

# Annual Report on the Japanese Economy and Public Finance 2007

- Toward Higher Productivity Growth -

## Summary

August 2007

Cabinet Office  
Government of Japan

# Contents

Chapter 1	Continued Economic Recovery and Future Prospects .....	1
Section 1	Continued Economic Recovery and the Business Cycle Mechanism .....	1
Section 2	Financial Markets Remaining Stable after the ending of the Zero Interest Rate environment .....	7
Section 3	Movement toward Moderate Price Increases .....	8
Section 4	Ongoing Fiscal Soundness .....	10
Chapter 2	Increase in Productivity and Corporate Behavior for Future Growth .....	11
Section 1	Changes of Economic Structure and Macro Productivity .....	11
Section 2	Japanese Corporate Behavior from the Perspective of Productivity .....	13
Section 3	IT Usage and Productivity in Japanese Companies .....	18
Section 4	Issues of Innovation in Japan .....	19
Chapter 3	Changes in the Labor Market and Their Impacts on the Household Sector .....	21
Section 1	Diversification of Employment Styles and Its impact on the Household Sector.....	21
Section 2	Employment system reforms in response to changes in employment environment.....	23
Section 3	Negotiation process on wage and employment conditions.....	24
Section 4	The relation between economic growth and disparity.....	25

This material has been tentatively prepared to explain the “Annual Report on the Japanese Economy and Public Finance.” For quotation and other purposes, please refer to the text of the “Annual Report on the Japanese Economy and Public Finance.”

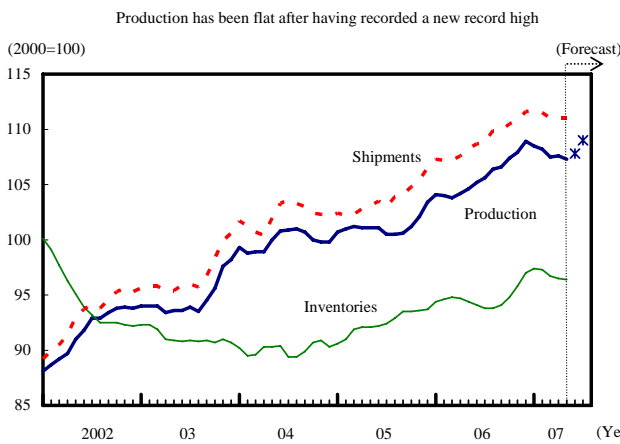
# Chapter 1 Continued Economic Recovery and Future Prospects

## Section 1: Continued Economic Recovery and the Business Cycle Mechanism

### 1. The state of continued economic recovery

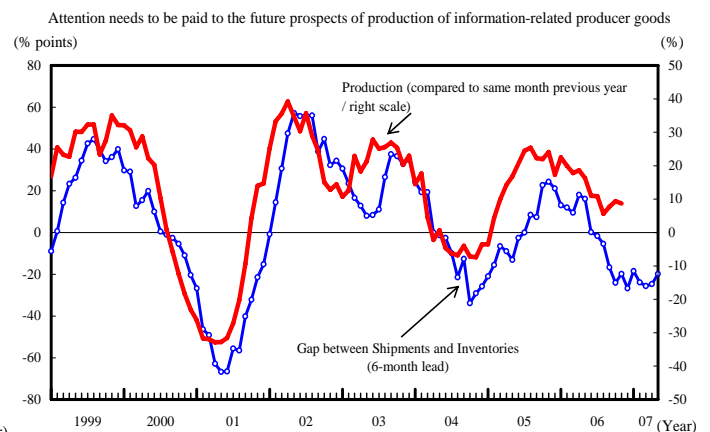
- In the corporate sector, as production continues on an upward trend, sales and profits continue to increase. However, as we enter 2007, there are visible signs of a weakening in some areas of production.
- Despite improvements in profit structures in enterprises overall, there appears to be a lull in improvements in small and medium enterprises (SMEs) in the non-manufacturing industry.

**Figure 1-1-8**  
Changes in Production, Shipment and Inventory Indices



Notes: 1. *Indices of Industrial Production*, Ministry of Economy, Trade and Industry.  
2. Seasonally adjusted figures (3-month moving average) have been used.  
3. Production for June and July 2007 have been calculated based on forecast indices.

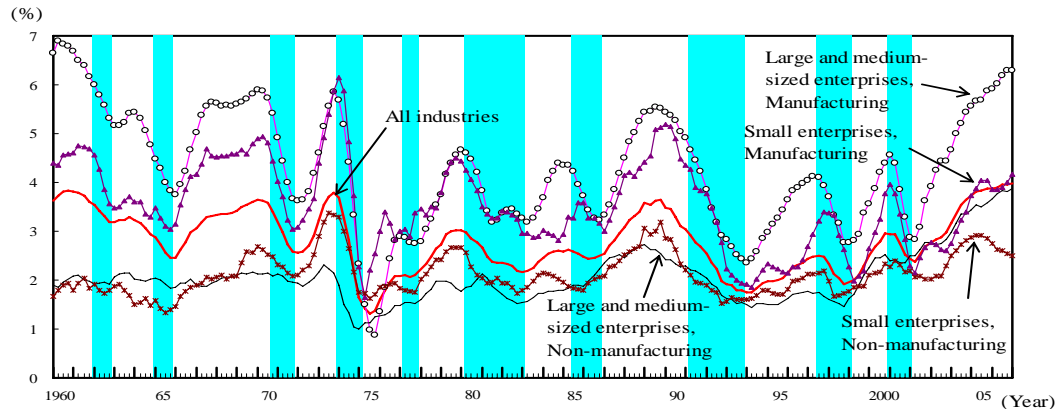
**Figure 1-1-10 (1) Changes in the Gap between Shipments and Inventories and Production of Information-related Producer Goods**



Notes: 1. *Indices of Industrial Production*, Ministry of Economy, Trade and Industry.  
2. Gap between Shipments and Inventories (% points) = Change in shipments from previous year (%) - Change in inventories from previous year (%)  
3. Gap between Shipments and Inventories was made to precede production by six months.

**Figure 1-1-11 (1) Changes in Profit-to-sales ratio**

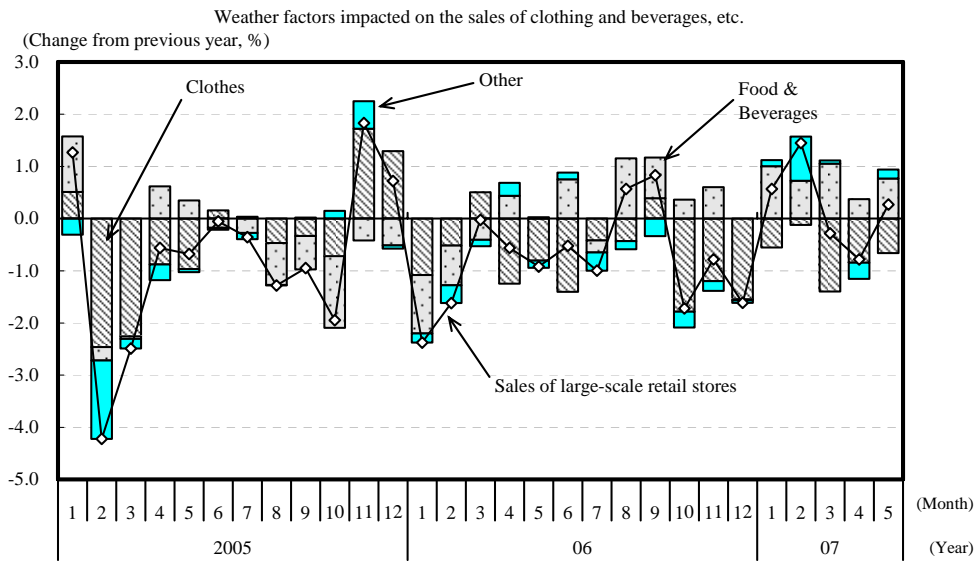
There is a slight sense of a lull in improvements in profit-to-sales ratio for small enterprises in the non-manufacturing industry



Notes: 1. *Financial Statements Statistics of Corporations by Industry, Quarterly*, Ministry of Finance.  
2. Large and medium-sized enterprises are enterprises with capital of 100 million yen and more, and Small enterprises are enterprises with capital of 10 million yen to less than 100 million yen.  
3. Four-quarter moving average.  
4. The shadows indicate recession periods.

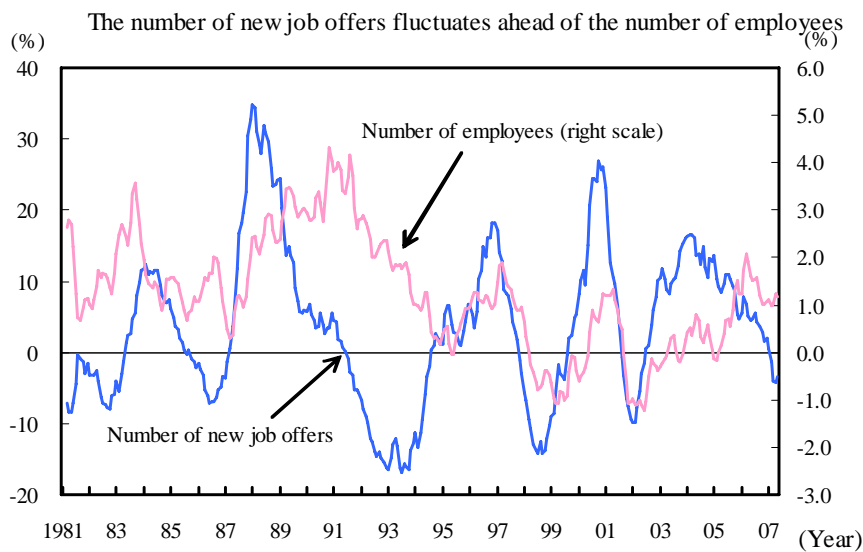
- The effects of unseasonable weather as well as decelerating households' income had led to sluggish household consumption since about the middle of 2006. However, since the beginning of 2007, household consumption has been picking up, boosted by the consumption of spring goods attributable to the effects of a mild winter.
- The number of employees has continued to be on an increasing trend, and reached a record high. On the other hand, the number of new job offers has turned into decrease since about the summer of 2006.

**Figure 1-1-19 Trend in the Sales of Large-Scale Retail Stores**



Notes: 1. *Current Survey of Commerce*, Ministry of Economy, Trade and Industry  
2. Sales of large-scale retail stores is the sum of department store sales and supermarket sales.

**Figure 1-1-21 Trend in the Number of New Job Offers and the Number of Employees**

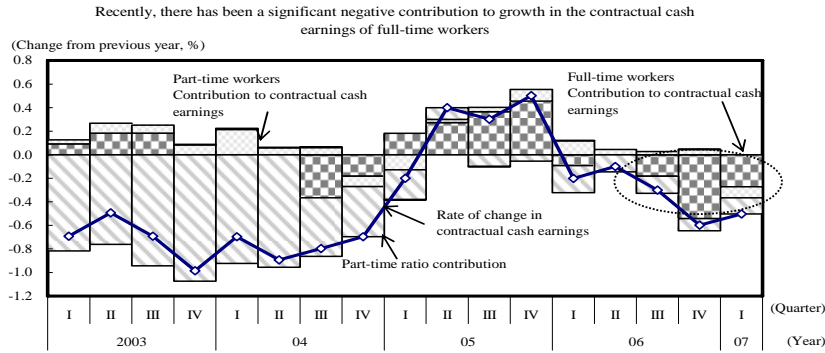


Source: *Labor Force Survey*, Ministry of Internal Affairs and Communications; *Employment Referral Statistics*, Ministry of Labor, Health and Welfare

Note : 3-month moving averages have been taken for the changes in the number of employees and the number of new job offers from the previous year.

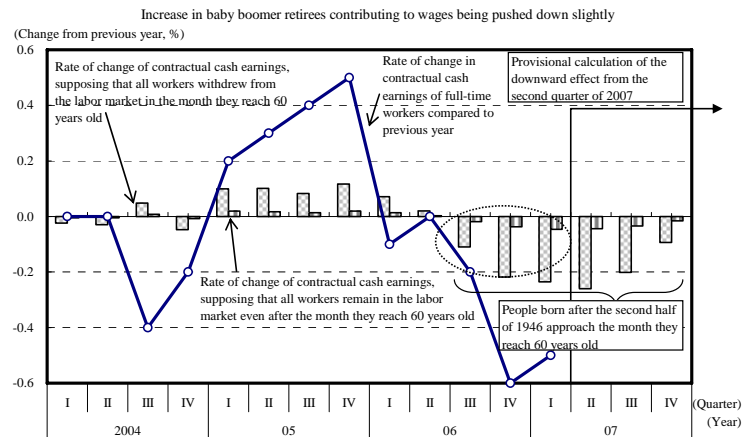
- Despite labor market conditions growing firmer, wages remain sluggish. The decline in scheduled cash earnings in the second half of 2006 is mainly due to the fall in wages of full-time workers.
- Several factors are contributed to the decline of wages in a complex manner.

**Figure 1-1-23 Decomposition Analysis of Scheduled Cash Earnings**



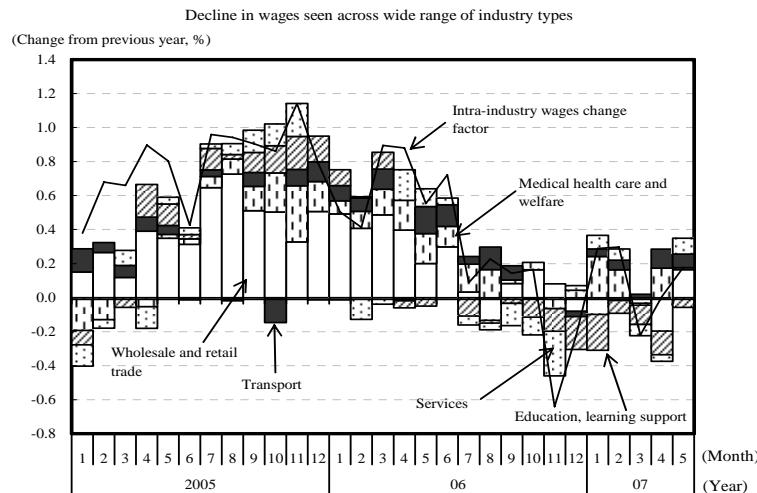
Source: *Monthly Labour Survey*, Ministry of Health, Labour and Welfare

**Figure 1-1-27 Effect of Retiring Regular Workers on Scheduled Cash Earnings**



Source: *National Census, Labor Force Survey (detailed version)*, Ministry of Internal Affairs and Communications; *General Survey on Wages, Monthly Labour Survey, Basic Survey on Wage Structure*, Ministry of Health, Labour and Welfare

**Figure 1-1-29 Effect of Changes in Wages between and within Industries on Scheduled Cash Earnings**



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

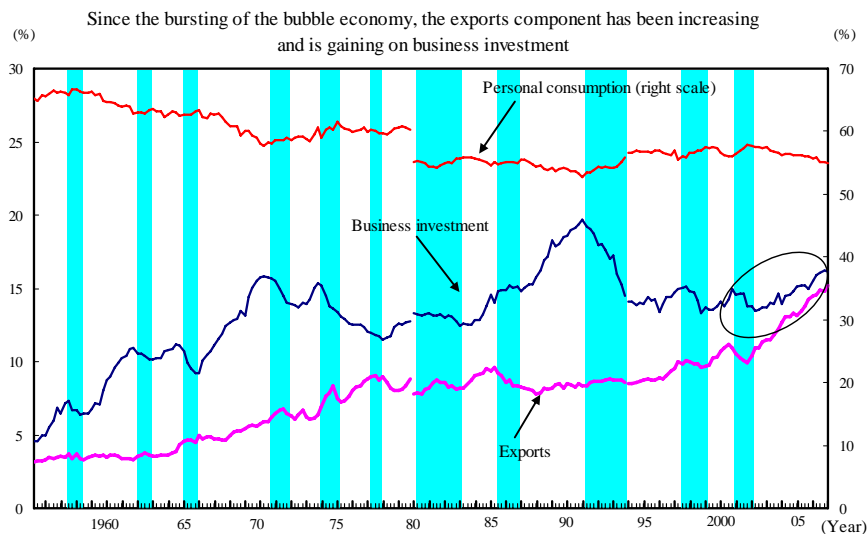
## 2 The Business Cycle and the Mechanism of Diffusion among Economic Sectors

- Increasing presence of exports as a driver of business fluctuations.
- The influence of increases in exports on domestic corporate profits and on production has been increasing since the 1990s.

[Analysis]

- Up until the middle of the 1990s, exports did not appear to have been leading business investment. Also, exports had not appeared to have been leading domestic demand.
- Since the middle of the 1990s, exports have appeared to be leading business investment, and exports and domestic demand have now appeared to affect each other.

**Figure 1-1-34 Change in the Ratio of Main Components of Demand to GDP**

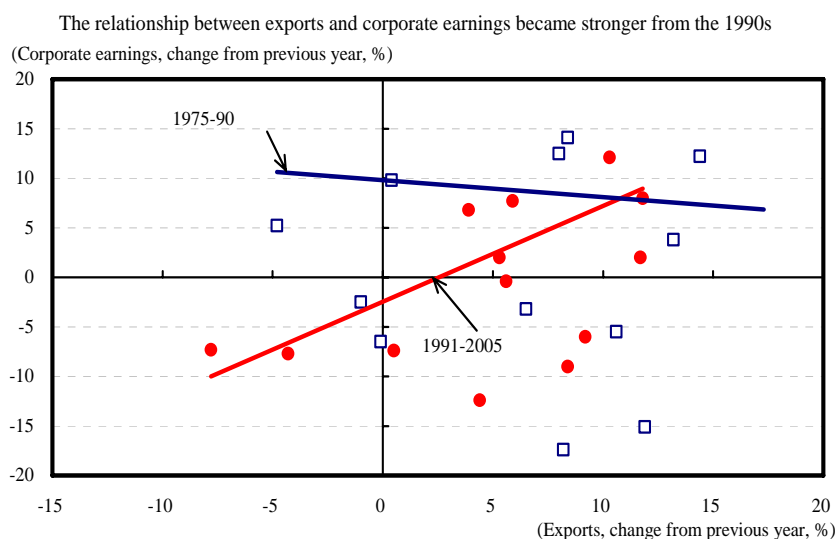


Source: *National Accounts*, Cabinet Office

Note: 1. Figures at constant prices on SNA68 fixed-based (base year = 1990) have been used up until the fourth quarter 1979; figures at constant prices on SNA93 fixed-based (base year = 1995) have been used up until the fourth quarter 1993; and figures at chained prices on 93SNA have been used since the first quarter 1994. For this reason, there are divisions in the graph.

2. Shaded areas indicate periods of recession.

**Figure 1-1-37 Elasticity of Corporate Profits to Exports**



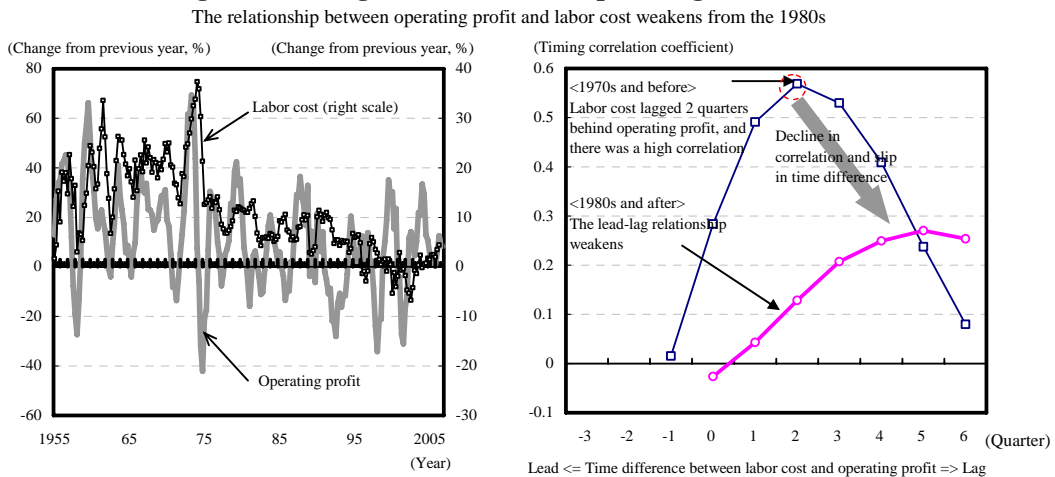
Notes: 1. *National Accounts*, Cabinet Office

2. Corporate earnings is the corporate income of private sector corporations (after dividends have been paid and received).

3. A significant gradient (elasticity) was not observed up to 1990, but a significant gradient is estimated for 1991 onward.

- There is a possibility that the relationship that increased corporate earnings leads to increased labor costs has been weakening since the 1980s.
- However, it should be noted that, in the current phase of economic recovery, good conditions in the corporate sector is linked to consumption through increases in the number of employees and increases in wages, and so a flow-on to the household sector was observed.
- As improvement in the supply and demand of the macro economy continues, there is a chance that flow-on from corporate profits to labor costs (income of the household sector) would appear.

**Figure 1-1-39 Changes in Timing Correlation of Operating Profit and Labor Costs**



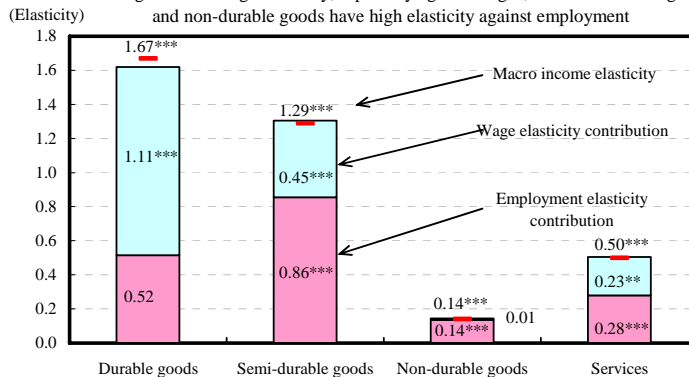
Notes: 1. Quarterly Financial Statements Statistics of Corporations by Industry, Ministry of Finance  
2. Changes from the previous year, and the associated timing correlation in all sizes and all industries.

[Analysis]

- Durable goods that are considered to have high income elasticity seem to have relatively higher elasticity to worker's wage. Semi-durable goods and non-durable goods, which are viewed to have low elasticity to income, might have relatively higher elasticity with respect to employment. Compared with goods, services have relatively lower elasticity to income.
- During the current phase of economic recovery, which has had relatively moderate increase in wage (but high increase in employment), durable goods supposedly having higher elasticity to income have been sluggish. Furthermore, high composition ratio of service consumption of lower elasticity to income than durable goods, etc. in the total expenditure might lead to have weakened the diffusion of increased income to consumption.

**Figure 1-1-44 Macro Income Elasticity of Consumption by Type of Goods**

Durable goods have high elasticity, especially against wages; and semi-durable goods and non-durable goods have high elasticity against employment



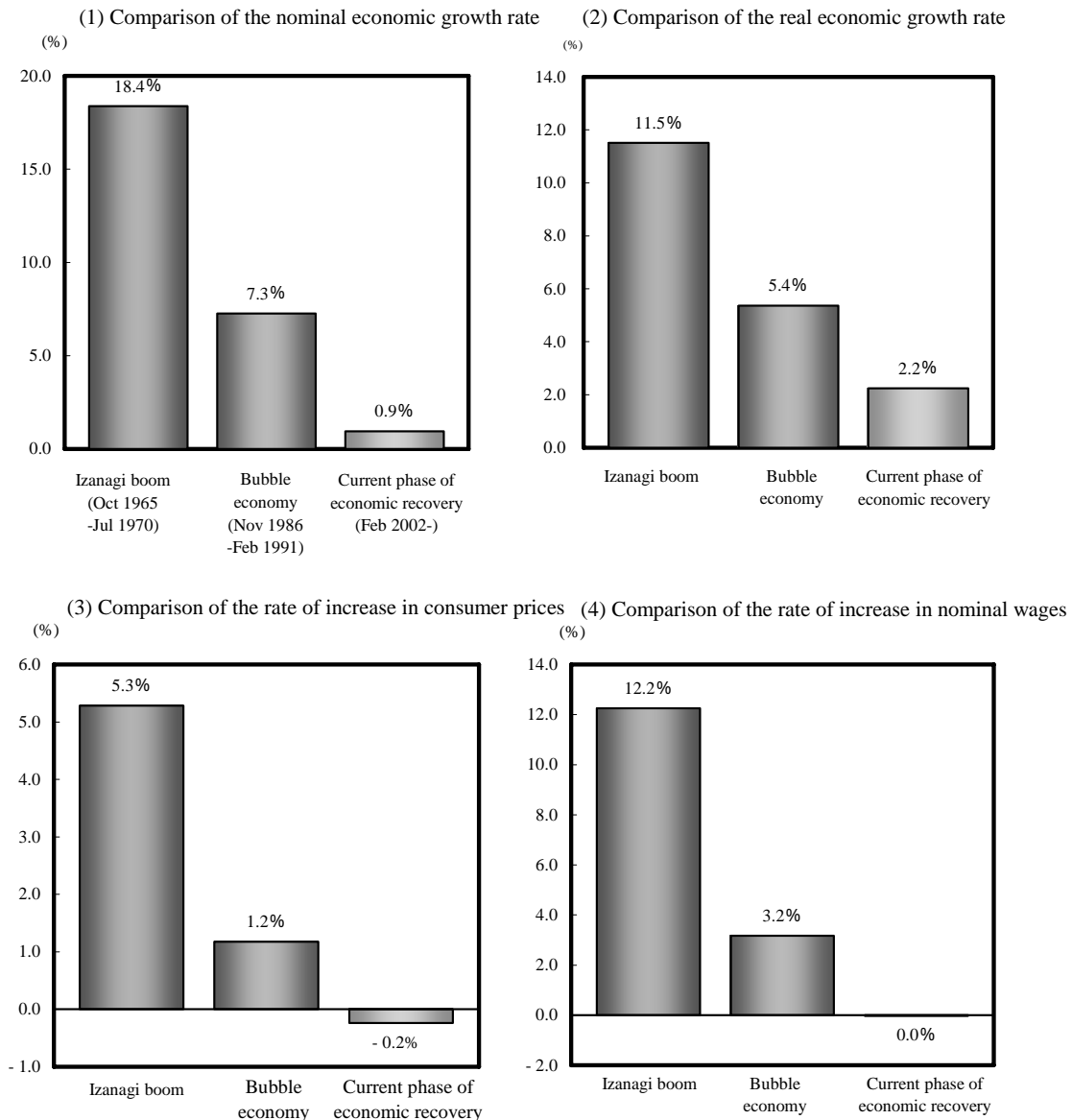
Notes: 1. National Accounts, Cabinet Office; Labor Force Survey, Ministry of Internal Affairs and Communications  
2. Imputed rent has been excluded from services.  
3. The estimation period is from the first quarter of 1995 to the first quarter of 2006.

Elasticity has been estimated, net of the effects of consumption tax. \*, \*\* and \*\*\* denote a significance level of 10%, 5% and 1% respectively.

- In spite of the length of this current period of economic recovery, it is often pointed out that people actually have a little sense of the recovery.
- Background of that people's feeling might be related to a number of factors, including a moderate increase in the real rate of growth; sluggish growth in nominal values such as income and earnings due to having been in deflation; and disparity among firms in terms of corporate profits and the weakness of the flow-on to the household sector.

**Figure 1-1-47 Comparison of Main Indicator Growth Rates with Past Periods of Economic Recovery**

Difficult to feel any real sense of economic recovery compared to the "Izanagi boom" and the "bubble economy"



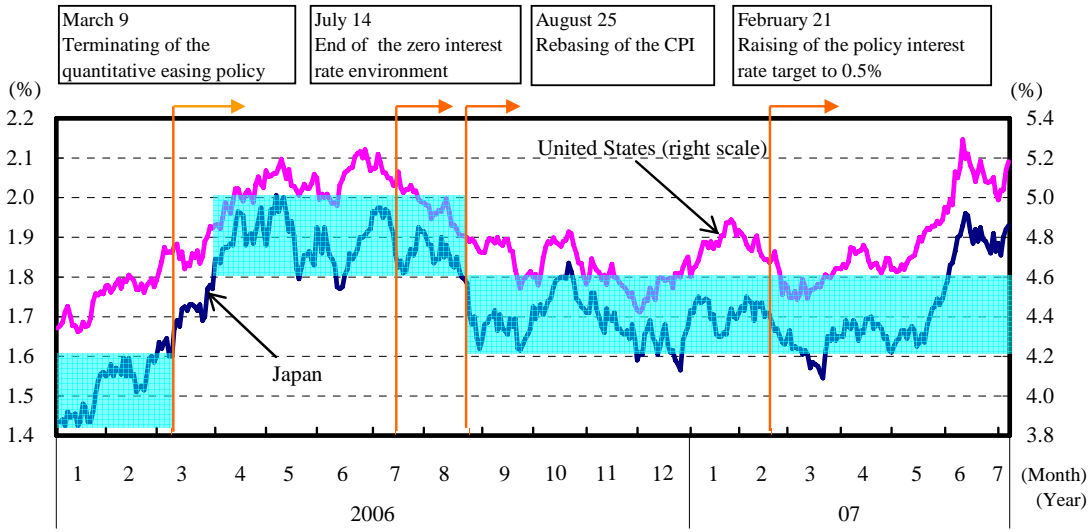
- Notes: 1. The names used for each of the economic periods are common names, not official names. The names have been sourced from the *Japanese Economy 2004*, Cabinet Office.
2. The rate of increase in consumer prices (CPI) in graph (3) is general, excluding imputed rent. The nominal wages in the Izanagi boom in graph (4) excludes the service industry.
3. The rate of increase in CPI in the bubble economy in graph (3) excludes the effects resulting from the increase in consumption tax.
4. In graphs (3) and (4), since past seasonally adjusted series cannot be obtained, calculations have been made for all periods using the average growth since the same month of the previous year.
5. For the current period of economic recovery, the GDP growth rate covers the period from Jan-Mar 2002 to Jan-Mar 2007; and wages and CPI cover the period from January 2002 to May 2007.
6. *National Accounts*, Cabinet Office; *Consumer Price Index*, Ministry of Internal Affairs and Communications; *Monthly Labour Survey*, Ministry of Health, Labour and Welfare.



**Section 2 Financial Markets Remaining Stable after the ending of the Zero Interest Rate environment**

- After the ending of the zero interest rate environment, long-term interest rates have fluctuated within a fixed range. Bank loans have increased slowly, mainly due to the demand for working capital of SMEs.
- Stock prices have continued an upward trend after a period of adjustment. In the foreign exchange market, yen have continued to depreciate against a backdrop of differences in interest rates.

**Figure 1-2-2 Changes in Long-Term Interest Rates**  
Long-term interest rates have moved between 1.6% and 1.8%



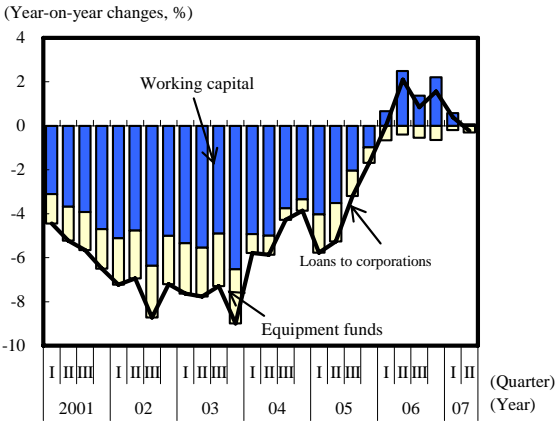
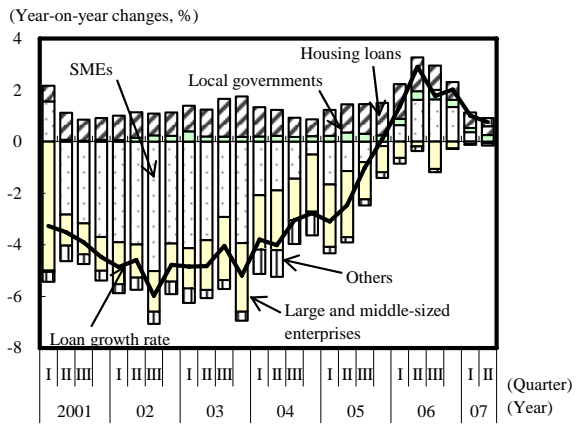
Notes: 1. Bloomberg  
2. 10-year government bond yields have been used for both Japan and the United States.

**Figure 1-2-8 Trends in Bank Loans**

Bank loans increasing slowly

(1) Changes in private banks' outstanding loans by borrower

(2) Breakdown of loans to corporations classified by purpose



Source: *Loans and Discounts Outstanding by Sector*, Bank of Japan  
Notes: 1. Second quarter figures for 2007 have been created using the figures for May 2007.  
2. The housing loans figure in graph (1) for the second quarter 2007 is the loans to individuals which includes loans other than housing

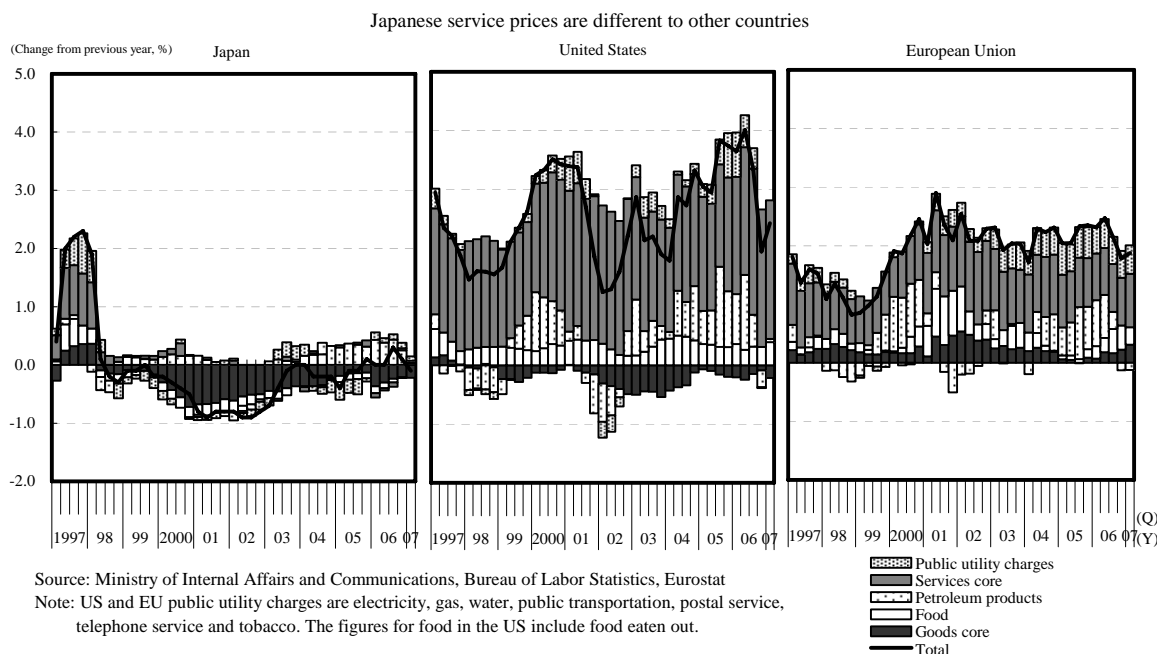
### Section 3 Movement toward Moderate Price Increases

- Movements toward price increases continue to be moderate.
- There is downward pressure on goods prices amid global competition. If service prices increase while realizing wage increase, steady increase in prices is expected in Japanese economy.

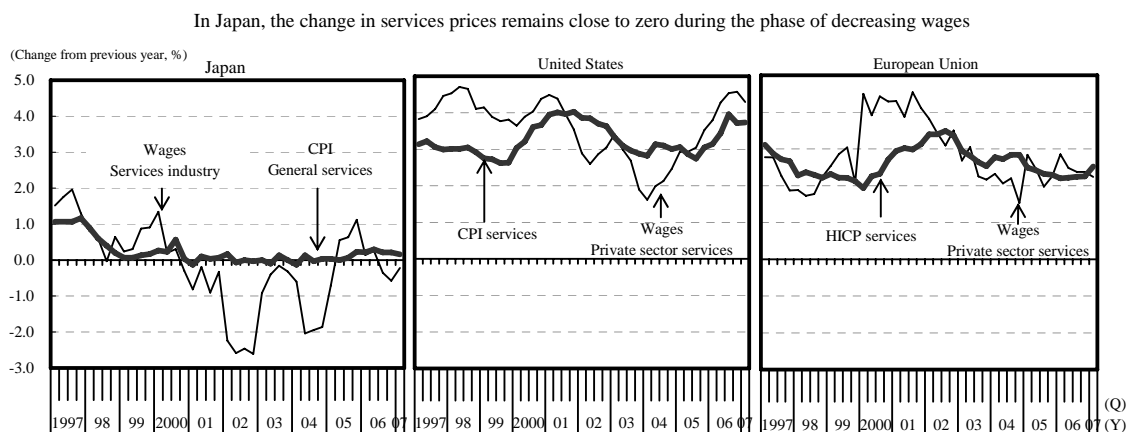
[Analysis]

- Compared to the United States and the EU, service prices do not contribute to an increase in the overall level of prices in Japan.
- In view of the low price elasticity and high income elasticity of the demand for services, if an increase in service prices is attributed to an increase in income in the overall economy due to the economic recovery, it is anticipated that prices will steadily increase in Japanese economy.

**Figure 1-3-5 Components of CPI in Japan, the US and the EU**



**Figure 1-3-6 Change in Services Prices and Wages in Japan, the US and the EU**

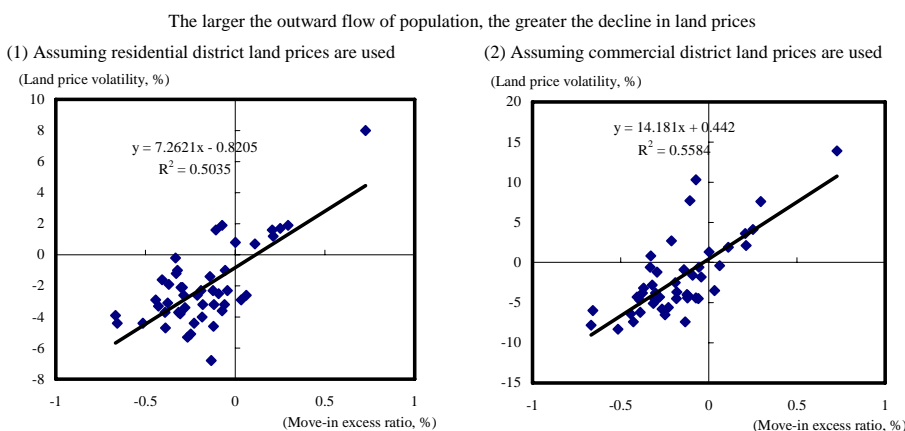


- Average land price, nationwide, rose for the first time in 16 years.
- While land price continued to fall in local areas, it increased in excess of 30 to 40 percent in some inner-city metropolitan areas.
- It is important to ascertain whether asset prices are backed by reasonable and expected growth rates.

[Analysis]

- A positive correlation is observed between the volatility of land prices and the move-in excess ratio. The larger the outward flow of population, the lower the demand for land in the area, and this is linked to the continuous decline in land prices.

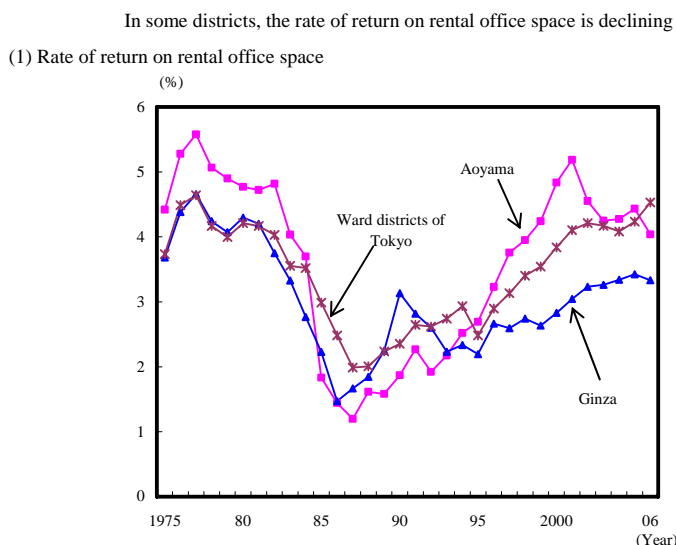
**Figure 1-3-9 Volatility of Land Prices and Move-In Excess Ratio**



- Notes: 1. Land Price Publication, Ministry of Land, Infrastructure and Transport; Report on the Internal Migration in Japan Derived from the Basic Resident Registers, Ministry of Internal Affairs and Communications  
 2. The move-in excess ratio is the ratio of the net inward flow of migrants (inward flow of migrants minus the outward flow of migrants) to the population of Japanese people in the particular region as of October 1. A negative ratio indicates an excess outward flow of migrants.  
 3. Graphs (1) and (2) plot the data for each prefecture.  
 4. Data from 2007 has been used for land price volatility, and data from 2006 has been used for move-in excess ratios.

- Although the rate of return on rental office space is tending to increase in the ward districts of Tokyo, the rate is declining in some areas.

**Figure 1-3-11 Rate of Return on Rental Office Space and Factor Analysis**

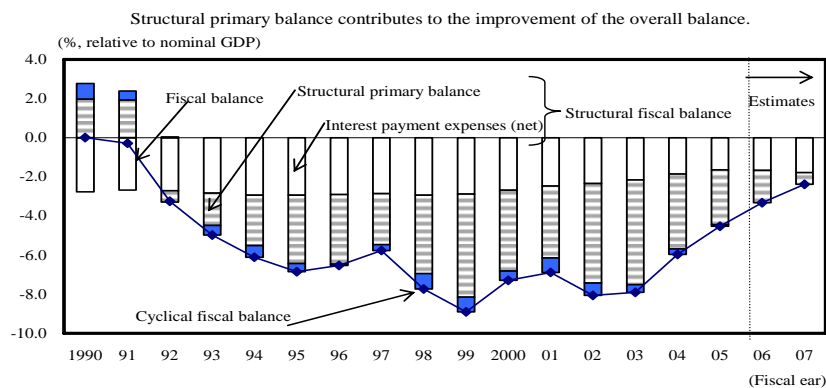


- Notes: 1. MTB-IKOMA Real Estate Investment Index, Ikoma Data Service System  
 2. Income return (net operating income / beginning asset price) based on the real estate investment indices has been used for the rate of return on rental office space.

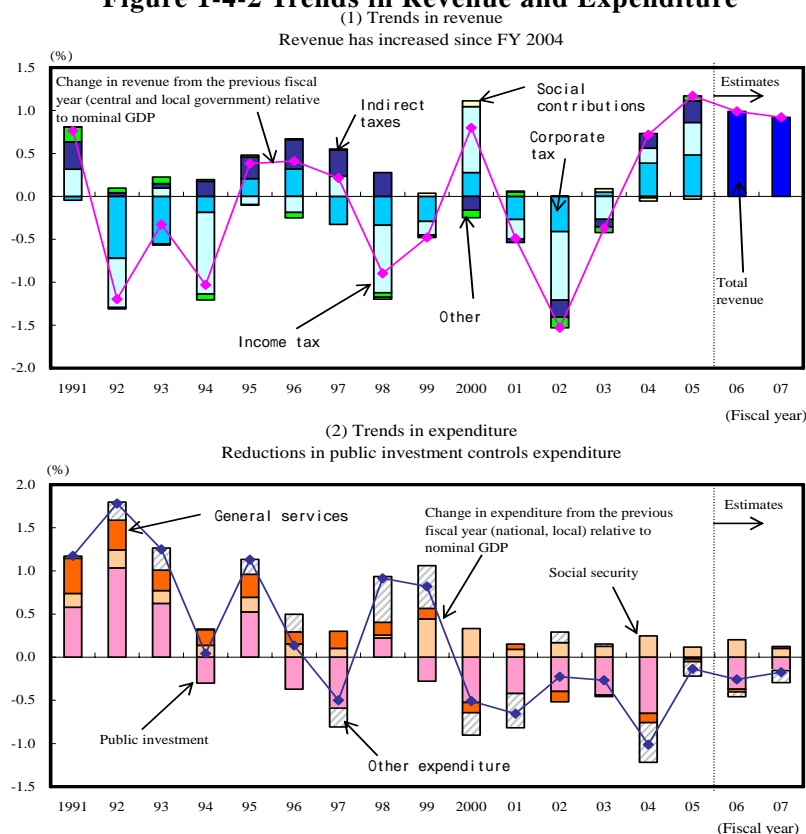
## Section 4 Ongoing Fiscal Soundness

- The primary balance of the central and local governments is steadily improving.
- Efforts to cut expenditure as well as economic recovery have both contributed to improving the fiscal balance since FY 2003.

**Figure 1-4-1 Cyclical and Structural Fiscal Balance of Central and Local Governments**



**Figure 1-4-2 Trends in Revenue and Expenditure**



Notes: 1. National Accounts, Cabinet Office. Actual figures are utilized until FY 2005, and estimated figures are utilized from FY 2006 and onwards.

2. The effect of current transfers between central and local governments was eliminated.

3. In Graph 1-4-1, Fiscal balance = Cyclical fiscal balance + Structural primary balance + Interest payment expenses (net). The GDP gap is assumed to be zero.

4. In Graph 1-4-2 (1), only total revenue has been displayed for FY 2006 and FY 2007. In Graph 1-4-2 (2), "Other expenditure" factors include subsidies to private enterprises, capital transfers (net), and consumption of fixed capital (deduction), etc.

5. The value for FY 1998 does not include those (about 27 trillion yen) of the Japanese National Railways and forestry that were transferred to the general account. The values for FY 2000 and FY 2001 include the tax revenue increase of about 4.5 trillion yen and about 3.7 trillion yen, respectively, resulting from the maturity of postal savings. The value for FY 2006 does not include the purchase price of the land transferred to the Japan Expressway Holding and Debt Repayment Agency from the four highway-related public corporations. The value for FY 2006 does not include those transferred from the Fiscal Loan Fund Special Account to the National Debt Consolidation Fund Special Account.