"Japan's 21st Century Vision" Reflects the Country's Deadlock

By Izumi Masaki

IN April 2005, the Japanese government's Council on Economic and Fiscal Policy (chaired by Prime Minister Koizumi Junichiro) drafted "Japan's 21st Century Vision," a report that sets out an image of what Japan will look like in the year 2030. In order to ensure stable economic growth despite a rapidly declining birthrate and the progressively aging population, the report proposes to enhance productivity and create a highly efficient government by promoting structural reform. It seeks to provide a blueprint for an affluent society in which people are able to live healthy, independent lives until the age of 80 – up from the current average of 75 – and with the Japanese economy posting sustained real GDP growth rate of around 1.5%.

Designing this vision was part of the Basic Policies for the Macroeconomic Management and Structural Reform of the Japanese Economy formulated in June 2004 at the request of Minister of State for Economic and Fiscal Policy Takenaka Heizo. The Council on Economic and Fiscal Policy established a special board of inquiry, whose combined thoughts from numerous sessions are reflected in the report. The document constitutes an expert panel report but has not been approved in a Cabinet meeting.

The report begins by taking up the issue of the significant effects that the declining birthrate and an aging population are having on Japan's economy and society. By 2030, Japan's population will be 10 million less than now, with nearly one out of three citizens estimated to be 65 or older, and nearly one out of five will be 75 or older. Going by these estimates, many of today's socio-economic systems, which were devised on the premise of a growing population, are in need of drastic reform: from the system design targeting the optimum distribution of new added-value to maximizing the number of those who participate in supporting – instead of depending on – society.

The report says Japan is at a crossroads and the next one or two years will be critical, with examples of negative scenarios to be avoided, such as declining productive activity due to a contracting population and gradual economic atrophy combined with stagnant production; a bloated government weighing down and thus retarding economic activity, leading to an inactive, highly dependent and burdensome society; suburban ghost towns emerging as local bodies are denied independent action under a dictate of standardization; and descent to a closed "had-been" economic power that has missed out on growth opportunities because of a delay in establishing international economic alliances.

Some of the desirable images offered are of Japan as an attractive nation, rich in personality and serving in a role to bridge divides in the world, while being able to increase its influence in the international community based on its imagination and inventiveness; a nation where people live 80-year life spans, enjoying health and surrounded by an environment that allows willing and able senior citizens to work and participate in society; a nation where government's role is small, with corporations and non-profit organizations taking active roles.

Additionally, the report includes numerous quantitative goals such as: (1) a sustained real GDP growth rate of around 1.5%; (2) per-capita real GDP growth of around 2%; (3) an increase in the weighting of non-manufacturing in GDP from approximately 76% (2000) to around 80%; (4) an approximate 6.7% growth rate in the content market such as animation, with a 5% weighting in GDP; (5) a potential increase to 40 million in the number of annual foreign tourists to Japan compared with 6 million in 2004.

The report emphasizes that economic atrophy accompanying the falling birthrates and an aging population can be avoided if the Koizumi cabinet's structural reform such as postal privatization and pension reform is continued, along with increasing economic efficiency. Prime Minister Koizumi, whose term as president of the Liberal Democratic Party (LDP) ends in September 2006, said he would like to see the report used as a reform "bible" for policy announcements by politicians aspiring to power in the post-Koizumi era.

However, as even the report itself notes, economic stagnation and contraction will directly result from neglecting to boost productivity and reform the public sector, and bold administrative reform and opening of markets will be necessary in order to increase economic efficiency. At present, it is natural that experts who have read the report criticize it for having laudable objectives but a less-than-impressive description of the road for achieving future goals, and the vision proposed by the report would quickly become pie in the sky if reform were to stagnate.

A case in point is what the report says about fiscal rehabilitation. It opens with a call to prevent the shifting of the fiscal deficit burden to future generations, declaring that, with the declining savings rate, shortfalls in government funding cannot continue. It goes on to note that improvement of fiscal deficits is the basis for minimizing impediments to capital accumulation in the corporate sector, and to shore up sinking economic growth rates.

The report mentions that rising long-term interest rates combined with the rising cost of interest for JGBs could potentially render fiscal rehabilitation even more of a challenge. If fiscal deficits are to continue, financial policy could erode Japan's economy and in the worst case cause its collapse. The report calls for an urgent reform to return national and local primary balances (a basic measure of fiscal revenues and expenditures) to the black by the early part of the second decade of the 21st century.

At the joint committee meeting of the Fiscal System Council (an advisory council of the Minister of Finance) held in April, however, as deliberations on the budget for FY 2006 began, there was a flood of criticism, labeling the outlook of the report excessively optimistic.

This outlook is based on a trial calculation in "Reform and Perspectives" of the cabinet, according to which the national and local primary balances can be restored to the black by FY 2012 from a ¥20 trillion deficit in FY 2005 without increasing the consumption tax or raising other taxes, if a reform course is pursued with an emphasis on expenditure curbs. If these cutbacks continue until FY 2013 and later, the report expects that it will be possible to keep the primary balance in the black based on a consumption tax rate of around 5%-plus (or a 10%-plus tax rate without expenditure cuts), and with real GDP growth of around 1.5% despite the continued aging of the population.

However, members of the Fiscal System Council have expressed doubt at the very premise of returning to a positive primary balance by FY 2012 through expenditure curbs alone. In a forthcoming opinion statement, an agreement is expressed that it is necessary to clearly identify the revenue and expenditure issues if the government's objective is to be attained. Prompted by a string of examples in which the draft bill for postal privatization was diluted by adjustments made to accommodate the opposing faction of the LDP, council members' criticism appears to reflect a concern that focusing on the bright side of the report alone may hinder reform efforts focused on a review of revenue and expenditure structures.

At the meeting of the Council on Economic and Fiscal Policy in May, Koizumi issued directives in connection with the drafting of the FY 2006 budget to further increase expenditure efficiency through concentrated allocation, and confirmed a policy of focused investment on fostering human resources and supporting areas of leading-edge technology as well as strengthening international competitiveness in order to revitalize the economy. If Japan is indeed to find itself at a crossroads within the next one or two years as the report says, there remains little time for reforming the bloated public sector, including postal privatization and a review of government-related financial institutions.

The persistent lack of strength in the economic recovery is also the result of a struggle between the bright and dark sides of the Japanese economy, represented by disparities between large corporations and small to medium-sized business or disparities between urban locations and regional areas. Increasingly, the consensus is taking hold that, in order to ameliorate the dark side and revitalize the economy, bold deregulation measures and tax reform are indispensable. The report, however, neither reflects this type of problem awareness nor indicates a clear path toward a solution.

The section on "stable macroeconomic management" also elicited a broad response. The report asserts that monetary policy is the basis of macroeconomic management, denying fiscal policy: (1) because it cannot be flexibly mobilized given the time lag until a policy decision is made; and (2) because fiscal policies should not be adopted without careful consideration due to a risk of distorting effective resource allocation. Moreover, the report opines, if fiscal rehabilitation works to dampen the business cycle at the demand level, one available option is a policy mix combining fiscal tightening with accommodating monetary policy, thus stressing the need to cover a fall-off in demand through continuing monetary relaxation. Amid a debate over an exit from quantitative easing, a policy now in its fifth year, the report calls for considering the adoption of inflation targeting, a policy which the Bank of Japan may oppose.

However, it is obvious that demand stimulus from a policy of quantitative easing can have only a limited effect in the face of structural deflation. The Ministry of Finance (MOF) envisages the complete termination of the fixed-rate reduction of income tax in FY 2006, and is drawing up a scenario for a higher consumption tax to be introduced in FY 2007, while the redemption of JGBs issued in large volumes in FY 1998 under the active fiscal policy of then-Minister of Finance Miyazawa will reach its peak in FY 2008. The MOF seeks to avoid at all cost conditions that may prompt a surge in long-term interest rates and an economic slowdown due to overlapping phases of tightening in monetary and fiscal policies. As a result, a strain may be placed on monetary policy, and the optimal form of macroeconomic management may be compromised. All things considered, "Japan's 21st Century Vision" reveals that Japan today is caught in a deepening policy deadlock. JS

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