

TABLE OF CONTENTS

ASSESSMENT AND RECOMMENDATIONS.....	8
I. MACROECONOMIC DEVELOPMENTS AND KEY ECONOMIC CHALLENGES	18
The economic recovery remains on track.....	19
An overview of progress in implementing the reform programme	25
The stance of macroeconomic policy.....	26
Prospects in the short and medium term	28
Key challenges facing Japan	32
II. BRINGING DEFLATION TO AN END.....	38
Monetary policy in the quantitative easing framework.....	38
How can monetary policy contribute to restoring sustainable growth of nominal income?	46
Improving the health of the banking sector.....	48
Assessment.....	60
III. ACHIEVING FISCAL SUSTAINABILITY	62
Recent developments in fiscal policy: the deterioration continues	62
Is fiscal policy sustainable over the medium term?	69
Assessment.....	82
IV. PRODUCT MARKET COMPETITION AND ECONOMIC PERFORMANCE	84
Macroeconomic performance and indicators of competition.....	84
Enforcement of competition law is not strong enough.....	93
Regulatory policies at the sectoral level.....	98
Potential macroeconomic effects from regulatory reform are large.....	112
Overall assessment and scope for further action.....	115
V. FURTHER STRUCTURAL REFORMS TO ENHANCE GROWTH.....	117
The labour market	124
Regulatory reform	128
Special structural reform zones	130
Openness to international competition	131
Sustainable development in Japan.....	132
NOTES	143
BIBLIOGRAPHY	155
ANNEX I THE PHILLIPS CURVE IN JAPAN: ESTIMATING THE RELATIONSHIP BETWEEN OUTPUT AND INFLATION AT LOW INFLATION RATES	163
ANNEX II ASSESSMENT OF THE GOVERNMENT'S STRUCTURAL REFORM PROGRAMMES. 167	
Deregulation.....	168
Financial-sector reform (non-performing loans, rehabilitation, securities markets).....	168
Improving human capital and making labour market flexible	169

Competition, openness and entrepreneurship.....	170
Social security reform	170
Fiscal reform	171
Devolution of power from central to local governments.....	171
ANNEX III CHRONOLOGY OF MAIN ECONOMIC EVENTS.....	173

Boxes

Box 1. Inflation and output	33
Box 2. Policy commitment to ending deflation.....	48
Box 3. Assessment of recent public expenditure reforms	76
Box 4. Organisation and activities of trade associations in Japan.....	94
Box 5. Potentially-harmful trading practices	99
Box 6. "Family" group companies related to the government highway construction corporations	111
Box 7. Economy wide effects of sectoral reforms	113
Box 8. The integration of policies across environmental aspects of sustainable development.....	133

Tables

1.	The current account and international trade
2.	The short-term outlook
3.	Potential output growth over the medium term
4.	Composition of banks' assets
5.	The balance sheet of the Japanese banking sector
6.	Capital of the banking sector ¹
7.	Non-performing loans in the banking sector
8.	Comparison of bank profitability in Japan and the United States
9.	The FY 2002 budget
10.	The FY 2003 budget
11.	Fiscal packages since 1992
12.	Estimated impact of FY 2003 tax reform
13.	General government deficit and debt
14.	The government's Medium-term Economic and Fiscal Perspective
15.	Performance indicators: sustainable retirement income
16.	Income and consumption of retired and working households
17.	Replacement rates for different income bases and family situations
18.	Output, employment and productivity
19.	International comparison of import penetration by type of manufacturing industry
20.	FTC enforcement activity
21.	Key structural features of the retail distribution sector, 2000
22.	Assumptions and effects of pro-competitive regulatory reform in selected industries
23.	Summary of recommendations
24.	Recommendations for structural reform and assessment of progress
25.	Grants for private-sector employment remain underutilised
26.	Regulatory reform
27.	Special zones for structural reform
28.	International comparison of average tariff rates
29.	Main indicators: air pollution
30.	Imports of non-energy goods from developing countries

31. Japanese non-energy imports from developing countries
32. Structure of Japan's Official Development Assistance
33. Tariff rates in major trading areas
34. Principal rice exporters: production and income indicators
35. Welfare impact of full agricultural liberalisation by developed countries

Annexes

- A1. Co-efficients of the demand pressure indicator in standard Phillips curves
- A2. Asymmetry in the relationship between the output gap and inflation
- A3. Wald tests for asymmetry and breaks
- A4. Deregulation
- A5. Financial sector reform
- A6. Human capital and the labour market
- A7. Competition, openness and entrepreneurship
- A8. Social security reform
- A9. Fiscal reform
- A10. Devolution

Figures

1. Economic growth and deflation
2. Export growth led by Asia
3. The collapse of the asset price bubble
4. Household saving rates
5. Trends of deflation
6. Decomposition of deflation
7. Supply-side influences on inflation
8. The structural reform programme
9. The stance of monetary policy
10. Savings-investment balances by sector
11. Potential growth
12. Per capita income in Japan is falling relative to other OECD countries
13. Phillips curve has become flatter
14. Budget balance and public debt
15. Outstanding current account balances at the Bank of Japan
16. Share prices
17. The spread between corporate and public bonds
18. Interest rates on government bonds
19. Investment in foreign securities and the exchange rate
20. The monetary base and money supply have diverged
21. Profitability in the Japanese banking sector
22. Loans purchased by the Restructuring and Collection Corporation
23. Operating expenses of banks
24. Interest margin on lending
25. Government expenditure and revenue trends
26. Interest payments
27. Tax revenue and GDP growth
28. Projected social security spending

29. Public finance in the Medium-term Economic and Fiscal Perspective
30. Progress in liberalisation of service sectors in OECD countries
31. Industry level mark-ups in Japan and other OECD countries
32. International comparison of prices
33. Indicators of market openness
34. FDI positions in the OECD countries
35. Foreign direct investment restrictions
36. Regulations of professions: restrictiveness indices for OECD countries
37. Energy prices in an international perspective
38. Telecommunication charges in the OECD
39. Broadband penetration and user charges in the OECD
40. International harbour terminal handling charges
41. International airport charges
42. The evolution of the age-earnings profile
43. Labour force participation rates