World Economic Trend, Autumn 2006, No. 10
***Published on November 27* by the Cabinet Office**

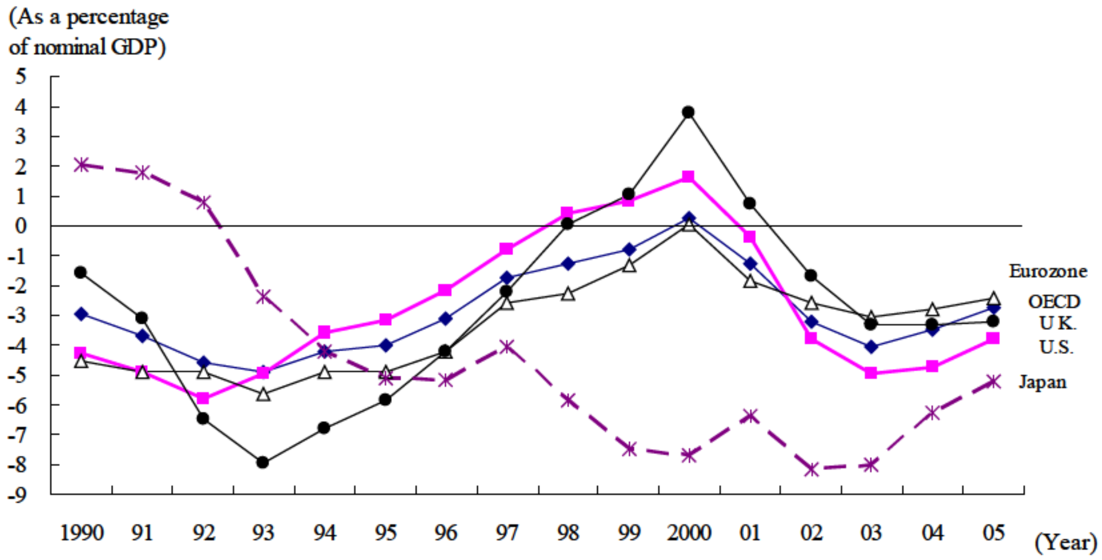
(summary)

Key Points of Chapter 1 in Part I

1. Fiscal situations in industrial nations since the 1990s

• Fiscal consolidation made major progress thanks to the effects of various budget discipline rules in industrial nations in the 1990s. But, many of these nations have seen their fiscal situations deteriorating again since the beginning of the 2000s, while some improvements have been witnessed since around 2004 (Figure 1-1-1).

Figure 1-1-1 Fiscal Balance Conditions in Major Countries

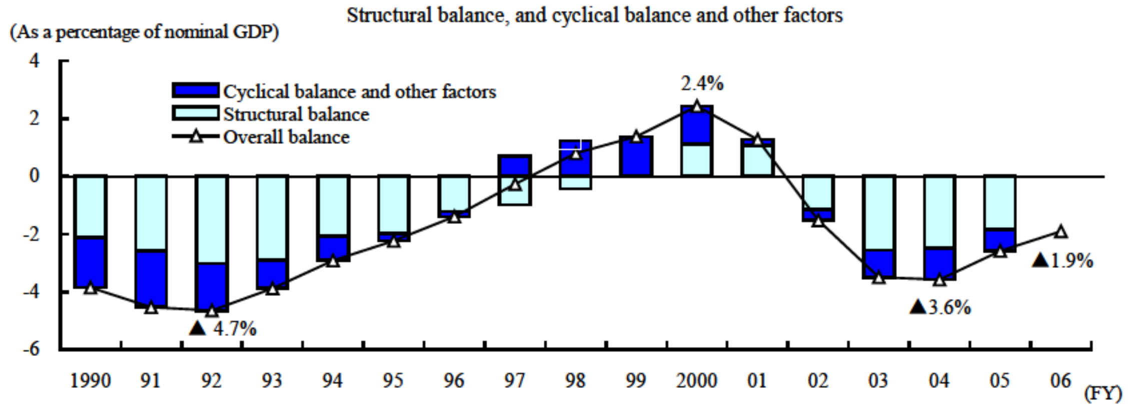


Source: OECD, *Economic Outlook 79*
Note: On a general government basis.

• U.S. fiscal improvements in the 1990s owed much to enhancement of personal income tax's progressiveness on the revenue side and defense spending cuts on the outlay side. The U.S. fiscal situation, however, deteriorated again in the early 2000s, mainly due to the growth oriented tax cuts and a defense spending expansion. The situation has improved to some extent due to economic expansion in recent years. There is a possibility that further improvements come over the medium

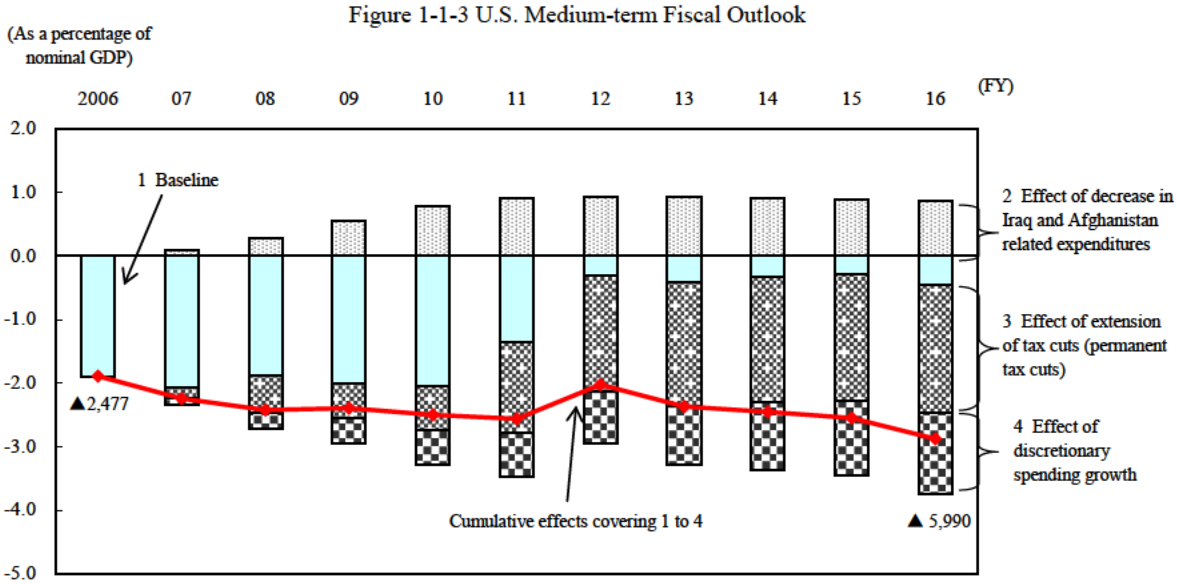
term. However, budget deficits could expand if the tax cuts are made permanent and discretionary spending grows at the past pace (Figures 1-1-2 and 1-1-3).

Figure 1-1-2 U.S. Federal Budget Balance



Sources: Department of the Treasury; Congressional Budget Office (CBO), *The budget and Economic Outlook Fiscal Years 2007 to 2016*
Note: "Structural balance" and "cyclical balances and other factors" are estimated by CBO. The latter includes fluctuations attributable to various temporary factors.

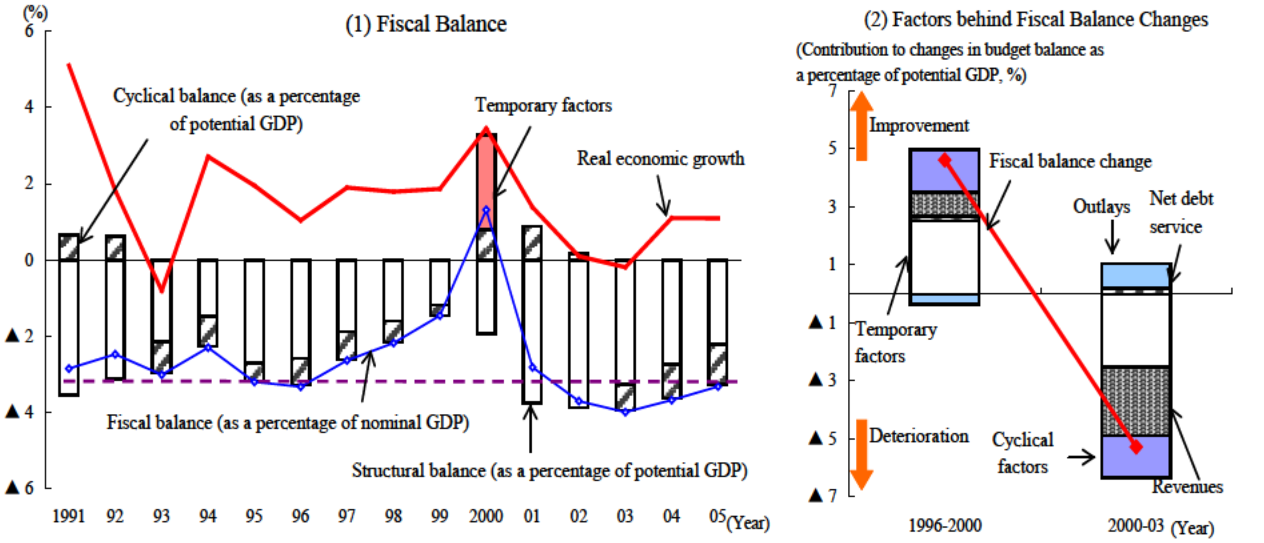
Figure 1-1-3 U.S. Medium-term Fiscal Outlook



Sources: CBO, *The Budget and Economic Outlook An Update*. A Department of the Treasury release for fiscal 2006 (estimate).
Notes: 1. The decrease in Iraq and Afghanistan related expenditures mean phasing down in outlays for Iraq and Afghanistan in and after fiscal 2007.
2. The extension of tax cuts means the extension of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA), the revision of the alternative minimum tax, and the extension of other expiring tax cuts.
3. Discretionary spending growth means that discretionary spending would increase from a level after supplementation for Iraq and Afghanistan in fiscal 2006 at the same pace as nominal economic growth.
4. The line represents the combination of the four effects. Figures indicate fiscal balance estimates (in hundreds of millions of dollars) including these effects.

- **European countries attempted fiscal consolidation in the 1990s. Since the early 2000s, however, not a small number of European nations have seen fiscal balance deterioration again. The excess deficit procedures based on the Maastricht Treaty have been invoked for six of the 12 eurozone countries. Contributors to the deterioration included tax cuts in Germany** and France, and education, healthcare and social security spending growth in Britain. Moderate fiscal situation improvements have come about in these countries since 2004 or 2005 (Figures 1-1-4 and 1-1-5).

Figure 1-1-4 German Fiscal Conditions



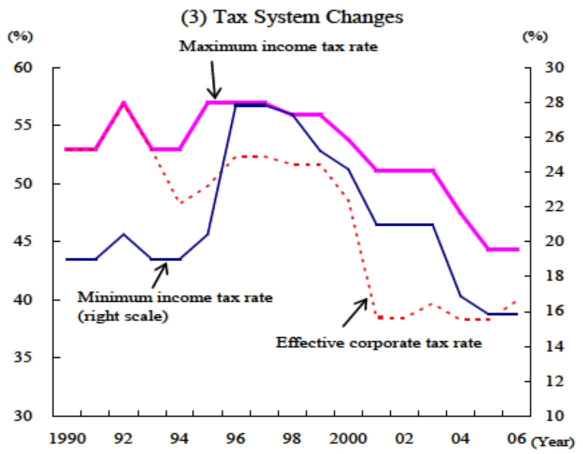
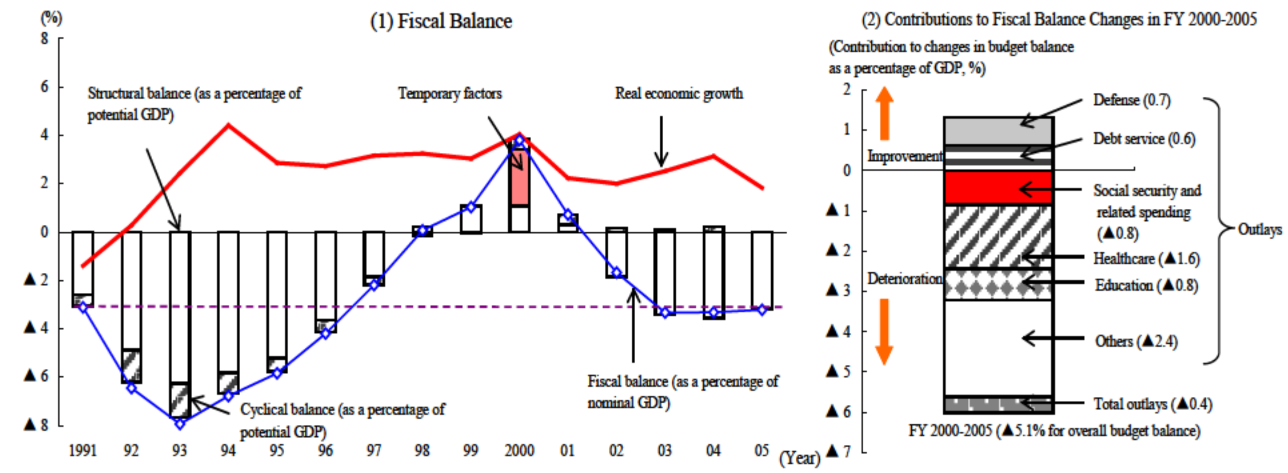


Figure 1–1–4 Sources: OECD, Economic Outlook 79 Database; Ministry of Finance, Ministry of Finance Statistics Monthly; European Commission, Economic Forecasts, Autumn 2006

Figure 1–1–5 Sources: OECD, Economic Outlook 79 Database; European Commission, Economic Forecasts, Autumn 2006; HM Treasury; Office for national statistics

Figure 1-1-5 British Fiscal Conditions



●The experiences of 20 countries which accomplished substantial fiscal consolidation in the 1990s are widely diverse. A general trend may be that countries which have given priority to spending cuts rather than revenue increases and among expenditures curbed social security spending have maintained fiscal soundness (Figures 1-1-6, 1-1-7 and 1-1-8).

Table 1-1-6 Countries Implementing Fiscal Consolidation in 1990s

Countries seeing fiscal deterioration later (8)

(As a percentage of potential GDP)

Country	Consolidation period	Period length (Year)	Change	Annualized change	Best fiscal balance	Deterioration period	Period length (Year)	Change	Annualized change	Worst fiscal balance	Balance in 2005
Germany	96~2000	4	4 6	1 2	1 3	2000~03	3	▲ 5 3	▲ 1 8	▲ 3 9	▲ 3 3
France	93~2000	7	4 2	0 6	▲ 1 5	2000~03	3	▲ 2 7	▲ 0 9	▲ 4 2	▲ 2 9
Britain	93~2000	7	11 5	1 6	3 8	2000~04	4	▲ 7 2	▲ 1 8	▲ 3 3	▲ 3 2
Greece	90~99	9	12 4	1 4	▲ 3 4	99~2004	5	▲ 3 6	▲ 0 7	▲ 7 0	▲ 4 5
Italy	89~2000	11	10 7	1 0	▲ 0 9	2000~05	5	▲ 3 3	▲ 0 7	▲ 4 2	▲ 4 2
Netherlands	90~2000	10	7 8	0 8	2 4	2000~03	3	▲ 5 5	▲ 1 8	▲ 3 1	▲ 0 3
Portugal	91~99	8	4 8	0 6	▲ 2 8	99~2005	6	▲ 3 0	▲ 0 5	▲ 5 8	▲ 5 8
U S	92~2000	8	7 3	0 9	1 7	2000~03	3	▲ 6 5	▲ 2 2	▲ 4 9	▲ 3 8
Average	-	8 0	7 9	1 0	0 1	-	4 0	▲ 4 6	▲ 1 3	▲ 4 5	▲ 3 5

Countries maintaining fiscal soundness (12)

(As a percentage of potential GDP)

Country	Consolidation period	Period length (Year)	Change	Annualized change	Best fiscal balance	Deterioration period	Period length (Year)	Change	Annualized change	Balance in 2005
Australia	92~99	7	7 9	1 1	2 1	99~2005	6	▲ 0 5	▲ 0 1	1 5
Austria	95~2001	6	5 6	0 9	▲ 0 1	2001~05	4	▲ 1 5	▲ 0 4	▲ 1 6
Belgium	92~2001	9	8 6	1 0	0 6	2001~05	4	▲ 0 6	▲ 0 2	▲ 0 1
Canada	92~2000	8	11 8	1 5	3 0	2000~05	5	▲ 1 3	▲ 0 3	1 7
Switzerland	93~2000	7	5 0	0 7	2 4	2000~05	5	▲ 2 9	▲ 0 6	▲ 0 5
Denmark	93~2000	7	6 0	0 9	2 3	2000~05	5	1 6	0 3	3 9
Spain	93~2000	7	5 9	0 8	▲ 0 9	2000~05	5	2 0	0 4	1 1
Finland	93~2000	7	13 5	1 9	7 2	2000~05	5	▲ 4 8	▲ 1 0	2 4
Ireland	92~2000	8	7 5	0 6	4 6	2000~05	5	▲ 3 6	▲ 0 7	1 0
Iceland	94~2000	6	6 9	1 2	2 5	2000~05	5	0 9	0 2	3 4
New Zealand	89~93	4	7 9	2 0	3 2	93~2005	12	2 7	0 2	5 9
Sweden	93~2000	7	15 5	2 2	5 1	2000~05	5	▲ 2 4	▲ 0 5	2 7
Average	-	6 9	8 5	1 2	2 7	-	5 5	▲ 0 9	▲ 0 2	1 8

20-Country Average

(As a percentage of potential GDP)

	Consolidation period	Period length (Year)	Change	Annualized change	Best fiscal balance
Average	-	7 4	8 3	1 1	1 6

Source: OECD

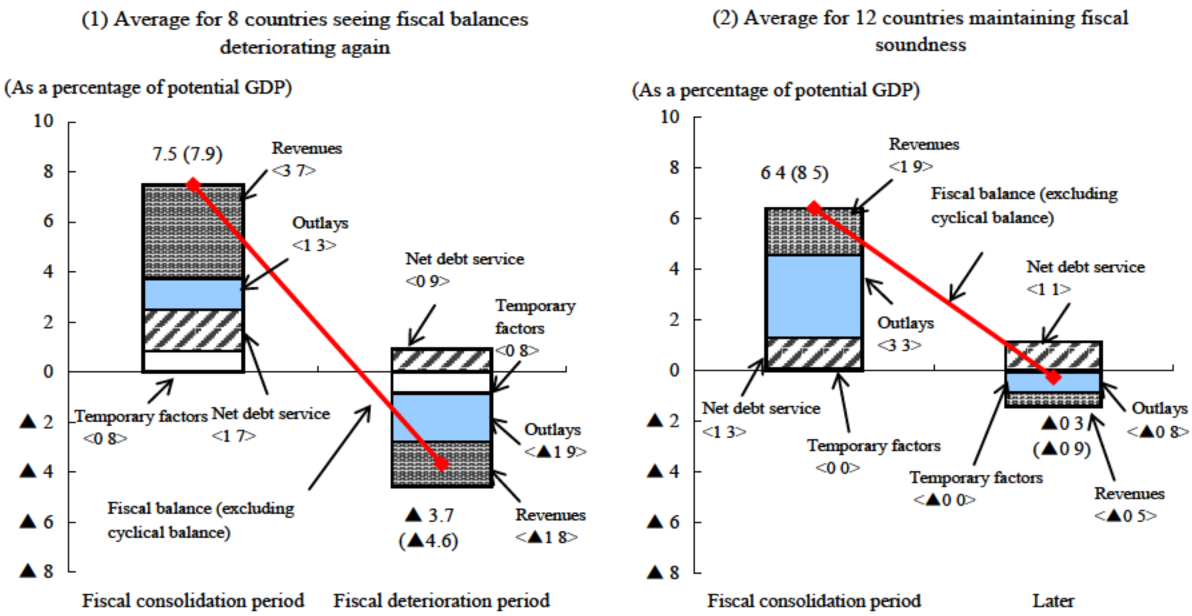
Notes: 1 The analysis covers 20 countries that improved fiscal balances by 4% or more of GDP in the 1990s (including a few years before and after that decade) Countries that saw their fiscal balances deteriorating by 2% or more of GDP with annual deficits exceeding 3% of GDP are classified as those seeing budgetary deterioration later The others are interpreted as those maintaining budgetary soundness

2 The period after fiscal consolidation for a country seeing budgetary deterioration later is between the final year of the fiscal consolidation period and the year for the budget balance bottom (or 2005 for a case of continuing deterioration) Such period for a country maintaining budgetary soundness is between the final year of the fiscal consolidation period and 2005

3 Of the 30 OECD member countries, 10 countries were excluded from the analysis – two lacking sufficient data (Mexico and Turkey), four former socialist countries (including Poland), three maintaining fiscal soundness (fiscal surplus) almost throughout the 1990s, (Korea, Luxemburg and Norway) and two failing to implement fiscal consolidation meeting the above standard (Japan and Poland) See Appended Note 1 (only in Japanese) for details

4 See Appended Note 1-1 for details

Figure 1-1-7 Factors behind Fiscal Balance Changes



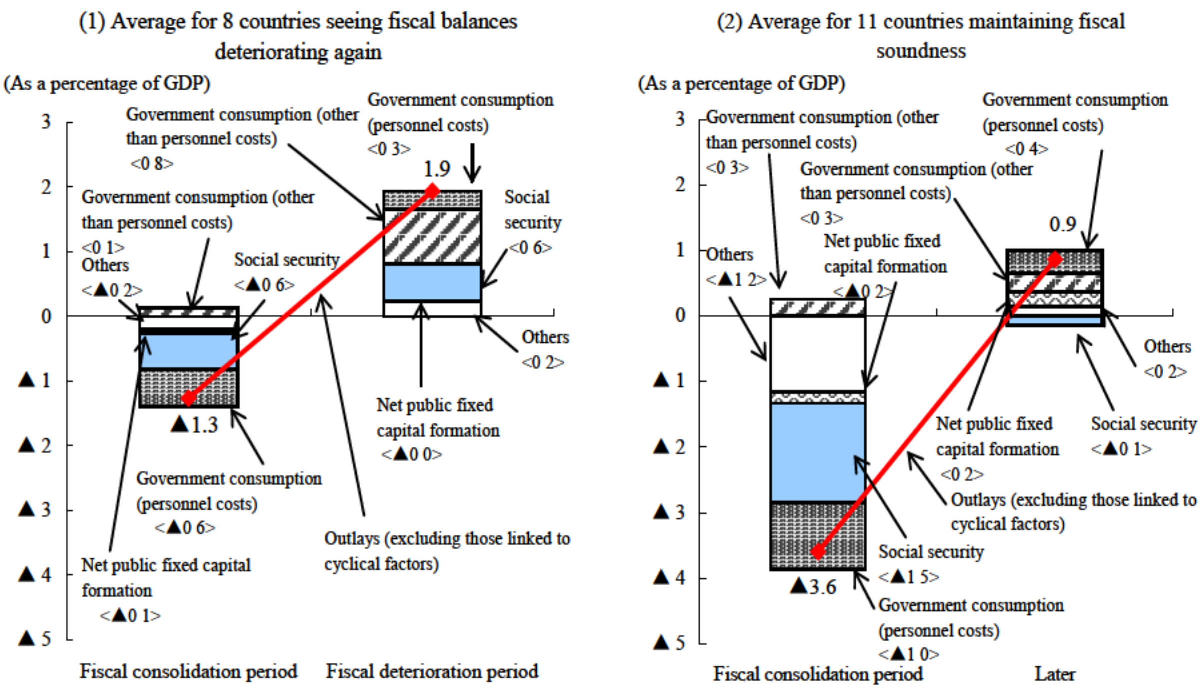
Source OECD, *Economic Outlook 79 Database*

Notes 1. Revenues exclude those linked to cyclical and temporary factors. Outlays exclude those linked to cyclical factors.

2. The fiscal balance excludes the cyclical balance. In each parenthesis is the fiscal balance including the cyclical balance.

3. Figures in <> parentheses after fiscal balance items represent contributions. On the left is the fiscal consolidation period. On the right is the new deterioration period or period after the consolidation.

Figure 1-1-8 Factors behind Structural Outlay Changes



Source: OECD, Economic Outlook 79 Database

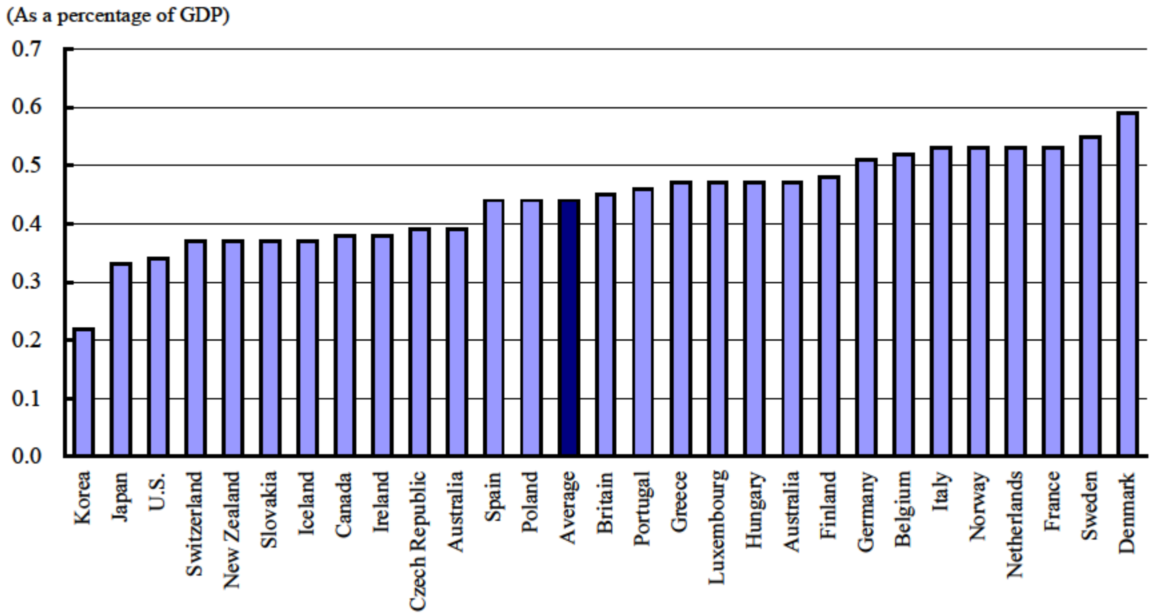
Notes: 1 Figures in <> parentheses after outlay items represent contributions On the left is the fiscal consolidation period On the right is the new deterioration period or period after the consolidation

2 Australia has failed to separate personnel costs from non-personnel costs in government consumption and is excluded from the countries maintaining fiscal soundness

2. Fiscal policy, business cycle and economic growth

• **Regarding a fiscal automatic stabilization function, an estimate says that a 1% change in the GDP gap is accompanied by a 0.44% change in the cyclical fiscal balance as a percentage of GDP on average for industrial countries. This apparently indicates that the automatic stabilization function can considerably contribute to supporting the economy in the downturn of business cycle (Figure 1-1-9).**

Figure 1-1-9 Impact of Fiscal Automatic Stabilization Function



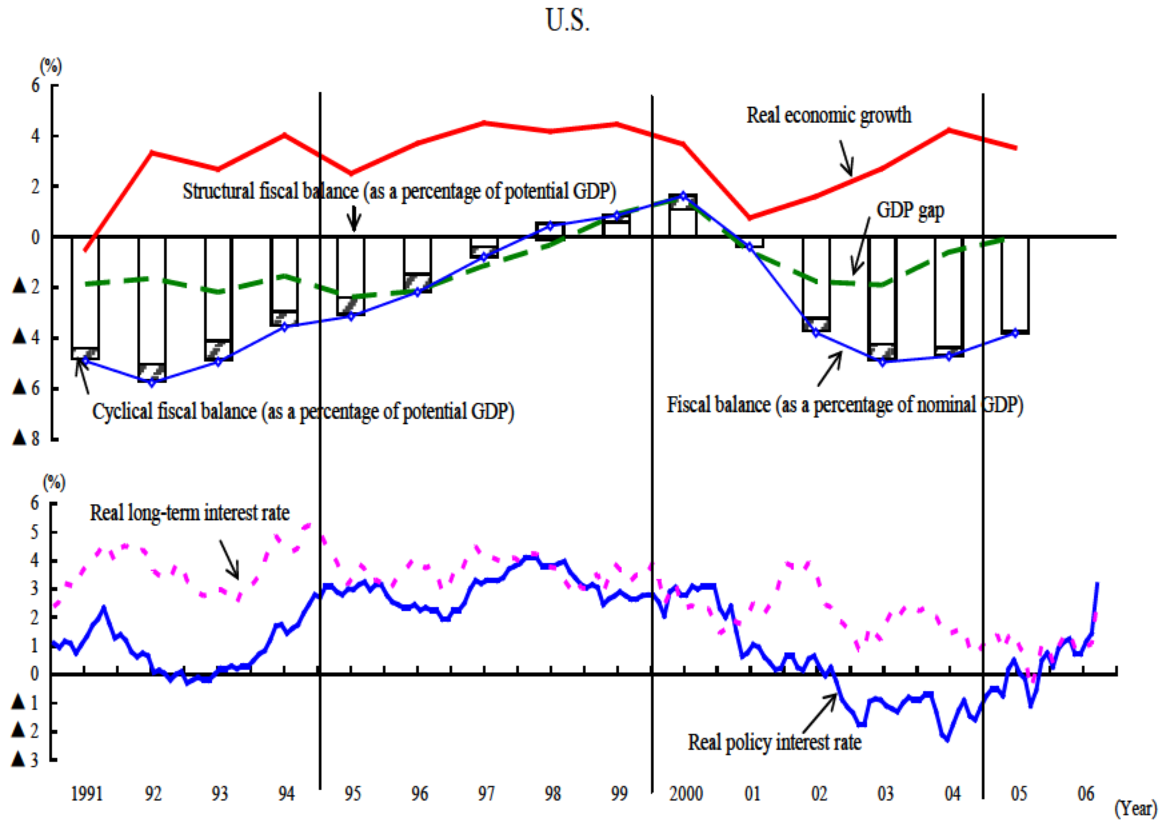
Sources: OECD (2005); Girouard and André (2005)
Notes: 1. Norway here covers only the mainland
2. A fiscal balance change that accompanies a 1% change in the GDP gap.

• **In order to allow the automatic stabilization function to work fully, considerations must be given to the way of fiscal consolidation. For example, the government may reserve some room of the fiscal balance for responding to cyclical fluctuations of the balance and/or create exemptions from fiscal consolidation measures during a recession period. If the government slows down fiscal consolidation during a recession and accelerates it during an economic expansion, it may be able to effectively proceed with fiscal consolidation while allowing the automatic stabilization function to work well.**

• The recent progress of monetary policy is a reason for giving priority to the medium-term stability of fiscal policy. Monetary policy may now be required to play a greater role in stabilizing the economy.

• In the early 2000s, a fiscal expansion was coupled with monetary accommodation both in the United States and Europe, apparently making great contributions to easing a global recession. However, it should be noted that these countries may have not planned discretionary policies to that end but that their policies taken for their respective purposes may have eventually had fiscal effects to ease a global recession. Given current difficult fiscal conditions, each country should take advantage of the fiscal automatic stabilization function more effectively (Figure 1-1-10).

Figure 1-1-10 U.S. Fiscal Balance, Economic Growth, GDP Gap, and Real Long-term and Policy Interest Rates



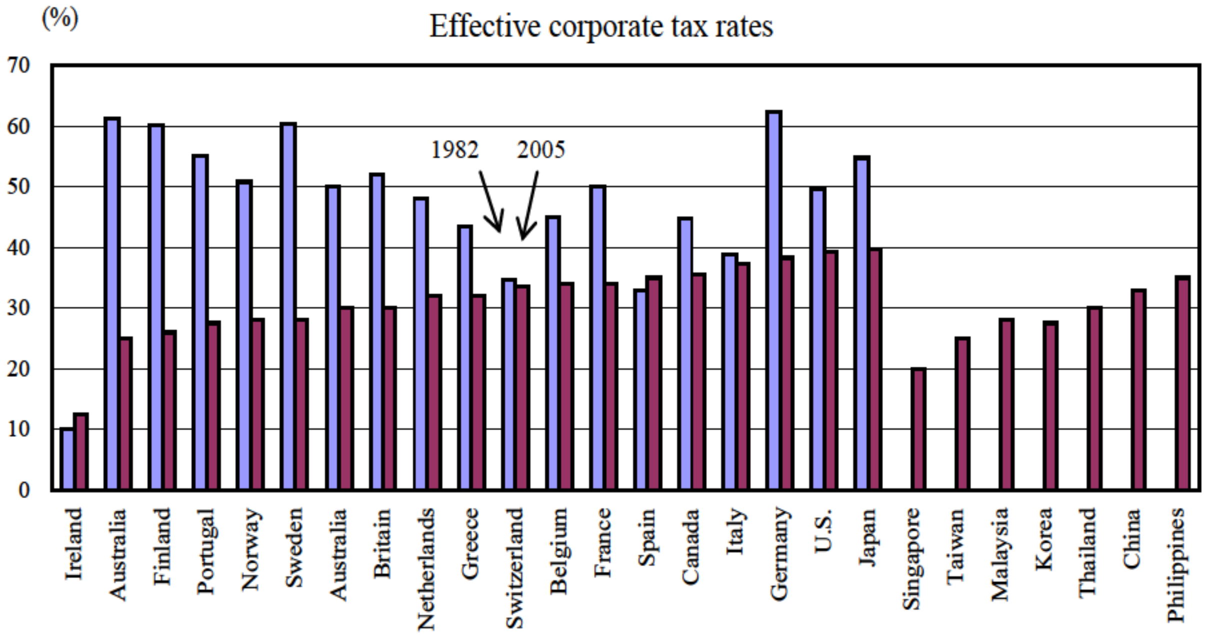
Source: OECD, *Economic Outlook 79*, for fiscal balance, economic growth and GDP gap data

Notes: 1 The long-term interest rate is the yield on the 10-year Treasury note issue The policy interest rate is the federal funds rate

2 The overall consumer price index was used for computing real interest rates

• **Fiscal policy can play a key role in promoting economic growth and increasing economic efficiency as well as stabilizing economic fluctuation with its automatic stabilizing function. Many countries are implementing tax reforms for economic invigoration, and prioritization and rationalization of expenditures for economic growth promotion (Figure 1-1-11).**

Figure 1-1-11 Effective Corporate Tax Rates in Major Countries



Sources: Institute for Fiscal Studies; JETRO, *Comparison of Investment Costs in Major Asian Cities or Regions*
Note: Total tax on corporate profit

Key Points of Chapter 2 in Part I

1. China's fast economic growth in 2000s – Growth led by investment and exports, and expanding imbalances

- **China has seen continued double-digit economic growth since 2003. As a result, China's share of nominal global GDP has risen to 5.1% and its share of global trade value to 6.7%. As the division of labor deepens particularly for electrical appliances in East Asia, China's fast growth has had a favorable impact on neighboring countries by working to expand their exports (Figures 1-2-1 and 1-2-2).**

Figure 1-2-1 China's Growing Presence in Global GDP and Trade

Sources: World Bank, *World Development Indicators* ; IMF, *Direction of Trade Statistics*

Table 1-2-2 Neighbors' Growing Exports to China

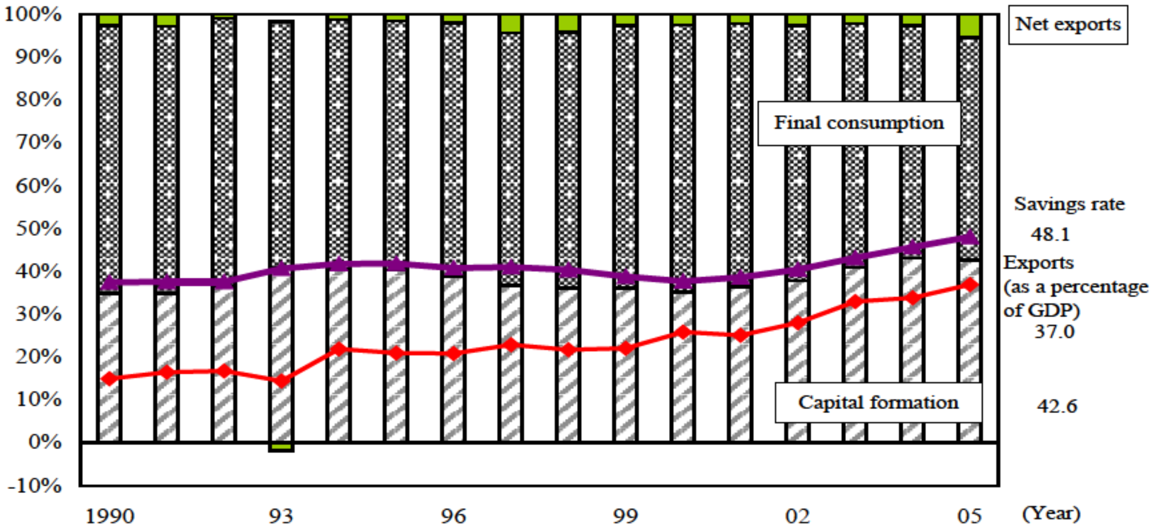
Growth in Exports to China

	Exports to China ($100 million)			China-bound exports' share of total exports (%)		
	1995	2000	2005	1995	2000	2005
Japan	219.9	303.8	800.7	5.0	6.3	13.5
Korea	91.4	184.5	619.1	7.3	10.7	21.8
Taiwan	6.2	42.1	408.5	0.5	2.8	21.6
ASEAN 5	84.3	146.6	489.3	2.7	3.6	8.1

Sources: United Nations, *UN Comtrade* ; Global Information Services, *World Trade Atlas*

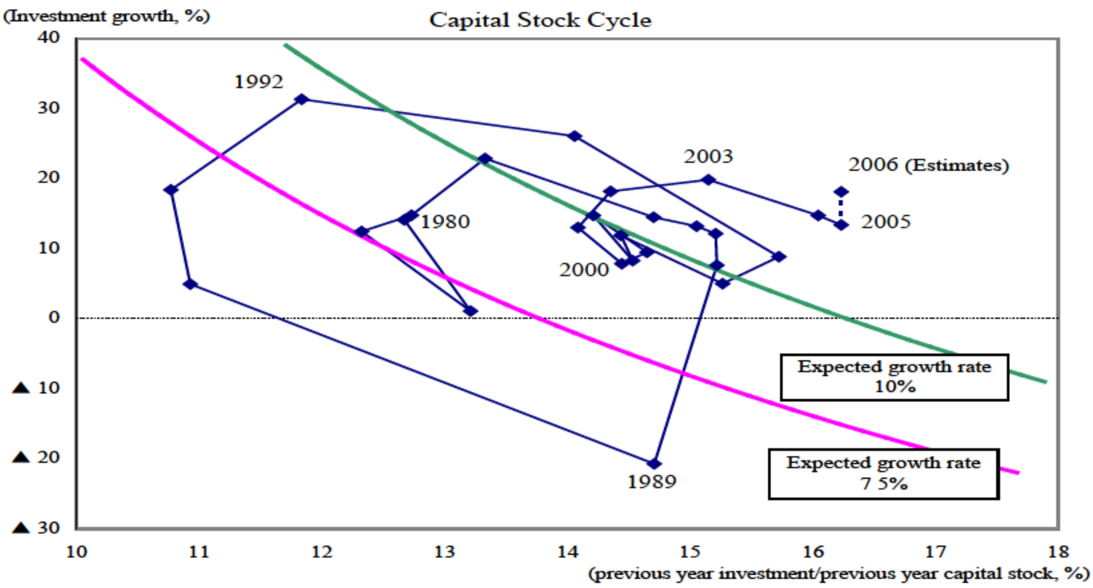
• **Leading the China's fast economic growth have been robust investment and an export expansion, which have caused overinvestment and a fast trade surplus expansion. In multiple industries, overinvestment has brought about overcapacity. China's fast expansion of trade surpluses with the United States and the European Community has resulted in trade frictions (Figures 1-2-3, 1-2-4 and 1-2-5).**

Figure 1-2-3 Capital Formation, Savings Rate and Exports as Percentage of Nominal GDP



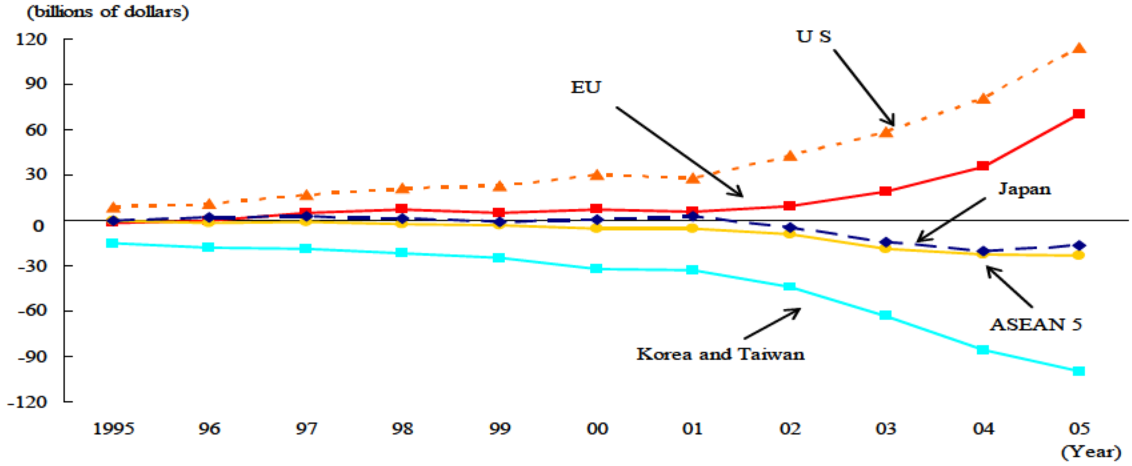
Source National Bureau of Statistics of China

Figure 1-2-4 Capital Stock Cycle



Source: National Bureau of Statistics of China
Note: Estimated by Cabinet Office, Japan

Figure 1-2-5 Region-by-Region Trade Balances

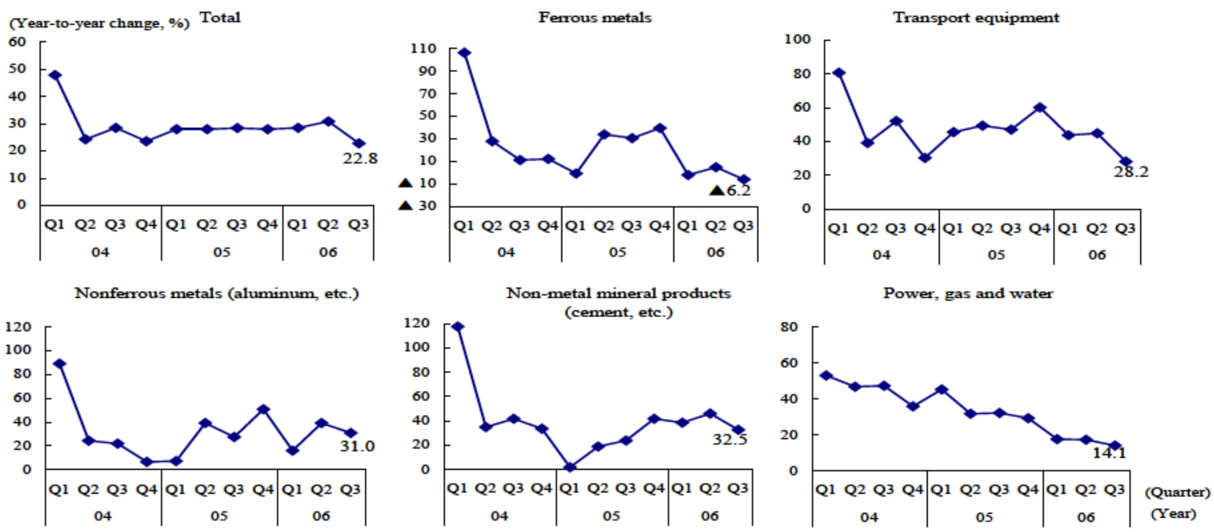


Source: General Administration of Customs of the People's Republic of China

2. Responses to expanding imbalances and challenges – Eliminating overinvestment, overliquidity and oversavings

• Oversupply resulting from overinvestment is feared to bring about deflation and non-performing loans. The Chinese government has implemented macroeconomic control measures including restructuring of oversupply industries, guidance of banks and interest rate hikes. Signs of these measures' effects have been seen. The government is expected to continue curbs on overinvestment to strengthen China's economic structure (Figure 1-2-6).

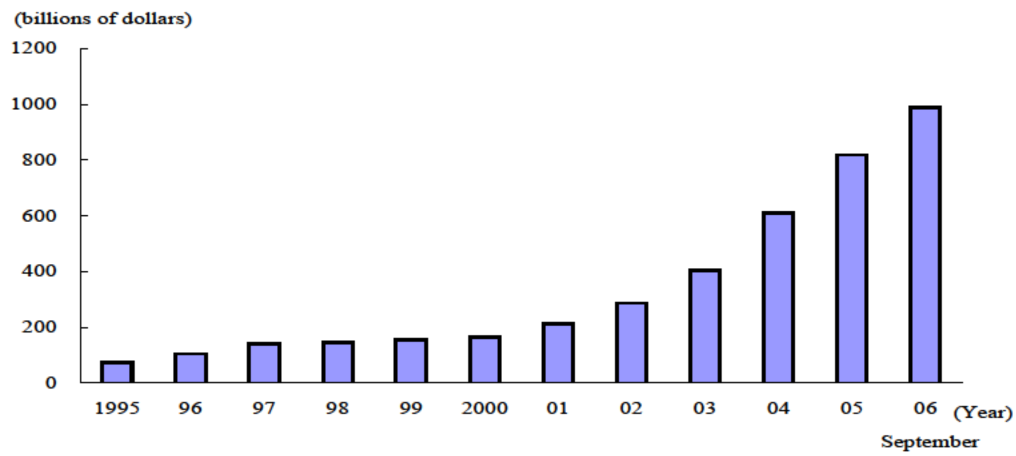
Figure 1-2-6 Industry-by-Industry Fixed-asset Investment



Sources National Bureau of Statistics of China, CEIC

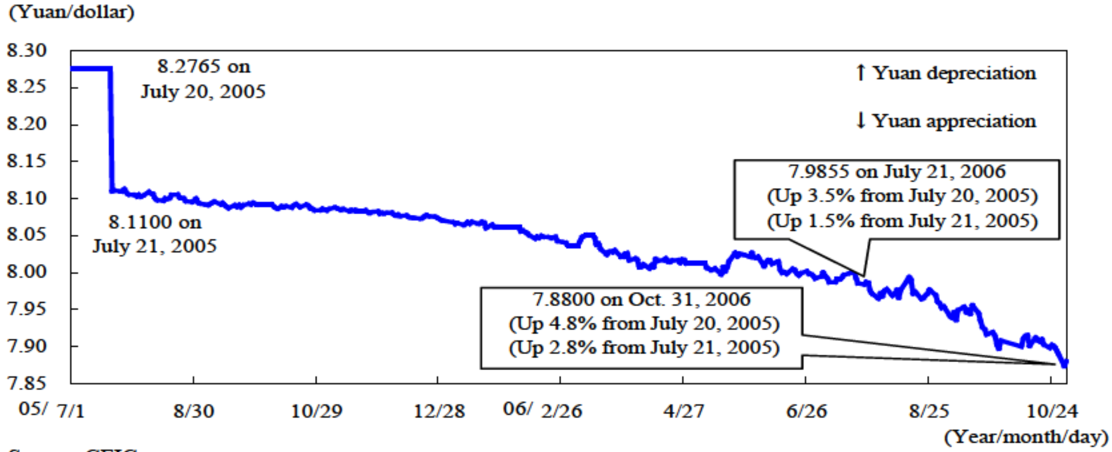
• **One factor behind overinvestment is the problem of overliquidity emerging from foreign currency inflow. The problem is attributable to the central bank's avoidance of any excessive rise in the value of the Chinese yuan, or renminbi, and its insufficient sterilization intervention. If the sterilization is difficult to sustain, it may increase inflation risks. The yuan problem is a problem for China itself. Greater flexibility of the yuan's exchange rates may contribute to eliminating overinvestment and trade surpluses. The stabilization of the domestic financial system for the purpose of greater flexibility has yet to be completed. In this sense, it may be difficult for China to rapidly increase the flexibility of exchange rates. But it may be important for China to promptly tackle various reforms to prepare itself for the expansion of exchange rate flexibility (Figures 1-2-7 and 1-2-8).**

Figure 1-2-7 Foreign Exchange Reserves (Stock)



Source: CEIC
Note: The figure for 2006 is that at the end of September 2006.

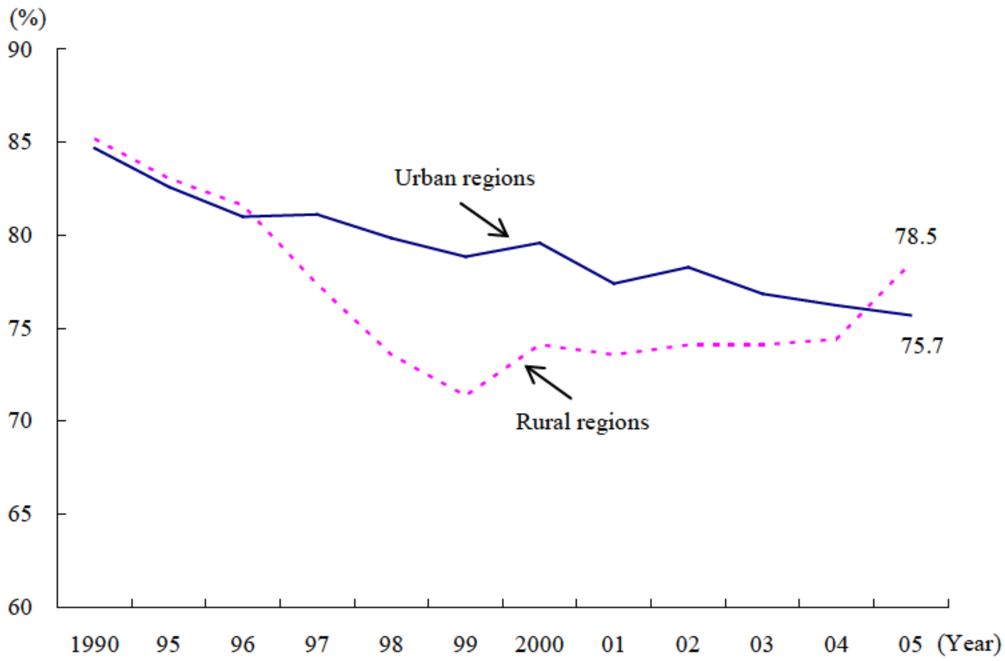
Figure 1-2-8 Chinese Yuan's Exchange Rate



Source: CEIC

• **The high savings rate has induced overinvestment in a sense and saving surplus should result in a current account surplus. In this respect, it is important to expand consumption. It is pointed out that social security problems have brought about a decline in the propensity to consume. China may have wide room to improve consumption conditions through its policies (Figure 1-2-9).**

Figure 1-2-9 Average Propensity to Consume



Sources: National Bureau of Statistics of China, CEIC

3. Toward harmonized and sustainable development – Promoting reforms under the 11th five-year plan

• **Under the fast economic growth conditions, various contradictions and problems have emerged, including income gaps, environmental deterioration and structural economic imbalances. In a bid to address these contradictions and problems, the new Chinese administration, inaugurated in 2003, has worked out the 11th five-year (2006-2010) development plan, which has shifted from a growth-oriented stance to a human-oriented stance based on the so-called "scientific development philosophy" that pursues a harmonized and sustainable society (Table 1-2-10).**

Table 1-2-10 Major Economic and Social Development Goals for Period of the 11th 5-Year Plan

	Indicators	2005	2010	Annual average change	Attribute
Economic growth	**GDP (trillion yuan)**	**18.2**	**26.1**	**7.5%**	○
	Per capita GDP (yuan)	**13,985**	**19,270**	**6.6%**	○
Economic structure	Services industries' share of value added (%)	40.3	43.3	*3.0*	○
	Services industries' share of employment (%)	31.3	35.3	*4.0*	○
	R&D expenditures as a percentage of GDP (%)	1.3	2.0	*0.7*	○
Resources	**Decline in unit energy consumption (%)**	-	-	***20***	◎
Quality of life	**Per capita disposable income in urban regions (yuan)**	**10,493**	**13,390**	**5.0%**	○
	Net income per farmer (yuan)	**3,255**	**4,150**	**5.0%**	○

Source: Summary of the 11th 5-Year National Economic and Social Development Plan

Notes: 1. Attributes:

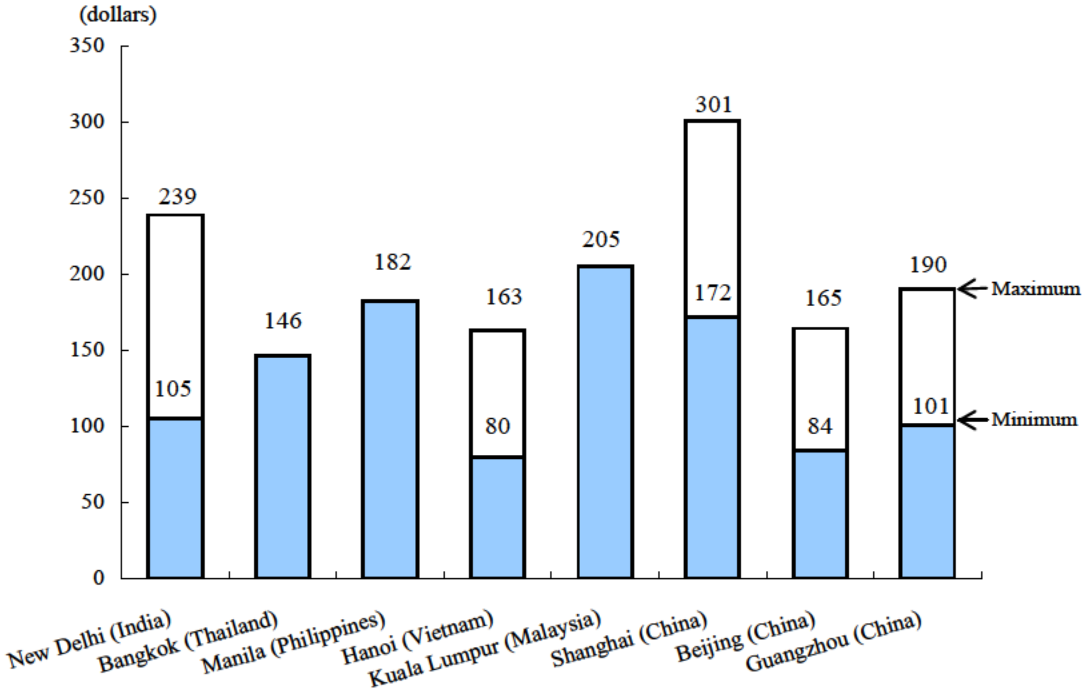
○: Goals that may be accomplished through the market.

◎: Goals that must be accomplished with control enhanced under law.

2. Italic figures indicate accumulations for five years.

- **China has so far achieved labor-intensive growth. But some regions and some occupations in China have gradually lost their competitive advantage in labor costs. A challenge for China is now to upgrade its industries. In this respect, the new five-year plan emphasizes development of high-tech industries, restructuring of inefficient sectors, advancement of services industries and enhancement of innovations (Figure 1-2-11).**

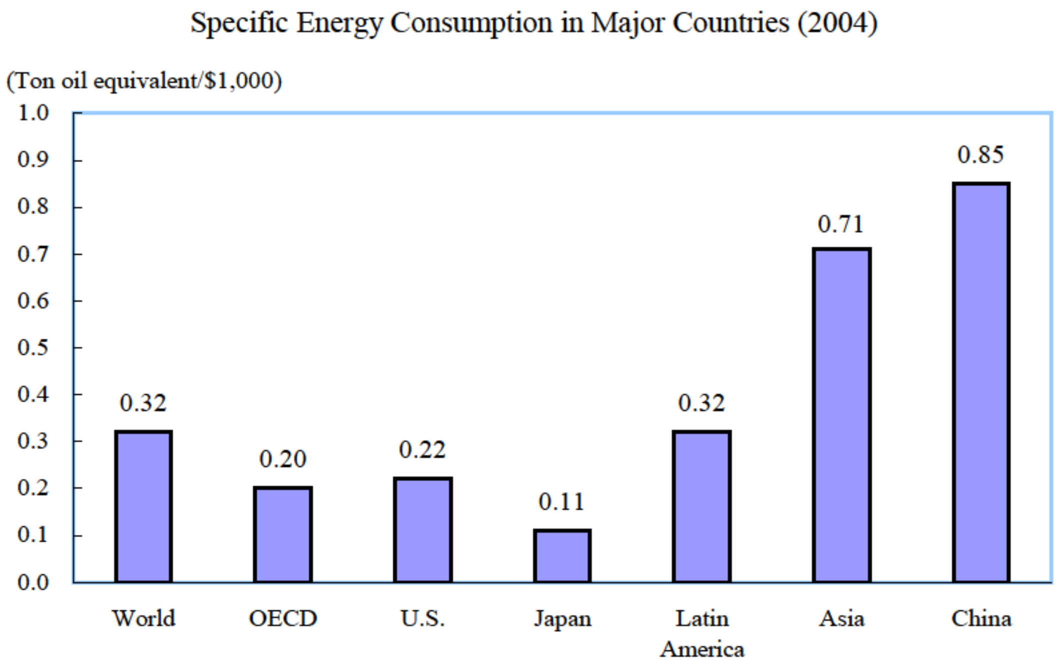
Figure 1-2-11 International Wage Comparison (for production workers)



Source: JETRO, *Overseas Data File*

● China's energy efficiency is lower than in other countries. This is feared to affect future energy prices and economic growth. As the new five-year plan calls for constructing a resources-saving society, and further efforts are required to increase energy efficiency (Figure 1-2-12).

Figure 1-2-12 International Energy Efficiency Comparison



Source: IEA, "*Key World Energy Statistics 2006*"
Note: Specific energy consumption = energy consumption/GDP

● Responses to present imbalances are linked to upgrading of industries, stabilization of the financial system, development of social security systems and other structural reforms for medium- to long-term growth. Reforms are making gradual progress. Steadier and quicker implementation of reforms is expected to have favorable effects on China's growth toward the future and on East Asia's growth.

Key Points of Part II

World economic growth in 2007 expected to slightly slow down from 2006

● The world economy (based on 22 countries and regions with a close relationship with Japan) has been recovering. The 22 economies are expected to grow 3.8% in 2006, a little faster than in 2005.
● The world economy is expected to grow some 3.2% in 2007, a little slower than in 2006, as the U.S. growth moderates along with the eurozone's recovery (Table 2-1).

Table 2-1 Region-by-Region Economic Forecast by Private Institutions

Real GDP growth

(% change from previous year)

Country/region			2004 (Results)	2005 (Results)	2006 (Forecast)	2007 (Forecast)
World economy			3.9	3.3	3.8	3.2
U.S.			3.9	3.2	3.4	2.6
Asia	Northeast Asia		8.4	8.1	8.3	7.5
		China	10.1	10.2	10.4	9.3
	ASEAN		6.3	5.3	5.3	5.1
Europe 4			1.9	1.1	2.2	1.8
(Ref.) Eurozone			1.9	1.4	2.4	1.9
(Ref.) Japan			1.7	3.3	2.5	2.0

Note: Results are from statistics of each country. Forecasts are averages of forecasts made by private institutions.

1. U.S. economic growth in 2007 to slightly decelerate from 2006

● The U.S. economy has slowed its expansion. After growing at an annualized rate of 5.6% in the first quarter of 2006, the U.S.

growth slowed to 2.6% in the second quarter. In the third quarter, its growth decelerated to 1.6% on a residential investment drop in spite of faster rises in personal consumption and business investment. Moderate growth is expected for the fourth quarter as well. U.S. economic growth in 2006 is thus expected at around 3.4%. Its growth in 2007 is projected at around 2.6%, a little slower than in 2006, on the cooling of the housing market.

- **Behind this economic situation, the policy interest rate has been kept unchanged since August 2006 following incremental hikes since mid-2004. Consumer and producer prices firmed as crude oil prices rewrote record highs. But their rises have slowed down on a decline in crude oil prices. The core price rises are accelerating moderately.**

2. Asian economy to remain firm though with slower growth

- **Northeast Asia has continued an economic expansion led by China. Rapid economic growth has continued in China in spite of the government's stringent policy employing direct regulations, interest rate hikes and other control measures. In 2006, it is expected to post a 10.4% economic expansion for the fourth straight year of double-digit growth.**
- **The Asian economy is expected to remain firm in 2007, though slowing growth on deceleration of world economic growth. China's economic growth is projected to slightly decelerate to around 9.3%.**

3. Eurozone to moderately decelerate growth in 2007

- **The eurozone has accelerated its economic recovery since early 2006 as production, exports and capital investment have expanded on the world economy's recovery. The eurozone (12 countries) is expected to grow some 2.4% in 2006. Its growth in 2007 is projected to slow to 1.9% on deceleration of world economic growth.**
- **Consumer price hikes have slowed as energy prices' rise has been eliminated. But the European Central Bank views prices**

as having a clear upside risk due to such factors as past crude oil price hikes' impact and indirect tax increases. The ECB expects the average inflation rate to exceed 2% from the second half of 2006 to 2007.

4. Risk factors for world economy

- **Against the above main scenario, downside risks facing the world economy include (1) the U.S. economy's faster-than-expected deceleration on the housing market's substantial decline and its spillover effects, (2) growing price-boosting pressure on a possible re-rally in crude oil prices, and (3) rapid exchange rate realignments and long-term interest rate rises emerging from doubts about sustainability of the U.S. twin deficits in budget and current account.**