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Provisional Translation

# Annual Report on Japan's Economy and Public Finance (Fiscal 2001)

## --- Without reforms, no gains ---

Summary

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Cabinet Office

Government of Japan

# Chapter 1 Preconditions to Strong Recovery of the Economy

### [Section 1 From Short Recovery to Another Recession]

- The economic recovery that started in the spring of 1999 was short and the economy turned downward again: Why?
- Characteristics of the latest recovery = foreign demand driven + dependence on IT (U.S. and Asian economies were strong / degrees of dependence on IT: exports 30%, production 60%, and machinery orders 80%)
- Recovery of capital investment was weak; Investments concentrated mainly on IT, No increase in capacity enhancing investment, Investment slow in non-manufacturing industries
- Sluggish consumption ← weak income growth, Worsening employment situation (Mismatch of employment expanded → Of the 5% unemployment rate, close to 4% is structural unemployment)
- Non-performing loans and overhang debts are a burden on the Japanese economy

### [Section 2 Deflation and Monetary Policy]

The Japanese economy now in a mild deflationary phase. It has been in a state of deflation since two years ago in terms of the CPI and since the mid-1990s in terms of the GDP deflator. First experience of such kind since World War II for Japan and other advanced countries.

- Causes of the deflation: (1) "Supply-side structural factors" such as increase in cheap imports, IT and other technological innovations, and the distribution revolution, (2) "Demand factors" caused by a lack of strength of the economy, (3) Financial factors caused by disintermediation of banking system
- Corporations are saddled with excessive debts and banks with a large amount of non-performing loans → Deflation has adverse impacts on the Japanese economy even if it is mild.
- The "Theory of good deflation" is debatable. What is occurring is not only declines of individual prices caused by an increase in imports from China and IT (changes of "relative price") but also declines of "general price levels" (deflation). Deflation has adverse impacts on the economy.
- Adverse impacts of deflation → Deflation erodes corporation's profitability by (1) increasing the debt burdens of corporations saddled with excessive debts and (2) raising real interest rates and real wages, and thus curbs corporate capital spending.
- Although monetary policy is not a cure-all to bring about a complete recovery of the economy, it is believed that the Bank of Japan is now in the stage where it should positively consider further measures to ease deflationary pressures.

**[Section 3 Economic Outlook]**

- Probable scenario = The Japanese economy will turn to recovery over the second half of fiscal 2002, but the recovery will be weak for some time to come.
- Triggers to recovery = (1) Recovery of exports, (2) Self recovery power (Completion of inventory adjustment, Recovery of capital investment), (3) the effects of the "Front-Loaded Reform Program" and other structural reform measures
- Recovery will be weak for the time being because = The potential growth rate of the economy is low at around 1% + It will take time before the growth rates anticipated by corporations and consumers turn higher.
- Downside risks = Negative impacts of the terrorist attacks (If the recovery of the U.S. economy is drastically delayed, a recovery of the Japanese economy will not come in the second half of fiscal 2002 and the economic stagnation is likely to be prolonged.)

# Chapter 2 Non-Performing Loans Problem and Japan's Economic Potential

**[Section 1 Swelling Non-Performing Loans]**

- With cases of loans becoming fresh non-performing loans continuing, the balance of non-performing loans keeps increasing. (Estimate: About 10 trillion yen of bad loans disposed of a year and about 10 trillion yen of loans becoming fresh non-performing loans → Balance of non-performing loans remains high at slightly more than 30 trillion yen)
- With the cost for disposal of non-performing loans exceeding the profits from the core banking business, it can be said that, in terms of profitability, banks are virtually in the red. The non-performing loans will continue to erode banks' profitability for some time to come.
- The actual amount of bad debt write-offs far exceeded earlier estimates.
- 54% of the non-performing loans are concentrated in three industries: real estate, construction, and wholesale and retail. Recently, non-performing loans to manufacturers have been expanding.
- Factors that gave rise to fresh non-performing loans: Against the background of the prolonged economic recession, the following three points are important; (1) Since the three industries hold huge tracts of land, they were affected by a decline in land prices, (2) In addition to the sluggish economy, business performance with other industries is spreading in the wave of industrial structural adjustment pressures, (3) Stricter assessments by financial institutions.
- Estimate of excessive debts of corporations: About 70 trillion yen (Total outstanding debts: about 400 trillion yen)

**[Section 2 Non-Performing Loans and Excessive Debts weighing down the Japanese Economy]**

- The problem of non-performing loans drags on the economy in the following ways:

(1) Disintermediation of bank-system lending caused by the erosion of banks' profitability (Coupled with sluggish demand for lending, banks' lending decreased by an annual rate of 2%. DI reading for bank willingness to lend stays at a low level despite low interest rates (the DI reading of smaller enterprises still remains negative). Banks, busy with the disposal of non-performing loans, are unable to engage in forward-looking tasks.)

(2) Economic resources, such as labor and capital, are stagnating in low productive fields. (In the 1990s, lending to the real estate industry that had been suffering from sluggish profitability increased drastically: more than double (in 1990) compared with 1985 → increased nearly three-fold (in 1998))

(3) Corporations and consumers have become cautious due to a decline in confidence in the financial

system. (At present, the proportion of people who are worried about their deposits due to potential collapses of financial institutions = exceeds 50%, and those who are cutting back on consumption = 20%)

- The problem of excessive debts reduced corporate capital investment. (It dragged the level of capital investment down 8% in the second half of the 1990s)
- Necessary measures: (1) Drastic disposal of non-performing loans and establishment of bank revenue sources, (2) Economic revitalization through structural reforms will curb the incidence of non-performing loans and support the above.

**[Section 3　Economic Reforms raises Economic Growth]**

- As a result of low growth in the last 10 years, Japan's potential growth rate has declined drastically. Japan's potential growth rate over the next two to three years is about 1%. The decline of productivity of the non-manufacturing industries is conspicuous.
- If structural reforms are completed, Japan's potential growth rate is likely to rise to about 2% or above in the medium- and long terms.
- The present GDP gap is about 3~4%. (It was 4% during the 1998 recession.)

It is necessary to brighten future prospects (raise the expected growth rate) for corporations through structural reforms. Rise in expected growth rate ⟶ Expansion of corporate capital spending and personal consumption ⟶ Rise in growth rate (Estimate: A 1% rise in expected growth rate ⟶About 0.5% rise in the actual rate of growth)

# Chapter 3 Economic Analysis on Public Finance

## [Section 1 Expanding Fiscal Deficits]

- After the collapse of the bubble economy, fiscal deficits expanded drastically. (The fiscal deficits of the national and local governments combined stood at 8.2% of GDP in fiscal 1999. Their combined long-term debts stood at 130% of GDP as of the end of fiscal 2001.) ←Decline in tax revenues due to the long-term economic slump and tax cuts + increase in fiscal spending due to frequent economic measures
- Structural budget deficit (the deficit that does not decrease even if the economy picks up) has stood at about 6% of GDP in recent years. In order to reduce the deficit, fiscal reform is necessary.
- The primary balance deficits of the national and local governments are on an increasing trend after the collapse of the bubble economy. (The deficits stood at about 5% of GDP at the end of fiscal 1999)
- If the current situation ((1) huge primary balance deficits, (2) long-term interest rates > nominal GDP growth rate) continues → the balance of public bonds will explode, leading to financial ruin.
- According to the government spending (benefit) and the tax burden cost per capita by prefecture, the inter-regional disparity expanded during the 1990s. (The benefit that the five local self-governing bodies with the highest benefit-cost ratios increased 29% while the benefit that the five local self-governing bodies with the lowest benefit-cost ratios increased only 15%.)

## [Section 2 Public Finance as seen from the Stock Data]

- The stock data of assets and liabilities of the public sector was estimated in accordance with business accounting principles (accrual accounting, current value basis).
- For the public sector as a whole, assets came to 2,274 trillion yen, liabilities to 2,422 trillion yen, and net worth to minus 148 trillion yen.
- The development of social infrastructure in the 1990s increased relatively significantly with respect to roads, airports, waste disposal, and flood control rather than for school and social education facilities.
- The values of four road-related corporations (Japan Highway Public Corp., etc.) and two airport-related corporations (Narita, Kansai) were estimated based on the capitalization method.
- The differences between assets and liabilities (asset valuations – liabilities) of the four

road-related corporations and two airport-related corporations were minus 820 billion yen and 140 billion yen, respectively.

### [Section 3 Public Finance as seen from Lifetime Benefits and Contributions]

- The Government's financial position was assessed by benefits and contributions throughout one's life.
- In the last 30 years, disparities among generations have expanded.
- In terms of generational accounting, the "elderly generation" is the net recipient of benefits and the "younger generation" is the net contributor. (Throughout a lifetime, people aged 60 or older receive 57 million yen of benefits in excess of their contribution, while people aged 40 or younger make more contributions that the benefits they receive. The difference between the people in their 20s and the people in their 60s or older is more than 70 million yen.)
- The net contribution of the "future generation" will be three times as much as that of the current 20-year-old generation.
- Simulation analyses to reduce the heavy burden on the "future generation"

→ In the case when only the future generation makes additional contribution, the necessary additional contribution would be equivalent to a consumption tax rate of 90%. In the case when additional contribution is to be made starting in 2005 not only by the future generation but also by the contemporary generation, the necessary additional contribution would be equivalent to a consumption tax rate of 23%.

→ It is necessary to have the current generations make additional contributions and benefits must be curbed.

### [Section 4 Local Public Finance Issues ]

- Local finances are facing a severe crisis due to accumulated long-term debts.
- There are various problems concerning the revenue bases of local public organizations.

(1) National Financial Subsidy that cannot meet the needs of local residents (Subsidies that are in place for more than 25 years account for 43% and those that have been in place since the pre-war or post-war restoration period account for 12%.)

(2) Increase in the total amount of the Local Allocation Tax (increase of 42% in the 1990s)

(3) Changes in functions of Local Allocation Tax and efforts to review the way the Local Allocation Tax are calculated (as a financial means to pursue particular public works)

(4) Efforts to increase local tax revenues (strengthening incentives by increasing withheld revenue rates)

(5) Shift in attitude from depending on public funds to issuing local bonds by utilizing more private

funds

- Basic ideas of local administrative and financial reforms$\longrightarrow$spending cuts both in the central and local governments, municipal mergers, reduced involvement of the national government in local governments, reorganization and rationalization of state subsidies, fundamental reforms of the Local Allocation Tax system, obtaining of satisfactory local tax revenues including the allocation of tax revenue sources between the state and local governments
- Simulation of reforms (identifying effects of spending cuts and transfer of tax revenue sources)

(1) Transfer of tax revenue sources has made major urban cities (with over 100 thousand residents) independent from the national transfers while most small municipalities (with under 100 thousand residents) and especially those in local areas have yet to be successful in improving their financial resources.

(2) Problems in the revenue bases cannot be solved only by transfer of tax revenue sources; spending cuts, municipal mergers, and efforts by local governments to increase tax revenues are required at the same time.

<u>Experts from the text</u>

# Conclusion

■ Supporting structural reform by economic analyses

The Cabinet of Prime Minister Junichiro Koizumi is actively promoting structural reform. The Council on Economic and Fiscal Policy (Chairman: Prime Minister) that was established as part of the reorganization of the central government in January 2001 plays a central role in mapping out a strategy for the structural reform. The Cabinet Office is the Secretariat of the Council on Economic and Fiscal Policy and its first report, "the Annual Report on Japan's Economy and Public Finance", is designed to give an analytical base on which to promote structural reform.

The following are the basic ideas that lie behind the analyses of the main issues taken up in the White Paper of this fiscal year: the relationship between bad loan problems and the economy, problems that beset Japan's public finance, and the weak resiliency of the Japanese economy.

■ Relationship between non-performing loans problem and the economy

Japanese banks are still beset with a large amount of non-performing loans. The positioning of cause and effect in the relationship between the problem of non-performing loans and the prolonged stagnation of the Japanese economy is subject to debate.

Some argue that non-performing loans are a major factor that is dragging down the economy and that solving this problem is the key to extricating the Japanese economy from its prolonged stagnation. On the other hand, others argue that the problem of non-performing loans will not disappear while the economy remains in the doldrums and that non-performing loans are not the cause of the disease but rather merely one of the symptoms. According to these arguments, if non-performing loans are really an impediment to the economy, interest rates should have risen due to a credit crunch and trying to solve the problem hastily amid the current loose monetary situation will have far greater adverse effects than good effects on the economy, such as increases in bankruptcies and unemployment.

The White Paper addressed the problem of non-performing loans, one of the most important and controversial problems facing the Japanese economy. The conclusion of the White Paper that is based on detailed analyses (Chapter 2) is that although there is an interactive relationship between non-performing loans and the economic slump, it is important to radically resolve the problem of non-performing loans in order to extricate the Japanese economy from the difficult current situation.

The problem of non-performing loans is seen as a burden on the Japanese economy and putting downward pressure on its growth. This is because, first of all, the role of banks as financial intermediaries is not functioning properly due to the problem of non-performing loans. With their profitability eroding and their capital depreciating due to the problem of non-performing loans, banks are not eager to take on new risks and invest in new customers or growth areas. Occupied with the backward-looking work of solving the problem of non-performing loans, banks are unable to spare enough personnel or management focus for the forward-looking work of establishing a new earnings base. Secondly, the prolonged problem of non-performing loans has preserved inefficient corporations and industries and thus lowered the productivity of Japanese industry as a whole. Thirdly, concerns about the stability of the financial system cannot be dispelled due to the problem of non-performing loans and, as a result, corporations and households have become prudent in their investment and consumption behavior, which in turn serves to block economic recovery.

Under such circumstances, the White Paper analyzes the mechanism by which the problem of non-performing loans disturbs the growth of the Japanese economy. Since financing and the economy are deeply inter-related to begin with, there are various arguments as to the relationship between the two. Since there is a close relationship, in particular, between the development of the financial sector and economic growth, there have been difficulties in identifying which is the cause of the other. These arguments are analogous to the debates regarding the relationship between the non-performing loans and the stagnation of the recent Japanese economy. Schumpeter, who is known to have emphasized the importance of innovation, stressed that development of financial intermediaries, such as banks, is important for technological and economic development, while Robinson, an influential economist, argued that the development of financing has simply followed economic development.

In fact, a study on the relationship between various financial indicators and economic growth rates by using long-term data of various countries clearly shows that they are positively correlated with each other. The question is which is the cause and which is the result. Regarding this question, substantial empirical analyses have been made during the last 10 years. They reveal that (a) sound development of the financial sector increases the rate of economic growth and (b) development of financing is effective in increasing the rate of economic growth mainly through enhancing the productivity of the economy as a whole. (See Column 2-4: "A sound development of the financial sector increases economic growth rate.")

Such research findings concerning the relationship between financing and economy suggest that, in addition to rehabilitating industries, solving various problems that beset the Japanese financial sectors, such as the bad loan problem, is important for the growth of the Japanese economy.

■ Importance of economic analyses of Japan's public finance

Japan's public finance is in a severe condition. It is obvious that public finance is one of the important sectors of an economy. The condition of public finance is a mirror that shows the condition of an economy and how it is managed has a far-reaching impact on the performance of that economy.

When we say “government’s finance,” we have to clearly define the scope of the government. In the National Accounts that cover total economic activities, including public finance, the broadest concept of government is “general government.” A general government includes (a) central government, (b) local government, and (c) social security funds (public pension, medical insurance, etc.).

Finances of national government, local governments, and social security funds are under the jurisdiction of the respective authorities (the Ministry of Finance, the Ministry of Public Management, Home Affairs, Posts and Telecommunications, the Ministry of Health, Labour and Welfare, and local governments, etc.). Since each system is complicated, it is hard for outsiders to understand the actual state of its finances. Worse still, since the finance of one sector is closely inter-related with another, we cannot understand the actual state of our country’s finance simply by examining the financial condition of each sector individually.

In national finance, we usually focus only upon the revenues and expenditures of the general account. However, since the national finance includes many special accounts, it is hard to understand the condition of national finance simply by focusing on the general account. Moreover, local finances are closely related to the national finance and, as was described in Chapter 3, their dependence on the central government has increased, especially since the 1990s. Social security funds, which are managed with premium revenues such as pension premiums, are also closely related to the national finance as seen from the fact that one-third of the annual payments of pension benefit to basic pensions (part of public pensions) are financed by tax revenues of the national government. Unless we examine the national finance and social security funds together, we cannot correctly assess the impact that the aging of the population is expected to have on the nation’s finance.

Although not classified as part of the government sector in the National Accounts, the financial condition of public corporations (special corporations) also have a major impact on the national and local finances. Some of the special corporations have received subsidies or investment from the national government. In the event of the financial ruin of such corporations, disposal of its cumulative deficits would become a heavy burden on the national finance. A recent example of this was the collapse of the Japan National Railways (special corporation), which was placed under private management. In fiscal 1998, the national government assumed obligations of 24 trillion yen from the Japan National Railways and eventually had to dispose of the cumulative debts by using tax revenues.

In order to correctly understand what is happening with regards to the country’s finances and to objectively assess the impact of economic development and the aging population on these finances or, conversely, the impact of these finances on the economy, it is extremely important to study and evaluate the national finances, local finances, social security funds and public corporations in a comprehensive manner from the viewpoint of economic analysis. Since the financial situation of the country has a far-reaching impact on the life of the people, it is also important not only for financial experts but also for people in general to have correct understanding of the current condition of the national finance and its future developments. To this end, it is important for the government to provide the results of the analyses as clearly as possible.

The analysis of the White Paper (Chapter 3) is one step toward that end.

■ Break away from the thinking: "Increase demand because demand is lacking."

The economic recovery that began in the spring of 1999, the second recovery in the 1990s, was weak and did not even last two years and the Japanese economy has entered a downward cycle again. Why is the Japanese economy's potential for recovery so weak? How long will it remain in the doldrums? Answering these questions is one of the main themes of the White Paper.

Economic performance is sometimes robust and sometimes weak. One of the typical diagnoses when the economy is in a slump is as follows: "The economy is in bad shape because overall demand is weak and because demand is lacking as compared with overall supply. When demand is lacking, the government should create additional demand by such means as public investment, as the private sector is unable to get back on its feet through its own efforts."

In fact, the Japanese government created additional demand throughout the 1990s by repeatedly implementing economic measures. However, these economic measures sometimes drew criticism as being exaggerated and triggered debate over the *mamizu* (real water) content, as they included the expansion of credit by public financial institutions simply to replace private-sector financing. But, as a matter of fact, the *mamizu*, or the proportion of additional government spending which directly contributed to economic growth came to a huge amount. Such additional spending, coupled with a decrease in tax revenues, drastically increased the fiscal deficits of the national and local governments. But, the weakness of the economy remained unchanged.

The thinking that "We had better create demand, because the economic slump is due to the lack of demand" is based on Keynesian economics. The basis on which Keynesian economics stands is that it takes time for prices (including wages) to adjust in response to a change in demand and that prices are typically sticky on the downside (downward rigidity). Therefore, once the economy falls into a shortage-of-demand phase, the shortage stays as it is for a long time and the economy remains in the doldrums due to weak adjustment of prices. If the government expands its spending and creates demand, then, according to the theory, the economy can get out of the doldrums.

Can this thinking be applied to the current state of the Japanese economy? Given the following reasons, the argument based on Keynesian economics in its simplest form is not persuasive.

First, the price rigidity (or slow adjustment speed of prices) on which Keynesian economics is based is valid only for a short period of time. The prolonged slump of the Japanese economy that spans a period as long as 10 years cannot be explained by the lack of demand stemming from price rigidity.

Second, under the current conditions of the Japanese economy, various prices have actually been declining due to the advance of deflation. As was analyzed in Chapter 1, wages have been adjusted quite flexibly in line with a decrease in bonus payments and an increase in employment of low-waged part-time workers. In view of these facts, it is difficult to say that adjustment of prices takes several years, although, admittedly, its speed is slow.

Third, as was described earlier, although the government has carried out measures to create a huge amount of demand, the Japanese economy still remains in the doldrums. On this point, some may argue that it is because the government had made public investments that were low in productivity and wasteful. However, in terms of creating demand, whether they were wasteful or not does not make any difference. Keynes himself said that even such a totally wasteful project as "digging a hole and filling it again" is useful as an economic measure.

It is true that the Japanese economy as it stands is lacking demand. The GDP gap, one of the indicators to gauge the lack of demand, is estimated to stand at 3~4%. However, despite the long period of slow growth, the GDP gap has not expanded sharply over the last 10 years. This could be attributed to the fact that Japan's supply potential has decreased. The potential growth rate, which shows the growth of the supply potential, has now declined to about 1%. The analysis in the White Paper (Chapter 2) shows the mechanism whereby the "negative legacy" of 10 years of slow growth has been dragging down the potential growth ability of the Japanese economy.

In order for the Japanese economy to extricate itself from the prolonged stagnation and get back on a growth path, it is necessary to raise the potential growth rate of the economy. Merely creating demand by expanding government spending as the government has done in the past will not solve the problem. The potential growth rate can be raised by proceeding with structural reform.

■ Key to economic recovery

In order to ensure future economic growth, it is above all necessary to resolve at an early date the problems of non-performing loans and excessive debts that have been dragging down the Japanese economy. By resolving the problem of non-performing loans, banks will be able to take forward-looking, aggressive management policies, such as the establishment of new business models, and their lending to new customers and new fields will become active. In other words, the "blood" circulation, which has failed to function properly, will be normalized. The final disposal of non-performing loans will make it possible to reallocate the resources, such as labor and capital, that have remained unused in low-profit corporations that are unable to pay off their debts, to fields of high profitability.

Restoration of banks' financial intermediary function through early resolution of the bad loan problem and easy-monetary policies to ease deflationary pressures will work together to remove the fragility in the Japanese financial system. The Bank of Japan is now at a stage where it has to positively consider further measures to ease deflationary pressures.

We cannot achieve a rebirth of the Japanese economy simply by removing the bad loan problem. We also have to increase the productivity of the Japanese economy by promoting structural reform, including deregulation, fiscal reform, reform of pension and medical insurance systems, and promotion of start-up ventures, science and technology. As to government spending, including public investment, it is particularly important to make well-organized, focused distribution of funds to fields with high social needs and to fields that are effective in increasing employment and spurring private demand, not from the standpoint of "creating demand" but from the standpoint of "increasing growth potential." Steadily implementing structural reform in a tangible way will be effective in dispelling the concerns held by corporations and households about their future and in brightening their future prospects (expected growth rate). It will also enable the Japanese economy to extricate itself from the vicious circle of "depression causing bearish mood and bearish mood causing depression."

Structural reform will enhance the growth potential of the Japanese economy as it shifts Japan's precious economic resources, such as labor, management resources, capital and land, to fields of higher productivity. The structural reform that will enhance the supply potential of the Japanese economy will also be accompanied by a sustainable expansion of private demand. This is because it increases private investment in highly profitable fields and because it brightens consumers' future prospects and thus results in a sustainable recovery of consumption. We cannot get out of this economic difficulty simply by creating demand through public investment. The key to the recovery of the Japanese economy is structural reform that will increase a growth potential that has declined during 10 years of economic stagnation and that will spur a sustainable expansion of private demand.