

## Chapter 1

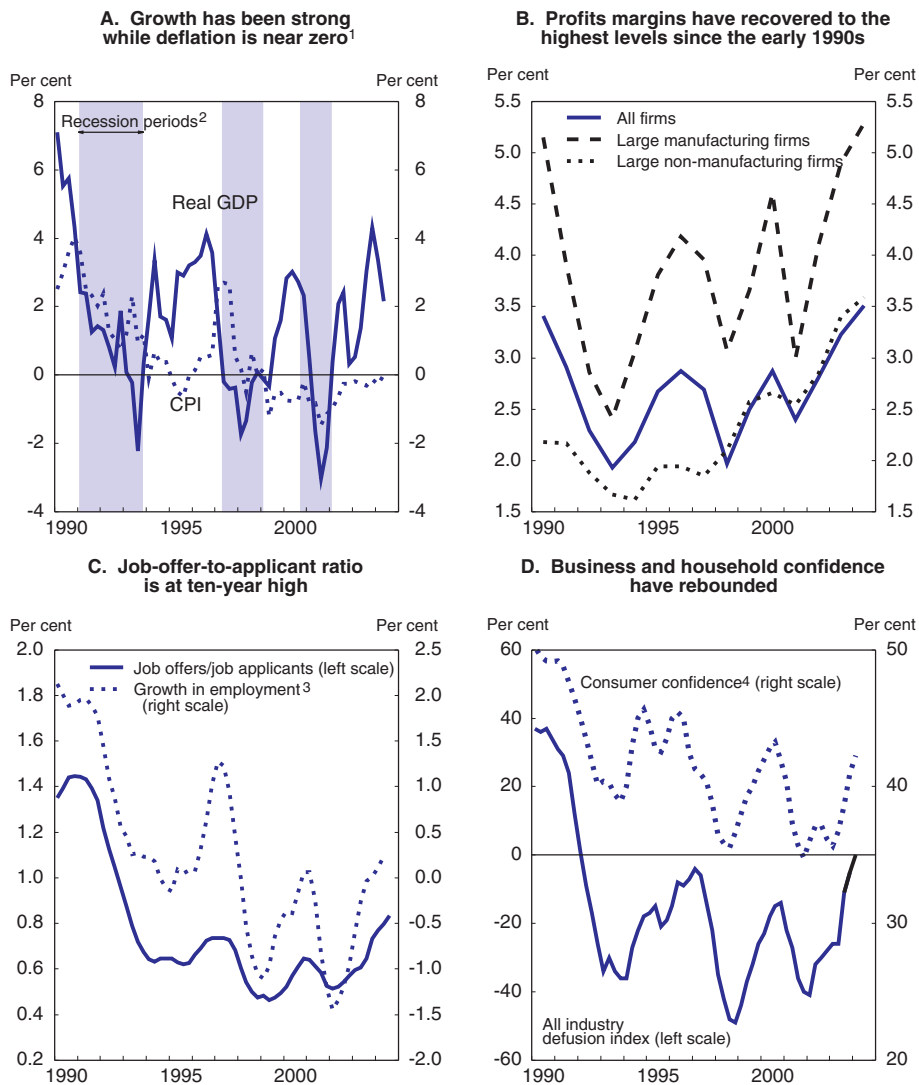
# Key economic challenges facing Japan

*This chapter discusses the key challenges facing the Japanese economy. Although the current expansion is encouraging, there are a number of problems that will make it difficult to sustain growth over the medium term and ensure rising living standards. Five key challenges are addressed in this chapter: i) bringing an end to deflation, which has negative implications for growth, and further rehabilitating the banking sector to sustain the expansion; ii) ensuring fiscal sustainability in the face of the sharp run-up in debt and population ageing; iii) improving relations between levels of government in order to benefit more fully from decentralisation and increasing the fiscal discipline of local governments; iv) raising Japan's growth potential through structural reform and stronger competition; and v) improving the functioning of the labour market by addressing the trend toward greater dualism and encouraging greater labour force participation.*

Following a decade of stagnation in the wake of the collapse of the bubble in the early 1990s, a number of indicators suggest that there has been a marked improvement in the Japanese economy (Figure 1.1). Output has been growing at an annual rate of slightly more than 2 per cent since 2002, according to the revised national accounts using the chain-linked methodology (see Annex 1.A1). The rate of deflation, as measured by the consumer price index, has been stable at less than ¼ per cent (Panel A). Profit margins and the return on assets have risen to their highest levels since the early 1990s (Panel B). In the labour market, the job offer to applicant ratio is now more than 0.8, a level not seen since 1993, and employment is increasing (Panel C). These favourable developments have boosted business confidence to its highest level since the early 1990s (Panel D).

The improved economic conditions are due in part to buoyant export growth and the progress made in restructuring the corporate sector, which have boosted profitability and helped to fuel a rebound in business investment. In addition, the present government has contributed importantly to these positive developments through the implementation of a reform programme aimed at shifting power from the government to the private sector and from central to local government. Perhaps most important has been the emphasis placed on restructuring the banking sector and upgrading prudential supervision, thereby reducing the threat of financial-sector fragility. And in contrast to the ineffective fiscal stimulus programmes pursued during the 1990s, the government has cut public investment by more than a quarter during the past three years, thus improving the allocation of resources and limiting the growth of public expenditures. In addition, important regulatory reforms, such as easing requirements for starting new companies and relaxing land-use regulations in urban areas, have been implemented. The government has now embarked on its most ambitious project – the privatisation of Japan Post, the largest financial institution in the world. It has also made the strengthening of international competition a top priority, notably through increasing inflows of foreign direct investment and pursuing free trade agreements.

While the recent progress is certainly encouraging, there are a number of difficult challenges that must be overcome in order to put a definitive end to a decade of economic stagnation. Deflation, as measured by the consumer price index, is now in its sixth year, while the GDP deflator has been declining since 1995. The fall in bank lending since 1998 has reduced total bank credit by 150 trillion yen (30 per cent of GDP). Given the reliance on land as collateral for lending, banks have been negatively affected by the fall in nationwide land prices, now in its 13th year. Looking ahead, financial institutions may be vulnerable to turbulence in financial markets during the transition to positive inflation and the end of zero interest rates. Meanwhile, the government's financial position continues to deteriorate, in part due to a lack of fiscal discipline at the local government level. Gross public debt has surpassed 160 per cent of GDP, the highest in the OECD area, just as Japan enters a period of declining population and pressure for increased ageing-related expenditures. The growing share of the elderly makes productivity growth essential to support rising living standards. However, the reforms needed to accelerate productivity

Figure 1.1. **The best economic conditions in a decade**

1. Seasonally-adjusted quarterly changes at annual rate, three-quarter moving average.
2. The identification of recessions is based on detailed analyses of a variety of indicators.
3. Growth over four quarters with a three-quarter moving average.
4. Three-quarter moving average.

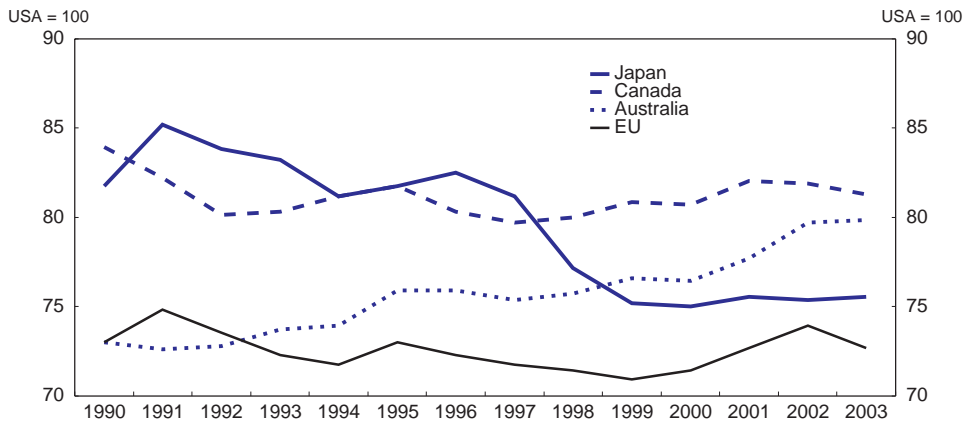
Source: Cabinet Office, Bank of Japan, Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications and Ministry of Economy, Trade and Industry.

gains continue to advance at a modest pace. In the labour market, the rising share of non-regular workers, who are subject to significantly lower wages, precarious employment and less protection by the social safety net, creates both efficiency and equity concerns. After a brief look at Japan's growth prospects over the medium term, this chapter addresses the key challenges of bringing deflation to an end and supporting the recovery, achieving fiscal sustainability, reforming relations between levels of government, removing obstacles to faster economic growth and improving the functioning of the labour market. The chapter concludes with a brief assessment.

## Japan's economic prospects over the medium term

Japan's per capita income relative to the United States has fallen from a peak of 85 per cent when the bubble collapsed in the early 1990s to 75 per cent in 2003, in contrast to many other OECD countries that were able to continue the convergence process or at least avoiding losing ground (Figure 1.2). This disappointing performance reflects a sharp deceleration in Japan's growth potential from a rate of nearly 4 per cent in the later half of the 1980s to 1½ per cent during the past decade (Figure 1.3). A report by the Cabinet Office estimates that potential growth fell even further, to 1.2 per cent in the first half of 2004. One key factor in the deceleration was the shift of labour inputs from a positive to a negative contribution since 1990, reflecting a reduction in working hours, a substantial rise in structural unemployment and a decline in the working-age population since 1996. A

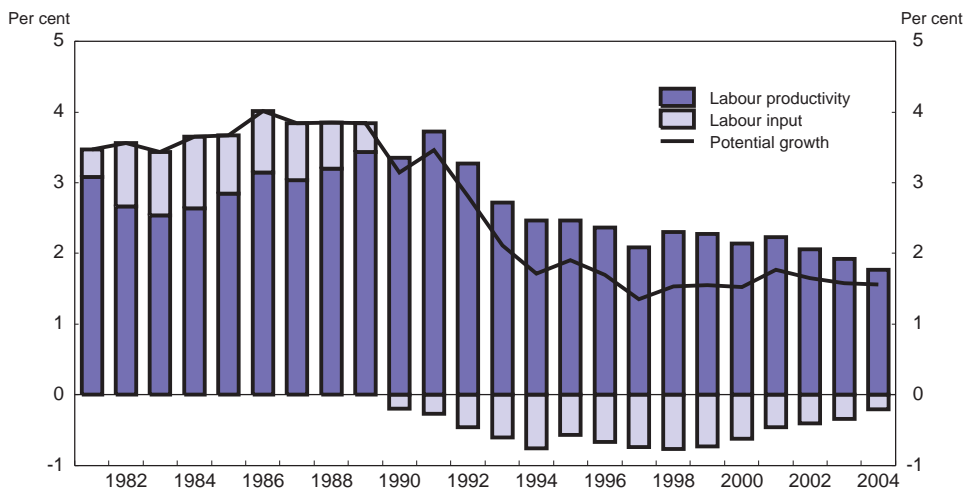
Figure 1.2. **Per capita income in Japan has fallen relative to other OECD countries**



Note: Based on current purchasing power parities.

Source: OECD, *National Accounts of OECD Countries*.

Figure 1.3. **Potential growth in Japan**



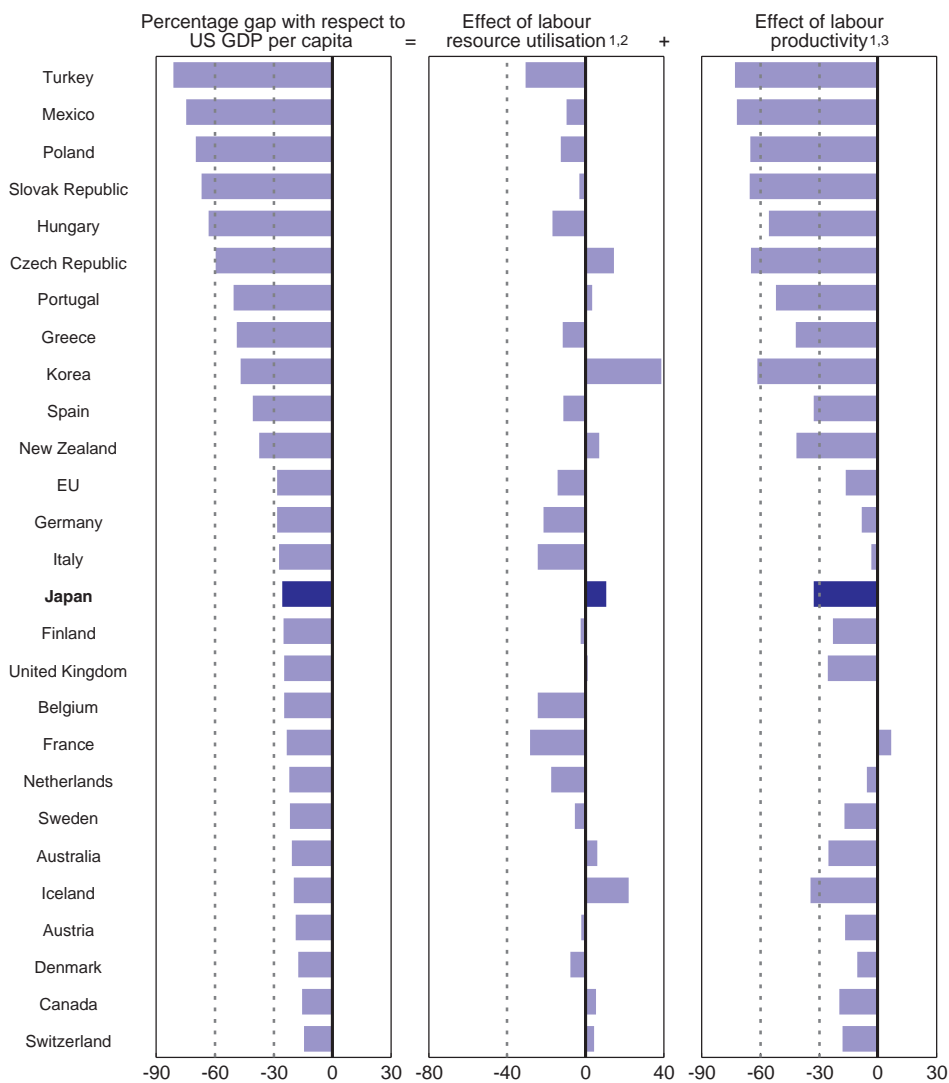
Source: OECD *Economic Outlook*, No. 76.

second, more important factor has been a deceleration in labour productivity growth from more than 3¼ per cent in the second half of the 1980s to around 2 per cent during the past decade.

Japan's income per capita is a quarter below the US level, putting it in the middle of the OECD countries by this criterion. Taking account of the level of labour inputs, labour productivity in Japan is more than 30 per cent below that in the United States, the largest gap among the seven major economies (Figure 1.4). The size of the gap and the deceleration of Japan's growth potential are somewhat surprising in light of Japan's strong fundamentals in some of the indicators identified in the OECD's *Growth Study* as important determinants of

Figure 1.4. **The sources of real income differences**

In 2002, using PPP exchange rates

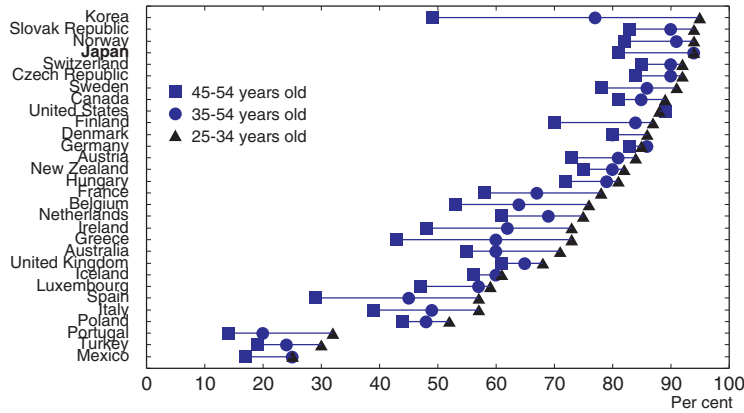


1. Percentage gap with respect to the United States level.
2. Labour resource utilisation is measured as trend total number of hours worked divided by population. Information on hours worked for Austria, Luxembourg and Poland is not available.
3. Labour productivity is measured as trend GDP per hour worked.

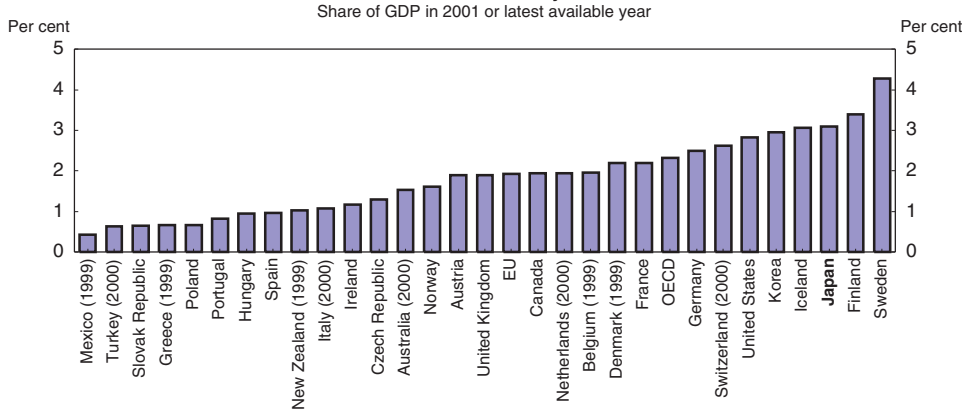
Source: OECD, *The Sources of Economic Growth in OECD Countries*.

Figure 1.5. Sources of growth

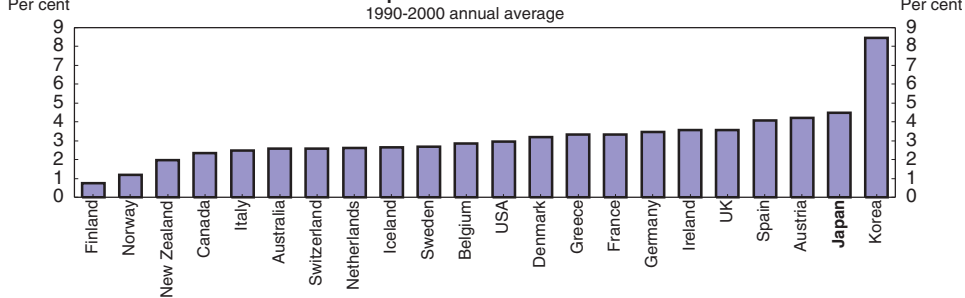
A. Share of the population with at least an upper-secondary qualification



B. R&D intensity



C. Growth of capital stock in the business sector



Source: OECD Education at a Glance, OECD Science, Technology and Industry Scoreboard and OECD Economic Outlook, No. 76.

growth. For example, the proportion of the population between the ages of 35 and 54 with at least a secondary school education is the highest in the OECD area (Figure 1.5). Educational standards appear high, according to the PISA tests comparing the performance of 15-year-old students. Indeed, Japan ranked first among the OECD countries in math and second in science. In addition, R&D expenditures in Japan account for 3 per cent of GDP, the third-highest share in the OECD area, with an exceptionally large share funded and undertaken by the business sector (Panel B). Another positive factor for growth is investment in physical capital. During the 1990s, Japan's capital stock increased at an annual rate of 4.5 per cent, the second highest in the OECD area after Korea (Panel C).<sup>1</sup> Japan has also shown improvement in the degree of openness to international competition, another key to growth identified in the Growth Study.

The stock of inward foreign direct investment tripled between 1998 and 2003, although its level as a share of GDP is still the lowest in the OECD area. Manufactured imports as a share of GDP have also been on an upward trend. Despite the high level of investment in physical capital and knowledge and increasing international openness, Japan experienced a sharp slowdown in growth in the 1990s and the emergence of a significant productivity gap relative to some other leading economies. While weak demand in the wake of the collapse of the bubble was certainly an important factor in this decline, it also suggests fundamental problems in allocating resources efficiently in Japan.

Future economic growth prospects, as noted above, can be attributed to labour inputs and labour productivity growth. Labour inputs are determined in part by working hours and the labour force participation rate, which are both high in Japan. Indeed, working time, at about 1 800 hours per year, is 8 per cent above the OECD average, while the labour force participation rate, at 77½ per cent of the working-age population, is significantly higher than the OECD average of 70 per cent.<sup>2</sup> If these factors, as well as the structural unemployment rate, were to remain unchanged at their 2004 levels, and if the decline in the working-age population continues at the 0.2 per cent annual rate recorded in the first four years of this decade, the potential growth rate would remain at 1.6 per cent over the period 2004 to 2010 (Scenario B in Table 1.1).<sup>3</sup>

However, labour inputs are likely to be reduced more sharply by demographic factors. Between 2004 and 2010, the Japanese government projects that the decline in the working-age population will accelerate to a 0.7 per cent annual rate (Table 1.2), while an increasing number of elderly persons will keep Japan's total population virtually constant. Consequently, the elderly dependency ratio will rise by 3 percentage points by the end of the decade, although it will be accompanied by a decline in the youth dependency ratio. Indeed, the number of workers per elderly person is projected to fall from 2.6 in 2004 to 2.1 in 2010. The demographic projection of the Japanese authorities implies that potential growth would slow to a 1.1 per cent rate over the period 2004 to 2010 (Scenario C in Table 1.1), assuming as before that working time, the labour force participation rate and structural unemployment remain at their present levels. However, if in addition, working hours were to fall halfway to the OECD average,<sup>4</sup> the potential growth rate would be reduced to only 0.4 per cent over the period 2004 to 2010.

In summary, while a few other OECD countries will also experience negative contributions to growth from demographic factors, the impact in Japan is by far the largest (Table 1.3). The OECD's Medium-Term Baseline (Scenario A in Table 1.1) projects a potential growth rate of 1.3 per cent over the period 2004 to 2010. This is based on the assumption that working hours remain virtually unchanged and that the participation rate rises by 1 percentage point. In addition, it incorporates a 1.7 per cent annual rise in trend labour productivity, compared to an OECD average of 2¼ per cent. Even if these favourable assumptions are fulfilled, the resulting potential growth rate would be significantly below the 2 per cent rate included in the Medium-Term Economic and Fiscal Perspective, which aims at a primary budget surplus by the early 2010s (see below). Achieving such a growth rate would require that labour productivity growth accelerate to a 2½ per cent annual rate (Scenario D). In sum, Japan needs to increase labour force participation rates and keep working hours relatively high, while maintaining productivity growth, in order to sustain per capita income gains at around 1½ per cent a year, which is close to the average of the other G-7 countries since 1990.

Table 1.1. **Japan's potential growth rate over the medium term**Annual average in percentage points<sup>1</sup>

	2000-04	2004-10	2000-10
<b>A. The OECD's medium-term baseline</b>			
Potential growth	1.6	1.3	1.4
Labour force	0.0	-0.5	-0.3
Working-age population	-0.2	-0.7	-0.5
Trend participation rate	0.2	0.2	0.2
Potential employment <sup>2</sup>	-0.1	-0.5	-0.3
Hours worked <sup>3</sup>	-0.2	0.0	-0.1
Total labour input	-0.4	-0.5	-0.4
Labour productivity growth	2.0	1.7	1.8
Potential growth rate per capita	1.5	1.3	1.4
<b>B. Ageing advances at a constant rate and no change in the participation rate<sup>4</sup></b>			
Potential growth	1.6	1.6	1.6
Labour force	0.0	-0.2	-0.1
Working-age population	-0.2	-0.2	-0.2
Trend participation rate	0.2	0.0	0.1
Potential employment <sup>2</sup>	-0.1	-0.2	-0.1
Hours worked <sup>3</sup>	-0.2	0.0	-0.1
Total labour input	-0.4	-0.2	-0.2
Labour productivity growth	2.0	1.7	1.8
Potential growth rate per capita	1.5	1.6	1.6
<b>C. Ageing accelerates as projected and no change in the participation rate<sup>5</sup></b>			
Potential growth	1.6	1.1	1.3
Labour force	0.0	-0.7	-0.4
Working-age population	-0.2	-0.7	-0.5
Trend participation rate	0.2	0.0	0.1
Potential employment <sup>2</sup>	-0.1	-0.7	-0.4
Hours worked <sup>3</sup>	-0.2	0.0	-0.1
Total labour input	-0.4	-0.7	-0.5
Labour productivity growth	2.0	1.7	1.8
Potential growth rate per capita	1.5	1.2	1.3
<b>D. Baseline scenario with an acceleration in productivity growth</b>			
Potential growth	1.6	2.0	1.8
Labour force	0.0	-0.5	-0.3
Working-age population	-0.2	-0.7	-0.5
Trend participation rate	0.2	0.2	0.2
Potential employment <sup>2</sup>	-0.1	-0.5	-0.3
Hours worked <sup>3</sup>	-0.2	0.0	-0.1
Total labour input	-0.4	-0.5	-0.4
Labour productivity growth	2.0	2.5	2.2
Potential growth rate per capita	1.5	2.0	1.8

1. These estimates were made prior to the introduction of chain-linked indices in the national accounts in December 2004.

2. During the 2000 to 2004 period, the rise in the structural unemployment rate made a negative 0.1 contribution to potential employment.

3. In each of the scenarios, hours worked during the period 2004 to 2010 are assumed to increase by a small positive amount that rounds to zero.

4. The decline of the working-age population continues at the 2000 to 2004 pace of 0.2 per cent over the period 2004 to 2010, while the participation rate remains at its 2004 level of 78.3 per cent.

5. The decline of the working-age population accelerates to the 0.7 per cent rate projected by the government, while the participation rate remains at its 2004 level.

Source: OECD Economic Outlook, No. 76.



Table 1.2. **Japan's demographic outlook**

	2000-04	2004-10 <sup>1</sup>	2000-10
<b>A. Growth rates</b>			
Working-age population	-0.2	-0.7	-0.6
Population over 65	2.9	2.5	2.7
Total population	0.1	-0.0	0.0
	2000	2004	2010
<b>B. Dependency ratios</b>			
Elderly dependency ratio <sup>2</sup>	17.4	19.4	22.5
Youth dependency ratio <sup>3</sup>	14.6	14.0	13.4
Total dependency ratio <sup>4</sup>	32.0	33.4	35.9
Number of employed per elderly person <sup>5</sup>	2.9	2.6	2.1

1. Projection by the Ministry of Health, Labour and Welfare.
  2. Population over 65 years of age as a share of working-age population (15 to 64).
  3. Population under 15 years of age as a share of working-age population (15 to 64).
  4. Sum of elderly and youth dependency ratios.
  5. Assuming that the unemployment and participation rates remain at their 2004 levels.
- Source: Ministry of Health, Labour and Welfare.

Table 1.3. **International comparison of potential output growth**

Annual average from 2004 to 2010 in percentage points

	Potential GDP growth rate	Potential labour productivity growth (output per hour)	Potential labour input (total hours worked)	Components of potential employment				Hours worked
				Trend participation rate	Working-age population	Structural unemployment	Potential employment growth	
<b>Japan</b>	<b>1.3</b>	<b>1.7</b>	<b>-0.5</b>	<b>0.2</b>	<b>-0.7</b>	<b>0.0</b>	<b>-0.5</b>	<b>0.0</b>
Australia	3.4	2.2	1.2	0.0	1.1	0.0	1.1	0.1
Austria	2.1	1.9	0.2	0.1	0.0	0.0	0.2	0.0
Belgium	2.1	1.9	0.2	0.3	0.3	0.0	0.6	-0.3
Canada	3.0	2.1	1.0	0.1	1.0	0.0	1.1	-0.1
Denmark	1.9	1.7	0.2	-0.1	0.0	0.0	-0.1	0.3
Finland	1.9	2.3	-0.4	-0.3	0.1	0.1	-0.1	-0.3
France	2.0	1.5	0.6	-0.1	0.4	0.0	0.3	0.3
Germany	1.6	1.8	-0.2	0.2	-0.2	0.0	0.0	-0.2
Greece	3.7	3.0	0.7	0.4	-0.1	0.1	0.5	0.2
Iceland	3.9	2.6	1.3	0.0	1.3	0.0	1.4	-0.1
Ireland	4.6	3.7	0.9	0.3	0.8	0.1	1.3	-0.3
Italy	1.6	1.5	0.1	0.5	-0.2	0.1	0.2	-0.1
Korea	4.6	3.6	1.0	0.2	0.9	0.0	1.1	0.0
Netherlands	1.8	1.3	0.5	0.2	0.3	0.0	0.6	0.0
New Zealand	3.4	2.2	1.1	0.1	1.1	0.0	1.2	0.0
Norway	2.9	2.4	0.5	0.1	0.7	0.0	0.7	-0.3
Spain	2.8	1.4	1.4	1.0	0.8	0.1	1.6	-0.1
Sweden	2.4	1.4	1.0	-0.2	0.5	0.0	0.3	0.7
Switzerland	1.5	1.2	0.3	0.1	0.3	0.0	0.4	0.0
United Kingdom	2.6	2.2	0.3	0.0	0.5	0.0	0.5	-0.1
United States	3.2	2.3	0.9	-0.2	1.1	0.0	0.8	0.1
Euro area	2.0	1.6	0.3	0.3	0.1	0.1	0.4	-0.1
<b>Total OECD</b>	<b>2.7</b>	<b>2.2</b>	<b>0.5</b>	<b>-0.2</b>	<b>0.7</b>	<b>0.0</b>	<b>0.5</b>	<b>0.0</b>

Source: OECD Economic Outlook, No. 76.

## Key challenges facing Japan

The medium-term outlook underlines the need to accelerate output growth in the context of population ageing and rising public debt. It is thus essential to avoid complacency about the strength of the recovery and to press ahead with macroeconomic policies to promote sustainable growth while speeding up structural reforms to remove obstacles limiting the economy's growth potential. This section outlines the major challenges that will be analysed in the following chapters. A serious environmental problem – improving air quality – is addressed in Box 1.1.

### ***Ending deflation and sustaining the economic expansion***

Overcoming deflation remains the top priority for the monetary authorities. The persistence of price declines in the face of a 4¼ per cent pace of growth during the first half of 2004 indicates the degree to which deflation has become entrenched after six years. Indeed, about 60 per cent of the items in the consumer price index are reporting falling prices. Nevertheless, the growth-inhibiting effects of deflation have diminished as deflation has moderated, at least according to some measures (Box 1.2), and the risk of a deflationary spiral has receded. However, even the low rate of deflation appears to have a negative impact, particularly on the financial sector. *First*, it increases the burden of liabilities, thereby resulting in delayed payments and defaults, which hurt financial institutions. *Second*, deflation transfers income from debtors to creditors, who generally have lower marginal propensities to spend, thus tending to reduce aggregate demand. *Third*, falling prices of goods and services are linked to declining asset prices, notably the unremitting fall in land prices, which has a negative effect on banks' balance sheets. *Fourth*, deflation has kept real interest rates higher than they should be, thus reducing the potency of monetary policy.

The path of deflation depends to a great extent on the duration and strength of the current expansion. A continued recovery sufficiently robust to narrow the output gap should bring an end to deflation. However, there are questions about the strength of the upturn that began in 2002; it appeared to have peaked in early 2004, followed by a marked deceleration in the following two quarters. Most recent indicators give mixed signals. Moreover, there are a number of external risks to a continued expansion, such as a hard landing in China and further increases in oil prices. On the domestic side, there are also a number of uncertainties, including the continued fall in wages. Given the sharp decline in the household saving rate, a further increase in private consumption is likely to require income gains. Furthermore, there is the ever-present risk of a substantial hike in long-term interest rates in the context of the sharp run-up in public debt.

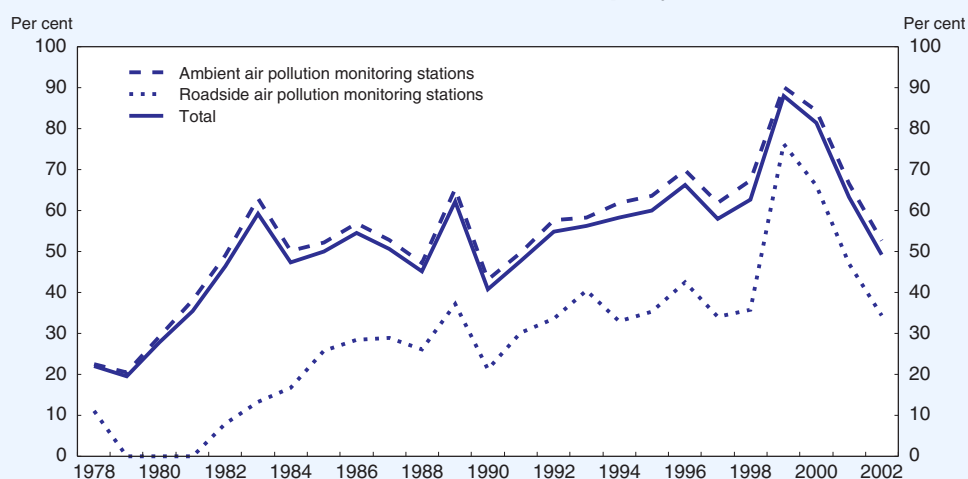
Meanwhile, the Bank of Japan maintains its policy of zero short-term interest rates and quantitative easing, which it introduced in 2001. While this policy has boosted the monetary base by 60 per cent during the past three years, its effectiveness in ending deflation has been limited by the closure of the credit transmission channel. Bank lending, adjusted for write-offs of non-performing loans, is still declining at a year-on-year rate of more than 1 per cent (Figure 1.8), despite increased mortgage loans from banks that have taken the place of government housing loans. The sharp rebound in investment suggests that the continued decline in lending is due in part to the persistent reluctance of banks to take credit risks and increased reliance on retained earnings. Marked progress has been achieved in reducing non-performing loans and operating profits were recorded in FY 2003

### Box 1.1. Improving air quality in Japan

The level of emissions of sulphur dioxide and nitrogen dioxide are only between a fifth and a quarter of the OECD average (see the 2003 Survey). Nevertheless, the geographically concentrated nature of economic activity has resulted in poor air quality in some areas. One problem is photochemical oxidants; high concentrations of this so-called “photochemical smog” can cause respiratory problems in addition to affecting plants. In March 2003, less than 1 per cent of monitoring stations nation-wide achieved the environmental quality standard of 0.06 ppm. Moreover, 40 per cent showed levels that were at least twice that standard. A second major concern is “suspended particulate matter”, which also damages human respiratory organs. The proportion of monitoring stations achieving the quality standard fell from 88 per cent in FY 1999 to 49 per cent in FY 2003 (Figure 1.6), in part due to windblown yellow sand from China.

Figure 1.6. Air quality in Japan

Achievement rate of the environmental quality standard



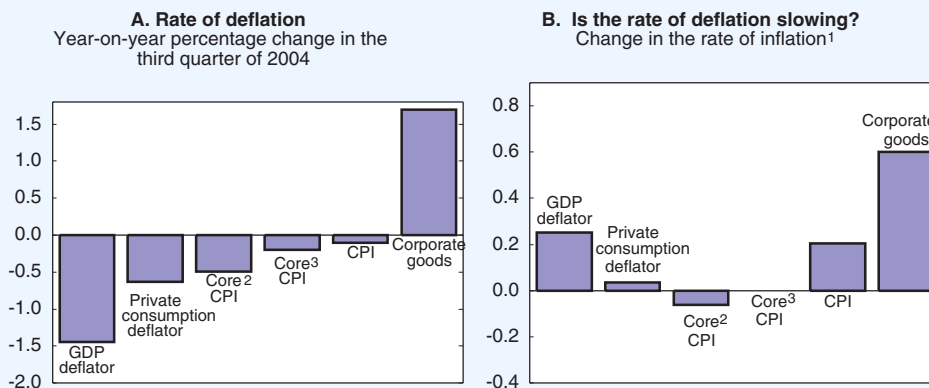
Source: Ministry of the Environment.

Particulate matter emissions from diesel vehicles have not been sufficiently reduced because particulate filters have not yet been attached to vehicles. Therefore, the government decided in 2000 to reduce the sulphur content of diesel from 500 ppm to 50 ppm by the end of 2004, allowing particulate filters to be used effectively on vehicles. Following this decision, fuel suppliers began to sell diesel fuel with a sulphur content of less than 50 ppm on a voluntary basis since April 2003. The availability of cleaner fuel has been accompanied by regulations limiting emissions by heavy diesel trucks. It is important to make further progress by implementing the Central Environmental Council's recommendation to move to ultra-clean diesel fuel – which has a maximum sulphur content of 10 ppm, a level below US and European standards – by 2007. In addition to these regulatory moves, vehicles that reduce air pollutants by 50 per cent below the 2005 emission standard are subject to lower tax rates. Similar benefits are accorded to vehicles meeting the Automobile Fuel Efficiency Target for FY 2010. The use of such economic instruments should be encouraged to improve air quality. In addition, the use of road pricing can be a useful strategy to reduce both congestion and pollution.

### Box 1.2. The different measures of inflation

Understanding the path of inflation is complicated by the diverging trends reported by the various measures of the overall price level. Indeed, the rate of inflation is significantly negative, close to zero or positive depending on the index chosen. The most important indicator for the Bank of Japan is the core consumer price index, which excludes fresh food but includes energy. By this measure, the price level fell slightly in the third quarter of 2004, while the price deflators in the national accounts showed faster rates of decline of 0.6 per cent (year-on-year) for private consumption and 1.4 per cent for GDP (Figure 1.7).<sup>\*</sup> The high rate of deflation reported by the GDP deflator reflects significant falls in the price of investment goods, which declined 2 per cent in 2003. Indeed, the prices of some ICT products have fallen at rates of more than 30 per cent a year. In contrast, the domestic corporate goods price index, which is limited to sales between firms, has reported positive inflation since the beginning of 2004. In addition to the large differences in the level of inflation, the various measures do not agree on whether the rate of deflation accelerated in the third quarter of 2004 (Panel B).

Figure 1.7. Different measures of inflation



1. Change in the rate of inflation in percentage points, in the third quarter of 2004 compared to the second quarter of 2004. A negative number indicates that the rate of deflation accelerated.
2. OECD measure of core CPI excludes food and energy, which account for about a quarter of the index.
3. Japanese definition of core CPI, which excludes only fresh food.

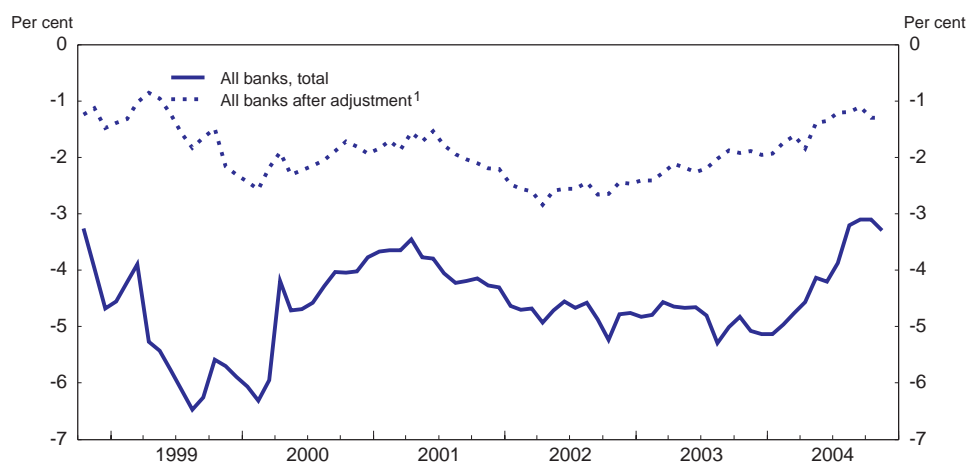
Source: Bank of Japan, Ministry of Internal Affairs and Communications and OECD *Economic Outlook*, No. 76.

<sup>\*</sup> The gap between the consumer price index (CPI) and the private consumption deflator reflects differences in method of calculation. The CPI is a Laspeyres-type index, while the deflator is a Paasche-type index.

for the first time in a decade. Nevertheless, bank profits are low, lending margins are narrow and their capital base is weak. Indeed, deferred tax assets account for more than a third of Tier I capital. Moreover, the improvement in the regional banks has lagged behind that of the nation-wide banks. The health of the banking sector and the durability of the economic expansion are likely to be closely interrelated. Continued output growth will further strengthen the banks and eventually end the contraction in lending. At the same time, increased lending is necessary for a sustainable and broad-based expansion, given Japan's bank-centred financial system.<sup>5</sup>

Figure 1.8. **Bank lending continues to decline**

Year-on-year change



1. Excluding loan write-offs and related items and securitisation of loans, and adjusting for exchange-rate changes.  
Source: Bank of Japan.

Once deflation ends, the monetary authorities will face the challenge of exiting its current policy of quantitative easing and zero interest rates. One issue is the appropriate timing of this policy shift. A premature exit could undermine the expansion and send the economy into renewed deflation. On the other hand, maintaining the current policy stance too long could result in high and sustained rates of inflation once the money multiplier begins to work again, given that the monetary base has expanded from 13 to 21 per cent of GDP over the past three years. The Bank of Japan will need to absorb the excess liquidity at some point in order to achieve price stability. The quantitative easing policy was implemented through large central bank purchases of government bonds amounting to about one-third of new issues, boosting the central bank's holdings to 60 trillion yen (12 per cent of GDP). Such purchases encouraged private-sector purchases as well; banks' holdings of government bonds have reached 169 trillion yen (34 per cent of GDP). While these purchases have helped to keep long-term bond yields below two per cent, it has created concern about a possible bubble in this market. Once the Bank of Japan ends its purchases of government bonds and begins to reduce its holdings, there is the potential for a rapid and significant decline in bond prices, which might result in large capital losses for financial institutions. Moreover, a sharp rise in interest rates has implications for the real economy and the budgetary situation.

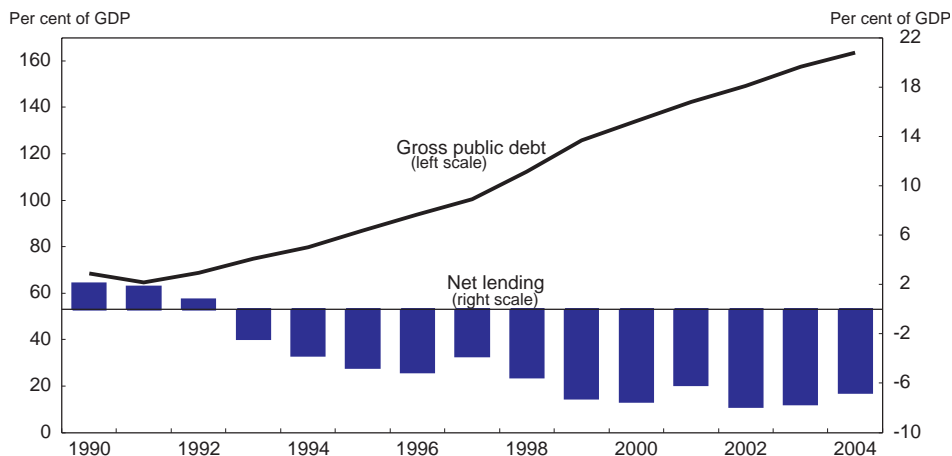
In sum, the key challenges, which are discussed in Chapter 2, are:

- Sustaining the current expansion long enough to bring deflation to an end.
- Correctly timing the end of the Bank of Japan's quantitative easing policy in order to limit the risk of falling back into a deflationary trap, while absorbing the excess liquidity in time to avoid sustained inflation at high rates.
- Developing an effective exit strategy from the current monetary policy so as to limit the impact on the real economy and financial institutions.
- Further strengthening the banks in order to end the contraction of bank lending and thereby re-open the credit transmission channel necessary for effective monetary policy, thus providing the basis for a sustainable and broad-based expansion.

### Achieving fiscal sustainability

Japan's budget deficit peaked at nearly 8 per cent of GDP in 2002 and 2003 (Figure 1.9). Relative to 1992 – the year with the last budget surplus – the deterioration in the balance was due largely to a rise in spending (5 per cent of GDP) resulting from social security outlays. Revenues also declined (3 per cent of GDP) because of tax cuts and weak economic growth. Large deficits over the past decade have boosted gross public debt to 160 per cent of GDP. With long-term interest rates substantially higher than the growth of nominal GDP, the size of public debt relative to the economy continues to increase at a rapid rate.

Figure 1.9. **Fiscal indicators for general government**  
Per cent of GDP<sup>1</sup>



1. OECD estimates for 2003 and 2004.

Source: OECD Economic Outlook, No. 76.

The government's current objective, set out in the *Medium-Term Economic and Fiscal Perspective* revised in early 2004, is to limit public outlays through FY 2006 to the FY 2002 level of 38 per cent of GDP. This objective has been achieved thus far primarily through double-digit cuts in public investment spending. However, pressure for increased expenditures resulting from population ageing will make it increasingly difficult to limit spending over the medium term. Under current programmes, social security outlays – for pensions, health and long-term nursing care, will increase by 1½ per cent of GDP by 2010. Freezing total government spending as a share of GDP will likely require both significant cuts in discretionary expenditures combined with further reform of the social security system to limit the increase in outlays.

The government's *Perspective* also sets the objective of achieving “a surplus in the primary budget by the early 2010s”. In 2004, the primary deficit, which excludes interest payments, is estimated to have fallen by 1 per cent of GDP to around 5 per cent of GDP. However, the decline was due in part to exceptionally strong output growth of around 3 per cent; in cyclically-adjusted terms, the primary deficit fell by about ½ per cent of GDP.

The *Medium-Term Economic and Fiscal Perspective* includes a decline of ½ per cent of GDP in the primary budget deficit each year during the period FY 2004 to FY 2008, its final year (Table 3.4). If this pace of fiscal consolidation continues beyond 2008, it would take a full decade to reach a primary budget balance (Table 1.4). Achieving a balance would be

Table 1.4. **Fiscal consolidation scenarios**

Per cent of GDP

<b>Case 1: Medium-Term Economic and Fiscal Perspective (MEFP) baseline<sup>1</sup></b>	
Real growth of 2 per cent; real long-term interest rate of 2 per cent	
Target primary budget <sup>2</sup>	0.0
Number of years from 2004 to achieve target	10
Level of debt when stabilised	186.2
Additional debt, compared to 2003	23.2
Additional debt burden	0.5
<b>Case 2</b>	
Real growth of 1.3 per cent; <sup>3</sup> real long-term interest rate of 2 per cent	
Target primary budget <sup>2</sup>	1.1
Number of years to achieve target	12
Level of debt when stabilised	200.3
Additional debt, compared to 2003	36.8
Additional debt burden	0.9
<b>Case 3</b>	
Real growth of 2 per cent; real long-term interest rate of 3 per cent <sup>4</sup>	
Target primary budget <sup>2</sup>	1.4
Number of years from 2004 to achieve target	13
Level of debt when stabilised	207.8
Additional debt, compared to 2003	44.3
Additional debt burden	1.3
<b>Case 4</b>	
Real growth of 1.3 per cent; <sup>3</sup> real long-term interest rate of 3 per cent <sup>4</sup>	
Target primary budget <sup>2</sup>	2.6
Number of years from 2004 to achieve target	15
Level of debt when stabilised	230.3
Additional debt, compared to 2003	73.2
Additional debt burden	2.2

1. The average real GDP growth rate for the period 2004 to 2014 is based on the *Medium-Term Economic and Fiscal Perspective* for 2005 to 2008. The growth rate for 2008 (2.1 per cent in real terms) is assumed to continue indefinitely. The real interest rate is the *Perspective's* "nominal long-term interest rate" deflated by the implied GDP deflator in the baseline. Similarly, the nominal interest rate of 2.8 per cent in 2008 and the rise in the GDP deflator of 0.8 per cent are assumed to continue indefinitely.
2. Primary budget needed to stabilise public debt as a share of GDP. It is calculated as:  

$$b_t = d_t + b_{t-1} * [(1+r)/(1+g)],$$
 where b is the debt to GDP ratio; d is the primary deficit to GDP ratio; r is the nominal interest rate; and g is the nominal growth rate.
3. The potential growth rate in the OECD Medium-Term Baseline for 2004 to 2010 is assumed to continue into the next decade.
4. The real long-term interest rate has averaged around 3 per cent over the period 1990 to 2004, as well as during 2000 to 2004.

Source: *Structural Reform and Medium-Term Economic and Fiscal Perspective* and OECD calculations.

sufficient to stabilise public debt if both the real growth of output and the real long-term interest rate – assumed to be around 2 per cent in 2008 by the *Perspective* – remain indefinitely at that level. In this case, public debt would stabilise in 2014, though at a higher level of around 186 per cent of GDP.

However, public debt would rise significantly more under less optimistic economic assumptions. If the real growth rate were 1.3 per cent – the rate in the OECD Medium-Term Baseline and near the current estimate published by the Cabinet Office – a primary budget surplus of 1 per cent of GDP would be necessary to stabilise the debt to GDP ratio, assuming

a 2 per cent real long-term interest rate (Table 1.4, Case 2). At the *Perspective's* consolidation pace of ½ per cent of GDP per year, it would take 12 years to stabilize the debt to GDP ratio, though at around 200 per cent of GDP. Moreover, if the real long-term interest rate were higher at 3 per cent – its average level during the past 15 years – it would take 15 years to stabilize the debt to GDP ratio at around 230 per cent of GDP (Case 4). The cost of servicing this higher level of debt would amount to more than 2 per cent of GDP, requiring higher taxes that impose deadweight costs.

The pace of fiscal consolidation incorporated in the *Medium-Term Economic and Fiscal Perspective* thus suggests a substantially higher level of debt in the future. A continued run-up in debt raises the possibility of a higher risk premium, which would further exacerbate the fiscal position. The key to avoiding such an outcome is a credible medium-term plan. However, the *Perspective* that was announced in 2002 and updated annually should be more detailed and credible. Its economic assumptions may be on the optimistic side and it only indicates a spending and revenue path to achieve the fiscal target. The size of the fiscal consolidation needed to stabilise public debt – likely to be at least 6 per cent of GDP – appears to be too large to be accomplished through spending cuts alone. Consequently, the fiscal strategy will require increased government revenue, which at present is the second lowest in the OECD area at around 30 per cent of GDP. However, the government has no specific plans at present to increase taxes and has pledged that there will be no increase in the consumption tax rate during the term of the current prime minister, which continues until September 2006.

In sum, the key challenges to achieving fiscal sustainability, which are discussed in Chapter 3, are:

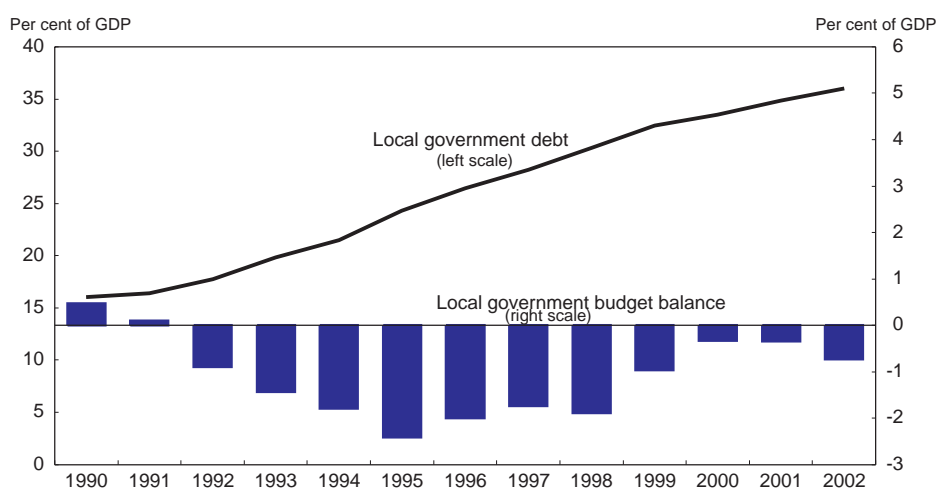
- Achieving the expenditure target by cutting discretionary spending and further reforming the social security system in order to limit the rise in ageing-related outlays.
- Boosting revenues from the current low level.
- Establishing a more credible medium-term plan with more information on the spending and revenue changes needed to achieve a primary budget surplus large enough to stabilise public debt, thereby helping to maintain confidence in the government's financial position.

### **Revamping the relationship between different levels of government**

One element of the public finance problem is the large budget deficit at the local level. Indeed, local government debt has risen from 15 per cent of GDP in the early 1990s to 40 per cent in 2003 (Figure 1.10). The lack of fiscal discipline reflects lenient budgetary rules and implicit guarantees from the central government to support financially-troubled jurisdictions. Spending pressures at the local level will increase with population ageing since local governments are largely responsible for healthcare and other welfare programmes, in addition to pensions for their own employees. The scope for achieving greater efficiency in the delivery of government services is limited by the fragmented nature of local government, which includes 47 prefectures and more than 3 000 municipalities. Given the 40 per cent share of local government in total public spending, the resulting efficiency costs are significant.

While Japan has a high degree of decentralisation, the ability of local governments to innovate and respond to preferences of local citizens is constrained. Major spending programmes at the local level, including education, social welfare and public works, are controlled by the central government and largely financed through earmarked grants (national



Figure 1.10. **The fiscal situation of local government**

Source: Cabinet Office.

treasury disbursements). Such grants, which account for 40 per cent of intergovernmental transfers, are used to steer local government spending decisions. Regulations to ensure equity by specifying minimum standards across the country also limit the scope for innovation.

In addition to grants, local government outlays are financed by 13 different taxes at the prefectural level and ten at the municipal level, resulting in overlapping tax bases. The complexity of the system is further increased by a proliferation of deductions and exemptions. Another weakness is the volatility of the major local taxes over the business cycle. In addition, tax bases are unevenly distributed across regions, requiring complicated equalisation schemes to achieve equity objectives. Although local governments have some flexibility in setting the rates and bases of some taxes, they rarely use it in practice. Local autonomy has thus failed to promote tax competition and discipline.

In sum, the key challenges in the relations between local governments, which are discussed in Chapter 4, are:

- Increasing fiscal discipline at the local government level as part of the fiscal consolidation process.
- Achieving greater efficiency in local government spending programmes, in part through economies of scale.
- Reaping the full benefits of decentralisation by allowing more scope for local governments to innovate and respond to the preferences of local citizens.
- Improving the grant system in order to enhance the autonomy of local governments, while strengthening incentives for fiscal discipline.
- Reducing the proliferation of local taxes and exemptions, thereby simplifying the local tax system and enhancing efficiency.

### **Removing obstacles that limit Japan's growth potential**

As noted above, weak economic growth has created a significant gap between per capita income levels in Japan and the most advanced OECD countries. Accelerating productivity growth is essential to improve living standards as the working-age population

declines at a faster pace (Table 1.1). Increasing the pace of productivity gains requires a wide range of reforms to reduce the government's role, accelerate regulatory reform and strengthen competition.

The top priority of the government is the privatisation of Japan Post, which is the world's largest financial institution with assets amounting to 80 per cent of Japanese GDP. The important role of Japan Post poses a number of problems. First, postal savings and life insurance provide the government with a large source of funds to support public corporations and finance public investment projects. Shifting a greater share of resources from such activities, which tend to be characterised by low productivity, to the private sector would allow for a better allocation of resources and thereby enhance Japan's growth potential. Second, Japan Post undermines the operations and health of private financial institutions, which are subject to taxes and have to pay for deposit insurance as well as facing various risks. Given these advantages, it is not surprising that the postal saving system's share of total assets of deposit-taking institutions nearly doubled from 11 per cent in 1989 to 20 per cent in 2000, at the expense of banks. The privatisation of Japan Post, however, is a daunting task. With 25 000 branches and 400 000 employees, it plays a fundamental role in rural areas without private financial institutions. Consequently, there remains significant opposition to the plan to separate Japan Post into four entities by 2007, including Postal Savings and Postal Life Insurance, which are to be privatised by 2017 at the latest. The government is probably justified in citing this as one of the most important reforms to be undertaken since the Meiji Era in the 19th century.

Although Japan has placed considerable emphasis on regulatory reform in recent years, overcoming vested interests in the ministries and among politicians slows progress. The reform proposals made by the private-sector *Council for Regulatory Reform*<sup>6</sup> form the basis of the government's Three-Year Plan for Promoting Regulatory Reform, which is updated each year. However, the three-year plans have generally been markedly less ambitious than the Council's initial proposals, as key reforms are blocked by the responsible ministries. The creation of Special Zones for Structural Reform, which allows the introduction of certain reforms on a trial basis in limited geographical areas, was intended to circumvent such opposition. However, it may fall short of expectations unless local governments play a more active role and there is a definite timetable for extending these reforms on a nation-wide basis. In addition, the ability of the government to achieve high quality regulation is limited by problems in regulatory institutions, tools and procedures. The resulting lack of transparency is one factor limiting foreign direct investment (FDI).

Increased inflows of foreign direct investment would help strengthen competition, which is essential to improve resource allocation and raise Japan's growth potential. At present, the enforcement of the competition law by the Japan Fair Trade Commission (FTC) is not strong enough, in part because of the low level of sanctions on violations of the Anti-Monopoly Act. Moreover, the regulatory policy framework for network industries still needs to be improved to enhance the scope for competition. Foreign competition is limited by the low level of FDI inflows. Achieving the government's goal of doubling the stock of FDI, which despite recent increases amounts to only 2 per cent of GDP, will likely require steps to improve the business environment by enhancing transparency. In addition, despite past increases, the level of imports of goods and services is surprisingly low, even after adjusting for transportation costs and other factors. Further increasing openness to international trade is thus another challenge for boosting competition.

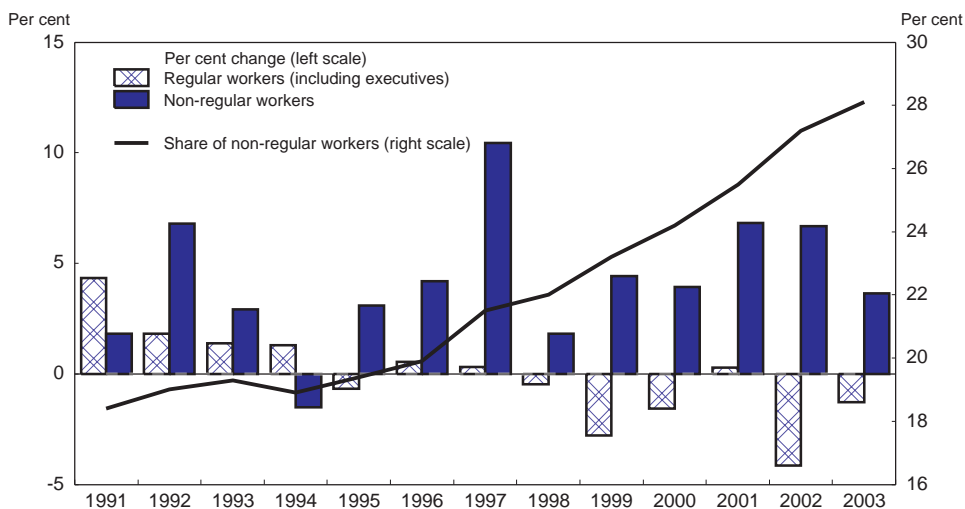
In sum, the key challenges to removing obstacles to growth, which are discussed in Chapter 5, are:

- Privatising Japan Post in order to reduce the flow of resources for public corporations and public investment and to level the playing field with private-sector financial institutions.
- Accelerating regulatory reform through better implementation of the three-year programmes and by making the special zone initiative an effective tool for nation-wide reform.
- Strengthening competition by upgrading the FTC and increasing its effectiveness through heavier sanctions.
- Improving the regulatory framework in the network industries in order to enhance competition.
- Increasing openness to international trade and inflows of FDI.

### **Addressing emerging problems in the labour market**

Employment has begun rising and the unemployment rate has fallen from a record high of 5.5 per cent to under 5 per cent. However, gains in employment are due to an increased number of non-regular workers, such as part-timers and those with temporary contracts, while the number of regular workers has been declining since 1998 (Figure 1.11). Consequently, the share of non-regular employees has risen over the past decade from 19 per cent of total dependent employment to 29 per cent. Non-regular workers, who generally have temporary contracts, provide greater employment flexibility than regular workers who are covered by relatively strict employment protection. In addition to employment flexibility, non-regular workers receive substantially lower wages. The total savings to firms are even larger since employees working less than 30 hours a week are exempt from all social charges except unemployment insurance. While the increased availability of part-time positions provides job opportunities to people who would otherwise be unable to find work, the unemployment rate is relatively high at 10.1 per cent for the 15 to 24 age group. In addition, the incidence of long-term unemployment has risen markedly to a level above the OECD average.

Figure 1.11. **The share of non-regular workers is rising**



Source: Ministry of Internal Affairs and Communications.

The increasing dualism of the labour market poses a number of efficiency and equity concerns. Perhaps most importantly, it is creating a group of primarily young people with only short-term employment experience.<sup>7</sup> Given the important role of firm-based training in Japan, such workers risk being left behind with a low level of human capital. There are also important equity problems. Although there is little evidence on the difference in productivity between regular and non-regular workers, it is likely to be much smaller than the 60 per cent wage gap. The equity concern is magnified by the fact that there is little movement between the regular and non-regular workforces. Consequently, a significant portion of the labour force may be trapped in a low-wage category from which it is difficult to escape. In sum, a quarter of the population is subject to low wages and reduced social protection, while bearing the brunt of adjustments in employment.

As noted above, Japan is one of the few OECD countries where the working-age population is already declining. Although this is partially offset by the upward trend in participation rates, the size of the labour force is shrinking. In addition, the number of hours worked, which remains higher than in most other major countries, may fall further. The accelerating decline in labour inputs will put a growing burden on workers as the population ages. The scope for boosting labour force participation of older workers (ages 55 to 64) is limited, given that it is already the highest in the OECD. There is scope to increase the female participation rate, which is low compared to some other major economies. Moreover, 42 per cent of women who do work are employed part-time. The fact that women account for two-thirds of non-regular employment may discourage their participation in the labour force.

In sum, the key challenges to improving the labour market, which are discussed in Chapter 6, are:

- Reversing the increased dualism in the labour market resulting from the preference of firms to hire non-regular workers.
- Lowering unemployment among young people.
- Addressing the problem of long-term unemployment.
- Limiting the decline in the labour force by maintaining the high labour force participation rate of older persons and boosting the share of prime-age women who work.

## Conclusions

The current economic upturn is helping to correct many longstanding problems in the Japanese economy. The expansion has helped to reduce deflation to a low level and to strengthen the banking system, thus slowing the contraction of bank lending. Structural reforms appear to have encouraged new investment and employment opportunities. However, while the Japanese economy is in its best shape since the early 1990s, the basis for comparison – the weak economic performance of the last decade – does not set the bar very high. Moreover, a number of short-term risks, such as higher oil prices and slower world trade growth, reflecting the cooling off of demand in China, have emerged, in addition to the medium-term challenges discussed above.

There is no room for complacency in this uncertain environment. While Japan may be emerging from a decade of stagnation and the risk of a deflationary spiral, the linked problems of rapid population ageing and the rising level of public debt present new challenges over the medium term. The remaining chapters discuss policy options for ending deflation and sustaining the recovery, achieving fiscal sustainability, revamping relations between levels of government, removing obstacles to economic growth and improving the functioning of the labour market.

## Notes

1. Japan has thus required large increases in capital in order to sustain productivity growth, suggesting a lack of efficiency.
2. This is calculated as total employment divided by the working-age population (15 to 64 years of age). If labour force participation rate is measured as the number of employed in the 15 to 64 age group divided by the working-age population, Japan's rate would be 72 per cent, which is close to the OECD average of 71.5 per cent by this definition.
3. The working-age population is defined as persons between the ages of 15 and 64. This scenario assumes trend labour productivity growth of 1.7 per cent, the rate in the Secretariat's Medium-Term Baseline. Japan is projected to have a positive output gap of 1.2 per cent in 2006. The assumption in the Baseline that output gaps close by 2010 reduces labour productivity growth slightly from the 2 per cent rate estimated for the period 2000 to 2004.
4. The average, for the 20 OECD countries for which data are available, was 1 648 working hours per year in 2003.
5. It should be noted that Japanese capital markets have been developing. In this regard, the Financial Services Agency has taken an initiative, the Program for Promoting Securities Markets Reform, to encourage greater reliance on direct financing and thereby reduced Japan's dependence on bank-centred finance.
6. The Council for Regulatory Reform consisted of 15 experts from business and academia, organised into eight working groups.
7. In Japan, this group is known as "freeters". Initially, members of this group appeared to have voluntarily rejected the traditional approach of regular employment in favour of increased flexibility.

## ANNEX 1.A1

*The revision of Japanese national accounts*

In December 2004, the Cabinet Office revised Japan's national accounts for GDP (by expenditure components) using the chain-linked methodology for the period between 1994 and the third quarter of 2004. The introduction of this approach had been studied since 2001 in order to avoid the distortions created by using a fixed-year base. Indeed, the distortions increase as one moves away from the base year, which had been set as 1995 for Japan. This bias is due to the fact that items whose prices are falling rapidly, such as computers and other ICT products, are given too much weight, leading to an almost 5 per cent decline in the business investment deflator in 2003. As a result, the fall in the GDP deflator – at 2.5 per cent that year (Table 1.A1.1) – was much larger than for the private consumption deflator and consumer price index, which fell by 1.7 and 0.3 per cent, respectively. The overestimation in deflation resulted in a corresponding overestimation of the rate of real growth.

Table 1.A1.1. **Change in GDP growth and deflation with chain-linked methodology**  
Percentage change from previous period at an annual rate

	2000	2001	2002	2003	2004		
					1st quarter	2nd quarter	3rd quarter
<b>GDP deflator<sup>1</sup></b>							
Fixed-year methodology <sup>2</sup>	-2.0	-1.6	-1.1	-2.5	-2.8	-1.9	-0.7
Chain-linked methodology	-1.5	-1.3	-1.3	-1.4	-2.0	-1.7	-0.4
<b>Real GDP</b>							
Fixed-year methodology <sup>2</sup>	2.9	0.4	-0.5	2.5	7.6	-0.4	0.6
Chain-linked methodology	2.4	0.2	-0.3	1.3	6.8	-0.6	0.2

1. The quarterly changes in the GDP deflator are calculated by the OECD Secretariat.

2. These figures were announced in late December, after the introduction of the chain-linked methodology.

Source: Cabinet Office and OECD calculations.

The chain-linked weighting method of price measurement is generally considered superior when relative prices are changing rapidly. The 1993 System of National Accounts recommends the chain-linked approach, which has already been adopted by some other major OECD countries, including the United States, the United Kingdom and Canada.

As expected, the chain-linked approach lowered the rate of deflation. In 2003, the fall in the GDP deflator is now reported to be 1.4 per cent, compared to 2.5 per cent under the old methodology. With nominal levels of expenditure unaffected by the shift to the

chain-linked approach, real GDP growth in 2003 rate was revised downwards by a similar magnitude, from 2.5 to 1.3 per cent.

This methodological change makes the current expansion look less robust. The annual average rate of growth over the ten quarters since the beginning of 2002 is now 2.1 per cent, a full percentage point lower than the rate reported by the fixed-weight approach. However, this methodological change does not negate the positive developments in the Japanese economy that are noted in Figure 1.1. Indeed, profit margins, confidence of firms and the job offer to applicant ratio have each risen to their highest levels since the collapse of the bubble economy at the beginning of the 1990s.

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## BASIC STATISTICS OF JAPAN

### THE LAND

Area (1 000 sq. km), 2002	377.9	Major cities, March 2003 estimate (million inhabitants):	
Cultivated agricultural land (1 000 sq. km), 2001	48.0	Tokyo (23 wards)	8.1
Forest (1 000 sq. km), 2001	251.1	Yokohama	3.5
Densely inhabited districts <sup>1</sup> (1 000 sq. km), 2000	12.5	Osaka	2.5
		Nagoya	2.1
		Sapporo	1.8
		Kobe	1.5
		Kyoto	1.4

### THE PEOPLE

Population, October 2003 estimate (1 000)	127 619	Labour force in per cent of total population, 2003	52.2
Number of persons per sq. km in 2003	338	Percentage distribution of employed persons, 2003:	
Percentage of population living in densely inhabited districts in 2000 <sup>1</sup>	65.2	Agriculture and forestry	4.4
Net annual rate of population increase (1995-2000)	0.2	Manufacturing	18.8
		Service	62.8
		Other	14.0

### PRODUCTION

Gross domestic product in 2003 (billion yen)	497 783	Share of agriculture, forestry and fishery in gross domestic product, at producer prices in 2002 (per cent)	1.3
Growth of real GDP, 2003	1.3	Net domestic product of agriculture, forestry and fishery, at producer prices, in 2002 (billion yen)	4 747
Gross fixed investment in 2003 (per cent of GDP)	24.0	Growth of industrial production, 2003	3.3
Growth of real gross fixed investment, 2003	0.9		

### THE GOVERNMENT

Public consumption in 2003 (in per cent of GDP)	17.7		House of representatives	House of councillors
Current public revenue in 2002 (in per cent of GDP)	29.7	Composition of Parliament, December 2004:		
Government employees in per cent of total employment, 2003	8.8	Liberal Democratic Party	249	114
		Democratic Party	177	84
		Peace and Reform (Komei)	34	24
		Communist Party	9	9
		Others	9	11
		Vacancy	<u>2</u>	<u>0</u>
		Total	480	242
		Last elections	November 2003	July 2004

### FOREIGN TRADE AND PAYMENTS (2003, billion yen)

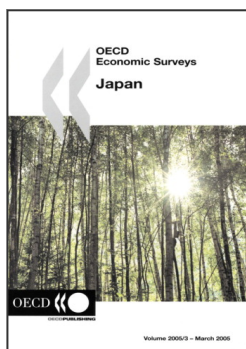
Commodity exports (fob)	51 934		Exports	Imports
Commodity imports (fob)	39 675	Percentage distribution		
Services	-3 904	OECD countries	53.8	41.7
Investment income	8 281	of which:		
Current balance	15 767	North America	27.2	18.1
Exports of goods and services (in per cent of GDP)	11.8	Other Asia	31.2	37.9
Imports of goods and services (in per cent of GDP)	10.2	Other	15.0	20.4
		Total	<u>100.0</u>	<u>100.0</u>
		Crude material and fuels (SITC 2, 3, 4)	1.3	27.6
		Semi-manufactured goods (5, 6)	18.6	16.4
		Machinery and transport equipment (7)	66.8	27.6
		Other (0, 1, 8, 9)	<u>13.3</u>	<u>28.4</u>
		Total	100.0	100.0

### THE CURRENCY

Monetary unit: Yen		Currency unit per US\$, average of daily figures:	
		Year 2003	115.9
		December 2004	103.9

Note: An international comparison of certain basic statistics is given in an annex table.

1. Areas with over 5 000 population whose population density exceeds 4 000 persons per sq. km.



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