The Fiscal 2003 Budget Proposal

By Tani Sadafumi

At the end of 2002, the Japanese government formulated a budget proposal for fiscal 2003 (from April 2003 to March 2004). The total amount in the budget for the general account was ¥81.79 trillion, an increase of 0.7% over the initial budget for fiscal 2002. This was the first time in three years that a budget proposal had called for an increase. The proposal neither presented an economic stimulus package, nor did it call for belt-tightening. According to the classical approach, all that is necessary to stop deflation is to create demand. The current condition of public finances, however, does not permit this option. Stating that "measures against deflation are necessary and that rebuilding public finances is also important," the budget proposal highlights the extent of the problems that financial authorities have.

Budget proposals are based on the government's economic outlook. The government forecast that in fiscal 2003, gross domestic product (GDP) would rise 0.6% in real terms (in comparison to a fiscal 2002 projection of 0.9%) and fall 0.2% in nominal terms (in comparison to a fiscal 2002 projection of a 0.6% decline). Export growth will flatten considerably from 4.8% in fiscal 2002 to 1.3% in fiscal 2003. Also, domestic production during the same period will slide from a 3.1% increase to a 2.0% increase. While the decline in the consumer price index is predicted to shrink from 0.8% in fiscal 2002 to 0.4% in fiscal 2003, the unemployment rate will worsen somewhat at 5.6%. This is the picture of the Japanese economy that the government has drawn.

One might say this is a prudent forecast according to the reality. The average forecast for the real GDP growth rate by 10 leading private sector think tanks is, however, 0.3%, even lower than the government's forecast. Exports helped to drive the economy in the first half of fiscal 2002. The expected scenario is that this energy will have an impact on production, consumption, employment, income and capital investment, and will usher in a full-scale recovery led by domestic demand. A look at recent economic indicators shows that Japan has shifted from an export-oriented economy to a domestic-oriented one.

However, the problem is its content. It is clear that restocking inventory has boosted Japan's economic growth. According to the Research and Statistics Department of the Bank of Japan, IT-related inventory is subject to more volatility because there is a lack of experience in this sector compared with other more conventional products. After the IT-bubble collapsed in the United States, manufacturers have cut back on production to a greater extent than was necessary. As a result, their inventory reductions have been excessive. Observers think this contributed to a recovery in production to restore the inventory shortfall.

While these inventory-related factors prevail, the primary engine of the economy must be ignited. Otherwise, this recovery could be short-lived. But consumption lacks dynamism, and it is apparent that exports have run out of steam. With the uncertainty over the future direction of the economy, companies will hesitate to make the capital investments that will be needed to boost production. Compared to those of the past, the government's economic outlook presents substantially honest figures, but it still has the air of targets for which Japan should strive.

The most salient aspect of the budget proposal is the amount of Japanese government bonds (JGBs) in general account revenue. At ¥36.445 trillion, the dependency rate on JGB issuance is 44.6%, a 7.7 percentage point rise from the initial budget of fiscal 2002. It is also the highest level in history, exceeding the figure of 42.1% for fiscal 1999. After bottoming out at 9.5% in fiscal 1991, the end of the bubble economy period, the extent of the reliance on JGBs has consistently moved upward. It reached 22.4% in fiscal 1994, when deficit-covering JGBs were again issued, and then 34% in fiscal 1998.

The reason why the reliance on JGBs will reach record levels in fiscal 2003 is that tax revenue will be limited to ¥41.79 trillion, ¥5.03 trillion (10.7%) below the previous year's level. This level is no more than two-thirds of the peak of ¥60.1 trillion marked in fiscal 1990. In addition to the growing concern over the direction of Japan's economy, the ¥1.54 trillion in front-loaded tax reductions at the national level, which were created as an anti-deflationary measure, will result in the collection of lower tax revenues.

If we view the budget proposal as a household account, annual income (taxable and non-tax revenue), including income from part-time work, would total $45,300. In the expenditure component, housing loan payments (national debt payments) would total $16,800. Remittances to parents who live in provincial areas (tax allocation for local governments) would require $17,400. Ordinarily, the household would have to make do with the remaining $11,100, but there are other outlays including food costs, medical expenses, children's educational expenses and household repairs. Expenditures for daily life (general expenditures) would require $47,600. That means an additional $36,500 must be borrowed (JGB issuance) to offset the shortfall.

Common sense tells us that this kind of financial measure could not continue for a long time. It is possible because banks will lend the money. That means that banks constantly purchase the

- The general account rose 0.7% to ¥81.7891 trillion compared to the initial budget for fiscal 2002
- General expenditures rose 0.1% to ¥47.5922 trillion. Apart from expenses for social security or promoting science and technology, these expenditures will be reduced
- There will be a 10.7% decline in tax revenue to ¥41.786 trillion. Front-loaded tax reductions will amount to ¥1.544 trillion.
- The government will issue ¥36.4 trillion in JGBs, the highest amount ever. The dependency rate on JGB issuance will amount to 44.6%, also the highest ever. The balance of government debt as of the end of March 2004 will be ¥450 trillion.
- The government's general Fiscal Investment and Loan Program will decline by 12.6% to ¥23.4115 trillion.

already issued JGBs. In addition to refunding the existing debt, the total amount of JGBs leads to ¥112 trillion during fiscal 2003 including new issues of ¥36.445 trillion. The Ministry of Finance is developing various plans, such as issuing JGBs specifically to individual investors, and issuing more 20 and 30-year JGBs that are in high demand in the market. It does not mean, however, that it will soon be difficult for the market to absorb these bonds.

With the economy in the doldrums and fund demand from the private sector slack, the banks are struggling how to invest the funds they have on deposit. It is difficult to invest these funds in stocks as the stock market itself has been unstable. This has resulted in the investment in JGBs, which are seen as a risk-free asset. Many bank managers feel that they have overbought JGBs within their total portfolios, but they continue to buy JGBs as long-term interest rates decline (and the price of the bonds rises).

The balance of JGBs has risen explosively through this perilous equilibrium. Calculations based on the fiscal 2003 budget proposal project show that the JGB balance as of the end of March 2004 will be ¥450 trillion, or ¥3.53 million per citizen. This amount corresponds to 11 years' worth of tax revenue in the general account. Considering that the JGB balance as of the end of March 1994 was no more than ¥192.5 trillion, it is apparent that there has been abnormal growth. Incidentally, the aggregate debt of all the developing countries in the world was ¥264 trillion as of the end of 2001.

The long-term debt balance for the national and local governments as of the end of March 2004 in the budget proposal for fiscal 2003 is ¥685 trillion, or 137.3% of GDP. This will be an improvement from the ¥705 trillion (141.2% of GDP) as of the end of March 2003. But this is because loans for the postal services and saving business will be separated from the government's debt balance after the establishment of the Postal Services Corp. in April 2003. The Organization for Economic Cooperation and Development (OECD) statistics will provide a more accurate international comparison.

According to OECD figures, the public debt balance against GDP at the end of 2003 among the seven industrialized countries is 62.0% for the United States and 63.7% for Germany, with an exceptionally high 151% for Japan. This same ratio was 123.8% for Italy at the end of 1994, but it later fell to 108.1% due to their fiscal restructuring efforts. At the end of 1994, Japan had a low level of 73.9% compared to Italy, Canada (97.2%) and the United States (75%). This shows that the deterioration of Japanese public finances has accelerated.

The government has not abandoned its objective of returning to the black at the beginning of 2010 in the primary balance for public finance, excluding the issuance of JGBs (income) and JGB redemption and interest payments (expenditures). This objective is, however, completely unrealistic. Nevertheless, if the government neglects the deteriorating state of public finances, it will be difficult for the government to sell the JGBs. Prime Minister Koizumi Jun-ichiro cannot very well lower the banner of financial reconstruction.

Ironically enough, the acceleration of the disposal of non-performing loans (NPLs), which the Koizumi administration is demanding, will cause a worsening of deflation, albeit temporarily. Calculations by the Cabinet Office indicate that if large banks write off ¥10.1 trillion in NPLs from their balance sheets for those debtors in danger of bankruptcy and those in worse financial condition, 420,000 people will be thrown out of work. Of this total, the number of new unemployed that could not find jobs would be 143,000.

The fiscal 2003 budget proposal projects double-digit growth for social welfare expenses, particularly funds for life security and unemployment measures. A large amount also has been allocated for promoting science and technology to ensure a more vital economy. Meanwhile, expenditures for public works, official development assistance, defense and energy measures will receive less money.

Fundamentally, it is better to embark on a drastic program of structural reform, and eliminate its negative impact with temporary fiscal measures. The fiscal 2003 budget proposal reflects the harsh conditions the Japanese economy is now experiencing, as well as the government's lack of confidence. JJTI

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