

Chapter 3 Public Finance in the Era of Globalization and Shrinking Population

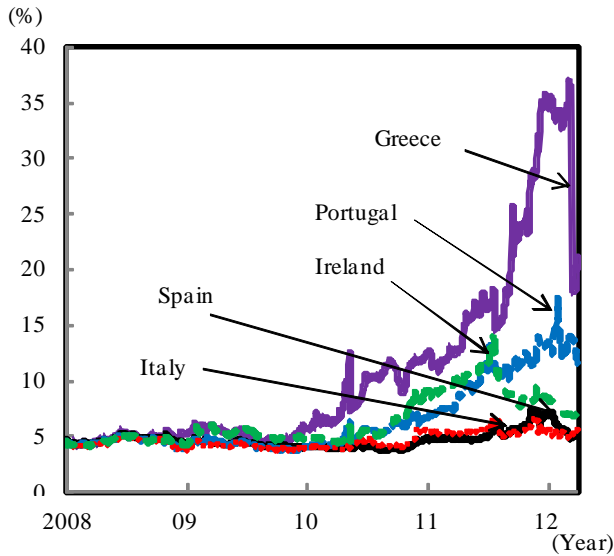
Section 1 Globalization and Fiscal Risks

- While the yields on government bonds issued by the GIIPS rose due to the European sovereign debt problem, the yields on government bonds issued by such countries as the United States and Germany declined as they attracted demand as safe assets. The yield on German government bonds has stayed lower than the euro OIS rate.

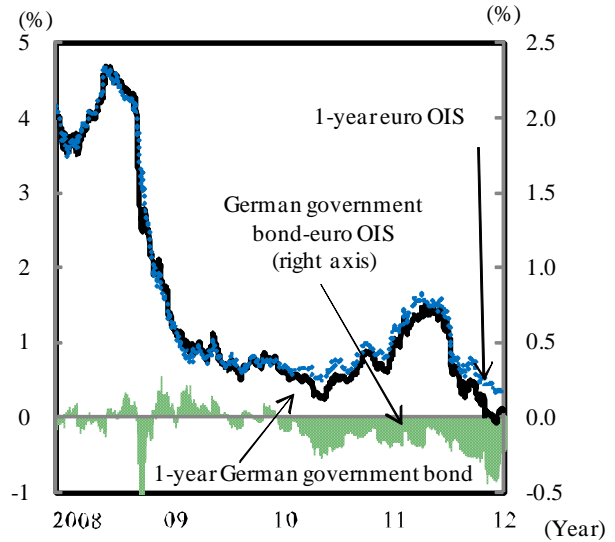
Figure 3-1-1 Changes in long-term interest rates in major countries

While the yields on government bonds issued by the GIIPS rose, the yields on government bonds issued by such countries as the United States and Germany declined.

(1) Changes in long-term interest rates in major countries (yields on 10-year government bonds)



(3) Yield on German government bonds, and the euro OIS



- Although there were concerns about the spread of fiscal risks to Japan, whose fiscal condition is deteriorating, the yield on Japanese government bonds has stayed low.
- However, the sovereign CDS spread for Japan expanded due to concerns over the deterioration of the fiscal condition.

Figure 3-1-1 Changes in long-term interest rates in major countries

(1) Changes in long-term interest rates in major countries (yields on 10-year government bonds)

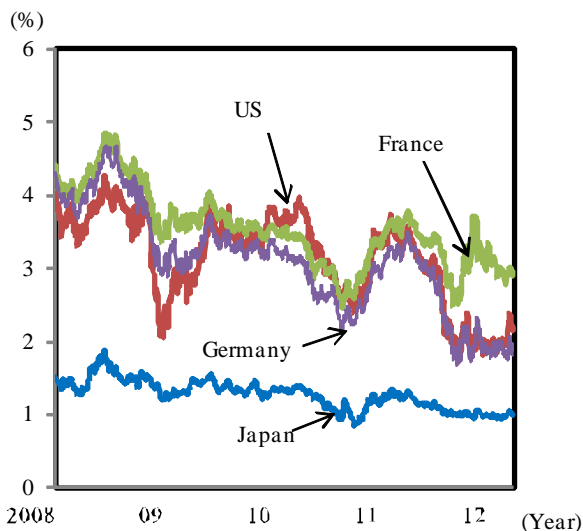
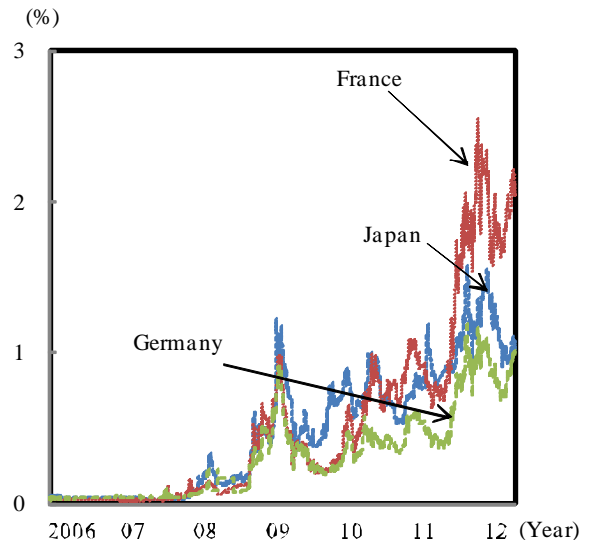


Figure 3-1-2 Changes in the sovereign CDS spread

The sovereign CDS spreads expanded after the Lehman Shock.

(2) CDS spreads for major countries



(Note) The sovereign CDS spread (premium) refers to the premium rate for the guarantee of the principal in the case of a credit event (premium/principal).

- Japanese government bonds have been smoothly absorbed by the market because of the abundance of domestic private savings as well as an expansion of the holdings of government bonds by financial institutions, central banks, etc.
- Banks, etc. are more strongly motivated than before to hold government bonds, due to (1) sluggish fund demand from companies, (2) enhancement of credit risk management, (3) prudence regulations applied to financial institutions (BIS regulation, etc.).

Figure 3-1-11 Government bond holding structure in major countries

Holdings by financial institutions, including banks, etc., and central banks increased.

(1) Japan

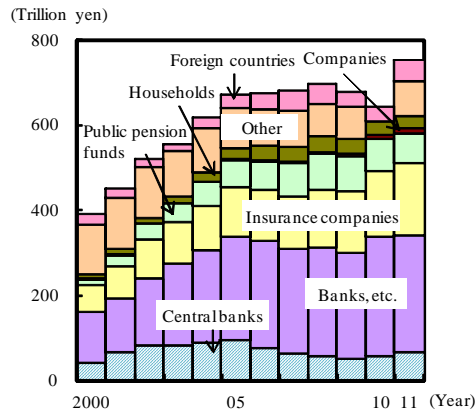
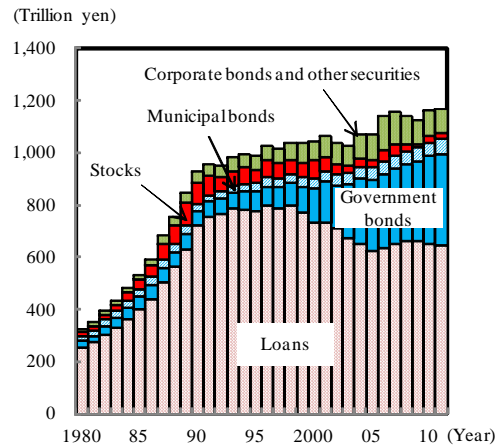


Figure 3-1-12 Asset mix of banks, etc.

The value of government bonds held by banks, etc. has been increasing.

(1) Japan



- Since the Asian currency crisis, emerging countries' demand for safe assets (investment of foreign currency reserves) has increased steeply.
- On the other hand, foreign investors' demand for Japanese government bonds has remained weak. As Japanese government bonds are domestically absorbed in principle, foreign investors' speculative activities have had a limited impact.

Figure 3-1-5 Increase in foreign currency reserves held by emerging countries and their investment in safe assets

Asian emerging countries are investing a large portion of their foreign currency reserves in safe assets, mainly U.S. government bonds.

(2) Countries holding U.S. government bonds

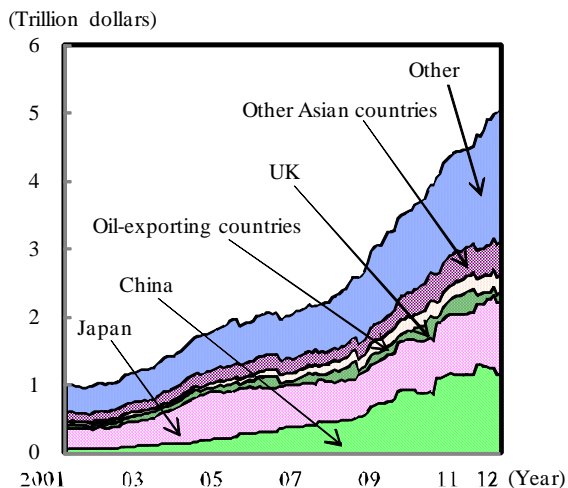
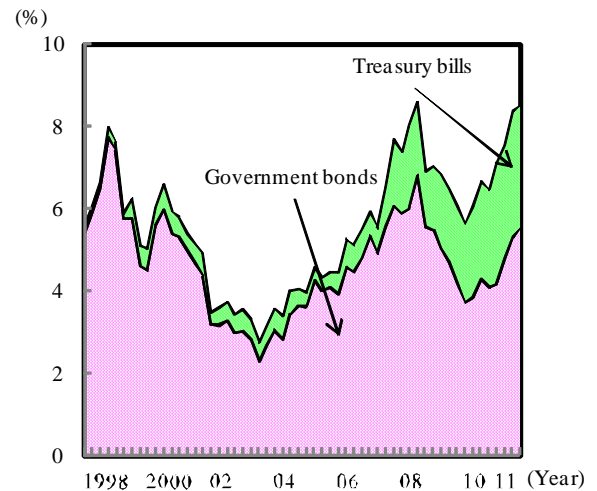


Figure 3-1-9 Foreign ownership ratio of Japanese government bonds

The foreign ownership ratio of Japanese government bonds has stayed low.



Section 2 Current Condition of Public Finance and Variation Factors

- Although the government strived to reduce the structural fiscal deficit throughout the 2000s, the deficit grew large again due to the Lehman Shock and the Great East Japan Earthquake.
- A decline in revenues and an increase in social security costs contributed to the expansion of the primary fiscal deficit.

Figure 3-2-1 Trends of national and local governments' cyclical and structural fiscal balances

Implementation of fiscal measures after the Lehman Shock and the Great East Japan Earthquake led to the deterioration of the fiscal balances.

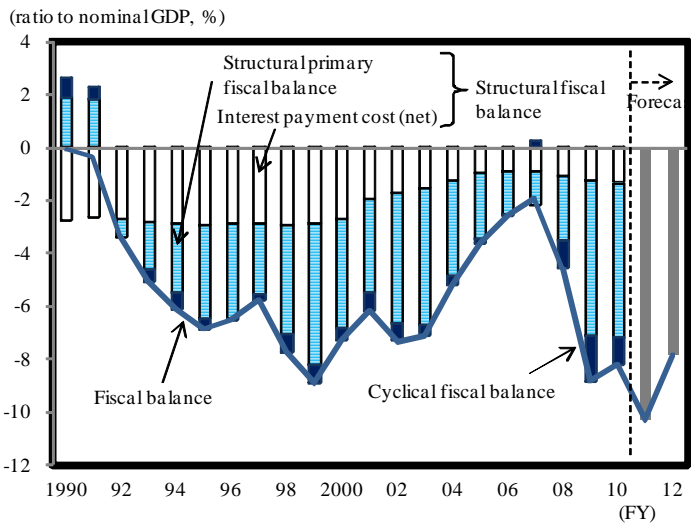
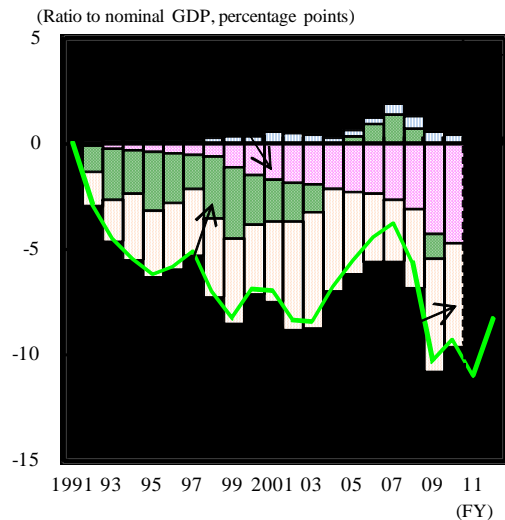


Figure 3-2-8 National and local governments' primary fiscal balances

A decline in revenues and an increase in social security costs contributed to the deterioration of the fiscal balances.

(2) Breakdown of national and local governments' primary fiscal balances by factor



- Although the level of expenditure is low by international standards, it has been rising due to such factors as an increase in social security costs.
- While the level of tax revenues is low by international standards, it has remained flat due to tax reductions adopted as an economic stimulus measure.

Figure 3-2-5 International comparison of expenditures

In recent years, expenditures have grown in various countries, mainly due to an increase in social security costs.

(1) Total expenditures (ratio to GDP)

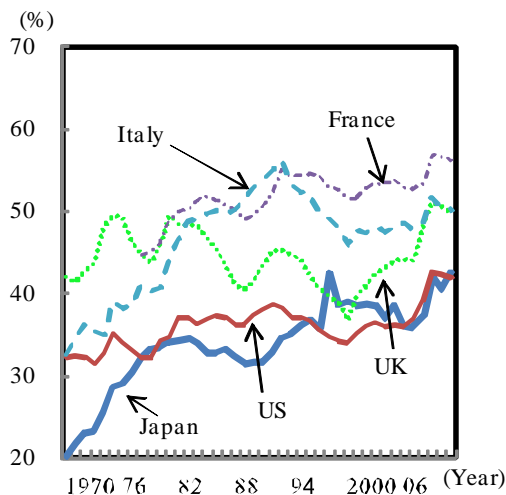
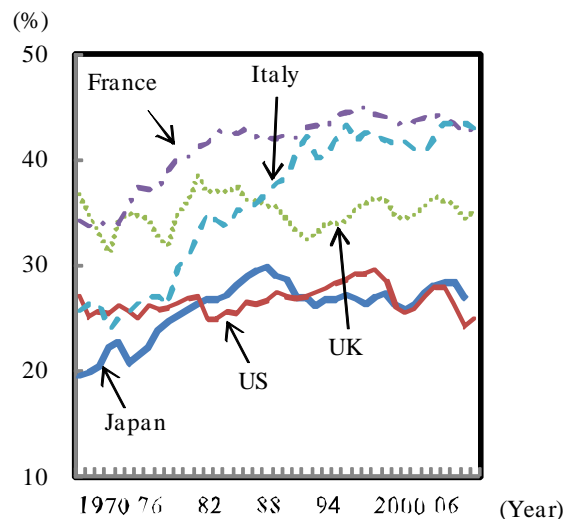


Figure 3-2-7 International comparison of revenues

The level of Japan's tax revenues is low by international standards.

(1) Total tax revenues (ratio to GDP)



- The decline in revenues is partly due to a tax revenue decreased by a discretionary tax policy.
- The interest payment cost has been curbed by the low interest rate.

Figure 3-2-11 Tax revenues, excluding the impact of tax system revisions

Since the 1990s, the margin of the tax revenue decline has grown larger due to tax system revisions.

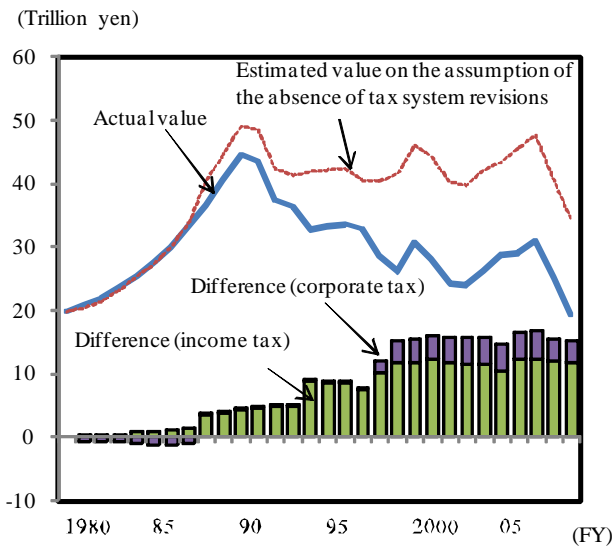
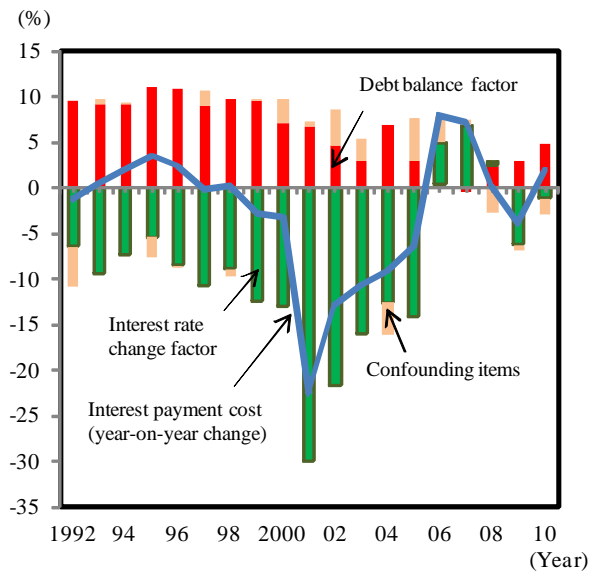


Figure 3-2-12 Balance of government debts and interest payment cost

Despite an increase in the balance of government debts, the interest payment cost has been declining due to the low interest rate.

(2) Variation factors of the interest payment cost



Section 3 Measures to Achieve Fiscal Consolidation

- Social security costs are growing due to the progress of the aging of society, putting pressure on public finance.
- The potential national burden ratio has risen while the budget deficit has stayed at a high level. It is necessary to correct the approach of passing the burden on the future generations.

Figure 3-3-1 Impact of aging of society on public finance

Social security costs are growing due to the progress of the aging of society.

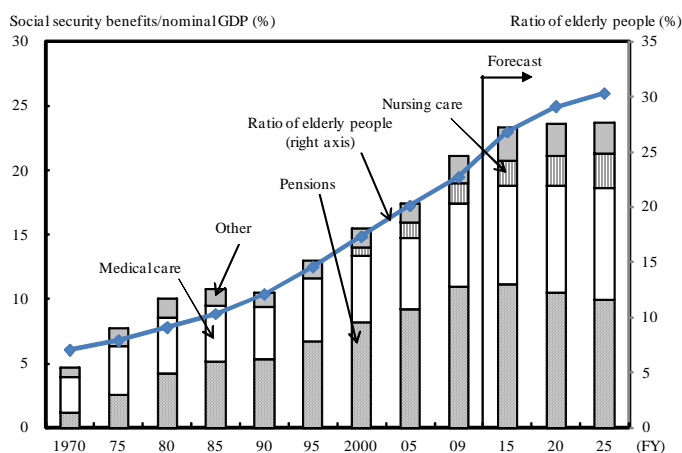
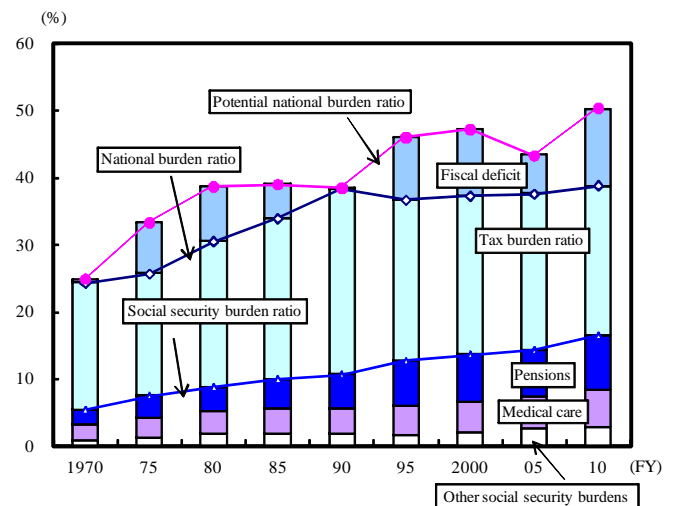


Figure 3-3-2 Changes in the national burden ratio

The potential national burden ratio has been rising.



- Regarding income distribution, amid a shift to low income, the generational gap has expanded. In addition, the number of households on welfare has been increasing.
- Amid the shrinkage of the middle class, social exclusion has emerged, mainly among low-income families. The amount of expenditure on foods satisfying basic human needs by single-mother households and low-income elderly households is small.

Figure 3-3-4 Income distribution and Gini's co-efficient by age group

The income distribution has shifted downward.

(1) Income distribution

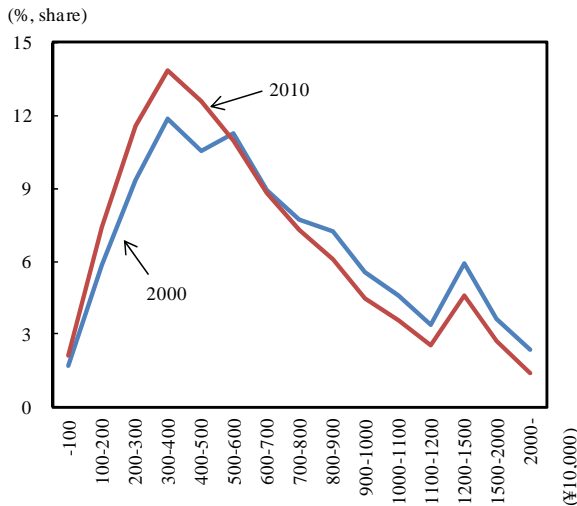
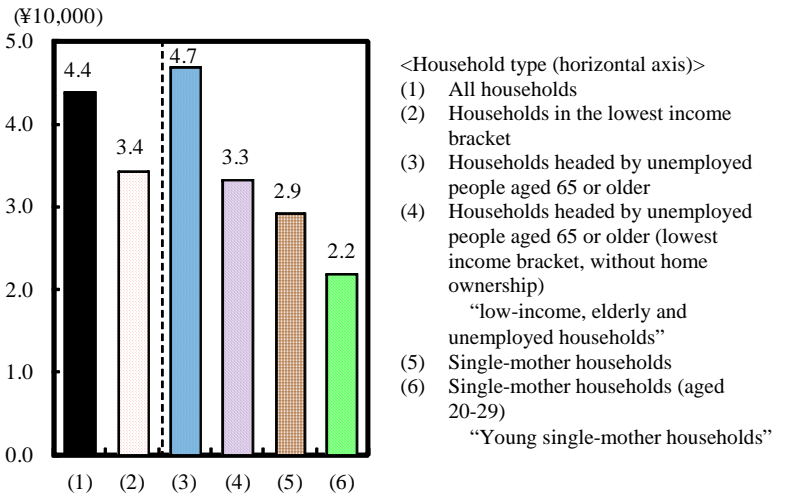


Figure 3-3-6 Characteristics by household type

Status of social exclusion as indicated by the Family Income and Expenditure Survey

(2) Food expenditure amount



- The effect of the income redistribution function based on social security systems has been growing year after year.
- However, there is a generational gap as pensions' income replacement ratio for elderly generations is higher than the ratio for the current and future working generations.
- Amid the progress of aging of society, it is essential to take further measures to strengthen the income redistribution function and correct the generational gap.

Figure 3-3-7 Income redistribution function based on tax and social security systems

The redistribution effect based on social security systems has been growing year after year.

(1) Changes in Gini's co-efficient before and after income redistribution

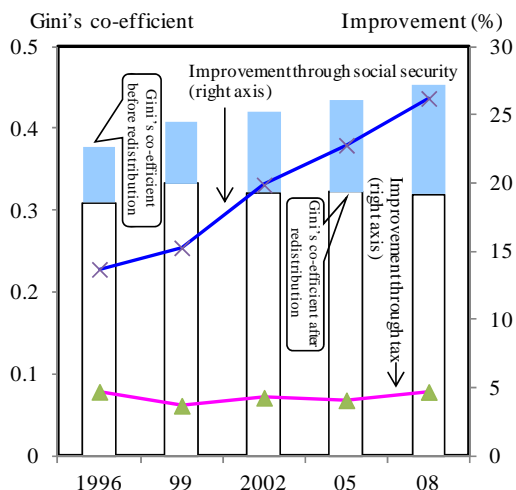
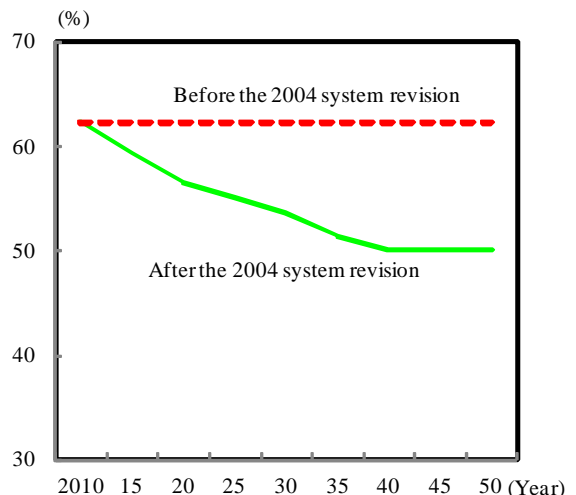


Figure 3-3-9 Employee pensions' income replacement ratio

Although the generational gap has been corrected by system revisions, the replacement ratio for elderly generations remains high.



Conclusion

○ Economic outlook and risks

>> Main scenario of the future

(1) Increase in exogenous demand

Reconstruction demand and continuation of the recovery in overseas economies

(2) Virtuous circle of income and expenditure

Recovery in corporate earnings and increases in wages and jobs

(3) Early overcoming of deflation

Policy measures to make use of physical, human, and financial resources

>> Future risks

(1) Risk of demand being depressed

Uncertainty over the European sovereign debt crisis; growing signs of global economic slowdown; volatile movements in financial and capital markets; and the future trend of automobile sales.

(2) Risk of the creation of a virtuous circle of income and expenditure being impeded

Slumps in production and corporate earnings, and decreases in wages and jobs, due to cost reduction by companies

(3) Risk of supply being depressed

Constraints on power supply in summer

○ Post-earthquake reconstruction is moving to a new stage

>> Selection and focus in the reconstruction of coastal areas

>> From the viewpoints of the three disaster-stricken prefectures as well as the whole of the Tohoku region

(1) Building up agglomerations of industries and companies

(2) Accumulation of high-quality human resources

○ Quality-oriented growth

>> Quantitative growth is a prerequisite.

>> Inclusive growth (all people enjoy the benefits of growth)

○ Enhancing the economy's crisis-resilience

>> Ensuring the sustainability of public finance and social security

>> Establishing an efficient and flexible economic structure

(1) Increased economic agglomerations and accumulation of high-quality human resources

(2) Innovations

(3) Countermeasures to deal with risks