

**Fiscal 2008 Economic Outlook  
and  
Basic Stance for Economic and Fiscal Management**

**January 18, 2008  
Cabinet Decision**

**1. Economic and Fiscal Management and the Japanese Economy in FY2007**

(Economic and fiscal management in FY2007)

In FY2007, in pursuit of establishing a new growth path, the Government decided on the “Economic and Fiscal Reform 2007” (cabinet decision on June 19, 2007, hereinafter referred to as “Basic Policies 2007”) which set a reform policy toward enhancing growth potential --by way of implementing measures<sup>1</sup> such as the “Program for Enhancing Growth Potential” (adopted by the Council on Economic and Fiscal Policy on April 25, 2007) -- and advancing fiscal consolidation while regarding them as being both inseparable and necessary. Toward revitalizing regional economies, the Government compiled the “Regional Revitalization Strategy” (approved by the Unified Headquarters for the Regional Revitalization on November 30, 2007) aimed at providing comprehensive support in an inter-ministerial and multi-sectoral manner.

Regarding administrative reform the Government decided on the following measures: “On the Reform of the Civil Servant System” (cabinet decision on April 24, 2007), the “Basic Policies on Public Services Reform” (revised and decided by the Cabinet on October 26 and December 24, 2007) and the “Plan for the Consolidation and Rationalization of Independent Administrative Agencies” (cabinet decision on December 24, 2007).

In December, in consideration of the serious effects of surge in crude oil prices on peoples’ daily lives and on small and medium enterprises (SMEs), the Government finalized the report entitled “Concerning Concrete Steps for the Implementation of Emergency Measures for Small and Medium Enterprises, Business Sectors, and the People’s Daily Lives to Counteract the Surge in the Crude Oil Price” (adopted by the Emergency Ministerial Meeting on the Surge in the Crude Oil Price and Subcontracted Small and Medium Enterprises on December 25, 2007). Under the principle of refraining from relaxing financial discipline, the Government formulated a supplementary budget that also takes into account public security and safety, regional revitalization and soaring crude oil prices (cabinet decision on December 20, 2007).

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<sup>1</sup> The “Economic Growth Initiative” (revised on June 19, 2007), the “Asia Gateway Initiative” (adopted by the Asian Gateway Strategic Council on May 16, 2007), a long-term strategy initiative “Innovation 25” (cabinet decision on June 1, 2007) and so on

In order to address issues caused by the enforcement of the revised Building Standard Law<sup>2</sup>, including the significant decrease in building construction, the Government has implemented measures aimed at facilitating the formulation of certification procedures and supporting fund-raising by related industries.

(The Japanese Economy in FY2007)

The economy is recovering, while some weaknesses are seen.

In FY2007, with the continuing strength of the domestic corporate sector, Japan's economic recovery is expected to continue. However, given the fact that housing construction is decreasing due to the enforcement of the revised Building Standard Law, the pace of economic recovery is expected to be moderate.

Looking at price movements, the consumer price index (CPI) is expected to rise due to price increases for oil and other products.

In sum, the real GDP growth rate in FY2007 is expected to be approximately 1.3% (with a nominal GDP growth rate of approximately 0.8%).

Close attention should be given to the effects of downside risks for the U.S. economy and fluctuations in financial and capital markets -- caused primarily by the subprime mortgage loan problem -- and soaring crude oil prices on the Japanese economy.

## **2. Basic Economic and Fiscal Management Measures for FY2008**

The Government will aim to realize a country of "Hope and Reassurance," wherein young people have hope for the future and the elderly have a sense of reassurance. To this end, the following three measures will be promoted in an integrated manner: (1) enhancing growth potential; (2) regional independence and revitalization and; (3) establishing secure and trustworthy finance, social security and administration.

In order to ensure sustainable economic growth led by private demand and establish a stable level of inflation, the Government and the Bank of Japan will implement policy management, sharing their basic perspectives on macroeconomic management that were described in the "Basic Policies 2007."

Close attention should be given, as it was done in FY2007, to the effects of risk factors such as fluctuations in financial and capital markets -- caused primarily by the subprime mortgage loan problem --, soaring crude oil prices and overseas economic trends on the Japanese economy.

The Government will continue to practice decisive and flexible policy management in

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<sup>2</sup> Act to partially amend the Building Standard Law to ensure the safety of buildings (Act No. 92 of 2006)

accordance with the economic situation.

(1) Toward enhancing growth potential

(Growth strategies based on “networking ability and environmental prowess”)

In order to ensure future growth by way of the principles of “self-reliance and mutual cooperation” and achieve the shape of Japan that should be aimed at within 10 years or so, the Government will set the following three goals for which reform strategies will be pursued in an intensive manner: “goal 1: an open country which develops together with the rest of the world,” “goal 2: a country where people can live without anxiety into their 90s,” and “goal 3: a country that achieves sustainable economic growth even with a declining population.”

With the aim of realizing these three goals, the Government will strive to: (1) create an “economy in which all participate,” in which IT is thoroughly utilized and the elderly and the young, urban and rural areas, and large enterprises and SMEs cooperate and grow in partnership; (2) create an “economy that develops its strengths,” which is characterized by the pursuit of “only one” value-added in the world, achieving growth by way of converting risks into opportunities and creating high quality of life by way of realizing a “long-lasting and slow lifestyle”; (3) an open “economy that develops together with the rest of the world,” which expands flows of people, goods, money, and information.

To this end, the three new strategies mentioned below should be promoted. In all strategies, the Government will aim to demonstrate “networking ability” and “environmental prowess:” the former will enable all entities to become independent, demonstrate their strengths and promote coordination by way of developing excellent talent as well as circulating and sharing ideas and information beyond boundaries of age, region, industry type and company size; the latter will enhance environmental innovation aimed at Japan’s assumption of a leading role in resolving global environmental issues and creating a low carbon society.

Strategy 1: “Strategy of mutual cooperation” (through the participation of all people)

Reviewing an economy that is driven by large enterprises, cities and working people and establishing an economy in which SMEs, venture companies, rural areas, consumers and elderly citizens also play leading roles and develop the economy in partnership. Maintaining a broad middle class along with a public safety net for a sense of reassurance

Strategy 2: “Strategy of independence” (through demonstrating strengths)

The assurance of independence of all individuals, enterprises and regions by way of departing from an economy whose weaknesses people both deplore and protect as well as enhancing strengths. Breaking the sense of stagnation and boosting international

competitiveness by taking on a new challenge

### Strategy 3: “Global Strategy”

Fully demonstrating Japan’s national character as seen in the fact that actively embracing the dynamism of the world economy has brought about the nation’s rapid progress, and developing together with the rest of the world.

#### (Concretization of the growth strategies)

In line with the aforementioned basic policy directions, the CEFPP will take a leading role in translating the new growth strategies into concrete measures around this spring based on the measures for enhancing growth potential that have been implemented so far, and compile them in the “Basic Policies 2008 (tentative title).”

#### (2) Toward regional independence and revitalization

##### (Supporting regional revitalization)

With an eye to supporting regional revitalization based on the “Strategy for Regional Revitalization,” the Government will comprehensively support ministerial measures with a focus on three key areas -- (1) protecting the lives of residents; (2) developing industries capable of serving as original sources of power enabling regions to maintain economic and social activities; and (3) regional development through intra- and inter-regional exchanges – while capitalizing on the “Program for Regional Revitalization” aimed at promoting comprehensive support in order to allow local regions to launch open initiatives that are based on their own ingenuity and ideas.

In order to pursue the revitalization of regional economies, the Government will submit a bill to the ordinary session of the Diet in 2008 aimed at establishing the Regional Power Revitalization Corporation. This Organization will support regional medium-sized companies and semi-public joint venture companies in their business revitalization and make efforts aimed at areal revitalization, in coordination with the “Strategy for Regional Revitalization,” while soliciting understanding and cooperation on the part of regional financial institutions and local governments.

#### (Decentralization reform)

With a view to realizing a system that enables local regions to explore their own ideas and implement them, the Government will strongly promote decentralization reform. The Committee for the Promotion of Decentralization Reform will review the division of roles between the central and local governments, as well as obligations and frameworks imposed on

local governments under state law and the central government's involvement in local administration. The central government will also consider the transfer of power to local governments and the rationalization of administrative services toward the development local tax and finance infrastructure and conducting the reform of local branch offices of the central government. In light of the fiscal conditions of the central and local governments, considerations will be made in pursuit of an integrated package to reform state subsidies and contributions, local allocation tax, and division of tax sources as well as local government bonds. Based on the "Law for the Promotion of Decentralization Reform," the Government will formulate a "plan for the promotion of decentralization reform" and submit a "new decentralization package law" to the Diet in FY2009 as early as possible.

### (3) Toward Establishing Secure and Trustworthy Finance, Social Security and Administration (Expenditure Reform)

The Government will further advance the Integrated Reform of Expenditures and Revenues including definitely achieving a surplus in the primary fiscal balance of the central and local governments combined by FY2011. In the FY2008 budget, the Government will steadily and systematically carry out expenditure reform specified by the "Basic Policies 2006,"<sup>3</sup> the "Basic Policies 2007" and the "Basic Principles of FY2008 Budget Formulation" (cabinet decision on December 4, 2007). As a result, the Government will make cuts in new government bond issues in contrast to the previous fiscal year's initial budget and the amount of reduction will be 25.348 trillion yen.

### (Tax Reform)

Based on the 2004 amended pension law<sup>4</sup>, the "Basic Policies 2006," the "Basic Policies 2007" and the "Basic Concepts" in the ruling parties' FY2008 tax reform outline, the Government will try to promptly realize a thorough reform of the tax system, including the consumption tax.

With a view to realizing sustainable invigoration of economy and society, while taking into account the current economic and fiscal environment, the FY2008 tax reform will take appropriate measures regarding tax systems for corporation, SMEs, financial and securities transactions, land and housing, etc. From the viewpoint of promoting activities for public interests undertaken by the private sector, it will also take tax measures corresponding to the reform of public interest corporations system and review the tax system for donation. In addition, measures will be taken from the viewpoint of reducing disparities in the fiscal strength

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<sup>3</sup> "Basic Policies for Economic and Fiscal Management and Structural Reform 2006" (cabinet decision on July 7, 2006)

<sup>4</sup> Act to partially amend the National Pension Law (Act No. 104 of 2004)

among local governments.

(Integrated Reform of Social Security and Tax System)

In order to reform the social security and tax systems in an integrated manner, the Government will continue discussions with the aim of designing the most suitable form of social security system in terms of both benefits and burdens and securing a stable supply of revenue, in line with the “Five Principles for Reassurance and Sustainability.”

In FY2008, the Government will work on effective reform to realize targets specified by the “Program for Improving Quality and Promoting Efficiency in the Medical and Nursing Care Services,” while reviewing systems and measures pertaining to medical care and other areas.

The Government will steadily address the problem of pension records and measures against people failing to pay premiums or join pension plans, reform the relevant organizations and operations, and thus try to solve the various problems involving pensions. Based on the revised national pension law in 2004, the Government share of contributions to the basic pension scheme will be raised to one-half by FY2009, after conducting the necessary fundamental tax reform for securing stable financial resources.

Based on the “Work-Life Balance Charter,” (adopted by the high-level public-private council for the promotion of work-life balance on December 18, 2007) the “Action Guidelines for Promoting Work-Life Balance” (the same as the left) and the “Key Strategies for Japan in Support of Children and Families” (adopted by the council for measures against the falling birthrate on December 27, 2007), in order to make Japan a society where the people can realize their marriage, childbirth and child-raising aspirations, the Government will implement the following two measures as “two wheels on the same axle”: the realization of a balance between work and personal life by both males and females and the enhancement of the social infrastructure for supporting child-raising.

(Shifting to a Government Befitting the 21st Century)

In order to create a simple yet efficient government, the Government should thoroughly review administrative functions and eliminate waste and inefficiency. To this end, the Government will review independent administrative agencies and promote overall personnel expenditure reform in accordance with the “Administrative Reform Promotion Law<sup>5</sup>”. At the same time, the Government will address civil service reform, regulatory reform, utilization of private-sector resources, active implementation of market testing, reform of public-interest corporation systems, and classifications and reviews of government duties.

For the basic areas of people’s lives, the Government will transform the administration into

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<sup>5</sup> Act on promotion of administrative reform to realize a simple yet efficient government (Act No. 47 of 2006)

one based on the standpoints of the people and the consumers and thoroughly review the whole range of the administration.

### **3. Economic Outlook for FY2008**

In FY2008, under the condition that the world economy will continue to recover, the domestic corporate sector will continue to be strong for the second straight year since FY2007 and the household sector will improve moderately. Japan's economic growth, led by private demand under stable prices, is expected to be realized by the acceleration and deepening of reform efforts based on the principle of "self-reliance and mutual cooperation," as well as by the united efforts of the government and the Bank of Japan.

In sum, the real GDP growth rate in FY2008 is expected to be approximately 2.0% (with a nominal GDP growth rate of approximately 2.1%), as mentioned in the main economic indicators in the attached paper.

The Government should keep a close watch, as it did in FY2007, on the impacts that risk factors such as those seen in overseas economic trends will have on the Japanese economy.

#### (1) Real Gross Domestic Product

##### (i) Private Consumption Expenditure

As the employment and income situations improve moderately, private consumption is expected to increase moderately (an approximate 1.3% increase from the previous fiscal year).

##### (ii) Private Residential Investment

Private residential investment is expected to recover from a decrease caused by the enforcement of the revised Building Standard Law (an approximate 9.0% increase from the previous fiscal year).

##### (iii) Business Investment

Supported by solid corporate profits and due partly to recovery from the enforcement of the revised Building Standard Law, business investment is expected to continue increasing (an approximate 3.3% increase from the previous fiscal year).

##### (iv) Public Demand

Due to a decrease in public investment as well as restraint in government consumption stemming from the government's promotion of expenditure reform, public demand is expected to remain around the same level as the previous fiscal year (an approximate 0.1% increase from

the previous fiscal year).

(v) External Demand

Alongside the recovery in the world economy, external demand is expected to continue increasing (net exports contribute approximately 0.4% to the real GDP growth rate).

(2) Labor and Employment

Though some difficulties remain, the labor and employment situations are expected to improve moderately and the unemployment rate will show a slight decrease from the previous fiscal year (approximately 3.8%).

(3) Industrial Production

As both domestic and external demand increase, industrial production is expected to continue increasing (an approximate 2.2% increase from the previous fiscal year).

(4) Prices

The domestic corporate goods price index and the CPI are expected to continue rising moderately (approximate 0.6% and 0.3% increases from the previous fiscal year, respectively). The rate of change in the GDP deflator is expected to turn positive (an approximate 0.1% increase from the previous fiscal year).

(5) Balance of Payment

As the world economy recovers, both exports and imports will increase. The current account surplus will increase slightly, along with the continuation of the large income account surplus (the current account surplus will represent approximately 4.9% of nominal GDP).

(Note 1) These economic trends and outlook are premised on the policies listed in “2. Basic Economic and Fiscal Management Measures for FY2008.”

(Note 2) As the Japanese economy mainly consists of private sector activity and is influenced by market fluctuations and other changes in the situation of the world economy, the main economic indicators should be recognized as being subject to upside and downside risk.

## Main Economic Indicators

|  | FY2006<br>(actual) | FY2007<br>(estimate) | FY2008<br>(forecast) | Percentage changes over the previous fiscal year |                                |                                |            |                   |            |
|--|--------------------|----------------------|----------------------|--|--------------------------------|--------------------------------|------------|-------------------|------------|
|  |                    |                      |                      | FY2006 (actual)                                  |                                | FY2007 (estimate)              |            | FY2008 (forecast) |            |
|  |                    |                      |                      | trillion yen<br>current prices                   | trillion yen<br>current prices | trillion yen<br>current prices | %          | %                 | %(approx.) |
| Gross domestic product                         | 511.9              | 516.0                | 526.9                | 1.6  | 2.3                            | 0.8                            | 1.3        | 2.1               | 2.0        |
| Private consumption expenditure                | 291.4              | 294.4                | 297.8                | 1.3  | 1.7                            | 1.0                            | 1.3        | 1.2               | 1.3        |
| Private residential investment                 | 18.8               | 16.7                 | 18.5                 | 2.4  | 0.2                            | ▲ 11.2                         | ▲ 12.7     | 10.4              | 9.0        |
| Private non-residential investment             | 81.0               | 82.4                 | 85.6                 | 6.2  | 5.6                            | 1.7                            | 0.9        | 3.9               | 3.3        |
| Increase in private inventory                  | 2.3                | 2.3                  | 3.0                  | (0.2)  | (0.2)                          | (▲ 0.0)                        | (▲ 0.0)    | (0.1)             | (0.1)      |
| Government expenditure                         | 111.3              | 111.5                | 111.8                | ▲ 2.3  | ▲ 1.8                          | 0.2                            | 0.0        | 0.2               | 0.1        |
| Government consumption                         | 89.9               | 91.1                 | 92.2                 | ▲ 0.7  | 0.1                            | 1.3                            | 1.6        | 1.2               | 1.1        |
| Public investment                              | 21.1               | 20.2                 | 19.3                 | ▲ 8.0  | ▲ 9.2                          | ▲ 4.7                          | ▲ 6.1      | ▲ 4.0             | ▲ 4.9      |
| Exports of goods and services                  | 83.9               | 91.6                 | 97.5                 | 12.0   | 8.2                            | 9.1                            | 7.1        | 6.5               | 5.2        |
| Less: Imports of goods and services            | 76.8               | 82.9                 | 87.2                 | 12.2   | 3.0                            | 8.0                            | 1.5        | 5.2               | 3.6        |
| Contribution of domestic demand                |                    |                      |                      | 1.5  | 1.5                            | 0.5                            | 0.5        | 1.8               | 1.7        |
| Contribution of private demand                 |                    |                      |                      | 2.0  | 1.9                            | 0.4                            | 0.4        | 1.8               | 1.7        |
| Contribution of public demand                  |                    |                      |                      | ▲ 0.5  | ▲ 0.4                          | 0.0                            | 0.0        | 0.0               | 0.0        |
| Contribution of external demand                |                    |                      |                      | 0.1  | 0.8                            | 0.3                            | 0.9        | 0.3               | 0.4        |
| National income                                | 373.2              | 377.3                | 384.4                | 1.8  |                                | 1.1                            |            | 1.9               |            |
| Compensation of employees                      | 263.0              | 263.1                | 265.2                | 1.3  |                                | 0.1                            |            | 0.8               |            |
| Property income                                | 17.5               | 20.4                 | 23.3                 | 24.1   |                                | 16.7                           |            | 14.2              |            |
| Entrepreneurial income                         | 92.8               | 93.7                 | 95.8                 | ▲ 0.3  |                                | 1.0                            |            | 2.2               |            |
| Labor & Employment                             | ten thousands      | ten thousands        | ten thousands        |  | %                              |                                | %(approx.) |                   | %(approx.) |
| Total labor force                              | 6,660              | 6,665                | 6,675                |  | 0.1                            |                                | 0.1        |                   | 0.1        |
| Total employment                               | 6,389              | 6,410                | 6,425                |  | 0.4                            |                                | 0.3        |                   | 0.2        |
| Employees                                      | 5,486              | 5,525                | 5,565                |  | 1.2                            |                                | 0.7        |                   | 0.7        |
| Unemployment rate                              | %                  | %(approx.)           | %(approx.)           |  |                                |                                |            |                   |            |
|  | 4.1                | 3.9                  | 3.8                  |  |                                |                                |            |                   |            |
| Production                                     | %                  | %(approx.)           | %(approx.)           |  |                                |                                |            |                   |            |
| Industrial production                          | 4.8                | 2.4                  | 2.2                  |  |                                |                                |            |                   |            |
| Prices   | %                  | %(approx.)           | %(approx.)           |  |                                |                                |            |                   |            |
| Domestic corporate goods price index           | 2.1                | 1.8                  | 0.6                  |  |                                |                                |            |                   |            |
| Consumer price index                           | 0.2                | 0.2                  | 0.3                  |  |                                |                                |            |                   |            |
| GDP deflator                                   | ▲ 0.7              | ▲ 0.5                | 0.1                  |  |                                |                                |            |                   |            |
| Balance of payments                            | trillion yen       | trillion yen         | trillion yen         |  | %                              |                                | %(approx.) |                   | %(approx.) |
|  | (approx.)          | (approx.)            | (approx.)            |  |                                |                                |            |                   |            |
| Balance of goods and services                  | 8.2                | 9.7                  | 11.2                 |  |                                |                                |            |                   |            |
| Trade balance                                  | 10.5               | 12.1                 | 13.2                 |  |                                |                                |            |                   |            |
| Exports  | 73.7               | 80.2                 | 85.4                 |  | 13.0                           |                                | 8.9        |                   | 6.4        |
| Imports  | 63.2               | 68.1                 | 72.1                 |  | 13.6                           |                                | 7.8        |                   | 5.9        |
| Current account balance                        | 21.2               | 25.1                 | 26.1                 |  |                                |                                |            |                   |            |
| Current account balance as a percentage of GDP | %                  | %(approx.)           | %(approx.)           |  |                                |                                |            |                   |            |
|  | 4.1                | 4.9                  | 4.9                  |  |                                |                                |            |                   |            |

\*The figures in the parentheses are the contribution to GDP growth.

(Note) Assumptions for world GDP (excluding Japan), exchange rate and crude oil import prices are as follows. These assumptions are neither projections nor forecasts of the government.

|  | FY2006 | FY2007 | FY2008 |
|--|--------|--------|--------|
| Real growth rate of world GDP (excluding Japan)(%) | 3.6    | 3.4    | 3.2    |
| Exchange rate (yen/dollar)                         | 116.9  | 115.6  | 111.2  |
| Crude oil import prices (dollar/barrel)            | 63.6   | 75.3   | 83.0   |

(N.B.)

- The real growth rate of world GDP (excluding Japan) is based on the forecasts of international organizations and other institutions.
- Exchange rate is assumed to stay constant after December 1st, 2007 at the one-month average (111.2 yen/dollar) from November 1st to 30th, 2007.
- Crude oil import prices in December, 2007 are estimated based on the one-month average from November 1st to 30th, 2007, plus freight costs and insurance premiums. After January, 2008, the prices are assumed to stay constant at the three-month average from September 1st to November 30th, 2007, plus freight costs and insurance premiums (83.0 dollar/barrel).