

**Annual Report on
the Japanese Economy and Public Finance
2005**

—No Gains Without Reforms V —

Summary

July 2005

Cabinet Office

Government of Japan

Contents

Chapter 1 Japanese Economy Aims for Long-term Growth.....	1
Section 1 Current Temporary Slowdown will come to an end	1
Section 2 Points to Keep in Mind Regarding Economic Trends	4
Section 3 From an Intensive Adjustment Period to a Concentrated Consolidation Period.....	6
Section 4 Evaluation of Fiscal and Monetary Policies	11
Section 5 Future Outlook for the Economy	11
Chapter 2 From Public Sector to Private Sector – Restructuring of Government Sector and Associated Challenges.....	13
Section 1 Views on Small Government	13
Section 2 From Public Sector to Private Sector – Various Methods	15
Section 3 Reform of Local Public Finances.....	17
Section 4 Challenges in Aiming for Small Government.....	18
Chapter 3 The “Demographic Wave” and its Impacts on the Economic Structure.....	20
Section 1 Demographic Change and its Economic Significance.....	20
Section 2 The Demographic Wave and its Impact on Household Behavior	22
Section 3 The Demographic Wave and Business Competitiveness	28
Section 4 The Source of Innovation and the Challenge to Improve Competitiveness.....	30
Conclusion.....	31

Chapter 1 Japanese Economy Aims for Long-term Growth

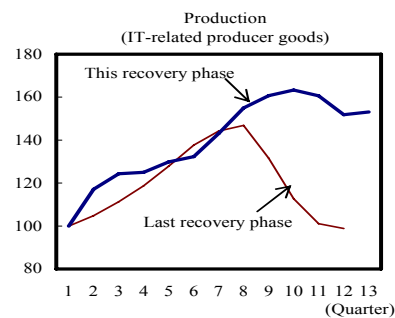
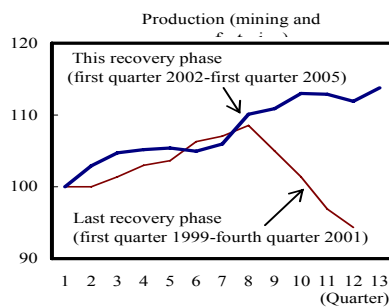
Section 1 Current Temporary Slowdown will come to an end

- The characteristics of the economic recovery phase now in its fourth year are among others 1) private demand is steadily supporting growth, 2) government spending is continuing to have a negative impact on the economy, and 3) the unemployment rate is steadily decreasing.
- The adjustment of IT-related producer goods is expected to be relatively small and to be completed in a relatively short period of time, unlike in 2001, because of 1) relatively early production adjustments, and 2) a broadening base for IT demand. Production other than for IT-related products has been steady so far.

Fig. 1-1-2 Inventory adjustment of IT-related producer goods

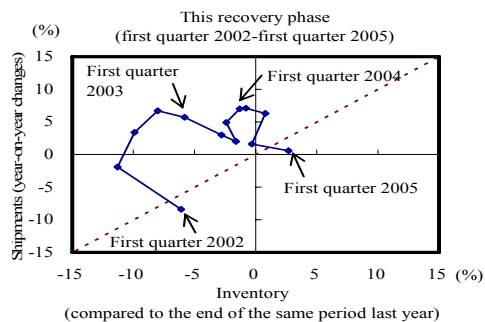
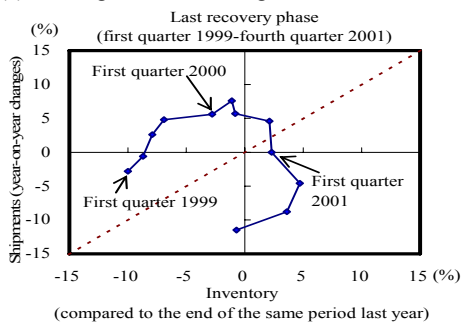
Inventory adjustment of IT-related producer goods advancing more quickly than in the last recovery

(1) Production Index

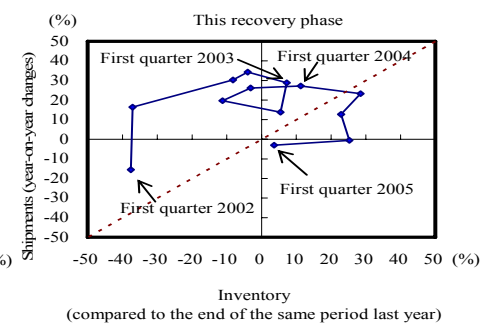
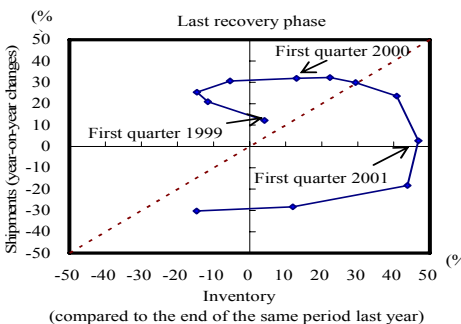


(2) Inventory cycle

(2)-1 Mining and manufacturing



(2)-2 IT-related producer goods



Notes: 1. *Indices of Industrial Production, Ministry of Economy, Trade and Industry. Seasonally adjusted indices were used for (1) and original indices were used for (2).*

2. For the figures in (1) an index was used that set the base period of the economy (last recovery phase: first quarter 1999, this recovery phase: first quarter 2002) to 100.

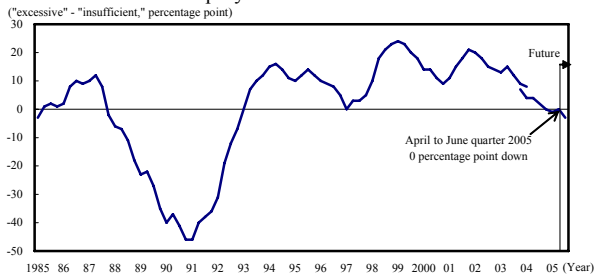
- The “three excesses” – employment, capital stock, debt – have been largely eliminated
- With the elimination of these excesses the break-even point has lowered and the business sector has been strengthened.
- Disposal of aging capital stock and introduction of advanced facilities have increased capital investment efficiency. It is also expected that the increase in the expected growth rate will result in an increase in capital investment.

[Analysis]

- The three excesses which have been the major growth constraining factors since the collapse of the bubble economy—excessive employment, excessive capital stock, and excessive debt—have been largely eliminated through restructuring (reduction in the number of personnel), etc., the disposal of aging facilities, etc., and debt repayment and disposal of non-performing loans, respectively.
- Both the “sense of over-employment” and the “sense of excessive capital stock” seen in the Bank of Japan’s *Short-term Economic Survey of Principal Enterprises in Japan* (Tankan survey) have been largely eliminated. The interest-bearing debt/cash flow ratio has declined to pre-bubble economy levels.

Fig. 1-1-8 (1) Over-employment

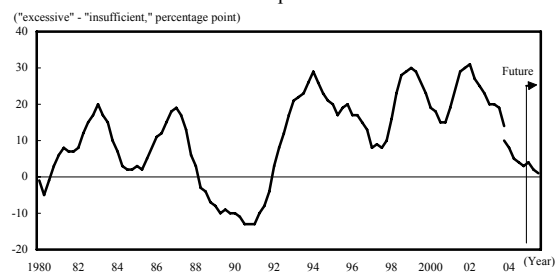
Over-employment has been eliminated



- Notes: 1. *Short-term Economic Survey of Enterprises in Japan* (Tankan survey), Bank of Japan.
 2. All sizes in all industries. The figure for the third quarter of 2005 is a future projection.
 3. The survey method has been changed from that used for the March 2004 survey. This caused the discontinuity in the graph.

Fig. 1-1-8 (2) State of excessive capital stock

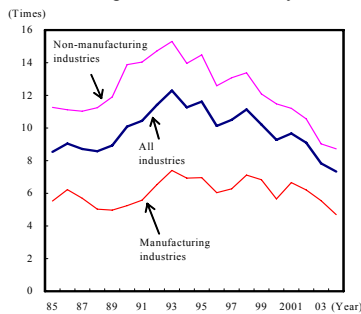
The sense of excessive capital stock is at a low level



- Notes: 1. *Short-term Economic Survey of Enterprises in Japan* (Tankan survey), Bank of Japan.
 2. All sizes in all industries. The figure for the third quarter of 2005 is a future projection.
 3. The survey method has been changed from that used for the March 2004 survey. This caused the discontinuity in the graph.

Fig. 1-1-8 (3) Interest-bearing debts/cash flow ratio

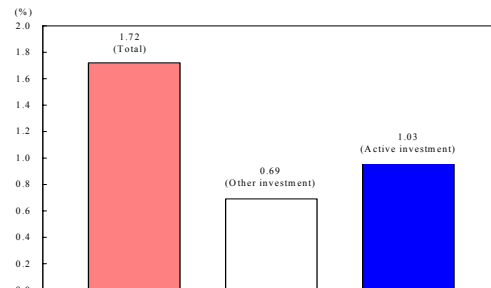
Decline to pre-bubble economy levels



- Notes: 1. *Financial Statements Statistics of Corporations by Industry, Quarterly*, Ministry of Finance.
 2. Interest-bearing debt/cash flow ratio = interest-bearing debts ÷ cash flow
 Interest-bearing debt = long-term loans + short-term loans + bonds
 Cash flow = current profits × 1/2 + depreciation

Fig. 1-1-14 The impact of the expected growth rate of enterprises on capital investment

Enterprises with a 1% higher expected growth rate have 1.72% higher capital investment



- Note: Estimated using a special calculation based on the *Annual Survey of Corporate Behavior*, Cabinet Office (FY2004).

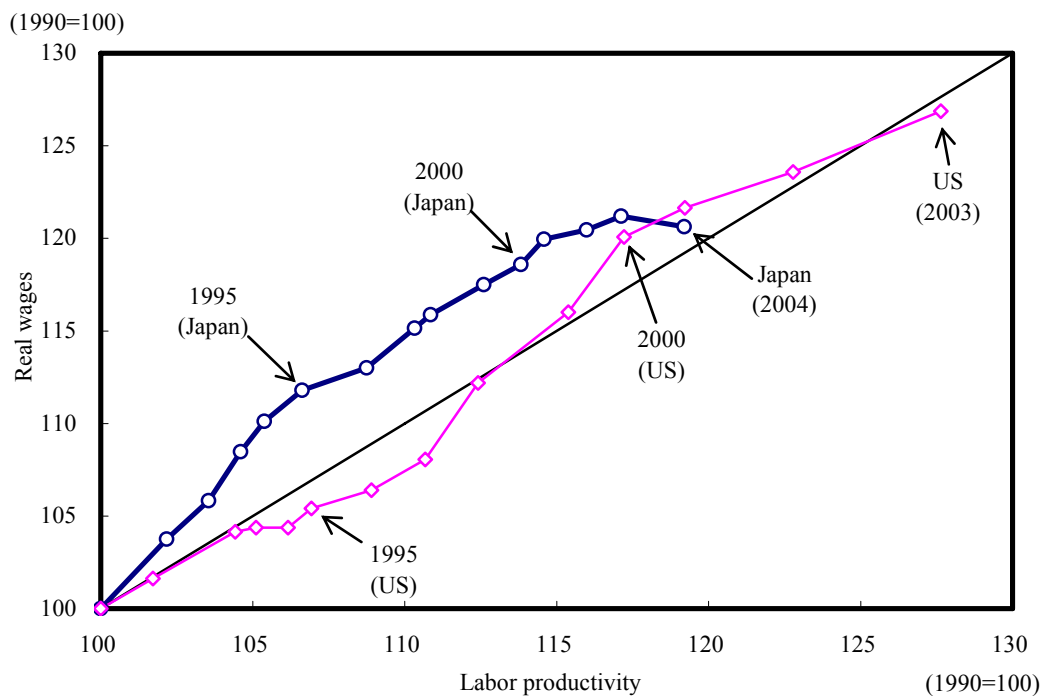
- Labor share remained at a high level during the second half of the 1990s but declined in the 2000s as a result of employment restructuring, and this led to the strengthening of the business sector.
- By 2004, labor share declined to a point where labor productivity and real wages are at the equilibrium.

[Analysis]

- Labor share in the first half of the 1990s increased because the real wage growth rate was higher than the growth rate of labor productivity. After that, it remained at a high level.
- After the beginning of the 2000s, real wages flattened out and labor share began to decline. If the real wage growth rate and the growth rate of labor productivity coincide (i.e. are in long-term equilibrium), the labor share stabilizes.
- The key from now is whether an improved balance of labor supply and demand will lead to employment growth and wage growth.

Fig. 1-1-16 Labor share and labor productivity and real wages in Japan and the US

Real wages are remaining flat and are pushing down labor share



- Notes:
1. *National Accounts*, Cabinet Office; *Labour Force Survey*, Ministry of Internal Affairs and Communications; *Monthly Labor Survey*, Ministry of Health, Labour and Welfare; OECD "*National Accounts*," etc.
 2. In Japan and the US, labor productivity = real GDP/labor input; labor input = number of people employed * total working hours
 3. In Japan and the US, real wages = (nominal compensation of employees/GDP deflator)/labor input
 4. Data is indexed with 1990 set to 100. Calendar year data.

Section 2 Points to Keep in Mind Regarding Economic Trends

- The increase in the price of crude oil has not had a major impact on the economy to date. However, it is necessary to be aware of risks such as pressure on corporate profits and uncertainty about the future leading to greater caution on the part of companies and households and a slowdown in the world economy, etc.
- Even though the overseas economy is sound, exports have been stagnant since the second half of 2004. There are multiple factors behind the slowdown of exports to China while the broadening base of demand for IT-related products is a positive factor.

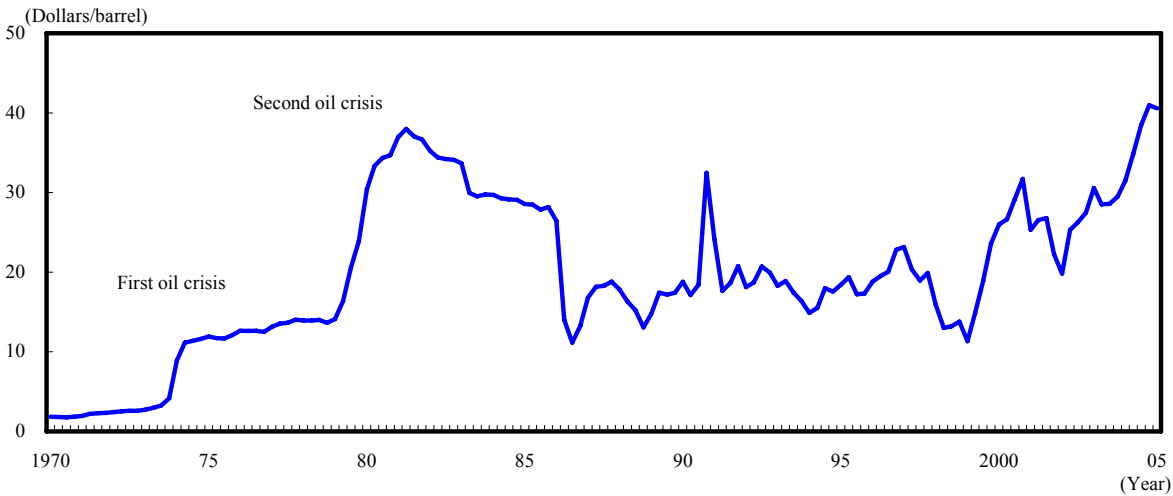
[Analysis]

- The price of crude oil is continuing to increase, but the economic environment differs from that during the oil crises in the 1970s in the following ways: 1) energy efficiency is higher, 2) cost increases are absorbed by productivity increases so that pressure is not put on corporate profits, and 3) price developments do not seem to be leading to high inflation.
- Exports of electric machinery, general machinery, etc. to Asia are slowing down. In addition to the worldwide softening in IT-related supply and demand, exports to China are slowing down due to the impact of a variety of factors such as China’s policies to curb business overheating, the increase in its self-sufficiency and exporting capability, an increase in the proportion of supplies procured locally by Japanese companies in China, etc.

Table 1-2-1 Comparison of crude oil price increases

Due to increased efficiency of energy consumption, the impact of crude oil price increases has been small compared to the time of the oil crises

(1) Trends in crude oil import price (quarterly basis)

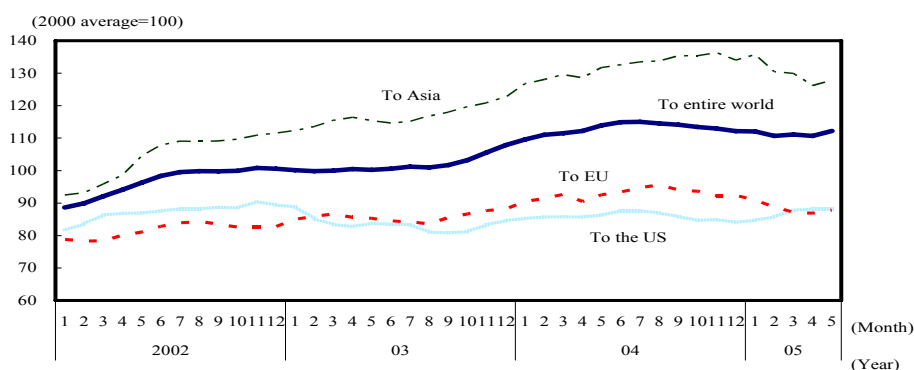


(2) Comparison with the oil crises

	First oil crisis	Second oil crisis	Now
Period	October 1973-August 1974	December 1978-April 1982	March 2002-
Change in crude oil import price ((2)/(1), multiples)	3.4	2.9	2.6
Price just before period began (\$/barrel) (1)	3.3	13.3	19.9
Highest price during period (\$/barrel) (2)	11.3	38.2	50.7
	FY1974	FY1980	FY2004
Crude oil imports (relative to nominal GDP, %)	4.2	4.8	1.3
Real income transfers (relative to real GDP, %)	2.8	2.9	0.6
Crude oil supply/real GDP (1970=100)	103.9	74.3	45.4 (FY2002)

- Notes: 1. *Trade Statistics*, Ministry of Finance; *National Accounts*, Cabinet Office; *General Energy Statistics*, Agency for Natural Resources and Energy, etc.
 2. Crude oil import prices are converted to a dollar basis using the monthly average value of the exchange rate.
 3. "Price just before the period began" and "highest price during the period" are both based on the monthly average of the crude oil import price.
 4. Refer to *Japanese Economy 2004*, Cabinet Office for the calculation method for real income transfers. The values for real GDP, etc. are calculated using a fixed base year method (calendar year 1995) for FY1974 and FY1980, and using the chain method for FY2004.
 5. Crude oil supply uses a breakdown (oil) of aggregate supply of primary energy.

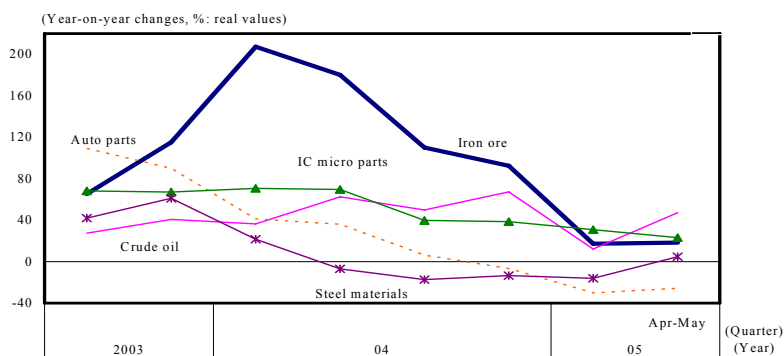
Fig. 1-2-2 Export volume



- Notes: 1. *Trade Statistics*, Ministry of Finance. Seasonally adjusted values by the Cabinet Office.
 2. Moving averages over the next three months.

Fig. 1-2-5 Trends of Chinese imports

(2) Among Chinese import items, the slowdown in iron ore, steel materials, auto parts, etc. stands out



- Notes: 1. *China's Custom Statistics*, National Bureau of Statistics of China.
 2. The real GDP quarterly values (except the first quarter) and the real value of imports by item are Cabinet Office estimates.

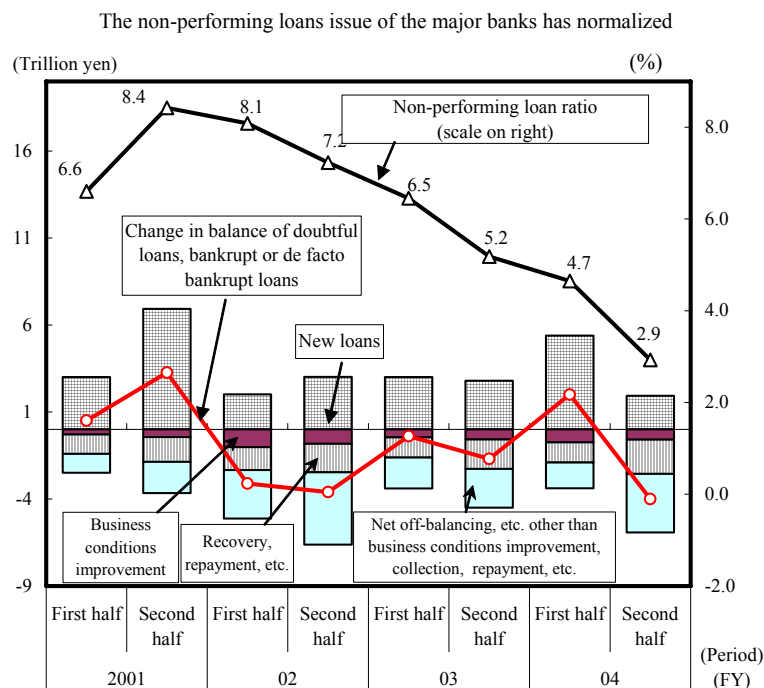
Section 3 From an Intensive Adjustment Period to a Concentrated Consolidation Period

- Through an intensive adjustment period the non-performing loans issue has normalized, financial system uneasiness has largely declined, and a deflationary spiral has been avoided.
- It was difficult to normalize the non-performing loans issue only through improved business conditions resulting from economic recovery. Policy measures (the Program for Financial Revival, etc.) have also made a big contribution. The loans capacity of financial institutions is steadily improving.

[Analysis]

- The non-performing loans ratio of the major banks has more than halved (March 2002: 8.4%→March 2005: 2.93%).
- The off-balancing of non-performing loans was not only due to improved business conditions resulting from economic recovery; policy measures have also made a big contribution.
- Estimating the loan supply function of financial institutions (based on all Japanese banks), the capital adequacy ratio and non-performing loans ratio improved throughout the concentrated adjustment period so that loan capacity is steadily recovering.

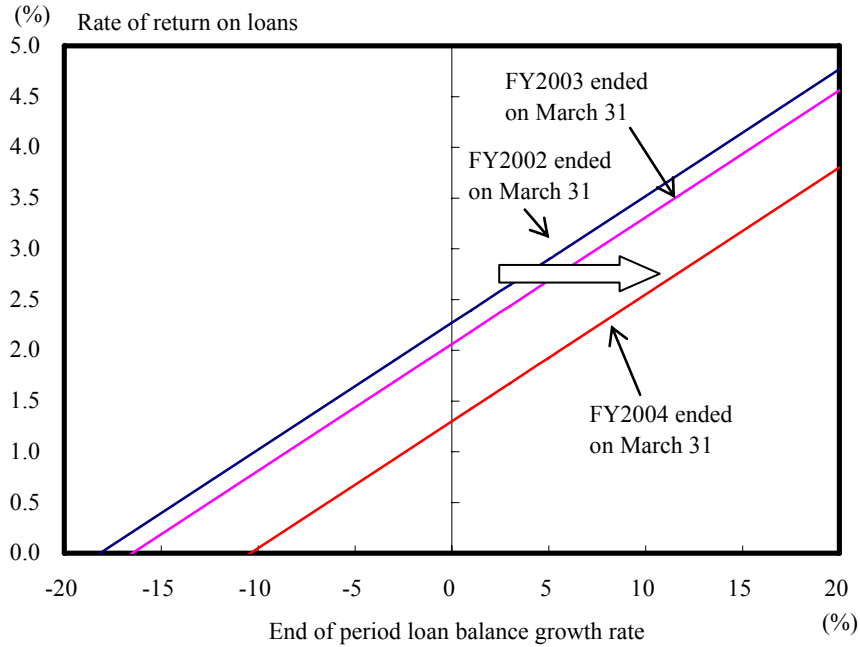
Fig. 1-3-1 State of disposal of non-performing loans by the major banks



- Notes:
1. Account statements documents from the banks (11 major banks, values for Resona Bank before the first half of FY2002 are the sum of its two predecessors), *The Status of Non-Performing Loans (NPLs)*, Financial Services Agency.
 2. Graphs other than the one for “Non-performing loan ratio” use the scale on left.
 3. “Net off-balancing, etc. other than business conditions improvement, collection, repayment, etc.” includes partial direct depreciation, disposal through liquidation, debt liquidation, etc.

Fig. 1-3-3 Estimate of the loan supply curve of financial institutions

Loan capacity of financial institutions (all banks nationwide) is steadily recovering



(Reference) Estimate of loans supply

Dependent variable: loan growth rate

	All banks nationwide (fixed-effect model)
Constant term average	-0.083
Non-performing loan ratio	-2.604 (-17.629) ***
Capital adequacy ratio	1.311 (10.714) ***
Rate of return on loans	0.080 (9.652) ***
Modified coefficient of determination	0.728
Sample size	288 (96 banks, 3 years)

The figures within the brackets are t-values. *** means significant to the 1% level.

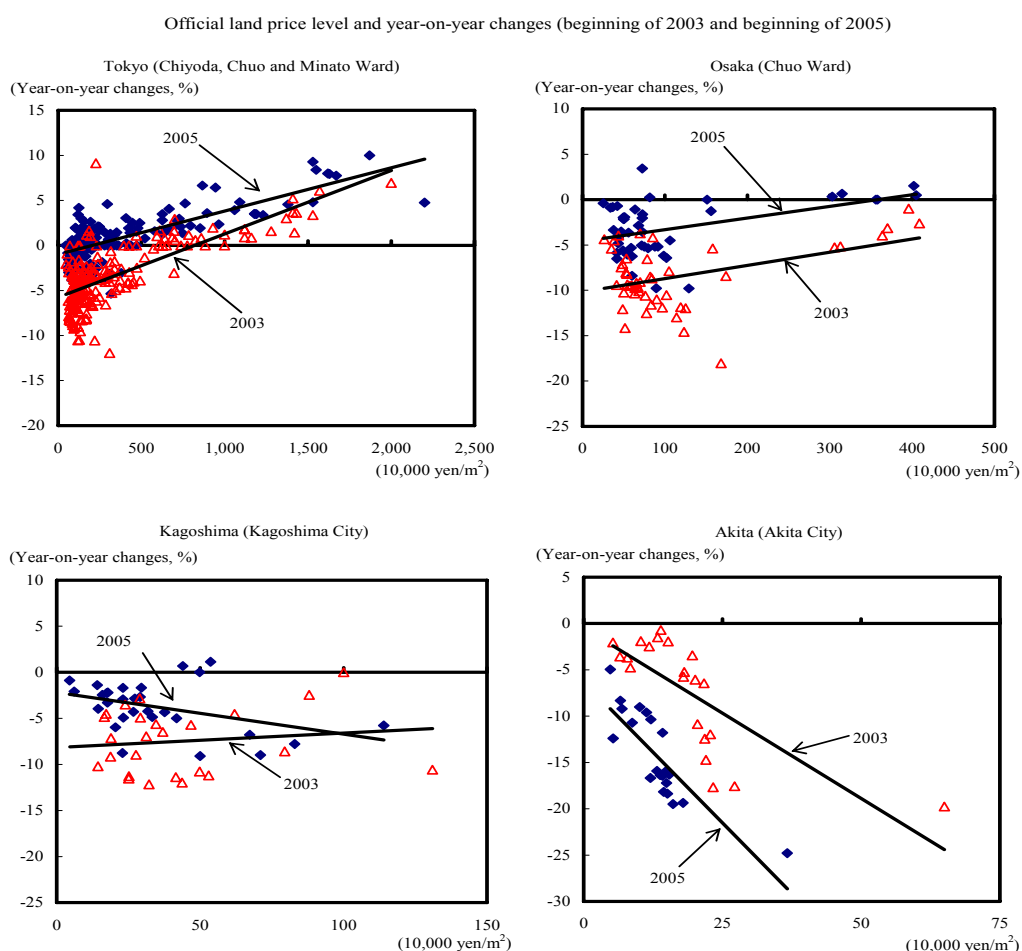
Note: Structural Reform Evaluation Report 4, Cabinet Office.
See Appended Note 1-5 for details about the estimation method.

- The rate of decline in land prices is decreasing even in the regions. Partly because the market for the securitization of real estate, including REITs, etc., is strong, real estate transactions are becoming revitalized, primarily in urban areas.
- Moderate deflation is continuing. Due to reduced prices for public utilities, etc., the rate of decline of consumer prices has marginally increased since last year. Corporate goods prices have increased since last year due to an increase in prices in the market for raw materials.

[Analysis]

- The rate of decline in land prices is decreasing even in the regions, but land prices are picking up primarily in the major cities. In Tokyo and Nagoya, etc. the trend is for land prices to rise more in areas with high land prices (namely, highly convenient and profitable areas). Conversely, in regional cities, areas with high land prices occasionally show a higher rate of decline.
- Moderate price deflation is continuing. Consumer prices are lower than last year due to the impact of reduced prices for public utilities. Domestic corporate goods prices are higher than last year due to the impact of an increase in prices in the market for raw materials.

Fig. 1-3-8 Land Prices in Central zones (commercial zones)

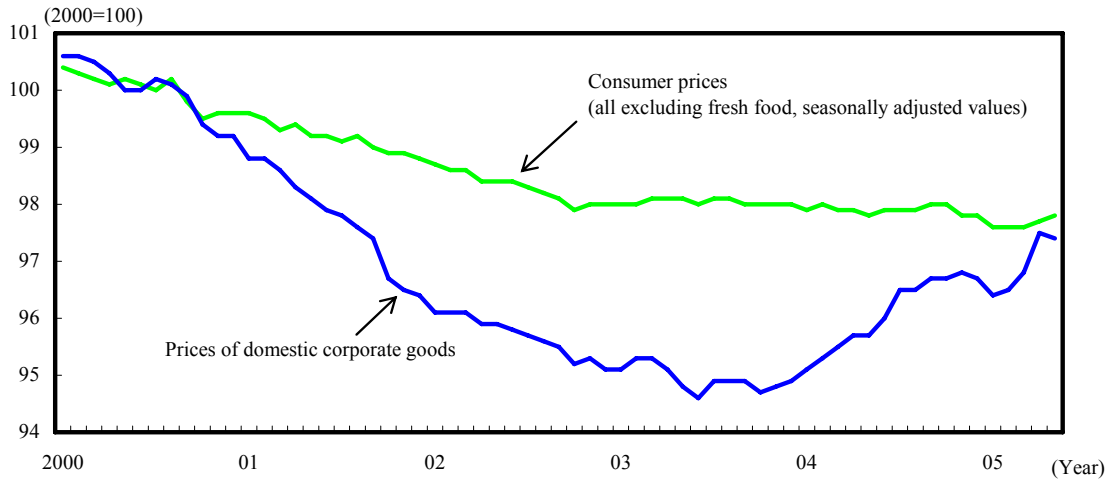


Source: Land Price Publication, Ministry of Land, Infrastructure and Transport.
 Notes: For areas with data published continuously between 2002 and 2005 in commercial districts in each region, the relationship between the level of land prices and year-on-year changes are shown. are for 2003 and are for 2005.

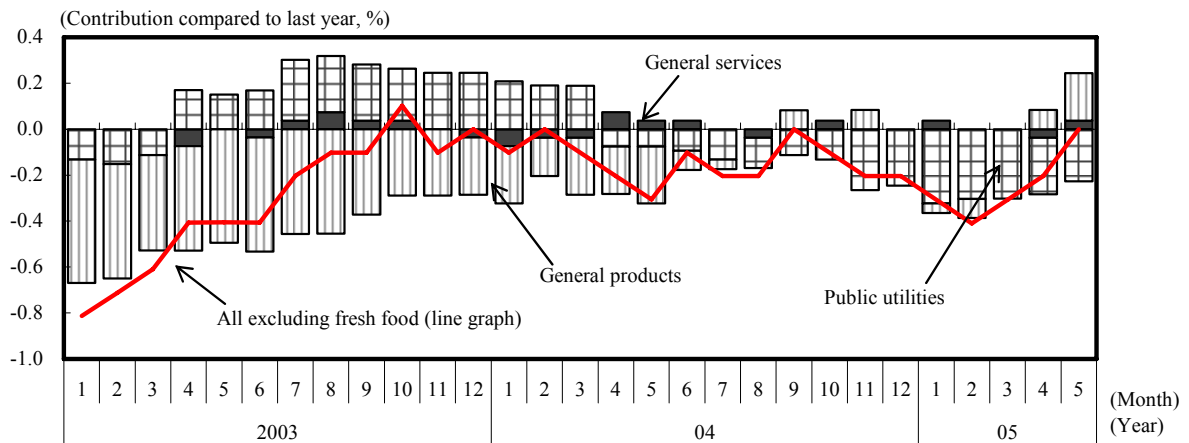
Fig. 1-3-9 Price Index

Moderate deflation continues

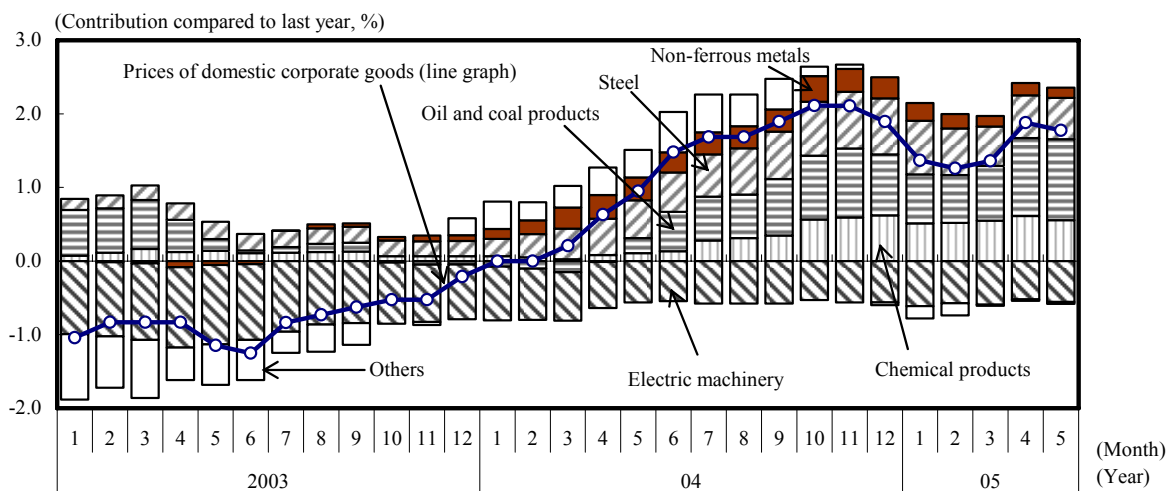
(1) Prices of domestic corporate goods, consumer prices



(2) Analysis of the contribution of consumer prices



(3) Analysis of the contribution of prices of domestic corporate goods



Note: Corporate Goods Price Index, Bank of Japan; Consumer Price Index, Ministry of Internal Affairs and Communications.

- The goal of structural reform is to improve regulations and systems that obstruct market functions and make it easy for market mechanisms to work. In recent years, factors of production (employment, capital, funds, etc.) have come to be allocated in a more fluid manner and the supply side is continuing to get stronger.

[Analysis]

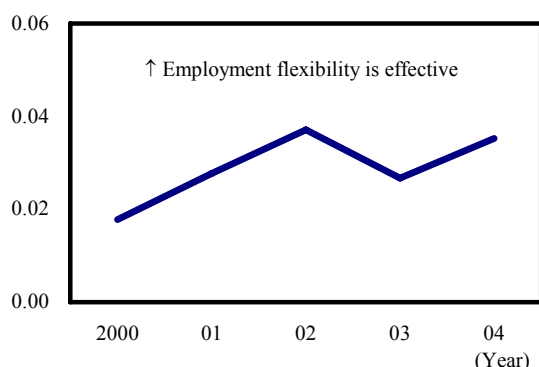
- The analysis focused on the growth rate of the factors of production (employment, capital, funds, etc.) and studied the degree of flexibility in each industry relative to the growth rate of the overall economy. The indicator showing the degree of flexibility (Lilien indicator) is increasing, showing that the factors of production have come to be allocated in a more fluid manner and that the supply side is increasingly getting stronger.

* Lilien indicator: an indicator showing the fluidity of allocation of resources among industries. The higher the value of the indicator, the more fluid the movement of resources and the higher the degree of flexibility.

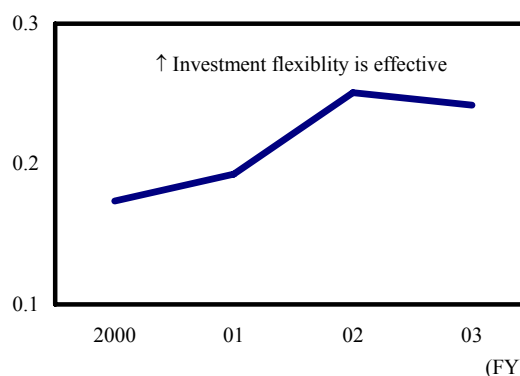
Fig. 1-3-15 Strengthening of the supply side - Lilien indicator

Employment, investment, and funds are increasingly being allocated in a fluid manner

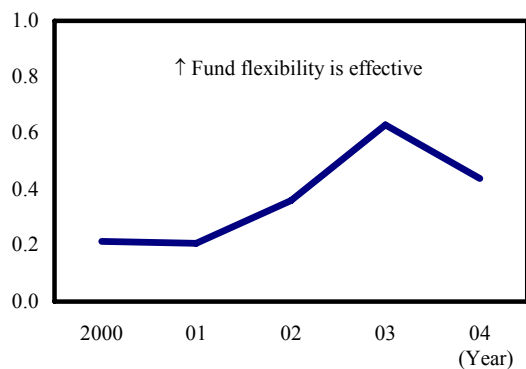
(1) Labor market



(2) Capital stock



(3) Loans



Notes: 1. *Labour Force Survey*, Ministry of Internal Affairs and Communications; *Gross Capital Stock of Private Enterprises*, Cabinet Office; *Loans by Borrower*, Bank of Japan.

2. Lilien Measure:
$$\left[\sum_{i=1}^n S_{Li} \left(\frac{\Delta Li}{Li} - \frac{\Delta La}{La} \right)^2 \right]^{1/2}$$

(1) Labor market

Li : number of people employed in industry i , La : total number of people employed, S_{Li} : share of people employed of industry i

(2) Capital stock

Li : capital stock of industry i , La : total capital stock, S_{Li} : share of capital stock of industry i

(3) Loans

Li : loans of industry i , La : total loans, S_{Li} : share of loans of industry i

3. Capital stock excludes the impact of the FY 2003 reorganization of the steel and transportation/communications sectors.

Section 4 Evaluation of Fiscal and Monetary Policies; Section 5 Future Outlook for the Economy

- The reduction in public investment has made a big contribution to the improvement in the primary balance (relative to nominal GDP) since FY2002. The increase in government revenue in FY2004 and FY2005 will further improve the primary balance.
- Concerning quantitative easing policies, even though there was a policy duration effect, the portfolio rebalance effect is not clear at this point in time. Effective monetary policy to avoid deflation is important.
- Concerning future trends in the economy, the private demand-led recovery is expected to continue through progress in the adjustment of IT-related producer goods, a moderate increase in consumption resulting from an improvement of employment and incomes, etc. It is necessary to be aware of the long-term increases in crude oil prices, possibility of an autonomous cycle of adjustments in inventories and capital stock resulting from maturing of the economy, etc.

[Analysis]

- Doing a factor analysis of the variation in the primary balance, it can be seen that the reduction of public investment has made a big contribution. The increase in government revenue in FY2004 and FY2005 resulting from the economic recovery will further improve the primary balance.
- Due to quantitative easing policies, medium- to long-term interest rates are stable (policy duration effect). Looking at the asset portfolios of financial institutions, the weight of loans has not increased high, and the portfolio rebalance effect has not clearly appeared up until this point in time.

Fig. 1-4-2 Factor analysis of the variation in the primary balance (national, regional)

The reduction in public investment has contributed to improvement in the primary balance

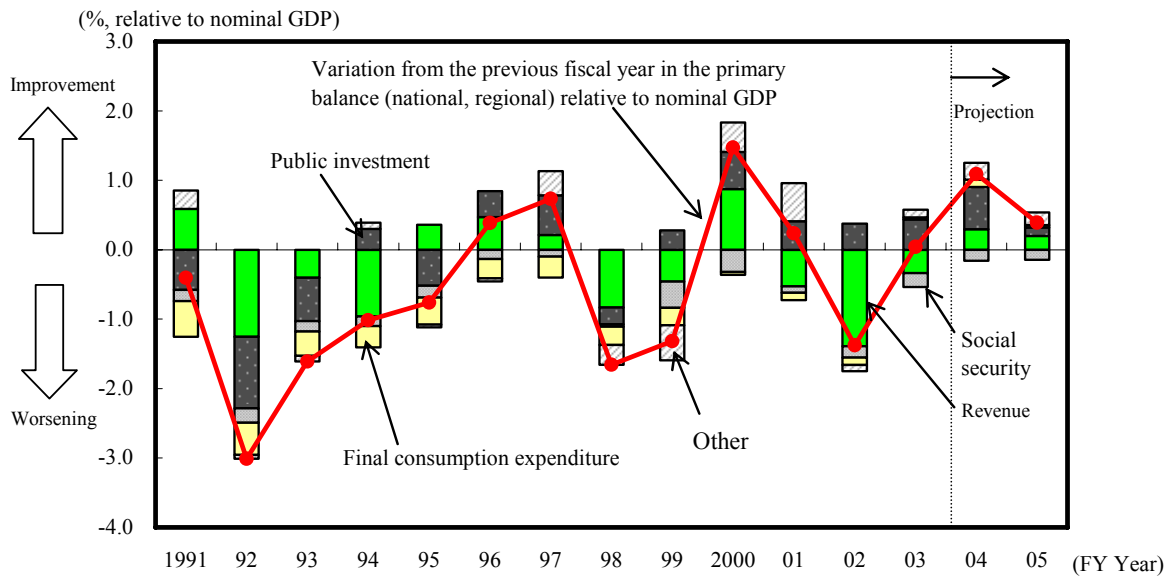
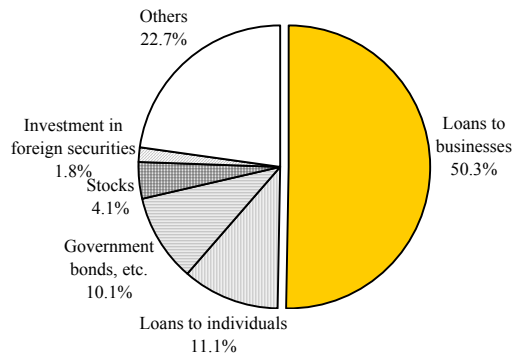


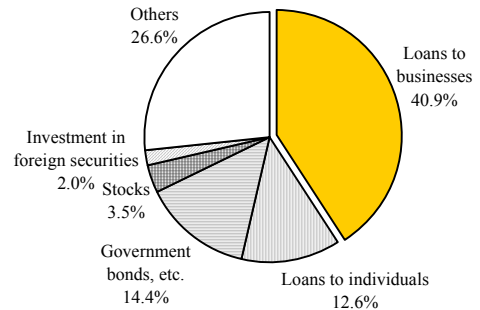
Fig. 1-4-4 Policy duration effect and portfolio balance effect

The weight of risky assets in banks is not high

(1) March 2001



(2) March 2005



Notes: 1. *Flow of Funds Accounts*, Bank of Japan.
2. Figures for March 2005 are preliminary.