

Fiscal 2003 Economic Outlook and Basic Stance for Economic and Fiscal Management

Cabinet approval

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1. Fiscal 2002 economic and fiscal managements and the Japanese economy

Fiscal 2002 economic and fiscal managements

The government formulated Japan's Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2002 (Basic Policies Stage Two), which was decided by the cabinet on June 25, 2002, with the objective of getting the economy onto a full-fledged recovery path driven by private-sector demand through social and economic revitalization. Subsequently, in light of increasing uncertainty in the financial and economic situation, in October the government compiled its Comprehensive Measures to Accelerate Reforms as a move to strengthen policies designed to bring about the country's economic revitalization. It took further action in December by deciding to map out the Program to Accelerate Reforms, which supplements and bolsters the Comprehensive Measures announced in October, and also to formulate the country's fiscal 2002 supplementary budget.

In addition to the above steps, Japan has steadily implemented such actions as the creation of designated special zone for structural reform, and the abolition, the transformation into independent administrative institutions, and the privatization of special public corporations on the basis of the Reorganization and Rationalization Plan for Special Public Corporations, which was decided by the cabinet on Dec. 19, 2001.

The Japanese economy in fiscal 2002

Thanks to such movements as a pick-up in production and an upswing in exports

since the beginning of the year, there are visible signs of a partial economic recovery in Japan in fiscal 2002. In the latter half of the year, though, such factors as concern about the direction of the U.S. economy and the impact of sluggish share prices would have been factors of depressed final demand. The outlook for the second half of fiscal 2002 is that the economy will generally continue to be flat.

As a result, looking at the economy as a whole in fiscal 2002, the real growth rate of Japan's gross domestic product (GDP) is expected to be approximately 0.9% (a nominal growth rate of negative 0.6 %). This will in part be due to relatively high growth during the first half of the fiscal year.

2. Basic stance for economic and fiscal management in fiscal 2003

Japan's difficult economic situation notwithstanding, the country's path to economic revitalization can only be to pursue prompt and steady "structural reform with nothing sacred." As the government continues to stick to its fundamental belief in "no growth without reform," it will carry out integrated and consistent structural reform consisting of the four main pillars of financial system reform, tax reform, regulatory reform, and reform of government expenditure. By further accelerating the process of structural reforms, Japan will seek to implement an economic and fiscal policy that fundamentally aims to bring about sustainable economic growth driven by private demand while overcoming deflation. It will simultaneously strive to contribute to the sustainable development of the global economy.

(1) Accelerating structural reform that leaves no sanctuary untouched

The government will steadily discuss and implement financial system reform, with the Program for Financial Revival serving as its Work Schedule. Through such action, Japan will aim to accelerate the disposal of non-performing loans (NPLs) and terminate NPLs problems toward fiscal 2004. In so doing, it will endeavor to revive financial intermediary functions and facilitate the smooth redirecting of resources into new growth areas. Additionally, in order to make a powerful push toward responses in which industry and finance are unified, Japan will establish the Institute for Industrial Revitalization(provisional name). It will be set up in accordance with the Basic Policy for Corporate and Industrial Revitalization

formulated by the Strategic Headquarters for Industrial Revival and Employment. Other forthcoming action includes radically revising the Law on Special Measures for Industrial Revitalization (the Industrial Revitalization Law). In these ways Japan will take further positive steps to bring about industrial reorganization and the prompt revitalization of business activity.

For tax reform, the government intends to pursue the integrated implementation of the reforms specified below through tax code revisions in fiscal 2003. Its objective is to create desirable tax structure that will bring about sustainable socio-economic revitalization in the context of the nation's current economic and fiscal circumstances.

One of the specific reforms to be tackled involves concentrating on and giving priority to the reduction of taxes related to research and development and capital investment so as to strengthen Japan's industrial competitiveness. Other reforms include integrating inheritance and gift taxes so as to contribute to the smooth transfer of assets to future generations, streamlining the financial and securities taxation system and introducing tax cuts so as to facilitate reform that shifts the focus from savings to investment, and reducing taxes, such as the registration and license tax, so as to help promote the effective use of land. From the perspective of simplifying personal deductions, the reform agenda also calls for the abolition of the special spousal exemption (the surcharge portion). Additionally, reforms designed to improve credibility and transparency in connection with the consumption tax will focus on the system of tax exemption limits and so forth. Also on the horizon are the introduction of pro forma standard taxation for Japan's corporate enterprise tax and a review of the country's liquor and tobacco taxes.

The implementation of these reforms will lead to tax cuts totaling approximately 1.8 trillion yen in fiscal 2003. The outcome will be a revenue-neutral tax policy over multiple fiscal years.

As Japan undertakes regulatory reform, it will assign maximum value to specific policies mentioned in the Second Report on the Promotion of Regulatory Reform, which the Council for Regulatory Reform presented on Dec. 12, 2002. Along with

revising the Three-Year Program for Promoting Regulatory Reform, the government will also pursue this program's steady implementation. It will proceed to take the lead in reform at the regional level by combining reform on a nationwide scale with the promotion of a program that designates special zones for structural reform. It will also expand preferential measures for regulations covered by this program. Additionally, for spheres in which the involvement of the public sector is great or areas that entail the provision of public services by national and local public entities, Japan will actively proceed with regulatory reform that will stimulate latent demand. This is to be accomplished through such steps as utilizing the option of outsourcing some services to private companies and lifting the ban on the private sector's participation in some spheres. In tandem with such efforts, the government will improve an environment regarding competition policy, judicial system and so on.

For expenditure reform, in light of such directives as Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2002 and the Guidelines for Formulation of the FY 2003 Budget (Cabinet Decision on Nov. 29, 2002), Japan will continue the previous fiscal year's practice and make its fiscal 2003 budget a "budget committed to reform." Furthermore, from the perspective of engineering a shift from the public sector to the private sector and from the central government to local governments and on the basis of discussions about a sweeping institutional and policy overhaul, Japan will conduct a full-fledged review of the government's total spending. It will utilize the findings of policy evaluations on that occasion. The scale of spending in the fiscal 2003 budget is to be such that the budget's general expenditures and total general account expenditures will both be kept at or below the fiscal 2002 level in real terms. Additionally, the fiscal 2002 budget's basic spirit of limiting government bond issues to no more than 30 trillion yen will be carried over into fiscal 2003, and the amount of such issues will be tightly controlled. Furthermore, the budget is to be allocated in a way that emphasizes four priority areas leading to future growth oriented toward the realization of a vibrant socio-economic milieu. These four areas are (1) the reinforcement of human resources, including education and culture, science and technology, and information

technology (IT); (2) the creation of attractive cities and local communities characterized with its own idea and characteristics; (3) the formulation of policies for a fair and secure society addressing progressively aging population and declining birthrate; and (4) the creation of a recycling-oriented society and efforts to respond to global environmental issues.

In addition to the above action, the government is actively working on the economic revitalization strategy that is mentioned in the Basic Policies Stage Two and that targets such objectives as the creation of new demand by responding to latent demand on the part of the public. Specifically, the government will continue to promote and follow up on six designated strategies and related action programs. These six strategies include the revitalization of consumer service industries--medical care, health care, tourism and so on--that cover a sweeping industrial base so as to produce extensive ripple effects in the economy. They focus on six areas: human resources, technology, management, development of new industries, regional strengths, and a global strategy.

Additionally, Japan will continue to actively press ahead with an administrative reform agenda that includes downsizing and improving the efficiency of its administrative organization as well as reforming special public corporations and other entities.

(2) Contributing to the sustainable development of the global economy

While making the maintenance and reinforcement of a multilateral trade framework built around the World Trade Organization (WTO) its fundamental policy, Japan will actively promote economic partnerships and free trade agreements to supplement this set-up. In order to revitalize the Japanese economy, the government will promote a multi-tier external economic policy and continue to be actively involved in the new round of WTO talks. Additionally, it will actively encourage regional ties, such as the Asia-Pacific Economic Cooperation (APEC) framework, the Asia-Europe Meeting (ASEM), the ASEAN+3 structure (the members of the Association of Southeast Asian Nations plus Japan, China, and South Korea), and the Japan-ASEAN Comprehensive Economic Partnership while

also actively promoting bilateral free trade agreements and economic partnerships with such nations as Mexico and Republic of Korea. Moreover, it will endeavor to contribute to the sustainable development of the global economy by undertaking various efforts. These will include the reinforcement of the international financial system and the provision of highly transparent and highly efficient strategic assistance to developing countries. Furthermore, while continuing to monitor developments in the international economy and so forth, Japan will work cooperatively with other countries to ensure that neither the world's economic system nor its own system is disrupted.

As it implements the policy management described above, the government will administer the fiscal 2002 supplementary budget and the fiscal 2003 budget in an integrated and uninterrupted manner. It will also pay adequate attention to various conceivable ramifications of accelerating structural reform, including the impact of expediting the disposal of NPLs. Additionally, it will make doubly sure that there are safety nets with respect to employment and small and medium-sized enterprises (SMEs). Furthermore, Japan will continue to practice bold and flexible policy management in accordance with economic circumstances.

The government and the Bank of Japan (BOJ) will continue to act as one and implement strong and comprehensive measures to overcome deflation. Furthermore, effective monetary policy management on the part of the BOJ is also anticipated.

3. *Economic outlook for fiscal 2003*

In fiscal 2003, maintaining the basic policy stance of "No growth without reform," the government carries out structural reforms in an integrated and consistent manner in order to revitalize the economy, and thus the government aims for the realization of sustainable economic growth led by private demand by unleashing the potential of the Japanese economy.

Positive policy impacts coming from joint efforts by the government and the Bank of Japan, including those of "the Program to Accelerate Reforms" and the supplementary budget for fiscal 2002 which is based on the Program, and tax

reductions in the “Fiscal year 2003 Tax Reform”, will appear in fiscal 2003. Furthermore, the world economy is likely to recover gradually in the first half of the fiscal year. Accordingly, while there would be negative impacts coming from acceleration of disposal of NPLs, it is expected that corporate sectors will show a gradual recovery and the Japanese economy will gradually move towards a moderate recovery centering on private demand. With regard to prices, although there is a concern that the deflationary trend will continue, it is expected that deflationary pressure will gradually diminish due to the recovery of domestic demand.

As a result, the growth rate of real GDP is projected to be about 0.6% (with the nominal GDP growth rate of about -0.2%). Projections of other key economic indicators are shown in the attached table.

(1) Real GDP

[1] Private Consumption

The private consumption will grow at a slower rate than in the previous fiscal year as severe employment and income conditions continue as a result of unavoidable short-term consequence of structural reforms (up approx. 0.4% from the previous fiscal year).

[2] Residential Investment

Residential Investment will fall below the previous fiscal year level as a result of the continuing severe conditions surrounding employment and income and continuing sluggishness of real estate prices (down approx. 2.0%).

[3] Non-residential Investment

Non-residential investment will gradually move towards moderate recovery as it is supported by tax incentives for investment as well as a pickup in production and improvement in corporate earnings. (up approx. 1.8%).

[4] Public Demand

Public demand will stay at the same level as in the previous fiscal year. This is

because elderly insurance payments will rise, while public investment will decline under the continued commitment of the government for fiscal discipline, “Budget Committed to Reform”. (Public demand will contribute approx. 0.0% to real GDP growth.)

[5] Net Exports

Net exports will slightly increase along with the gradual recovery of the world economy. (Net exports will contribute approx. 0.1% to the real GDP growth.)

(2) Labor Conditions

The unemployment rate will rise slightly above the previous year’s level due to the continuation of severe employment and income situations, as the structural reforms proceed (to approx. 5.6%).

(3) Industrial Production

Because of the increase in exports and the improvement of business confidence, industrial production will begin to pick up gradually (up approx. 2.0%).

(4) Prices

While prices will continue to fall, the rate of decline will be reduced by an improvement in oversupply conditions. (Domestic Corporate Goods Prices will decline approximately by 0.9% compared to the previous fiscal year, and consumer prices will be down approximately by 0.4%)

(6) Balance of Payments

The current account balance will remain roughly flat, since imports as well as exports will increase. (Current account surplus will reach approx. 2.7% of GDP.)

Note: In light of the fact that private economic activities account for the most part of the Japanese economy and the fact that there are numerous unforeseeable factors, particularly in terms of changes in the international economic environment, there should be some allowances for the projections of key economic indicators.