

**Fiscal 2007 Economic Outlook
and
Basic Stance for Economic and Fiscal Management**

January 25, 2007
Cabinet Decision

1. Economic and Fiscal Management and the Japanese Economy in FY2006

(Economic and Fiscal Management in FY2006)

In FY2006, the Government established the “Basic Policies for Economic and Fiscal Management and Structural Reform 2006” (Cabinet Decision on July 7, 2006, hereinafter “Basic Policies 2006”) and indicated efforts to address the three priority issues as its basic policy: enhancing the growth potential and international competitiveness, advancing fiscal consolidation, and achieving a safe, secure, flexible and accommodating society. From May, the Government continued to formulate the “Strategy in the Globalizing Economy” (adopted by the Council on Economic and Fiscal Policy on May 18, 2006) to present issues to be tackled and measures to be taken to respond to the rapid globalization, and the “Economic Growth Initiative” (adopted by the Council for Comprehensive Financial and Economic Reform on July 6, 2006) to indicate efforts to enhance the growth potential and international competitiveness. Additionally, the Government made a series of decisions related to administrative reform such as the “System Design regarding the Reform of Policy-based Finance” (June 27, 2006), the “Net Reduction of the Total Number of Civil Servants” (Cabinet Decision on June 30, 2006) and the “Basic Policies on Public Services Reform” (Cabinet Decision on September 5, 2006, and revised on December 22) which designated common guidelines and action plan to implement market testing. Moreover, the Government compiled “On the Government’s Measures regarding Regional Revitalization” (November 24, 2006) in November, and the “Specific Measures regarding Earmarked Revenue Sources for Roads” (Cabinet Decision on December 8, 2006) and the “Comprehensive Challenge Again Support Plan” (December 25, 2006) which seeks a society of opportunities where everyone has a chance to challenge again and again in December.

(The Japanese Economy in FY2006)

Despite weakness observed in consumption, the Japanese economy is continuing its recovery.

In FY2006, as robust performance in the corporate sector spread to households through improvements in the employment and income situations, the economic recovery led by private demand is expected to continue.

Looking at overall price movements, the consumer price index (CPI) has been rising compared with the previous year, but it has remained at the near zero level except special factors such as oil products. Gaps between demand and supply are also improving to the near zero level. Taken together, the end of deflation has come into sight, but the government should keep a close watch on a possible return to deflation while considering risk factors as shown in overseas economic trends.

In sum, the growth rate of real GDP in FY2006 is expected to be approximately 1.9% (with a growth rate of nominal GDP of approximately 1.5%).

2. Basic Economic and Fiscal Management Measures for FY2007

For “departure from the postwar regime” under the principle that “there can be no future for Japan without growth,” the Government will take advantage of innovation and openness to complete a “transition to a new growth economy” in about five years from now.

To enrich people’s lives and with a view to realizing “Innovative Growth,” the Government will not only accelerate and deepen reform for enhancing growth potential in the first period, FY2007, but also steadily promote measures to vitalize regional economies and small and medium sized enterprises and realize a society of opportunities where everyone has a chance to challenge again and again. Under the principle that “there can be no fiscal consolidation without growth,” the Government will strive to enhance growth potential and resolutely implement administrative and fiscal reforms which are inseparable. The Government will also accelerate its study of a regional government system (doshu-sei). Through promoting these policies in line with the “Basic Policies 2006,” the Government will accomplish economic vitalization and enhance growth potential. At the same time, in order to ensure sustainable economic growth led by the private sector under price stability, the Government and the Bank of Japan will make joint efforts, sharing their basic perspectives on macroeconomic management.

The Government will continue to practice decisive and flexible policy management in accordance with the economic situation.

(1) Decisive reform to enhance growth potential

Under appropriate macroeconomic management, the Government will promote decisive reform to enhance growth potential in line with the “Basic Policies 2006” and the “Economic Growth Initiative.” For the “Economic Growth Initiative,” follow-up assessments will be quantitatively implemented for possible revision. At the same time, efforts will be made to construct an open society as demonstrated by the “Asia Gateway Initiative.”

(Improving productivity, enhancing international competitiveness, human resource as a key to growth)

While promoting the innovation of the IT and service industry, through the implementation of the “New IT Reform Strategy,” and strengthening of competitiveness, the Government will work on development of the environment of and drastic institutional reform of the labor market, and improve productivity. For improving productivity through innovation and labor market reform, the Government will submit related bills to the Diet during its ordinary session in FY2007.

The Government will draw up and implement “Innovation 25,” a long-term strategic guideline spanning through the year 2025, and tackle the enhancement of international competitiveness through the promotion of such measures as “The 3rd Science and Technology Basic Plan,” the “Comprehensive Strategy for Creating Innovation” and strategy for intellectual property. Under a more globalizing economy, external economic policy will be accelerated and enhanced in coordination with domestic structural reform. In order to promote vitalization of the Japanese economy, the Government will strive for an early conclusion of the Doha Round of the World Trade Organization. Regarding economic partnership agreements (EPAs), the Government will strive to smoothly implement concluded agreements and, with full consideration of their impacts on domestic agriculture, forestry and fishery industry, and with attention to the status of the industry’s structural strength, will enhance efforts for an early conclusion of bilateral agreements with Asian nations and the entire ASEAN in line with the “EPA Timetable” attached to the “Strategy in the Globalizing Economy.” At the same time, based on the WTO, the Government will revise by this spring the “EPA Timetable” for strategic and effective development of EPA negotiations and promote study on wide-area economic partnership in East Asia. As

well, the Government will strengthen a mechanism to achieve growth together with Asian nations and develop an institutional infrastructure for promoting FDI in Japan.

With the aim of developing human resources, which is a key to growth, the Government will strive to construct a society in which every citizen can fully demonstrate their abilities, strengthen development of human resources through industry-academia collaboration, and enhance the competitiveness of human resources.

While building a society free from global warming, establishing a Sound Material-Cycle Society and promoting the harmonious coexistence with nature, the Government will work toward compatibility between the environment and the economy and achieve a sustainable society by aiming to create new demand through the development of environmental technologies.

(Regulatory reform)

The Government will drive regulatory reform and open up to the private sector, especially in the areas of education, employment and labor, medical care, welfare and child care, paying serious attention to the ‘Concrete Measures’ described in the ‘Third Report on the Promotion of Regulatory Reform and Opening up to the Private Sector (December 25, 2006, the Council for the Promotion of Regulatory Reform).

Based on the “Basic Policies on Public Services Reform” (revised on December 22, 2006), services covered by market testing will be expanded and actively implemented.

From the viewpoint of further promoting regulatory reform and strengthening efforts to enhance the originality and ingenuity of regional communities, the Government will conduct a review on a system of special zones for structural reform and submit a bill to amend the “Law on Special Zones for Structural Reform” to the ordinary session of the Diet in 2007.

(Revitalizing regional communities and SMEs)

In order to allow regions to be reborn as attractive regions full of wisdom and ingenuity by developing their own measures, the Government will work together to support regional communities’ own efforts by policy measures such as providing full information to the regions, building new networks of regional leaders, and implementing the Program for Helping Striving Regions to Help Themselves, based on the “Government Measures to Revitalize Regional Communities” (November 24, 2006).

The Government will promote the “Program to Regenerate Regional Employment” which, thorough cooperation between central Government agencies,

supports the realization of a regional renaissance plan for developing human resources and job creation.

To promote development and sales of new products and services utilizing local resources by supporting business launches capitalizing on the wisdom and motivation of local SMEs, a bill will be submitted to the ordinary session of the Diet in 2007. At the same time, the Government will promote revitalization of SMEs by smoothing the capital supply to SME operators, supporting R&D, fostering small- and medium-sized retailers and small companies, and revitalizing shopping areas.

Based on the “21st Century Agricultural Policy” (April 4, 2006), the Government will seek to strengthen the structure of domestic agriculture through the reform of business structure and aim to establish competitive agriculture.

(Monetary policy management)

The Government expects that the Bank of Japan will share the basic perspectives on macroeconomic management with the Government, and exercise, considering market trends, effective monetary policy management, which will be consistent with the Government’s efforts and economic conditions, so that the BOJ will continue to support the economy responsibly.

(2) Toward a Society Where a Second Chance is Possible

In order to realize a society in which there is no stratification into winners and losers, and a society in which ways of working, learning and living are diverse and multi-tracked -- in other words, a society of opportunities where everyone has a chance to challenge again and again, based on the “Comprehensive Challenge Again Support Plan” (December 25, 2006), the Government will promote the support of people who challenge again from jobless status or economic hardship due to prolonged deflation, the equalization of opportunity for people in various circumstances and difficulties, and the realization of multi-tracked society that diversifies options in life.

(3) Toward building an administrative and fiscal system suitable for the 21st century

(Expenditure reform)

In order to definitely achieve a surplus in the primary budget balance of the central and local governments combined by FY2011 and organize a simple yet efficient Government, the Government will enhance its expenditure reform while bearing in

mind that the FY2007 budget is a very important budget representing a first step toward the reform. For this, the Government will systematically implement plans shown in the “Basic Policies 2006” and “Basic Principles of FY 2007 Budget Formulation” (Cabinet Decision on December 1, 2006). As a result, the Government will make its largest-ever cuts in new Government bond issues from the previous year’s initial budget and the amount of reduction will be 25.432 trillion yen.

(Tax reform)

The Government will conduct full-fledged and specific discussions from autumn in 2007 and work to implement a fundamental tax reform around FY2007. In this regard, based on basic ideas of expenditure reform in the “Basic Policies 2006” and “Outlines of Tax Reform of the Ruling Parties,” the Government will avoid shifting a burden onto future generations by securing a stable supply of revenue to cover an increase in burden caused by social security services and the declining birthrate that cannot be covered by thorough expenditure cuts.

The Government will steadily consider basic ideas of tax reform to implement the above efforts smoothly.

In the FY2007 tax reform, to accomplish a desirable tax system for realizing the sustainable invigoration of the Japanese economy and society in the light of current economic and fiscal situations, the Government will make a drastic review of the depreciation system from the viewpoint of developing the basis for Japanese economic growth, as well as taking required measures on SMEs-related tax, the taxation of international transactions, tax on corporate reorganization and trust tax, financial and securities tax, housing and land tax and improvement of the tax payment system.

(Promotion of effective administration)

In order to transform policy-based financial institutions to a new structure securely and smoothly from October 2008, the Government will submit bills related to reform of policy financing to the ordinary session of the Diet in 2007.

The Government will conduct a review based on the “Specific Measures regarding Earmarked Revenue Sources for Roads” (Cabinet Decision on December 8, 2006). In the FY2007 budget, the Government will expand general revenues so that it can achieve the spirit of reform within the framework of the current system while soliciting the understanding of taxpayers.

The Government will submit bills to the ordinary session of the Diet in 2007

required to carry out significant revision of the special account regarding the integration of the special account and handling of accounting entry differently from the general account, such as carry-over of surplus.

Based on the “Law on Administrative Reform Promotion,” the Government will promote reduction of public servants’ labor costs, secure and smooth implementation of postal privatization, the review of incorporated administrative agencies’ business and organizations as a whole and the reform of the Government assets and debts.

(Decentralization reform)

Based on the law for the promotion of decentralization reform, the Government will promote decentralization reform by deliberating to submit the “New Decentralization and Unification Law” (provisional title) to the Diet within three years.

(Constructing a sustainable and reliable social security system)

In line with discussions for a comprehensive review of the social security system to construct a sustainable system in the future, the Government will tackle institutional reform of the employment insurance system and other areas in FY2007.

Based on the “basic policy and methods on the unification of employee pension scheme” (adopted by the Government and ruling parties council on the unification of employee pension scheme on December 19, 2006), the Government will submit bills to promote the unification of the employee pension scheme to the ordinary session of the Diet in 2007.

The Government will also submit bills to reorganize management of the pension system and eliminate the Social Insurance Agency to restore the public trust and divide the SIA’s functions into six sections.

3. Economic Outlook for FY2007

In FY2007, under the condition that the world economy will continue to recover steadily, the domestic corporate and household sectors of the Japanese economy will grow continuously and self-sustainable economic growth under the price stability, led by accelerating and deepening reforms and united efforts of the government and the Bank of Japan, is expected to be realized.

In sum, the growth rate of real GDP in FY2007 is expected to be approximately 2.0% (with a growth rate of nominal GDP of approximately 2.2%).

(1) Real Gross Domestic Product

(i) Private Consumption Expenditure

As the employment and income situations improve, private consumption is expected to continue increasing (an approximate 1.6% increase from the previous fiscal year).

(ii) Private Residential Investment

As the employment and income situations improve, private residential investment is expected to remain at a sound level (an approximate 0.2% increase from the previous fiscal year).

(iii) Business Investment

Supported by the improvement in corporate profits, business investment is expected to continue increasing (an approximate 3.6% increase from the previous fiscal year).

(iv) Public Demand

Although public investment will be reduced by the government's strengthening of expenditure reform policy, public demand is expected to be around the same level as the previous fiscal year due to an increase in payments of public medical and nursing care insurance (Public demand contributes approximately 0.3% to the real GDP growth rate).

(v) External Demand

Alongside the steady recovery in the world economy, external demand is expected to continue increasing (Net exports contribute approximately 0.3% to the

real GDP growth rate).

(2) Labor and Employment

Though some severe aspects remain, the labor and employment situations are expected improve on a broader basis and the unemployment rate will show a little decrease from the previous fiscal year (approximately 4.0%).

(3) Industrial Production

As both domestic and external demand increase, industrial production is expected to continue increasing (an approximate 2.1% increase from the previous fiscal year).

(4) Prices

The domestic corporate goods price index and the CPI are expected to continue increasing (approximate 0.7% and 0.5% increases from the previous fiscal year respectively). The GDP deflator is expected to turn positive (an approximate 0.2 % increase from the previous fiscal year).

(5) Balance of Payment

Under the steady recovery in the world economy, both exports and imports will increase. The current account surplus, along with the large income account surplus, will increase slightly (the current account surplus will represent approximately 4.3% of nominal GDP).

It should be noted that the future movements in crude oil prices and the world economy could have an influence on the Japanese economy.

(Note1) These economic trends and outlook are premised on the policies listed in “Basic Economic and Fiscal Management Measures for FY2007.”

(Note2) As the Japanese economy mainly consists of private activity and is influenced by market fluctuations and other changes in the circumstances of world economy, the above indicators should be recognized as being subject to upside and downside risk.

Main Economic Indicators

	FY2005 (actual)	FY2006 (estimate)	FY2007 (forecast)	Percentage changes over the previous fiscal year					
				FY2005 (actual)		FY2006 (estimate)		FY2007 (forecast)	
				trillion yen (approx.) current prices	trillion yen (approx.) current prices	trillion yen (approx.) current prices	%	%	%(approx.)
Gross domestic product	503.4	510.8	521.9	1.0	2.4	1.5	1.9	2.2	2.0
Private consumption expenditure	287.5	289.9	295.0	1.1	1.9	0.8	0.9	1.8	1.6
Private residential investment	18.4	18.9	19.1	0.1	▲ 1.0	2.5	0.5	0.9	0.2
Private non-residential investment	75.0	80.5	83.4	5.5	5.8	7.3	7.1	3.7	3.6
Increase in private inventory	1.0	1.7	2.5	▲ 0.1	▲ 0.1	0.1	0.1	0.1	0.1
Government expenditure	114.9	113.0	113.9	0.7	0.4	▲ 1.7	▲ 1.6	0.8	0.3
Government consumption	90.7	91.3	93.2	1.0	0.9	0.7	1.1	2.0	1.6
Public investment	24.0	21.6	20.7	▲ 0.0	▲ 1.4	▲ 10.2	▲ 11.4	▲ 3.8	▲ 4.3
Exports of goods and services	74.9	83.5	90.4	11.7	9.0	11.5	7.6	8.2	6.2
Less: Imports of goods and services	68.4	76.8	82.5	17.7	6.0	12.3	4.6	7.4	4.9
Contribution of domestic demand				1.5	1.9	1.4	1.4	2.0	1.7
Contribution of private demand				1.3	1.8	1.8	1.8	1.8	1.6
Contribution of public demand				0.2	0.1	▲ 0.4	▲ 0.4	0.2	0.1
Contribution of external demand				▲ 0.5	0.5	0.0	0.5	0.2	0.3
National income	367.6	374.3	383.2	1.3		1.8		2.4	
Compensation of employees	259.6	263.6	270.4	1.3		1.5		2.6	
Property income	14.0	15.6	16.8			10.8		7.9	
Entrepreneurial income	94.0	95.1	96.0	▲ 1.9		1.2		1.0	
Labor & Employment	ten thousands	ten thousands (approx.)	ten thousands (approx.)		%		%(approx.)		%(approx.)
Total labor force	6,654	6,660	6,655		0.2		0.1		▲ 0.1
Total employment	6,365	6,385	6,390		0.5		0.3		0.1
Employees	5,420	5,480	5,510		1.2		1.1		0.6
Unemployment rate	%	%(approx.)	%(approx.)						
	4.3	4.1	4.0						
Production	%	%(approx.)	%(approx.)						
Industrial production	1.6	4.5	2.1						
Prices	%	%(approx.)	%(approx.)						
Domestic corporate goods price index	2.1	2.7	0.7						
Consumer price index	▲ 0.1	0.3	0.5						
GDP deflator	▲ 1.3	▲ 0.4	0.2						
Balance of payments	trillion yen	trillion yen (approx.)	trillion yen (approx.)		%		%(approx.)		%(approx.)
Balance of goods and services	7.4	7.0	8.4						
Trade balance	9.6	9.3	10.3						
Exports	65.2	72.8	78.6		10.8		11.6		8.0
Imports	55.6	63.5	68.2		21.8		14.1		7.5
Current account balance	19.1	19.9	22.6						
Current account balance as a percentage of GDP	%	%(approx.)	%(approx.)						
	3.8	3.9	4.3						

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

(Note) Assumptions are as follows. These assumptions are not projections nor forecasts of the government.

	FY2005	FY2006	FY2007
World GDP (excluding Japan)	3.9%	3.8%	3.3%
Exchange rate (yen/dollar)	113.2	116.4	117.3
Crude oil prices (dollar/barrel)	55.5	64.6	61.1

(N.B.)

1. World GDP (excluding Japan) is based on the outlook of international organizations and other institutions.
2. Exchange rate is assumed to stay constant after December 1st, 2006 at the one-month average (117.3 yen/dollar) from November 1st to 30th, 2006.
3. Crude oil prices are assumed to stay constant after December 1st, 2006 at the three-month average (61.1 dollar/barrel) from September 1st to November 30th, 2006.