

**Annual Report on
the Japanese Economy and Public Finance
2003**

-No Gains without Reforms III-

Summary

October 2003

Cabinet Office

Government of Japan

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Chapter 1 Prospects for Economic Recovery

[Section 1 Present State of Economy and Positive Signs]

- Trough in January 2002 → Recovery phase thereafter
- Recovery originated from exports and positive signs mainly in the business sector.
- Global economic slowdown on Iraq Crisis → Export growth slump → Recovery at rest
- Uncertainties receded toward mid-2003 → export conditions improved

1. Positive Signs in Business Sector

- Improvement in Corporate Profits
 - Deflationary environment (falls in unit sales prices and purchasing costs), effects of restructuring
 - Manufacturing sector profits increased significantly and non-manufacturing sector profits stopped declining
 - First net profit in 2 years → Increasing debt repayments and stock buybacks
 - Moderate improvements continue in FY 2003
- Recovering Business Investment
 - End of stock adjustment, improvements in corporate profits, expected demand growth
- Export growth deceleration (← U.S. and Asian economic slowdown)
 - Production growth decelerated without inventory accumulation (← Deflationary expectations and falling expected growth rate)
 - Global economy gets onto recovery path

2. Changes in Severe Employment Situation

- Unemployment rate stays flat
- Unemployment leveling off ← fall in bankruptcies and slowdown in restructuring
- Job-holders remains flat ← fall in self-employed and family workers, recovery in employment (fall in full-time employees and rise in part-timers are decelerating)
- More workers out of labor force due to aging population
- While job offers are increasing, unemployment rate will not decline easily even on economic recovery because structural unemployment stemming from an employment mismatch accounts for a greater part of the unemployment.
- Basic wages are being reviewed to exert downward pressures on wage growth.

- Overtime wages are increasing and decline in bonuses is coming to an end ← an increase in production, improvements in corporate profits

3. Households Showing Firmness

- Personal consumption is stagnant.
- Real disposable income has fallen since 2000, meanwhile consumption has increased moderately.
 - Falling savings rate: 9.3% in FY 2000, 6.6% in FY 2001
- The real balance effect (rising purchasing power) and aging population

Figure 1-1-2 Real GDP Growth

Economic recovery was led by net exports

(%, Compared with the previous quarter)

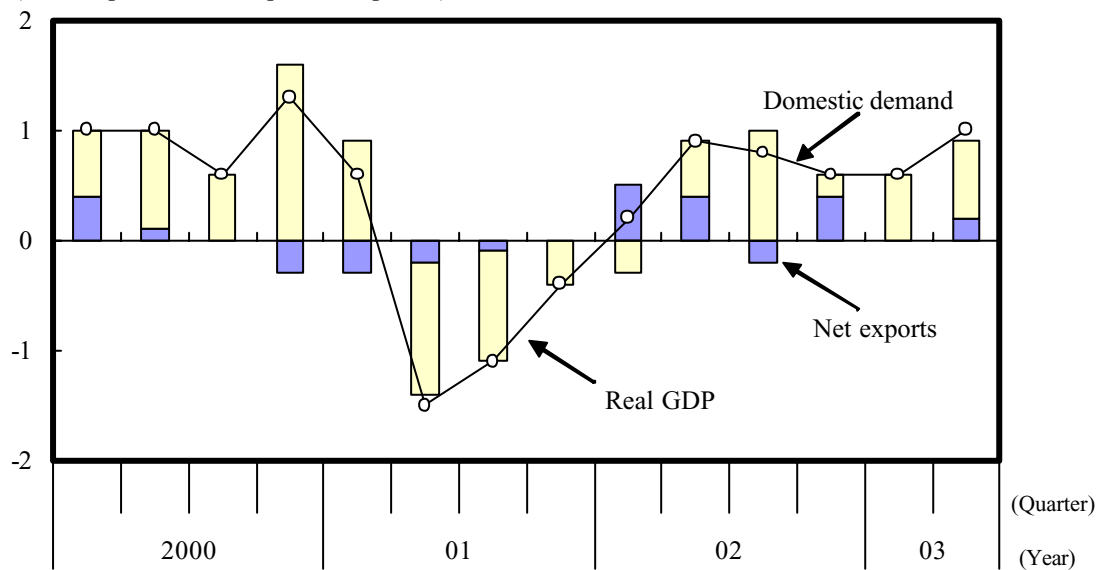


Figure1-1-4 Changes in Japan's Exports Volume

Export to Asia and U.S. declined temporarily

(The degree of ratio contribution of the previous quarter, %)

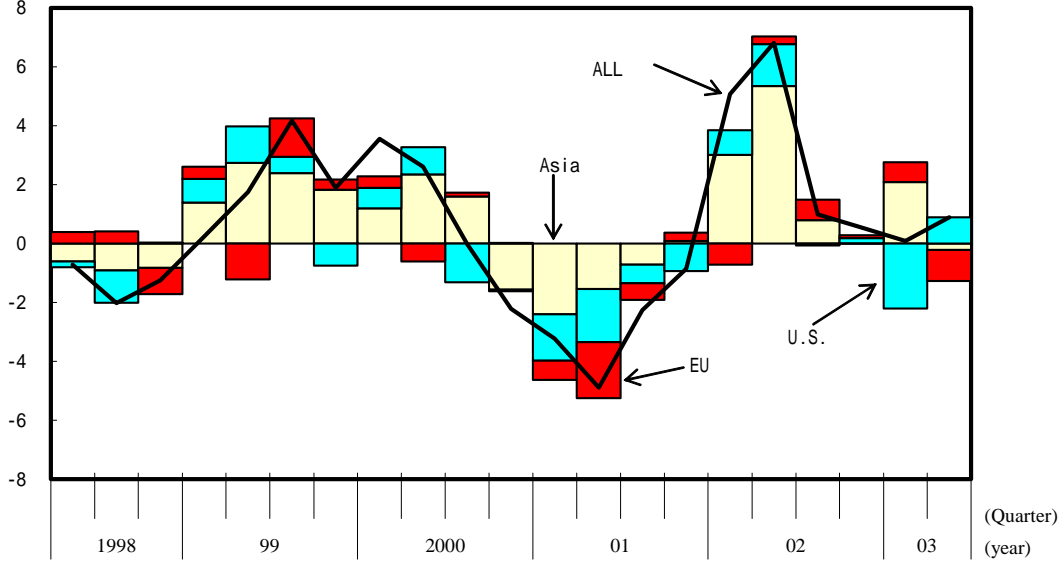


Figure 1-1-12 Inventory Cycle

No inventory accumulation seen

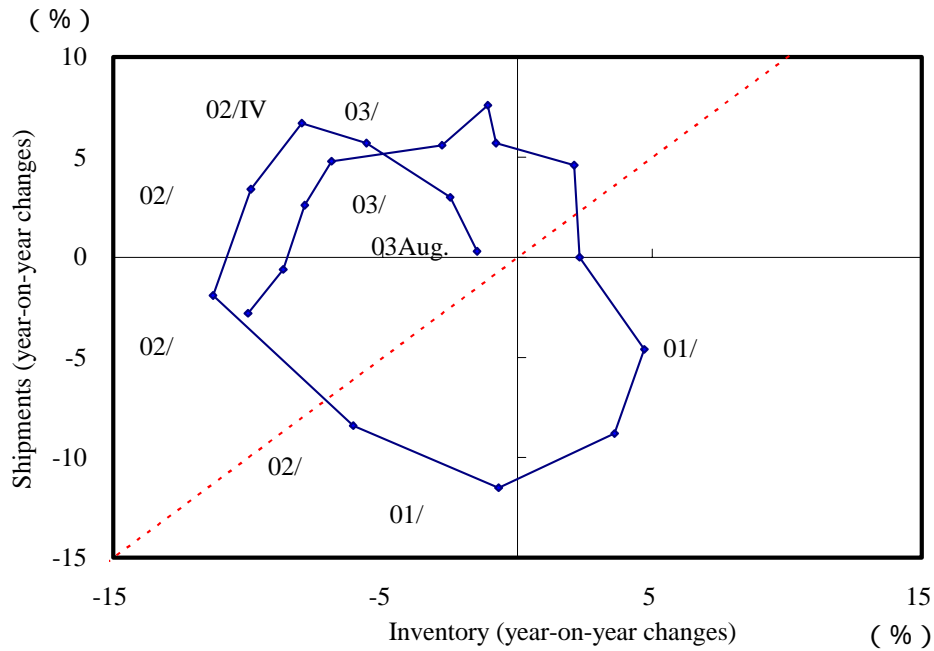


Figure 1-1-13 Corporate Profits

Corporate Profits improved in FY 2002 on efforts to cut personnel and other costs

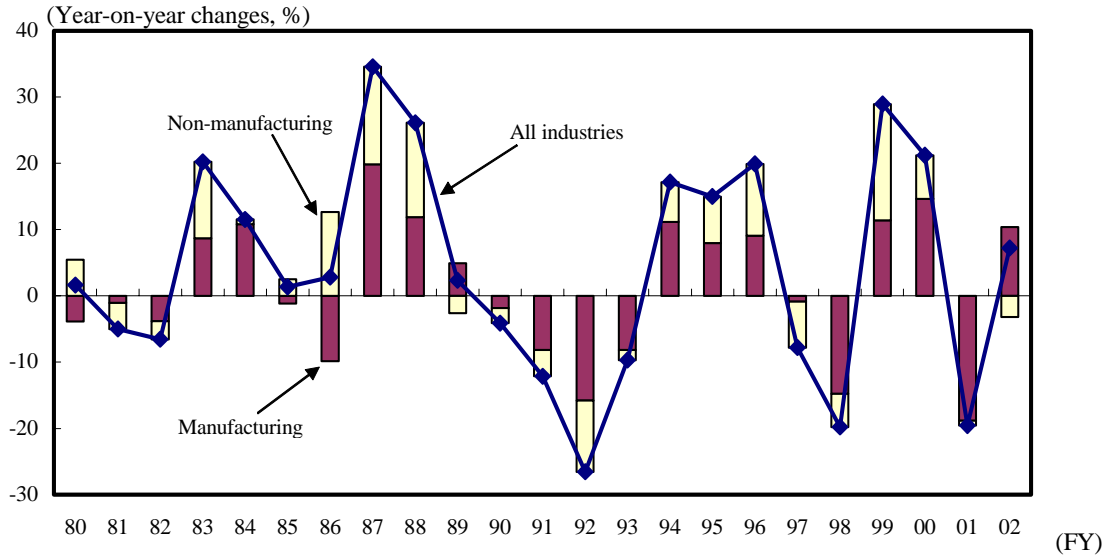


Figure 1-1-17 Cash Flow Management of Listed Companies

Business investment declined in FY 2002 while debt repayments increased

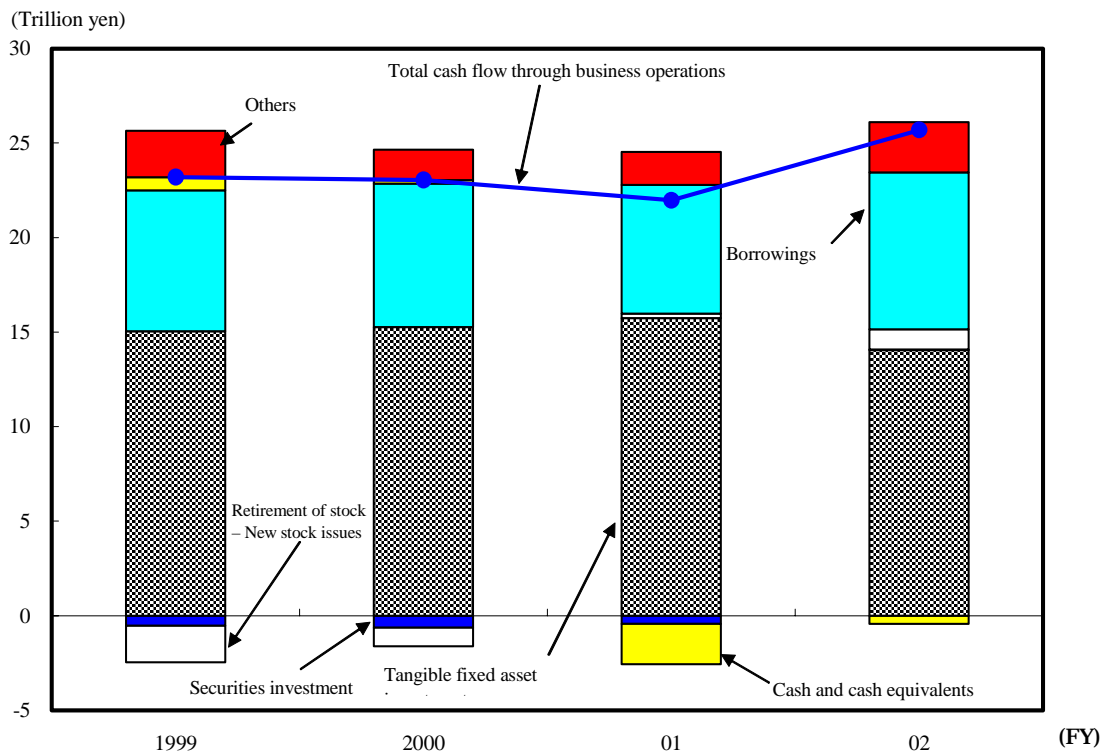
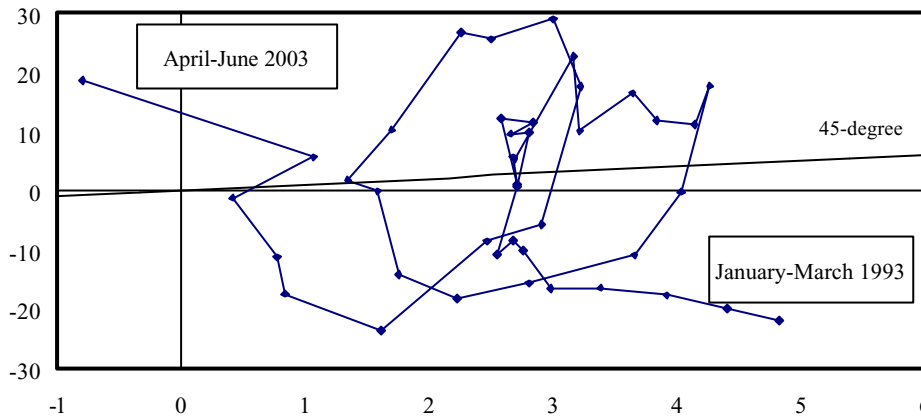


Figure 1-1-20 Capital Stock Cycle

Both manufacturing and non-manufacturing industries achieved progress in stock adjustments

Manufacturing industries

(Year-on-year changes in business investment, %)



(Year-on-year changes in capital stock, %)

Figure 1-1-22 Unemployment Rate

The unemployment rate has remained high

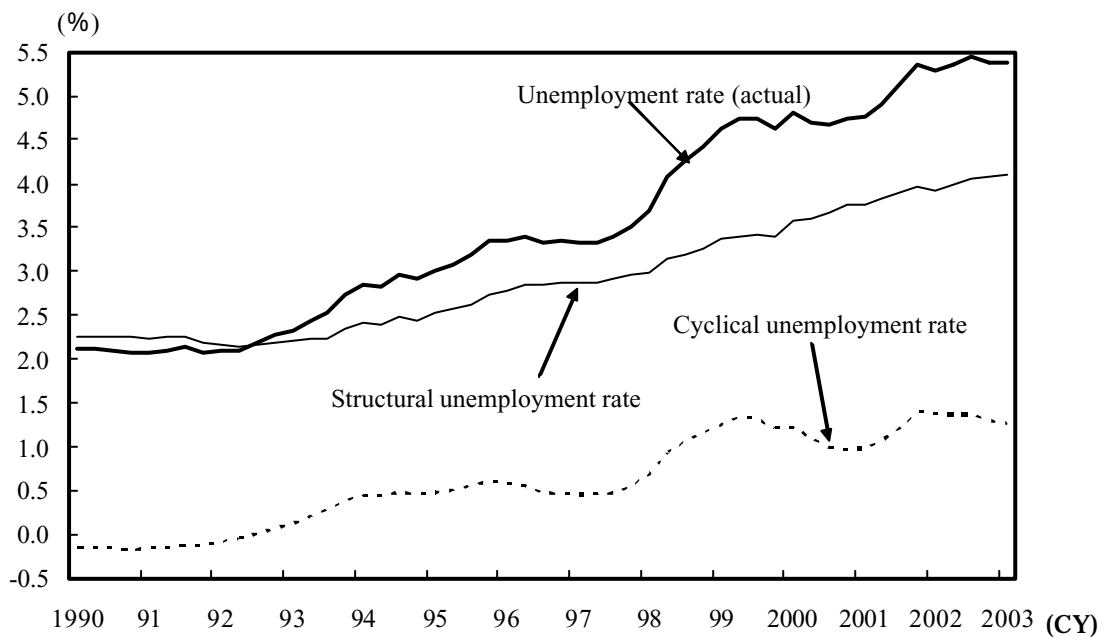


Figure 1-1-26 Breakdown of Job-holders by Status

The number of job-holders has recently remained almost flat

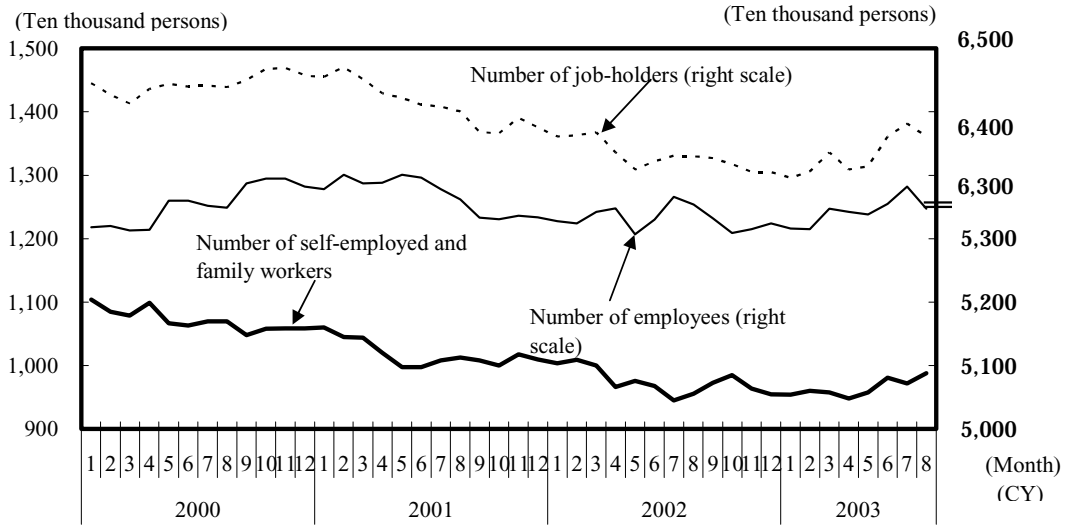


Figure 1-1-29 Breakdown of Wages

Wages decline came to an end

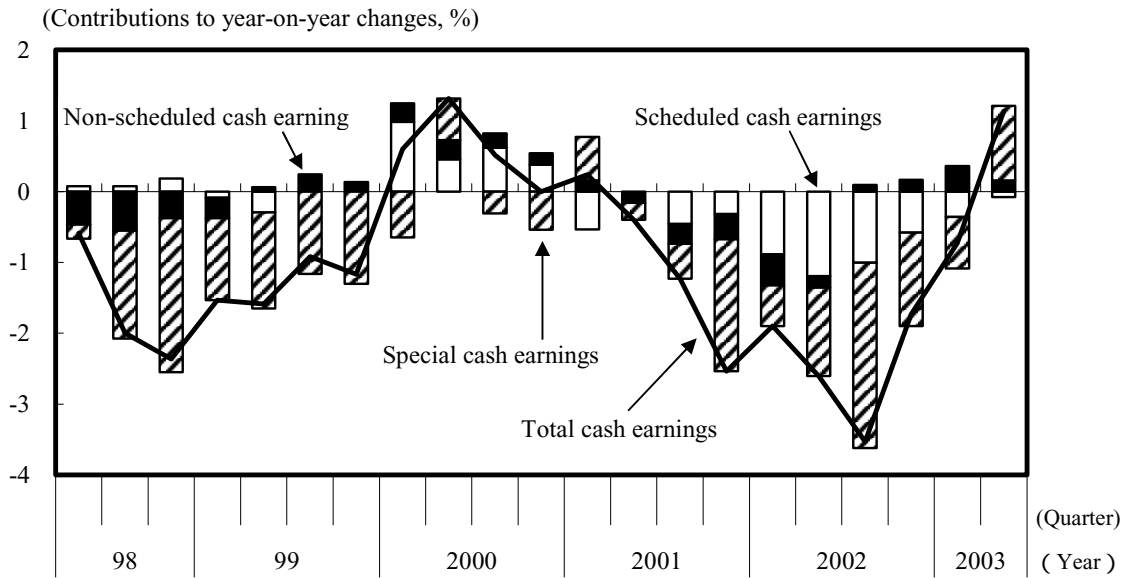


Figure 1-1-31 International Comparison of Household Savings Rates

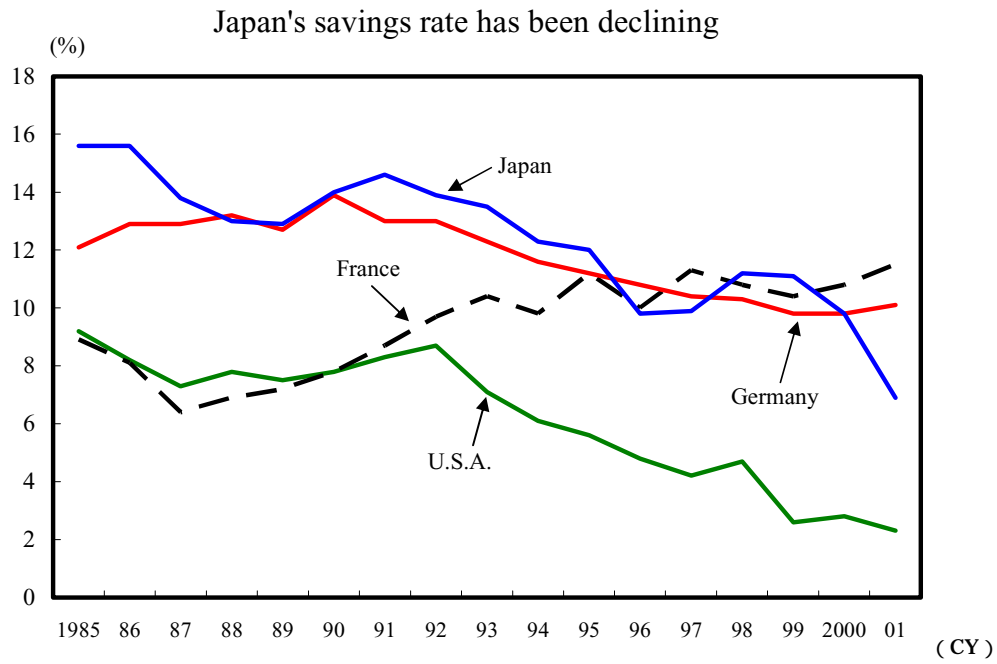


Figure 1-1-32 Savings Rate for Households Headed by Aged (60 and over) Jobless

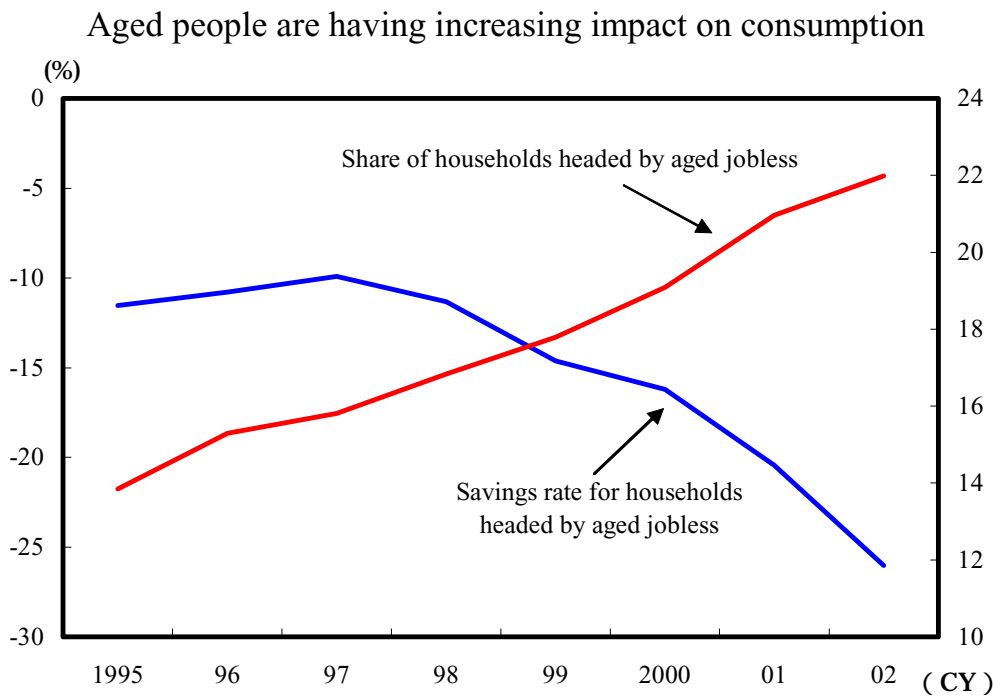
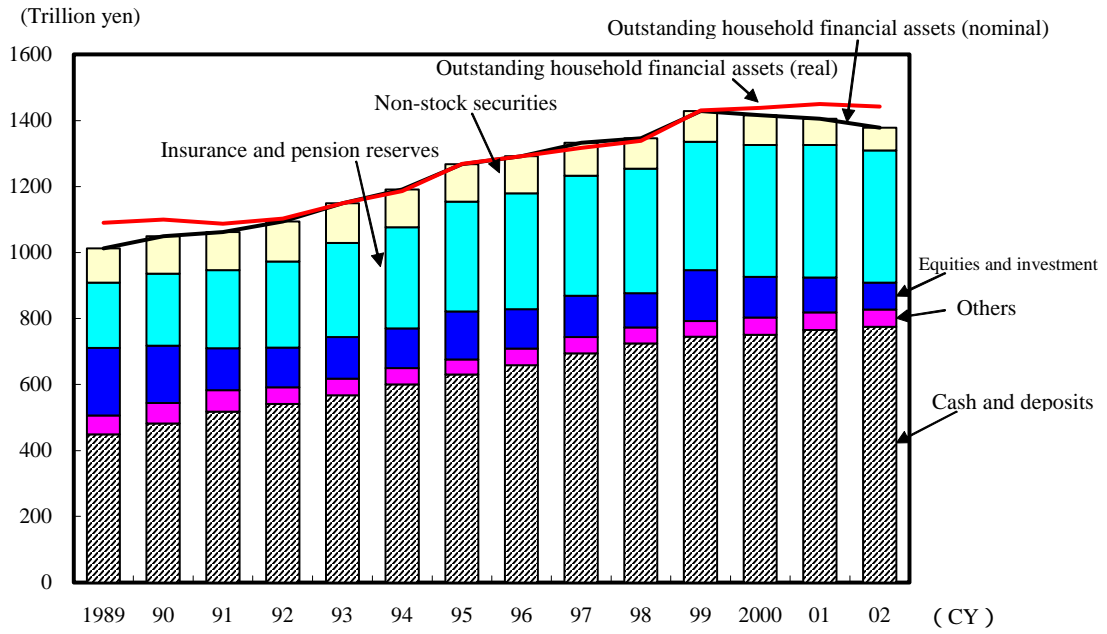


Figure 1-1-33 Outstanding Household Financial Assets

Outstanding real financial assets remained almost flat



[Section 2 Causes of Deflation and Challenges to Overcome It]

1. Asset deflation: Capital losses have totaled 1,330 trillion yen since the bubble burst.

(1) Land prices:

- Land prices have accelerated their decline since 1998 in almost all areas.
- Land price fluctuations (Capitalization model)
 - Price-boosting factors: yields on risk-free assets
 - Price-lowering factors: yields on land and their future prospects, risk premiums
- Prices have recently risen in some high-price zones; prices have risen to levels that match profitability
- Prices have risen in some J-REIT (Japanese real estate investment trust).

(2) Stock prices: Decline comes to an end.

- A peak in May 2002 → Nikkei average at 7,607 in late April 2003 (Post-bubble low)
- Upward trend since late April 2003 ← Global stock price rise, increase in corporate profits, more confidence over soundness of financial system
- Foreign investors led the latest stock market rally, domestic individual investors increased trading, and city, regional and trust banks posted net selling.
- Effects of stock price rises: Improved balance sheets at banks and other financial institutions, etc.

2. General price deflation: The general price deflation has continued since the mid-1990s.

(1) Moves of price indicators

- Domestic corporate goods prices: Downward trend in 2002, flat since the beginning of 2003 except for a period ← Oil and steel prices have been rising.
- Consumer prices: Flat since the autumn of 2002.
- GDP deflator: Fall accelerating since 2002 ← external factors such as oil price, etc.
 - The Japanese economy is still seeing moderate deflation.

(2) As consumer prices fell by around 0 to 1 percent, unemployment rate rose substantially.

- Phillips curve between consumer price change and unemployment rate
 - Impact of structural unemployment
- Phillips curve between wage change and cyclical unemployment
- Phillips curve between GDP deflator change and GDP gap
 - Confirming the demand-side factor (GDP) and the supply-side factor (potential

GDP)

(3) Monetary factors: Monetary policy has short- and long-term effects on money supply. Non-performing loans and excess debt problems have cut off transmission mechanism.

(4) How to overcome deflation:

- Reduce GDP gap
- Monetary policy: Money supply expansion → Aggregate demand expansion
- Disposal of non-performing loans and reduction of excessive debts → A smoother economic circulation is required.

Figure 1-2-2 Officially Published Land Prices

Land prices have continued their decline

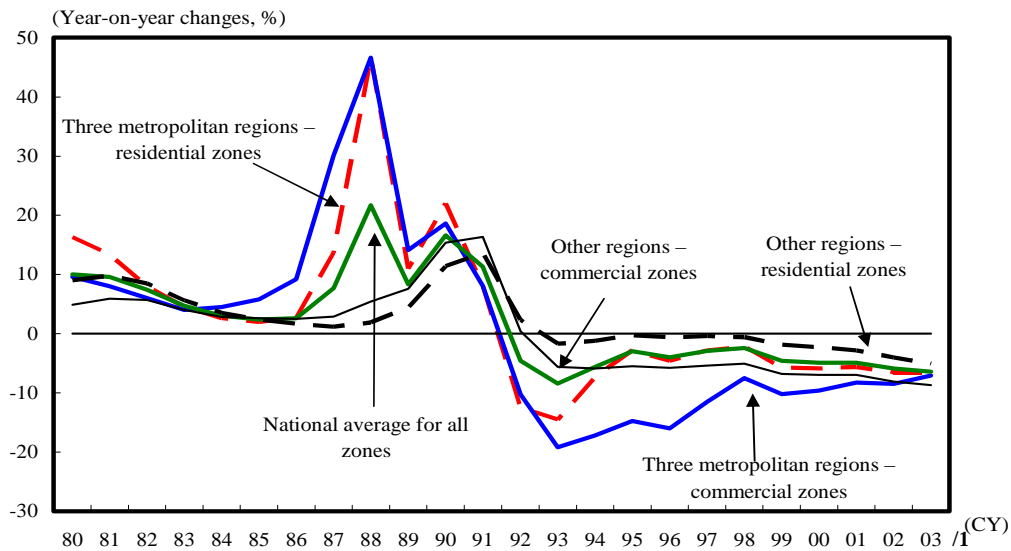


Figure 1-2-5 Rate of Return from Real Estate

Rate of return from real estate has been moderately rising since mid-1990s.

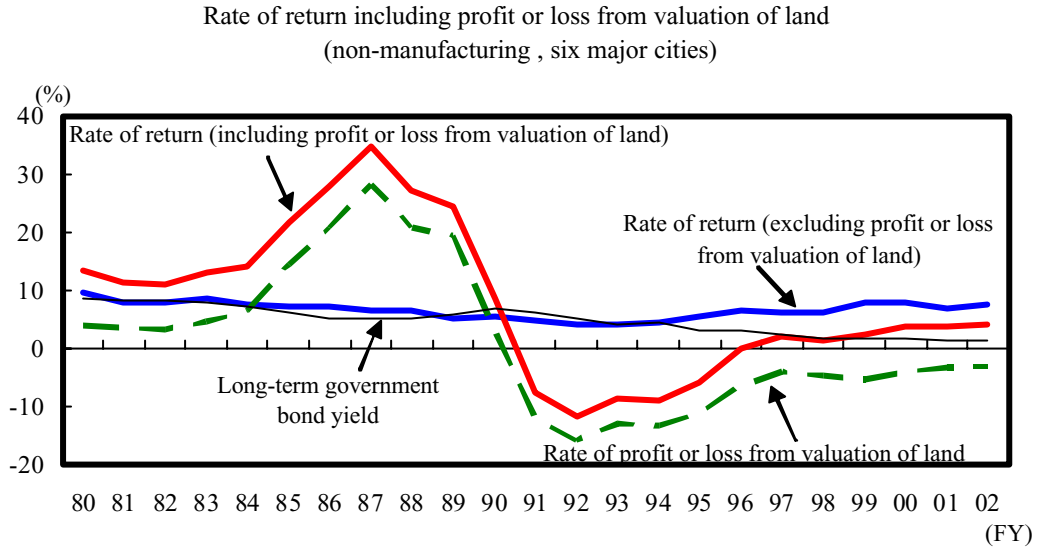


Figure1-2-7 Land Prices in Central Areas of Major Cities(Commercial Zones) Prices have Risen in High-Price Zones

Level of Official Land Prices and Year-on-year Changes (2002,2003)

(1) Tokyo (Chiyoda-ku,Chuo-ku)

(2) Osaka (Chuo-ku)

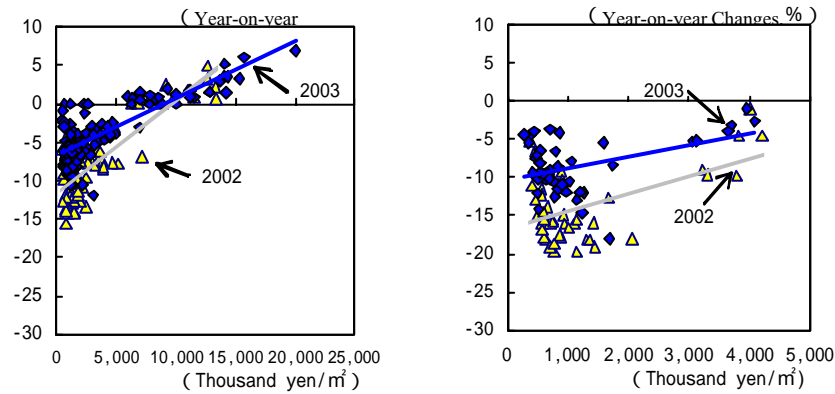


Figure 1-2-8 Stock Price Indexes in Japan and Other Major Countries

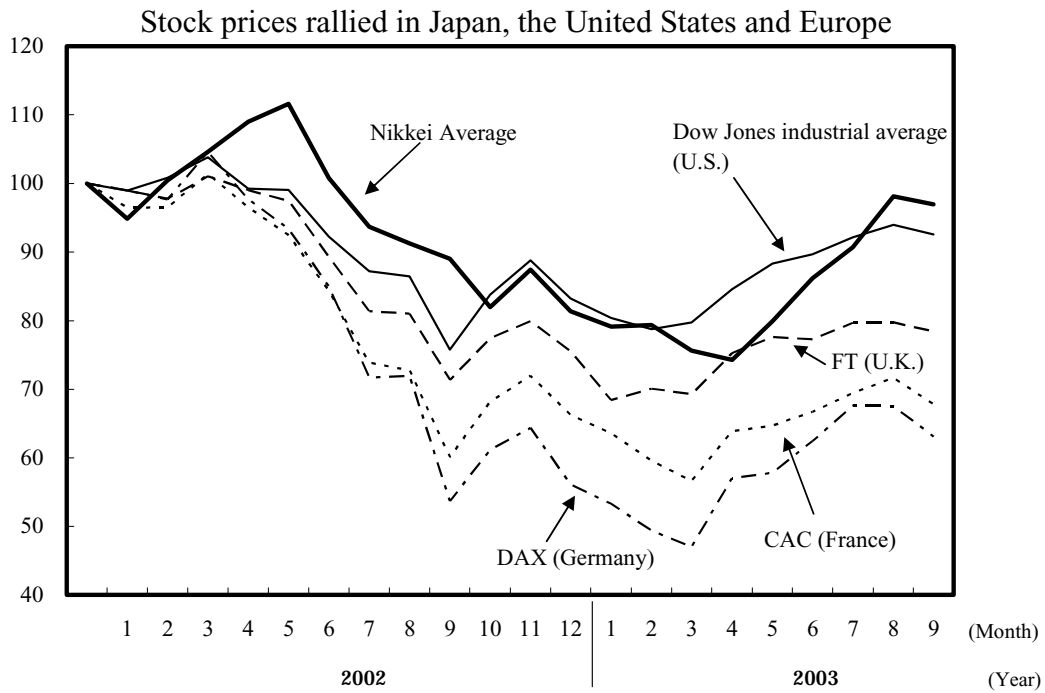


Figure 1-2-9 Breakdown of Stock Transactions by Investors

Foreign investors led a stock market rally

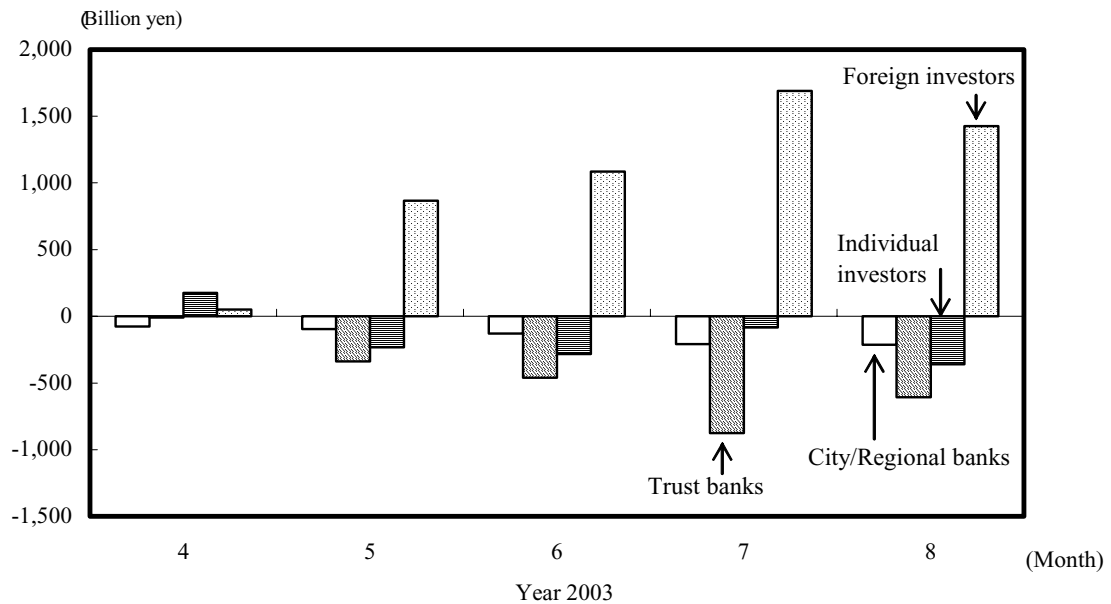


Figure 1-2-10 Domestic Corporate Goods and Consumer Prices

Domestic corporate goods prices, consumers prices are moving sideways

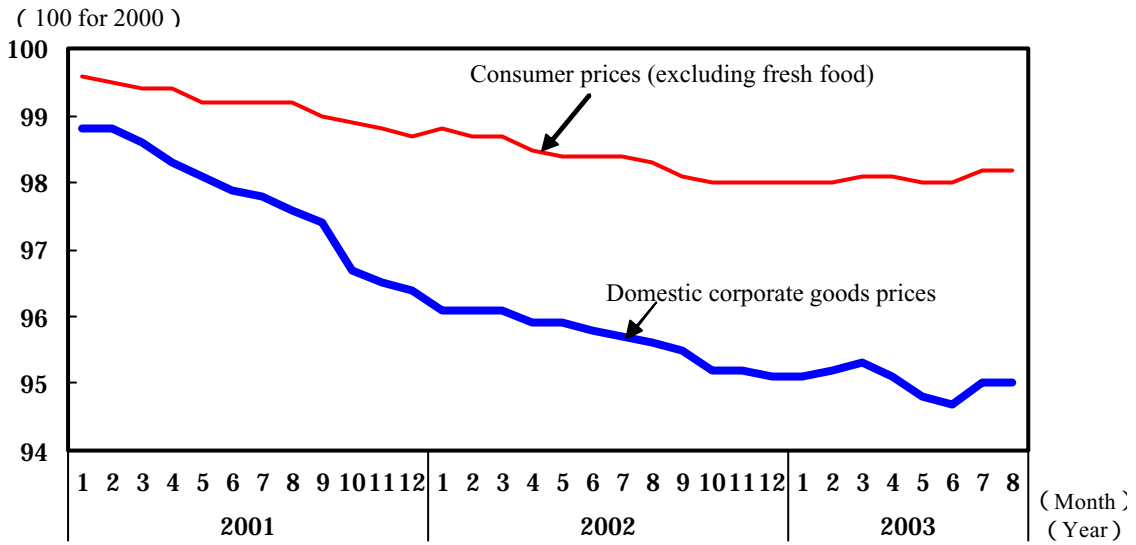


Figure 1-2-12 Unemployment Rate-Based Phillips Curve

The Phillips Curve becomes flat under deflation

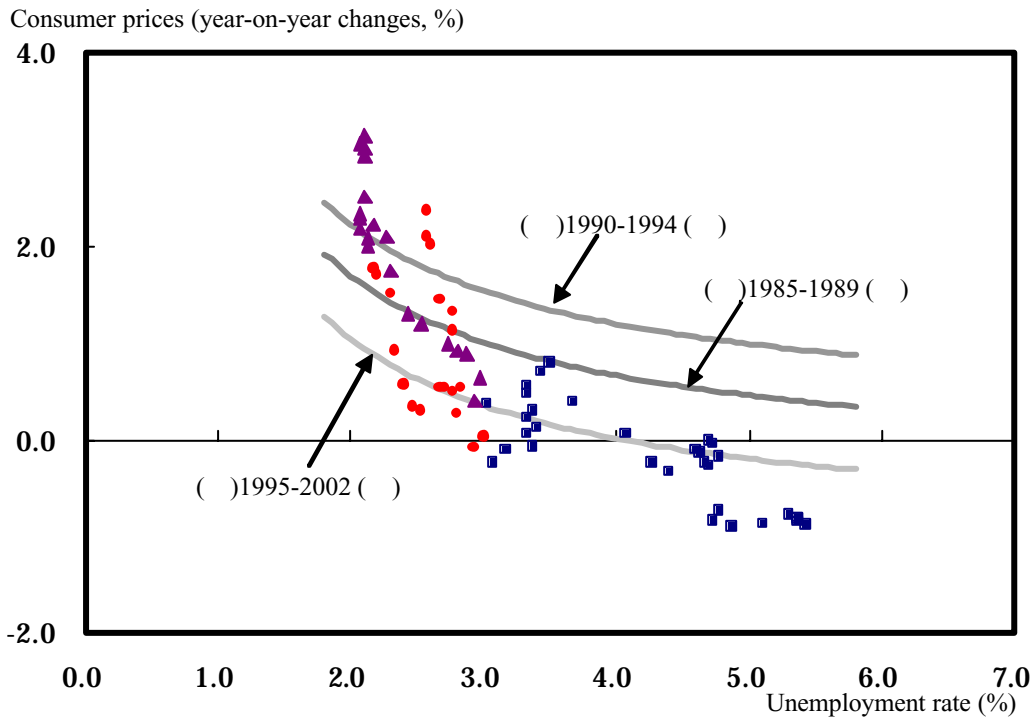


Figure 1-2-13 Expected Rate of Price Change: Consumer Prices

Moderate deflationary expectations have remained since 2000.

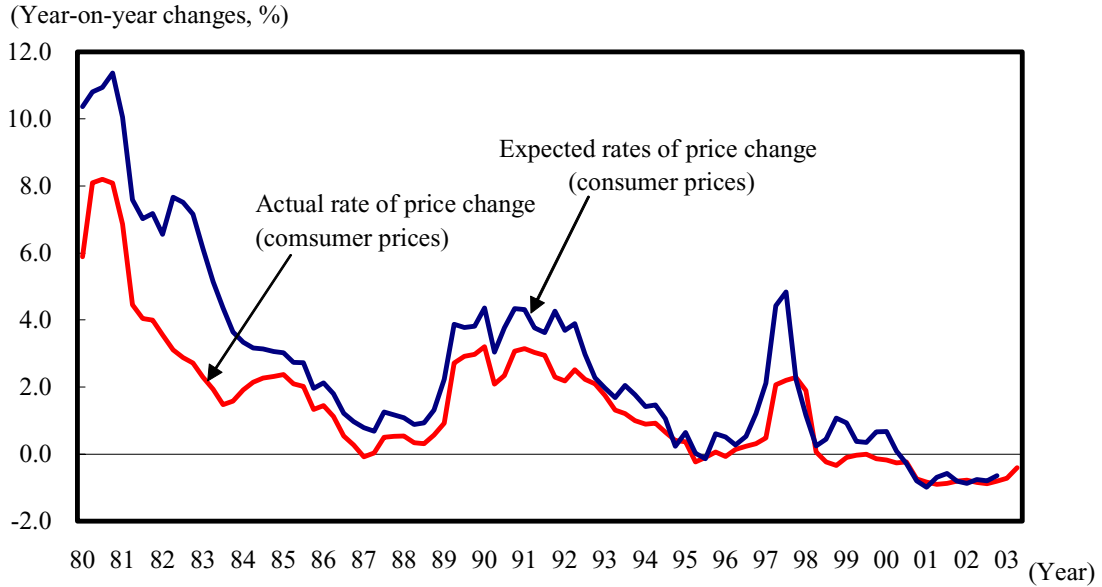


Figure 1-2-15 GDP Gap and GDP Deflator

The GDP gap has narrowed since the economy bottomed out

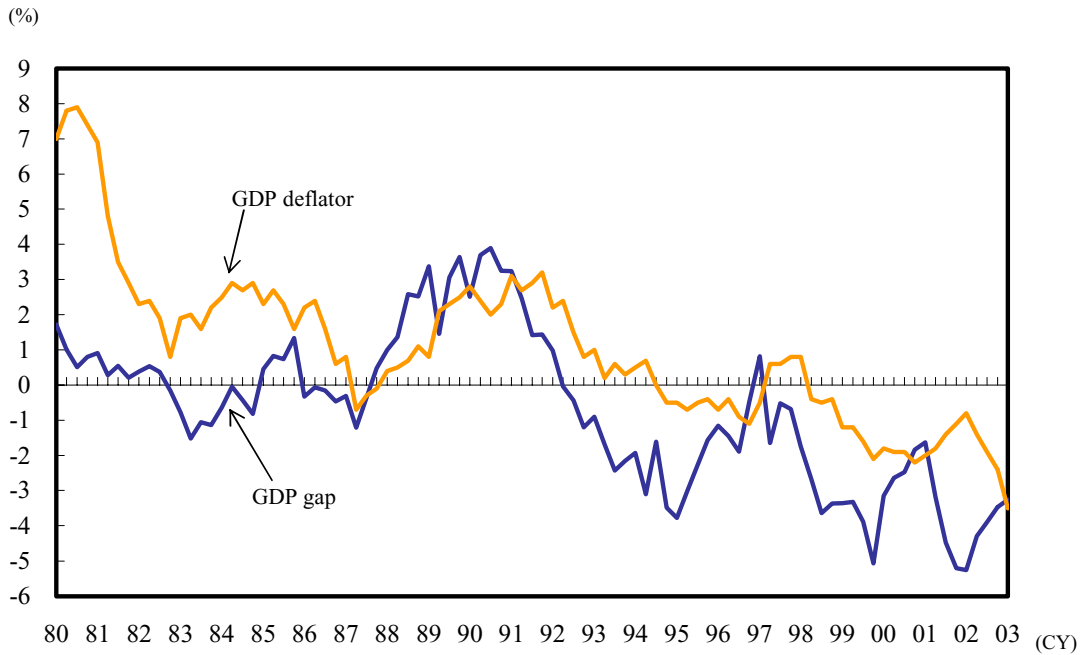
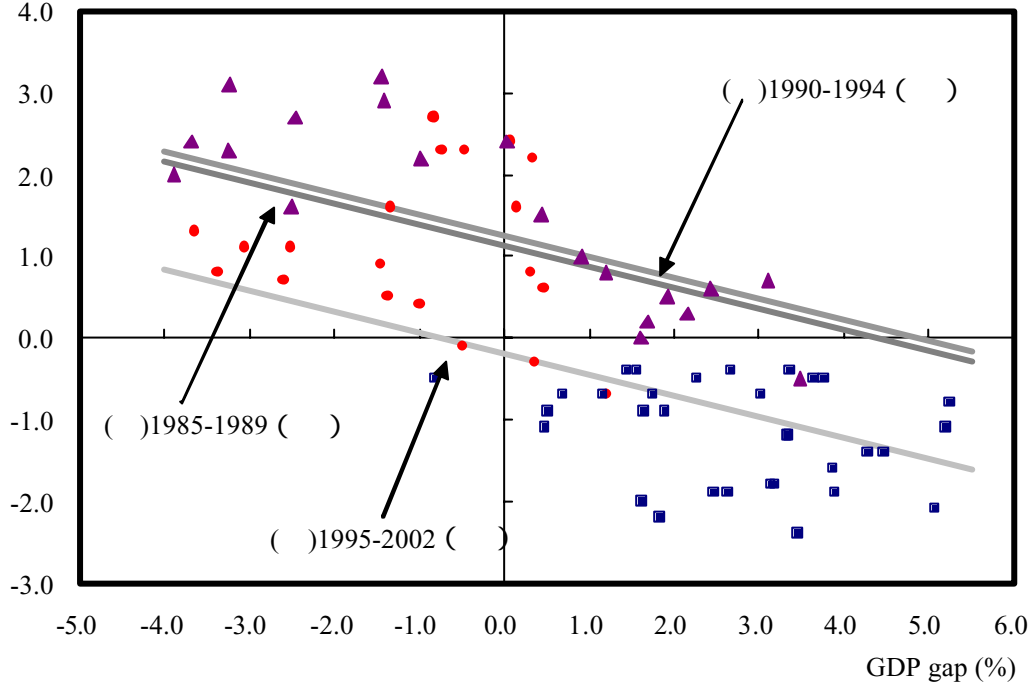


Figure 1-2-16 GDP-Based Phillips Curve

GDP-based Phillips Curve is observed between GDP deflator and GDP gap

GDP deflator (year-on-year changes, %)



[Section 3 Developments of Fiscal and Monetary Policy]

1. Macroeconomic Impact of Fiscal Policy

- Changes in General and Special Accounts Budget of Central Government

A breakdown of expenditures by economic characteristics shows that capital formation and current expenditures have remained flat or declined, while transfer expenditures have been rising due to aging population.

- Expenditures: General government expenditures in FY 2002 remained almost unchanged from the previous year.

- Revenues: General government revenues in FY 2002 decreased slightly.

← Among revenues, taxes fell due to drop in nominal GDP while pension premiums increased slightly.

- In FY 2002, the structural budget deficit expanded slightly, while the cyclical deficit remained almost unchanged. The general government budget deficit increased a little.

→ Fiscal policy did not necessarily have an adverse effect on the economy.

2. Effects of Quantitative Easing

- Developments since the Bank of Japan introduced quantitative easing :

While monetary base has expanded substantially, money supply has posted low growth. Monetary multiplier (money supply divided by monetary base) has dropped.

- Monetary velocity (nominal GDP divided by money supply) has declined.

(1) Money demand has increased due to anxiety over the soundness of financial system and the K2Y problem.

(2) Lending for business investment has declined.

- Effects of quantitative easing

(1) Banks have failed to increase of risk assets (buying government securities instead of lending)

(2) Investment in foreign securities → possible effect on exchange rate

(However, banks' foreign securities investments are mostly risk hedged).

- Reasons for absence of visible effects

(1) Concerns have grown over banks' capital adequacy ratios.

(2) Banks' liquidity demand increased.

- Future measures

(1) Non-performing loans should be disposed and indirect financing should be normalized.

(2) Efforts should be made to enhance effectiveness of policy which is already

taken. In addition, more effective monetary policy should be implemented. For that end, consideration should be given to what financial instrument the Bank of Japan should purchase and from whom, and how can price change expectations be influenced.

Figure 1-3-1 Ratio of Total Expenditure of Special Accounts to that of General Account
The ratio rose throughout the 1990s

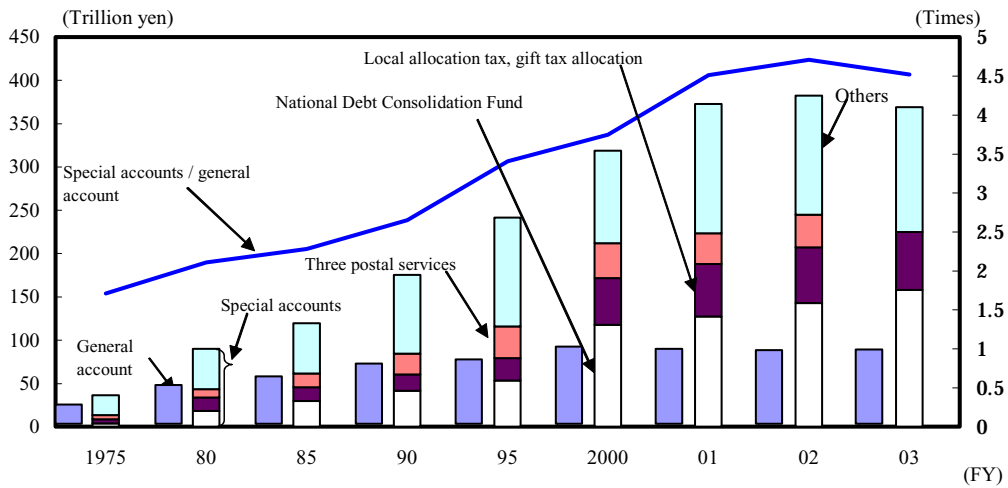


Figure 1-3-4 General Government Expenditures

The combination of public investment and government consumption has remained flat

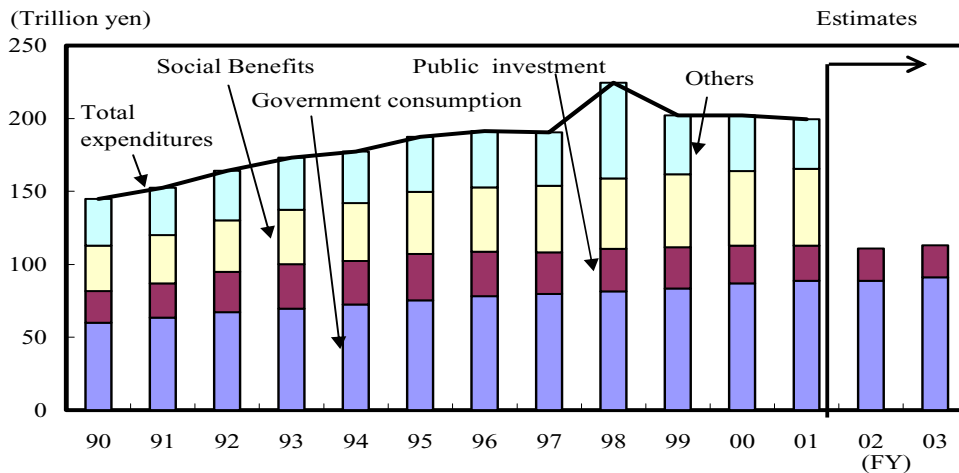


Figure 1-3-7 Cyclical Budget Balance and Structural Budget Balance of General
The structural budget deficit expanded slightly in FY 2002

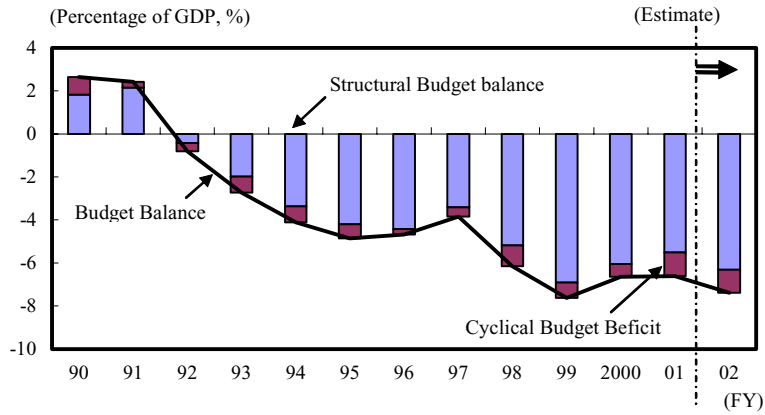


Figure 1-3-9 Monetary Base and Money Supply
The monetary base accelerated its growth while money supply growth remained low

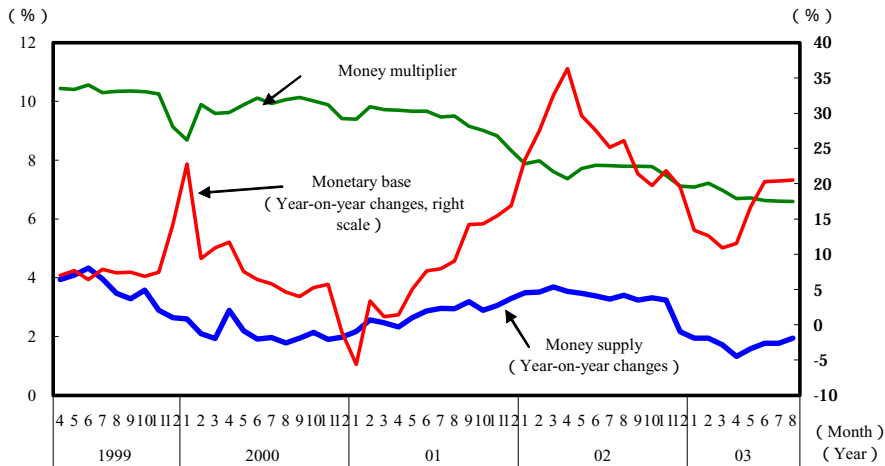


Figure 1-3-12 Velocity of Money
The velocity of money has declined

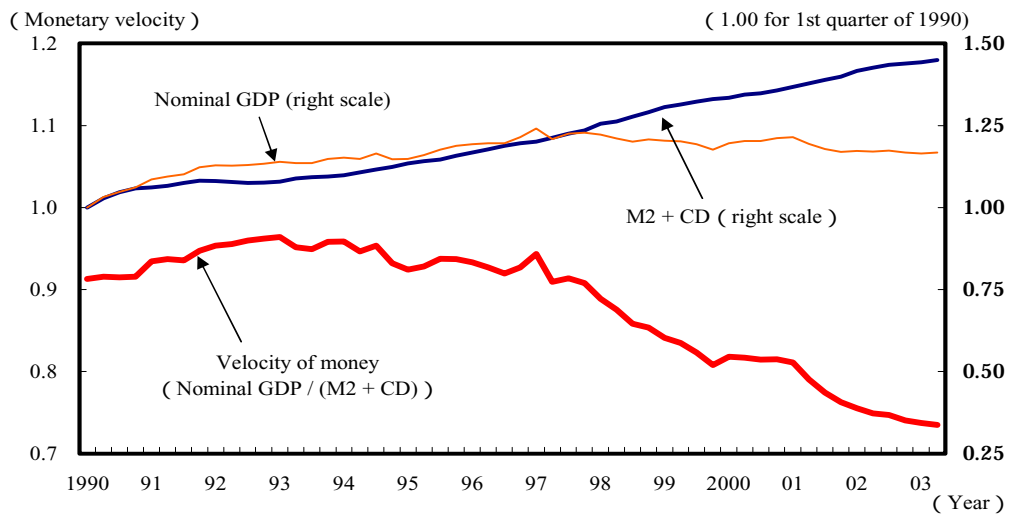


Figure 1-3-13 Changes in Portfolios of Japanese Banks
 Banks have failed to increase the weight of risk assets

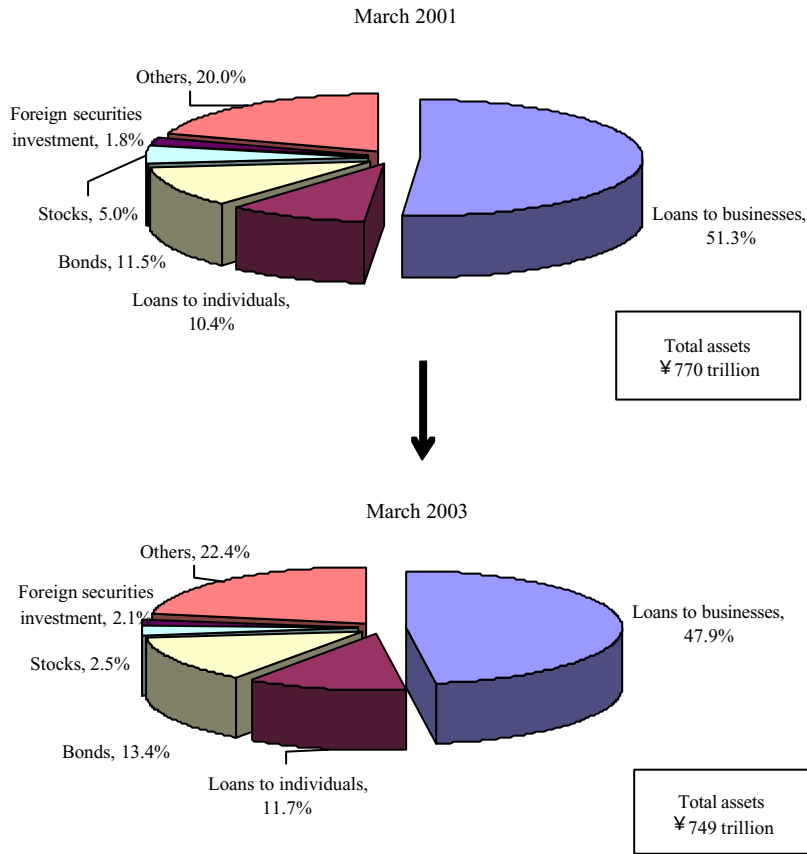
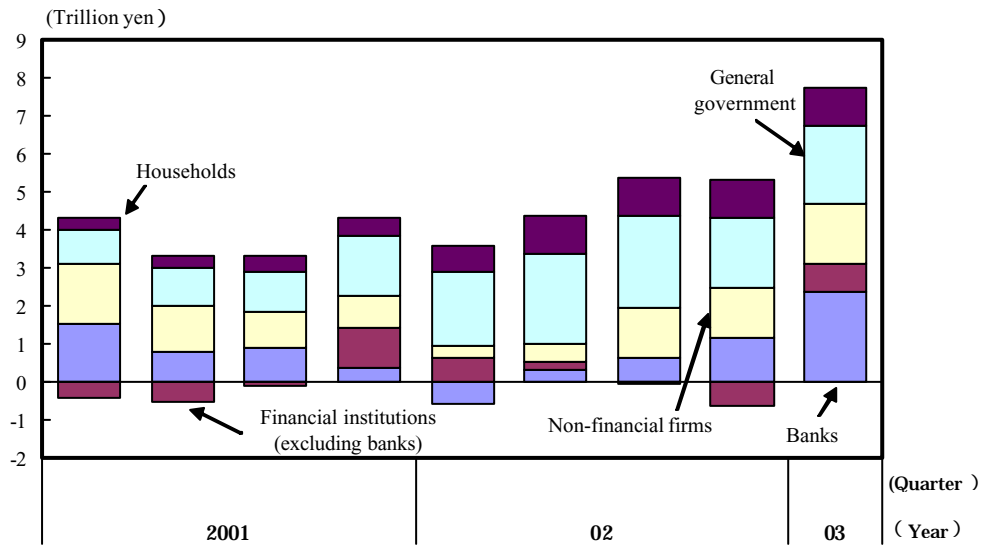


Figure 1-3-14 Foreign Securities Investment
 Japanese retained net purchase in foreign securities transactions



[Section 4 Economic Outlook]

1. Main Scenario for Economic Recovery

(1) Business Sector Sustains Positive Moves

- Corporate profits are expected to increase in FY 2003 as well. Business investment continues a gradual recovery.

(2) Global Recovery and Increase in Japanese Exports

- Faster U.S. Economic Growth ← Increase in business investment, improved corporate profits, macroeconomic policy
- Economic recovery's spread to Asia and Europe, increase in Japanese exports and recovery in production

(3) Recovery's Spread to Household Sector

- Business sector recovery → Gradual effects on employment and wages
- Recovery in employment and wages → Improvement in household income, gradual recovery in private consumption

(4) Prospects for Overcoming Deflation

- Moderate deflation may continue for the immediate future, but better prospects for overcoming deflation.
- Positive signs in stock prices: Land prices may continue a downward trend for a while.

(5) Economic and Fiscal Policy Stance

- Structural reform comprises of four pillars including regulatory, financial, tax system, and government expenditure reforms. They are to be implemented in an integrated and consistent manner.
- Quantitative easing to be maintained. A more effective monetary policy should be considered and implemented.

2. Risks Involving Main Scenario and Vulnerability of Economic Recovery

(1) Risks Involving Main Scenario

- U.S. economy: 1) employment situation, 2) deflationary concerns, 3) current account deficit
- Exchange rate
- Domestic stock prices and long-term interest rate

(2) Vulnerability of Economic Recovery

- Recovery in corporate profits stems from restructuring mainly at large enterprises
→ Downward pressures are exerted on sales of small and medium enterprises

- Corporations are still cautious about future short-term prospects → Business investment recovery may be limited
- Businesses' cautiousness about labor cost increases, existence of employment mismatch → Constraints on income recovery
- Cautiousness about employment and social security systems → Limits on private consumption growth
- Continued deflation → Downward pressures on economy. Land price falls in particular.
→ Vulnerability: Factors affecting autonomous economic recovery

3. Obstacles to Autonomous Recovery

- Non-performing loans have reduced financial institutions' risk-taking capacity
Excessive debts have increased corporate credit risk
→ Chapter 2
- Japan's productivity growth has decelerated
- Social and economic systems don't match present situation: uncertainties about the future
→ Chapter 3