



Looking at Japan's Finances

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Japan's finances are in pretty bad shape. The so-called Abenomics package of economic policies consists of “three arrows”—namely, monetary easing, increased public investment, and growth strategies. However, many economists believe that the government headed by Prime Minister Abe Shinzo should focus on the reform of state finances as its fourth arrow.

In this article, I would like to first explain how serious the state of Japan's finances is from the perspective of flow and stock.



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In terms of flow, Japan's financial deficits, including the deficits posted by the central and local governments, amount to 10.3% of its nominal GDP (according to the *OECD Economic Outlook*, published by the Organization for Economic Cooperation and Development in June 2013; all statistics cited hereinafter are taken from the same material). Japan leads major developed countries in this ratio. (The budget deficit to nominal GDP ratio averages 4.3% among all OECD members.)

Looking at stock, Japan's financial liabilities, including those reported by the central and local governments, equal 228.4% of its nominal GDP. This ratio is also the highest among major global powers. (The ratio of government financial liabilities to nominal GDP averages 111.9% among OECD members.)

These figures show that Japan's finances are in extremely bad shape at present. What is even more problematic is that Japan's finances are believed to be unsustainable, for the reasons stated below.

The first reason is that the ratio of Japan's financial liabilities to its nominal GDP is increasing. This rising trend means that its ratio of financial liabilities will continue to increase. That means that Japan's finance is bound to collapse somewhere, because this ratio can't go up infinitely.

There are two ways for the ratio of financial liabilities to nominal GDP to stop rising. The first is if Japan achieves a primary balance (a balance of public expenditures and tax revenues, or a surplus in this balance). The second way is if its nominal growth rate equals or surpasses its long-term interest rate.

However, Japan's finances are currently in a state that far from satisfies these two conditions. First of all, Japan's primary balance deficit, including the deficits registered by the central and local governments, reached 8.5% of the country's nominal GDP in 2013. (This deficit averaged 2.0%



among OECD members that year.) Secondly, the nominal interest rate in Japan has remained at the considerably low level of 1.3% for the last ten years (from 2004 to 2013). (The nominal interest rate has averaged 3.8% among euro zone countries over the same period.) However, Japan's nominal growth rate was -0.4% in the period from 2004 to 2013 (compared with an average nominal growth rate of 3.6% among OECD members over the same period). These figures definitely suggest that the ratio of Japan's financial liabilities to its nominal GDP is on a rising course.

The second reason is that Japan's current account surplus is shrinking. The ratio of Japan's current account surplus to its nominal GDP reached 4.8% in 2007. However, this ratio has been falling rapidly since 2011. The ratio will hit 1.0% in 2013, according to OECD estimates. This decline in the ratio of the current account surplus to nominal GDP is attributable to factors such as Japan's increased oil and natural gas imports to replace its nuclear power since the Great East Japan Earthquake in 2011, and its stagnant exports as a result of the slowdown in the global economy.

The question is whether or not these trends will continue. Experts have taken various views regarding this point. Some of them predict that Japan's current account balance will fall into a deficit in the near future. For example, in its Medium-Term Economic Forecast, released in December 2012, the Japan Center for Economic Research forecast that Japan's current account balance would plunge into the red in the beginning of the 2020s. Setting aside the question of whether or not the country's current account balance will fall into a deficit in the near future, most economists agree that the current account balance will slip into the red over the long term. They share this view because the savings rate in Japan is expected to fall in tandem with the progressive aging of the country's population.

In spite of the serious state of its public finances, the Japanese government has had no problem issuing government bonds. One reason for this is that the government can finance almost all government bonds with domestic savings because Japan has abundant funds. However, capital requirements in Japan are growing increasingly dependent on fund inflows from abroad, because domestic savings will inevitably fall short when the current account balance slips into the negative range. When that happens, the need to ask overseas investors to finance government bonds will increase. Examples of confidence in Japanese government bonds being shaken will arise gradually, assuming that overseas investors begin evaluating the government's credibility more rigorously.

How is the Japanese government planning to address this risk? The Abe administration has clearly stated its targets for rebuilding the state's finances, which consist of the following three. The first target is to lower the primary balance to nominal GDP ratio in fiscal 2015 to half of the level it was at in fiscal 2010. The second target is to achieve a primary surplus by fiscal 2020. The third target is to steadily reduce the ratio of financial liabilities to nominal GDP after fiscal 2020.

However, the Japanese government has revealed that it has no prospects for achieving its second target yet. To put this another way, the Cabinet Office has estimated that Japan's primary balance in fiscal 2020 will be a deficit of 2.0% based on the assumption that the country's nominal economic growth rate will reach 3% and the consumption tax will be raised to 10% in October 2014, according to the plan titled "Economic and Fiscal Projections for Medium to Long Term Analysis," which the Office published in August 2013. This means that the government can't achieve its target of realizing a primary surplus in fiscal 2020 under existing conditions.



The third target of steadily reducing the ratio of financial liabilities to nominal GDP after fiscal 2020 is believed to be even more difficult to achieve because long-term interest rates are expected to rise over this period. Consumer prices have remained unchanged or have fallen in Japan in recent years. (From 2004 to 2013 the year-on-year change in prices averaged -0.1% .) Long-term interest rates have continued to drop in Japan because the Bank of Japan has begun monetary easing on a large scale in the aforementioned environment of no inflation. To break the country out of these deflationary conditions, the Japanese government and the Bank of Japan have set the goal of meeting a 2% inflation target as quickly as possible. Long-term interest rates will rise if and when this target is achieved.

According to the Cabinet Office estimate cited above, consumer prices and long-term interest rates will go up 2.0% and 4.2% year on year, respectively, in fiscal 2020. Interest payments for government bonds increase when long-term interest rates rise. Japan's financial liabilities will keep expanding until fiscal 2020 if the country's primary balance remains in the red. As the outstanding debt swells in size, the interest payments accompanying the rise in interest rates will grow. In short, increasing interest payments will function as a major deficit factor in the period after fiscal 2020 even if the government moves Japan's primary balance back into the black through financial reform.

As I explained above, Japan's finances are in pretty bad shape. Rationalizing annual expenditures through steps such as controlling social security costs, and a further consumption tax hike, are believed to be indispensable for achieving the government's targets and ensuring the sustainability of Japan's finances. However, actively promoting these policies is politically difficult because they will cause great pain for Japanese citizens. Whether the government can persuade its citizens and implement these ruthless policies will be called into question from now on.

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Born in 1947. Graduated from the University of Tokyo and joined the Economic Planning Agency (currently the Cabinet Office), Japanese Government. Served as Director General of the Research Bureau at the Agency and Director General of the National and Regional Planning Bureau at the Ministry of Land, Infrastructure, Transport and Tourism. Has served as Professor at Hosei University since 2003.

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