Risks to be forestalled to smoothly raise consumption tax

- Diet should avert Japan's "fiscal cliff"
- Allocation of supplementary budget needs strategic thinking
- Buying foreign bonds helps to curve strong yen

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The economic situation warrants no optimism on its future course. The ruling and major opposition parties, which have finished their presidential elections, are turning attention to the Diet dissolution and a snap election rather than policies. The political stalemate could facilitate an economic downturn, possibly unraveling the scenario to restore fiscal health, including a consumption tax increase. Japan Center for Economic Research (JCER) makes urgent policy proposals to contain the immediate risk of economic recession while aiming for strategic fiscal management over the medium term. Ahead of the 2012 Annual Meetings of the International Monetary Fund and the World Bank Group to be started in Tokyo on Oct. 9, we also propose frameworks which will help arrest the yen's appreciation and stabilize the financial system.

Downward pressure on the economy increased

The economic outlook is clouded by the fading economy-boosting effect of government spending related to disaster reconstruction as well as green car subsidies and by increased factors putting downward pressure on the economy.

The first such factor is a delay in the recovery of the world economy. The JCER World Business Climate Index rated "rainy" in July for the ninth straight month. Europe has been suffering from the debt crisis while stagnation in China and other emerging economies have become evident.(Figure 1)

Figure 1  Rainy World Business Climate

(The World Business Climate Index for July, estimated by JCER)
On top of these, the stronger yen hits Japan, undermining the country's exports and production. The real exports index released by the Bank of Japan fell in August for four months in a row. Industrial production is also on the decline. (Figure 2) The inventory rates for electronic parts and the likes are as high as levels seen just after the Lehman shock.

Economic assessments at home and abroad are showing increasingly cautious views. The Japanese government downgraded in its monthly economic report for September its overall economic assessment, saying that business activity is treading water. In the past cases, the government has typically lowered its economic assessment after the economy had entered into a recessionary phase. The Organization for Economic Cooperation and Development estimated in its economic outlook published in early September that the Japanese economy would contract annualized 2.3% from the previous quarter in the July-September quarter in real terms.

The second negative factor is the "fiscal cliff," originally the conundrum that the U.S. will face when the country terminates tax cuts and begins spending cut at the start of 2013 as it plans. Japan could stand on the cliff before the U.S. As the enactment of a bill seeking to issue deficit-covering government bonds has been delayed, the Finance Ministry decided to curb the use of budget by ¥5 trillion by November. Unless the bill passes the Diet, financial resources could dry up by the end of November.

The third factor is deterioration in Japan's relations with China and South Korea over separate territorial issues. Notably in China, Japanese companies operating in the country were damaged in anti-Japan demonstrations and an increasing number of Japanese automakers' local plants are reducing production. Amid the slowdown of China's economic growth, soured diplomatic relations could deal a further blow to the Japanese economy.

In these circumstances, if the growth of the world economy turns out to be one percentage point below average forecast and the yen strengthens by another 10% on the deepening of the European debt crisis and for other reasons, the development would push down Japan's real gross domestic product for fiscal 2013 by about 1%. The Japanese government needs to strategically develop policies, looking at not just near-term economic conditions but further ahead.
Fiscal policies to be strategically designed

To begin with, there is a pressing need to stave off the economic downturn. Firstly, the government must promptly enact the deficit-covering bond bill in order to avoid the delay dampening the already weak economic situation.

Secondly, the government should quickly compile a supplementary budget to bolster the economy. It is possible to secure ¥2 trillion or so financial resources by tapping ¥1.3 trillion contingencies in the initial budget and ¥700 billion out of debt servicing funds, part of which remains unused every year. No matter who sits at the helm of government, he must not forget keeping alert to the economy. If a recessionary mood heightens, momentum could be built toward postponing the consumption tax increase planned in April 2014. The step should not be procrastinated.

Despite the largest amount of government debt among developed nations, Japan's government bond yield has been stable at a low level. This is because the market has factored in an ample room for future tax hike. If Japan betrays the market expectations, however, its bond prices could tumble, with the yield shooting up. JCER views that if the domestic absorption of government bonds diminishes in future and investors become conscious of the risk of holding the bonds, there is a danger of Japan's long-term interest rates rising to 10% (BOX).

The third point in the strategic fiscal management is to devise measures to minimize the negative impact of the higher consumption tax on the economy. One idea is to front load a corporate tax cut and to abolish automobile tonnage and acquisition taxes. Regarding the corporate tax, a cut in the effective rate has been deferred to fiscal 2015 with a view to financing reconstruction. If the tax cut is moved up by a year, companies' tax burden for fiscal 2014 would decrease by ¥700 billion. The removal of the two automobile taxes would make tax burden on car buyers lighter in fiscal 2014 than in the previous year, in spite of the consumption tax hike, thereby moderating last-minute surge and the subsequent plunge in demand.

Figure 3 Effects of advancing corporate tax cut and abolishing 2 car taxes (Real GDP boosting effect, deviation from baseline %)

There will be no one-time surge in demand for cars ahead of the consumption tax hike in fiscal 2014 and plunge in demand after the tax increase.

Estimated by JCER
In JCER's estimation, the effect of the front loading of the corporate tax cut and the abolition of the two automobile taxes (worth about ¥900 billion) would likely shore up the Japanese economy for two years from fiscal 2014. The reduction in the corporate tax, one of the so-called six-fold whammy plaguing Japanese businesses, would stem their production relocation overseas and increase the Japanese government's tax revenue in the long run. (Figure 3)

**BOX**

Growing sovereign risk may boost JGB yields to 10%, with foreign holdings seen rising to 20%-30% sometime between '18 and '28

Japan is saddled with the world’s largest public debt, but so far shows no signs of a sovereign debt crisis, with long-term interest rates remaining stable at low levels. This is because Japan's debt has long been financed mostly by the nation's abundant household assets deposited at financial institutions which use them to buy government bonds. This makes Japan very different from Greece and Spain which are also debt-ridden but not flush enough to buy up their own national debt. But if Japan's national debt is to continue to balloon, it will eventually exceed domestic investors' capacity to absorb additional debt and Japan may follow in the footsteps of the Southern European countries. The question then turns to what extent the government bond yield will go up.

We use an indicator called "domestic funds surplus" to measure the domestic market's capacity to buy government bonds. The surplus shows how much outstanding financial wealth held by the household and private sectors surpass the government debt. Based on the assumption that investors will begin demanding sovereign debt risk premium when the indicator’s reading falls below a certain level, we estimated coefficients correlated with long-term interest rates, using a methodology called threshold regression with panel data covering 25 countries.

Our studies show that when the surplus dips below 105% of GDP, the coefficients of long-term interest rates to public debt become significantly larger (meaning that debt will have a far greater impact on yields). Given Japan's sizable debt, the 10-year yields will reach 10% once investors become aware of sovereign default risk. At that time, 20% to 30% of Japan's debt will be owned by overseas investors.

The surplus is expected to fall below 105% of GDP in 2018 in a pessimistic scenario, and in 2028 in an optimistic scenario. The optimistic scenario represents the government's cautious scenario. Fiscal outlook built on the premises that Japan will achieve high nominal GDP growth rate will blunt our crisis mentality. Even if the pessimistic scenario prevails, Japan will be able to dodge fiscal crisis by raising consumption tax rate 2% every year between fiscal 2016 and 2020, because that will enable Japan's market to maintain its ability to finance national debt.

The government has decided to double the tax rate to 10% in 2015. We now need to discuss further steps we can take after that year to ward off a sovereign debt crisis.

(Senior Economist Hideaki Matsuoka and Research Trainee Syohei Terada from Mitsui Life Insurance Company, Ltd)
Instead of doing away with the two automobile taxes, an environmental tax can be raised from the viewpoint of cutting greenhouse gas emissions. Specifically, an increase in a petroleum and coal tax, which is effective until fiscal 2016, can be continued beyond that year.

Prioritize investment in future

For the allocation of a supplementary budget and a growth strategy, it is vital to prioritize investment in future such as disaster reduction and the development of renewable energies as well as to mobilize the private-sector funds and vigor. Conventional pork barreling or lavish handouts must be eschewed.

The first priority issue is to build power grids. At present, there are not sufficient enough means to transmit electricity generated by wind mills to urban areas. As power utilities which see business results declining cannot afford to enhance grids, the government should present guidelines and shoulder part of the costs. It ought to substantially expand related projects, for which ¥25 billion budget allocation request for fiscal 2013 has been submitted, and to advance the implementation of the projects.

The reinforcement of power grids will improve power interchange, helping reduce and mitigate disaster. Considering the possibility of massive Nankai Trough or Tokyo earthquakes occurring, power interchangeability between eastern and western Japan is important. With the frequencies of electricity different between the two regions currently, the government should work so that the same frequency will be used in the two areas.

The promotion of energy conservation is another key field to invest in. As experiments to encourage power saving by combining a smart grid and smart meters have been launched on a regional basis, the central government should support these attempts.

The government should also assist efforts to improve office buildings' quake resistance and energy conservation. Probably it can provide bold tax breaks for related investment by approving one-time depreciation for buildings meeting requirements, for instance. For houses, the government may as well consider creating an interest-free loan program.

The inclusion of highly quake-resistant and energy-saving "eco-friendly properties" in the portfolios of Japan's real estate investment trusts (J-REIT) would make it easier for institutional investors to invest in the instrument. If investment in kind in REITs, which is handicapped under the current tax system, is allowed, it would spur expand the REIT market. As a disaster countermeasure, a system to prompt companies to establish backup for computer systems by offering tax credit and financial assistance is also necessary.

To tap the private sector's energy, financial and institutional steps need to be taken. One of such efforts is to promote private finance initiative (PFI). Thanks to last year's law revision, latitude for private companies has broadened, with companies now given the right to manage facilities and allowed to decide the details of service and to set fees. The PFI approach has been adopted to rebuild Sendai airport damaged by the 3/11 disaster, for example. In the Strategy for Rebirth of Japan, the government aims to boost the total size of PFI projects to ¥10 trillion or more by 2020. The pace of promotion should be accelerated.

The other proposal is to introduce covered bonds, debt securities backed by confidence in
banks and their loan credits, which are one of the popular fund raising tools among banks in Europe. With loan credits against the central and regional governments and housing loans as collateral, covered bonds carry a low credit risk, helping banks to raise medium to long-term funds at low costs. Moreover, the sizes of public-private sector joint funds, which invest in projects difficult to be funded with private-sector money alone, should be expanded early on.

**New frameworks to build “Bretton Woods system III”**

One of the reasons for Japan's failure to end deflation is the strong yen. To arrest the ascent of the yen, new frameworks need to be set up in and outside Japan. One is to enhance the effectiveness of intervention into the currency market. To this end, the Bank of Japan needs to supply plenty of funds to the money markets at the same time as the government steps in the currency market. Therefore, we propose that the government and the central bank will jointly create about ¥50 trillion fund to enable the BOJ's purchase of foreign bonds.

The present situation of the international monetary system is also responsible for the yen's appreciation. As many Asian nations have pegged their currencies to the dollar, these currencies have been undervalued, which has widened these nations' current-account surplus. By purchasing the U.S. Treasuries with the dollar they acquired through market intervention, the countries have repatriated the dollar to the U.S. The framework, which can be defined as "Bretton Woods system II," pushes up the value of the yen compared with the currencies of other Asian countries while posing the risk of a collapse of the dollar to the U.S. running current-account deficit. It should be transformed into more solid "Bretton Woods system III."

The current framework with the IMF at the heart cannot adequately respond to the outflow of money from a large economy. Accordingly, in addition to existing systems to accommodate each other with money among Asian nations or Western central banks, the IMF as the last resort lender should have a funding ability to provide emergency loans. For the IMF to do this, the organization should be allowed to issue bonds denominated in special drawing rights to raise funds in the market. Sizable demand for the bonds can be expected as safe assets in emergency.

These safe nets would reduce the incentive for Asian nations excluding Japan to peg their currencies to the dollar and accumulate their foreign reserves. As a result, the yen's strength against other Asian currencies would be corrected and the global imbalance would be gradually redressed.

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