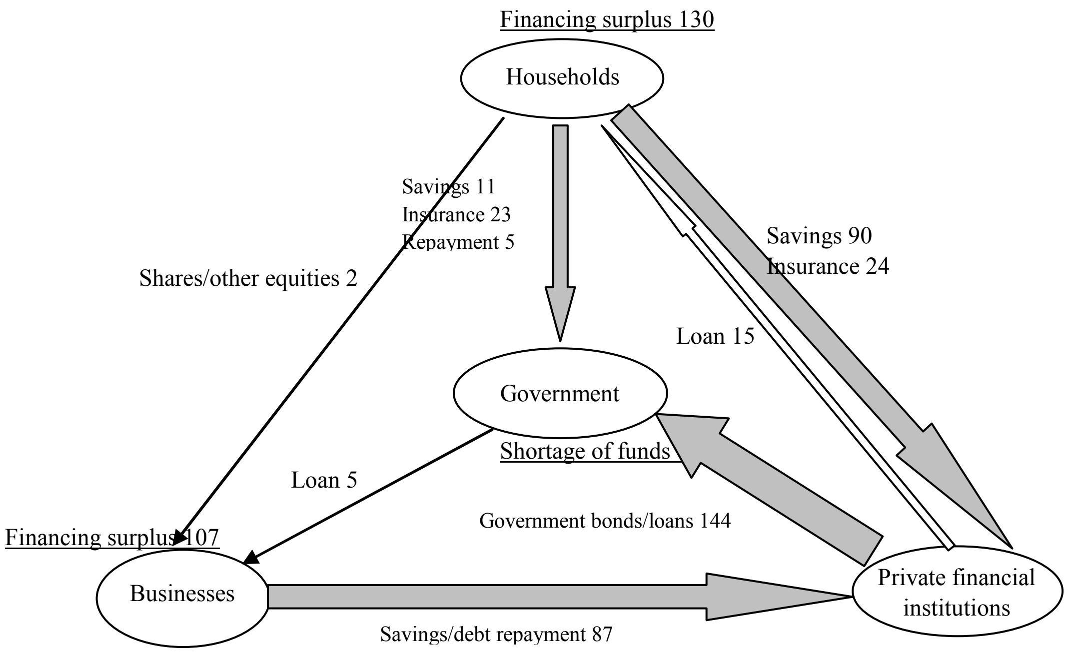
Fig. 1-5-11 Movements of funds among domestic economic players

Since the late 1990s, the flow of funds has been from companies to the government.

Total from FY1991 to 1996



Total of FY1997 to FY2002



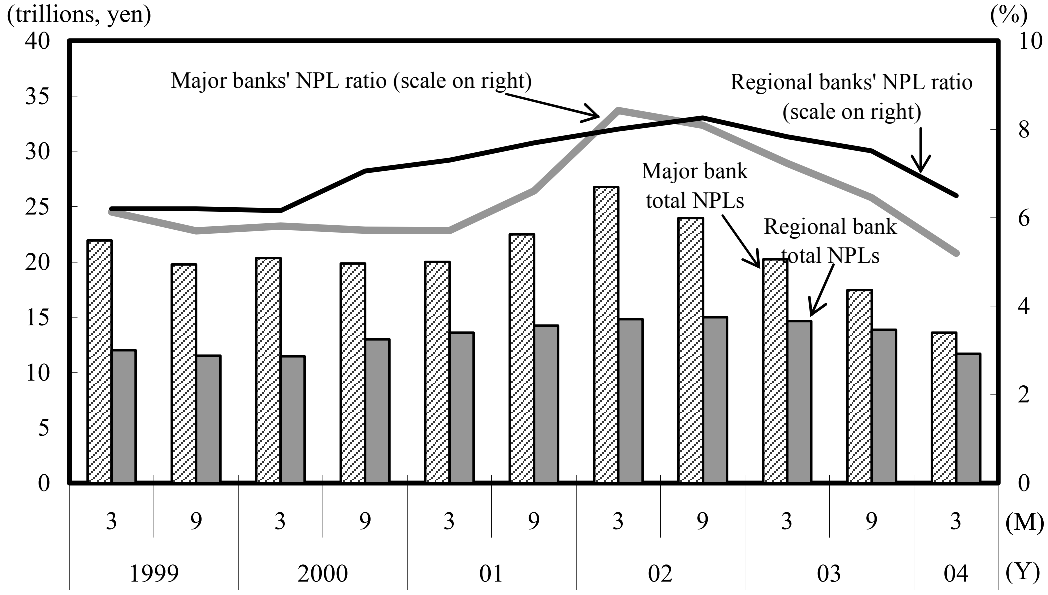
Notes: 1. From *Flow of Funds Statistics*, BOJ. Includes major financing flows between economic players.
2. Government includes central government, local goverment, social security funds, BOJ, postal savings, postal insurance, public non-life insurers, government loan and government-related financial institutions.

(Disposal of non-performing loans by major banks is progressing)

- Effective core operating profit exceeds non-performing loan disposal losses.
- Financial condition of banks continues on improving trend.

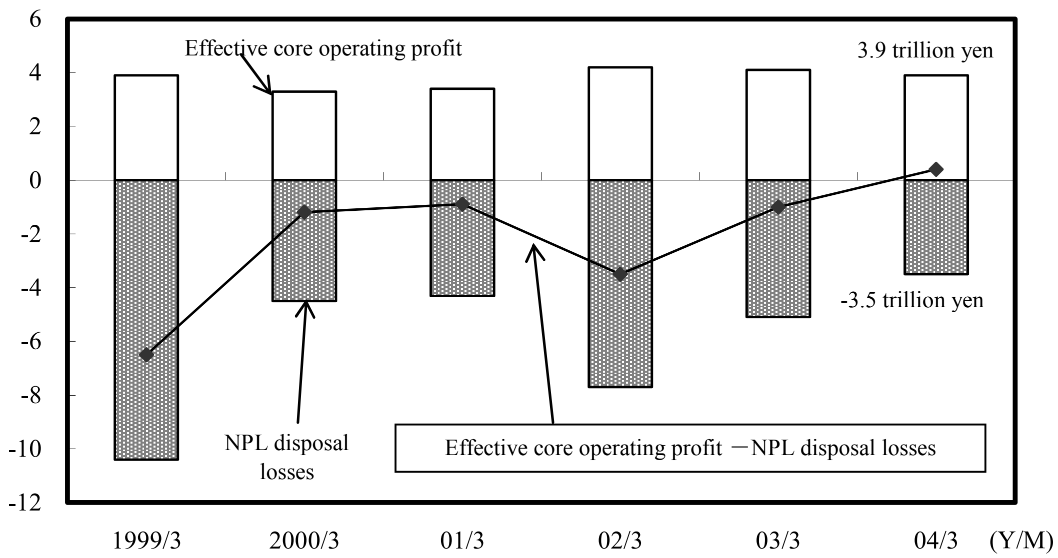
Fig. 1-5-12 Improvements in banks' nonperforming loans

(1) Disposal of nonperforming loans moving ahead steadily



Notes: 1. From Financial Services Agency documents. March 2004 values provisional.
2. Figures for major banks since March 2002 are the combined total of 11 city banks and trust banks.
3. From March 2003, regional banks include Saitama Resona Bank.

(2) Losses from NPL disposal are declining for major banks and have receded to below the level of effective core operating profit. (trillions, yen)



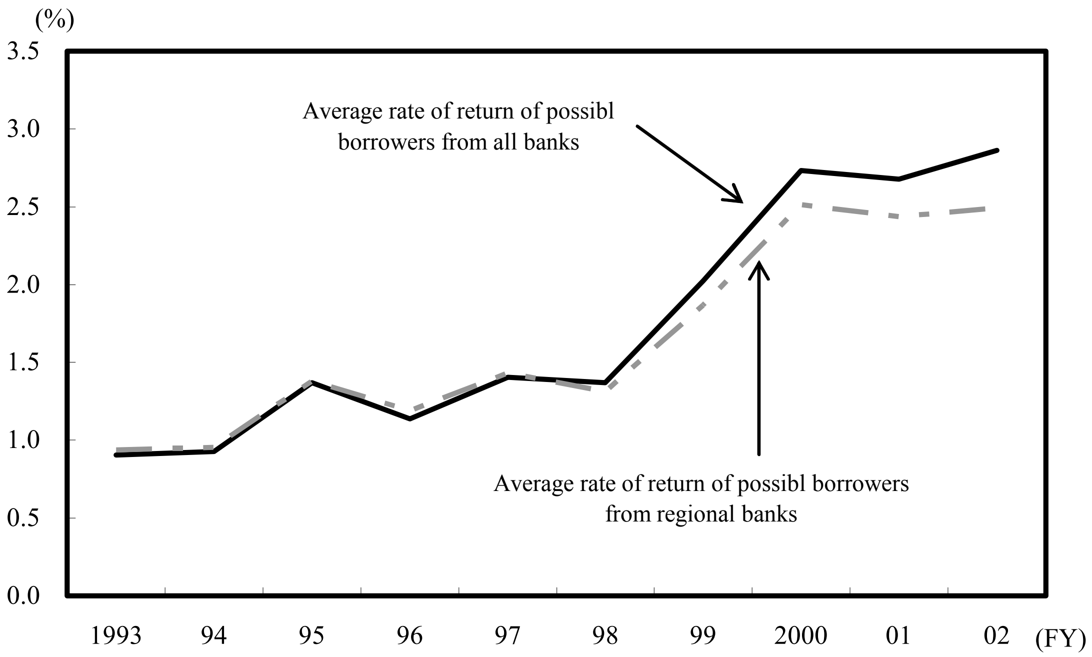
Notes: 1. From FSA documents.
2. Based on the 11 major banks excluding Shinsei Bank and Aozora Bank.
3. Effective core operating profit is core operating profit + transfer to general allowance for NPLs.

(The challenge of non-performing loan problems at regional banks)

- Promoting the disposal of NPLs based on the characteristics of individual regions is crucial.
- Comprehensive measures are needed in order to improve their profitability through regional revitalization.

Fig. 1-5-14 Simulated profit rate of possible borrowers from all banks and regional banks

The rate of return of regional firms is relatively low



Notes: 1. From *Financial Statements Statistics of Corporations by Industry, Annually*, Ministry of Finance, and *Financial and Economic Statistics,* BOJ.

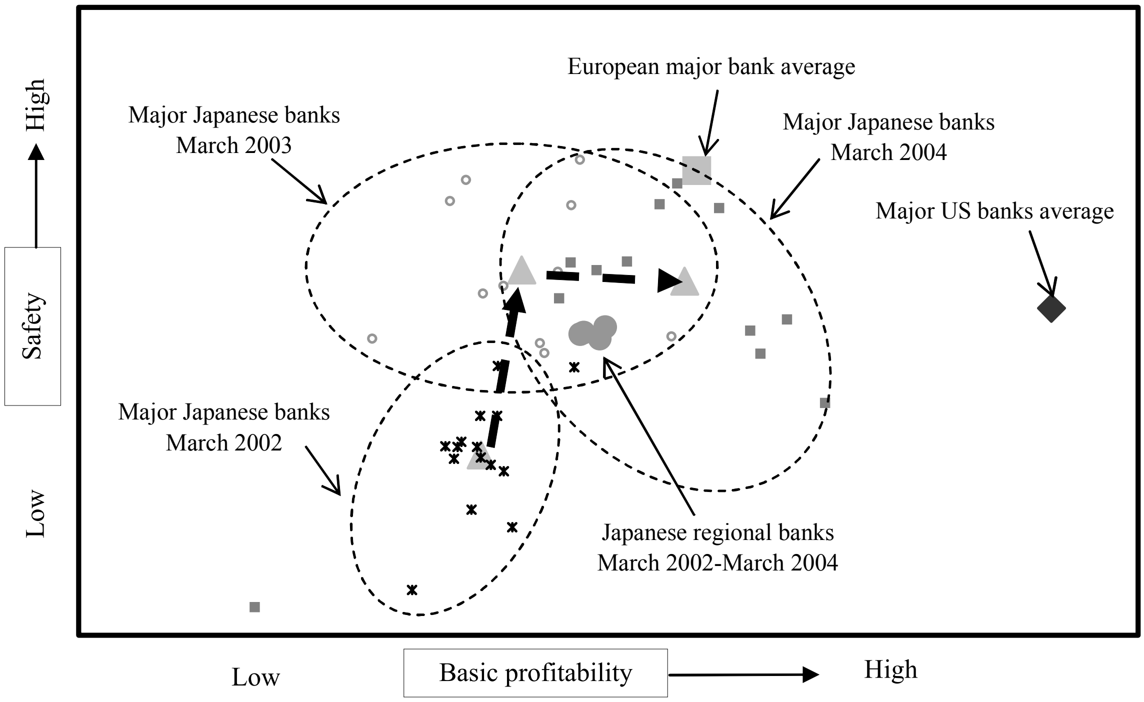
2. For each year, the annual operating profit rates by industry and company size are weighted according to all and regional banks' lending rates by industry and by company size respectedly. For these purposes there are seven industries (manufacturing, construction, electricity/gas/water, transport and communications, wholesale and retail, real estate and services.) In terms of company size, the categories are large companies (capital of over 100 million yen) and small and medium enterprises (capital of under 100 million yen).

(Evaluating the soundness of the financial intermediary system)

- The soundness of the financial intermediary system depends on the soundness level of the major banks.
- The management focus of the major banks is switching from ensuring safety to profitability.
- Reducing the risk in the financial intermediary system will require a diversification of bank management.

Fig. 1-5-15 Comparison of financial soundness by principal component analysis

Management focus of the major banks is shifting from ensuring safety to profitability.



Notes:
1. From *Analysis of Financial Statements of all Banks and Account Statement Documents from the Banks,* Japanese Bankers Association.
2. The value (representative characteristics) for major European and US banks is given by principal component analysis (PCA) using the financial data from Dec. 1994 to Dec. 2001 based on Bank Scope of Bureau van Dijk.
   For details, see *Discussion Paper on Analysis of Economy and Public Finance*, Cabinet Office DP/02-2.
3. The value for Japanese major banks in March 2002 is calculated using the financial data averaged from 1996 to March 2002, while financial data averaged from March 1999 to March 2002 is used for calculation of the value for regional banks in March 2002.
4. Due to limited data, the March 2004 value for regional banks is taken from September 2003 half year financial data.
5. The averages for Japanese banks for March 2003 and March 2004 do not include Resona Bank.

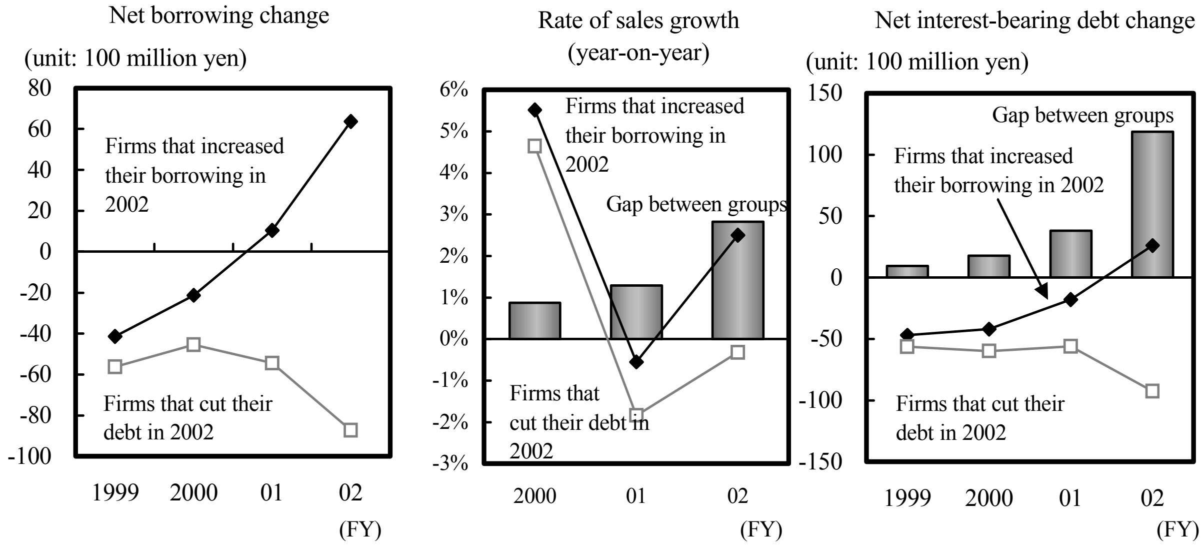
(Changing trends in businesses borrowing from banks)

- Move from loan repayment to increasing loans

  → Strengthening positive attitude among listed companies, which are increasing their borrowing from banks

Fig. 1-5-17 Traits of firms increasing their bank borrowing and those repaying loans

Companies borrowing more are more positive, repaying firms are paying loans faster.



Notes: 1. From *Development Bank of Japan's Corporate Financial Databank,* Japan Economic Research Institute.

2. Aggregate of 1,823 listed companies with available consecutive consolidated accounting data.
3. Firms are divided into two groups, one which increased their borrowing in FY2002 and the other which cut their borrowing. The amounts are the aggregate of these amounts per company.
4. Interest-bearing debt is the combined total of corporate bonds and borrowing. The change in net interest-bearing debt is the net total of borrowing and corporate bonds.

(Reform of public financing/business sectors)

- The presence of public financing is growing due to lower financial transaction in the private sector.

  → Capital distribution needs to be made to function effectively via the market mechanism through reform of the fiscal investment and loan program (FLIP), reform of special public institutions and the privatization of postal services.

Section 6 Future Economic Prospect

(Impact of external demand)

- While the contribution of external demand to GDP growth in FY2003 was 0.8%, domestic production and capital investment are correlated closely with exports. Any slowdown in overseas economies or appreciation of the yen would accordingly affect the Japanese economy to some extent in negative fashion.
- The pace of recovery in the Japanese economy may slow if the economic growth in the US and China, both of which have already been taking steps to restrict economic overheating, decelerates.
- Development of the US interest rates needs to be watched with some caution.

(Spreading improvement in domestic demand)

- Income growth is likely to stay mild, given that the growth of wages through overtime pay and bonuses will be partly offset by the effect of a rise in rate of part-time work. However, a modest increase in consumption is expected as saving rate is likely to decline moderately, reflecting aging population and the recovery in consumer confidence backed by improved employment conditions.

(Low level of inventory and capital stock)

- Despite increased production and capital investment, there is no excessive accumulation of inventory or capital stock. Even a slight fallback in demand is unlikely to lead to stock adjustments immediately.

(Impact of higher pension premiums)

- A survey conducted by the Cabinet Office in March 2004 found that 80% of respondents were aware of the rise in pension premiums. Of the respondents, around half said it would affect their spending, while the other half said it would not. Even among those who said they would reduce their spending, 40% said that the timing of the cut would be conditional on the state of their household income after the increase in premiums. So even if the rise in pension premiums is likely to have some impact, the extent to which it affects consumption will depend on the income situation at the time.
- However, some caution will be needed as a half of respondents could cut spending, responding to such a slight increase in premiums.

(Projected shape of the recovery)

Overseas economic development remains a risk, but the Japanese economy is building the foundations of continued recovery based on private demand.

1) By reducing their excess debt and employment, companies are strengthening their financial health to withstand some shocks.
2) Consumption is expected to continue its modest increase as falling unemployment rate boosts consumer

confidence.

3) Rather than a temporary impact, demand for digital electronics is expected to continue to grow for the time being.

- However, the pace of recovery will slightly slow as the growth in the US and China could decelerate.
- Prices, which currently remain flat, are likely to move off to mild increase as the economic recovery continues. However, a number of challenges remain before deflation can be truly overcome, including the recovery of the soundness of the financial sector.

Fig. 1-6-4 Results from survey on increased pension premiums