Government debt sustainability in Japan

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Main Points

- Fiscal situation is not a crisis
- But deficit needs to be cut
- Main focus should be tax hikes, social security and tax reform
- Monetary policy can support adjustment
- Structural reforms needed to support growth
- Asian economic environment supportive

Japan fiscal situation not a crisis

- No net debt (generational transfer) burden
  - Debt almost entirely domestically held
  - Virtually all in yen terms
- Net debt much lower than gross debt, though very high
  - 128% of GDP vs. 213% (2011 OECD est.)
- Debt stability conditions not bad
  - Net interest payments only 1.6% of GDP (2011), lower than OECD average, and this may be over-estimate
- Huge net foreign asset position--52% of GDP (2010)
  - Japan would benefit from weaker yen!
- Current account surplus is key, and it may be surprisingly stable
  - Corporate savings high despite falling household savings rate
  - Income on foreign assets the main support

But Deficit Needs to be Cut

- Low nominal GDP growth makes it difficult to grow out of debt
- Ageing of society means rising long-term fiscal burdens
  - Pensions
  - Health
- High debt levels entail risk
- Should be done gradually

Main focus should be tax hikes, social security reform

- Public expenditures relatively low
  - 42.1% of GDP vs. OECD average of 43.7% (2011)
- Tax/other revenues even lower
  - 33.2% of GDP vs. OECD average of 37.0% (2011)
- "…future revenue increases look the only realistic option for most of the required fiscal adjustment in Japan." (Kirkegaard)
- Consumption tax hike is obvious candidate to raise revenues—low, with broad coverage
  - But should be raised gradually, not all at once
  - A modest proposal: raise by one percentage point per year
- Tax collection needs to be improved
  - Introduce taxpayer ID no.
- Pension/health reform needs to be tackled on both income and expenditure side

Monetary Policy Can Support Adjustment

- Monetary policy needs to remain supportive
  - Output gap widened because of earthquake/tsunami/nuclear accident
  - OECD: -5.6% in 2011
- Significant deflation persists (ex food & energy)
- But policy already at conventional limits
- BoJ can buy more government debt if needed (LOLR function)
- Really unconventional policy would be needed to make a big difference in growth

Structural Reforms Needed to Support Growth

- Japan has plenty of room for structural reforms to raise both labor inputs and productivity and growth
- Low level of inward FDI the best sign of barriers to entry
  - 0.2% of GDP (2009)
- Areas for improvement
  - Labor-force participation of women
  - Child support policy
  - Immigration policy
  - Deregulation

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Asian economic environment supportive

- GFC was a “speed bump” for Asia ex Japan
- Fiscal exit generally not problematic, debt levels generally still manageable
  - Interest rate repression helps in many countries
- Rising exchange rates should help Japanese competitiveness

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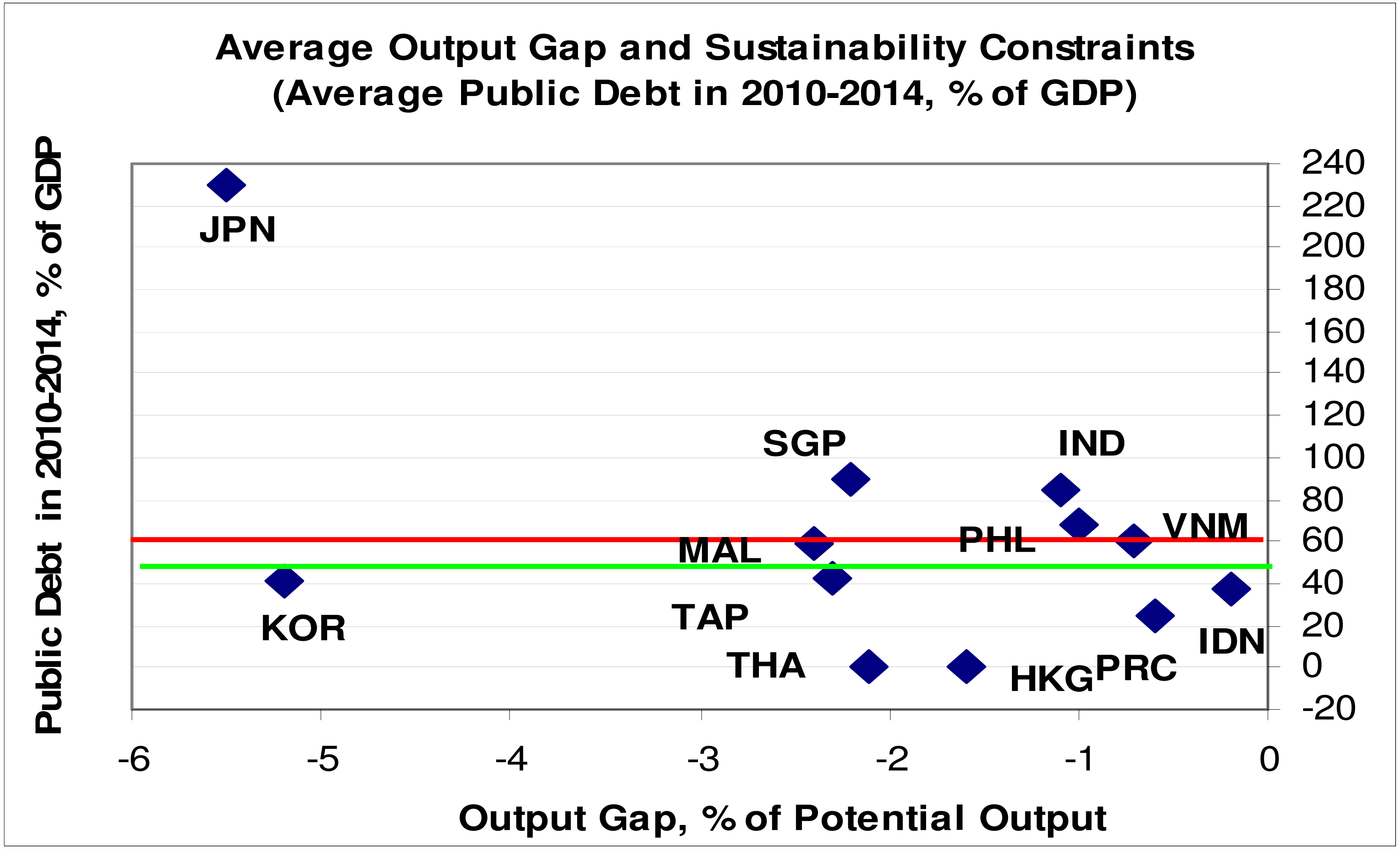
Asia ex Japan Generally in Good Fiscal Shape



Source: Horton (2010)

Conclusions

- Japan's conditions considerably different from those of S. Europe
  - Current account surplus and large net assets
  - Debt virtually all domestically held, including substantial public sector assets
  - Relatively low ratio of expenditures to GDP
  - Independent monetary policy, floating exchange rate
- But interest burden still a potential risk if market sentiment shifts

Thank you
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