

CAN JAPAN'S DETERIORATING FINANCIAL SITUATION BE IMPROVED?

— REFLECTING ON THE DEBATE SPARKED BY THE OPINION PIECE IN THE *BUNGEI SHUNJU* BY THEN-ADMINISTRATIVE VICE FINANCE MINISTER KOJI YANO (2021) —

Kouichi Hasegawa
Global Economic & Political Studies Div.
Mitsui & Co. Global Strategic Studies Institute

SUMMARY

- In an article published in the November 2021 issue of *Bungei Shunju*, then-Administrative Vice Minister of Finance Koji Yano warned that Japan's national finances would collapse if the current financial situation continued as is, likening it to “the Titanic rushing toward an iceberg”. The opinion piece became a major topic of debate and elicited a variety of reactions from political and academic circles.
- In fact, Japan's financial situation is worsening day by day and is by far the worst in the country's history, and also when compared to other countries in the world. While the circumstances call for perseverance in pursuing reforms of income and expenditure systems to improve the situation, there is still no roadmap in sight. It is advisable to go into business with a full understanding of these conditions.

It has been a year and a half since then-Administrative Vice Minister of Finance Koji Yano contributed an opinion piece to the November 2021 issue of the monthly magazine *Bungei Shunju*, entitled, “If we go on this way, our national finances will collapse”. For Japan to break out of the long-continuing deflationary situation and achieve stable economic growth, it is necessary to implement not only monetary policy but also fiscal policy and other measures, as has become clear over the past decade. In addition, the public is growing ever more concerned about government finances, as evidenced in the discussions of the post-COVID fiscal policy and increased defense spending. In light of this situation, this report looks into the future of Japan's public finances with reference to the discussion surrounding the article penned by Koji Yano.

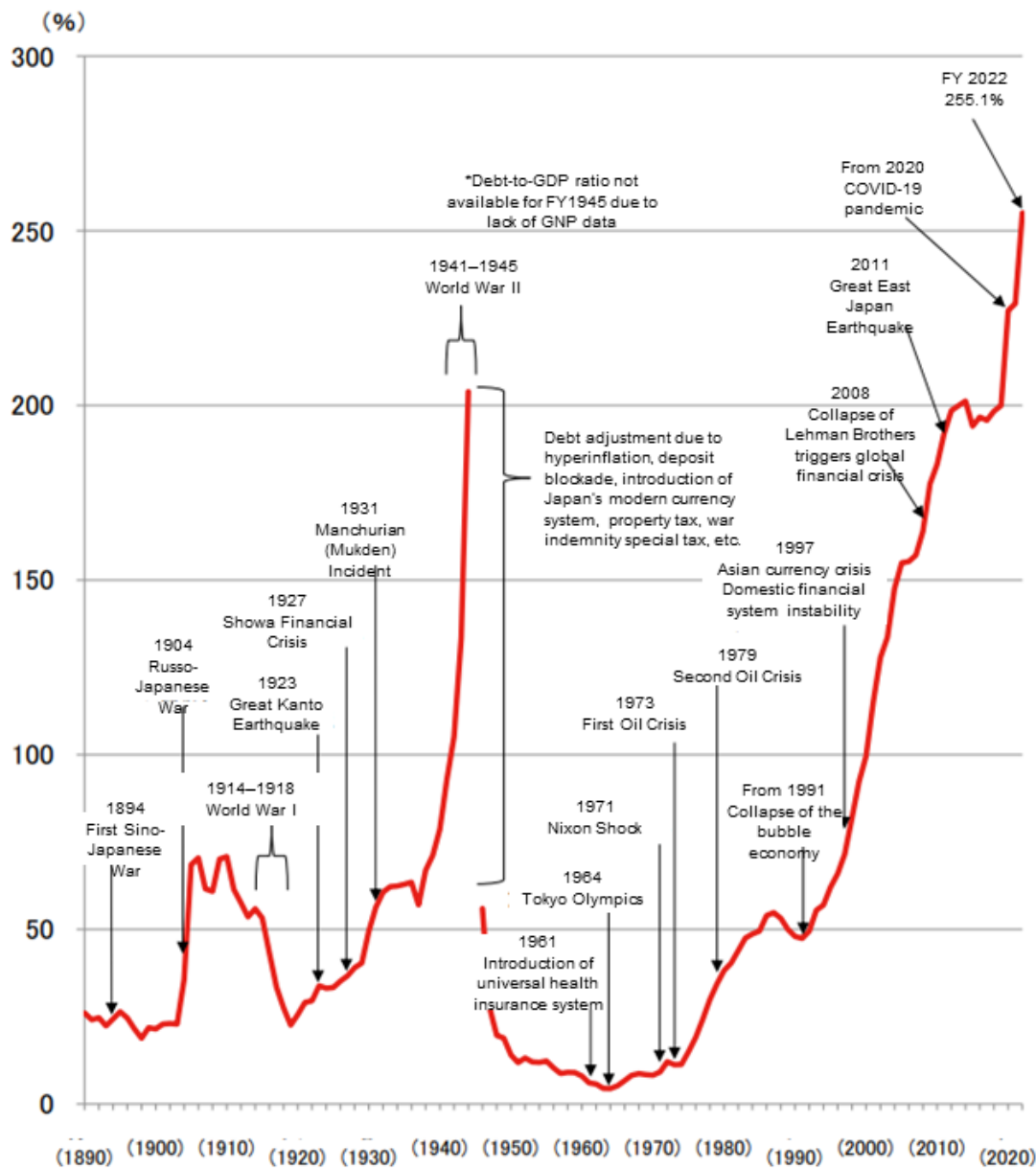
1. ESSENCE OF FORMER ADMINISTRATIVE VICE FINANCE MINISTER YANO'S OPINION PIECE IN THE *BUNGEI SHUNJU*

In his article, Yano commented, “As I listened to recent policy discussions, which resembled a lavish spending contest, ... I felt I could not remain silent any longer,” and he used a metaphor to describe Japan's current fiscal situation by likening it to the Titanic rushing toward an iceberg. “The iceberg (mountain of debt) is already huge, and yet we are continuing to sail on, making this mountain even bigger,” he said, warning that the nation's finances will collapse if the situation continues.

The salient points of the opinion piece can be summarized as follows:

- Japan's budget deficit, at 256.2% of its GDP, is the worst on record, exceeding that of the immediate post-World War II period and worse than that of any other developed country (Figures 1 and 2).

Figure 1: Japan's debt-to-GDP ratio since the pre-World War II era

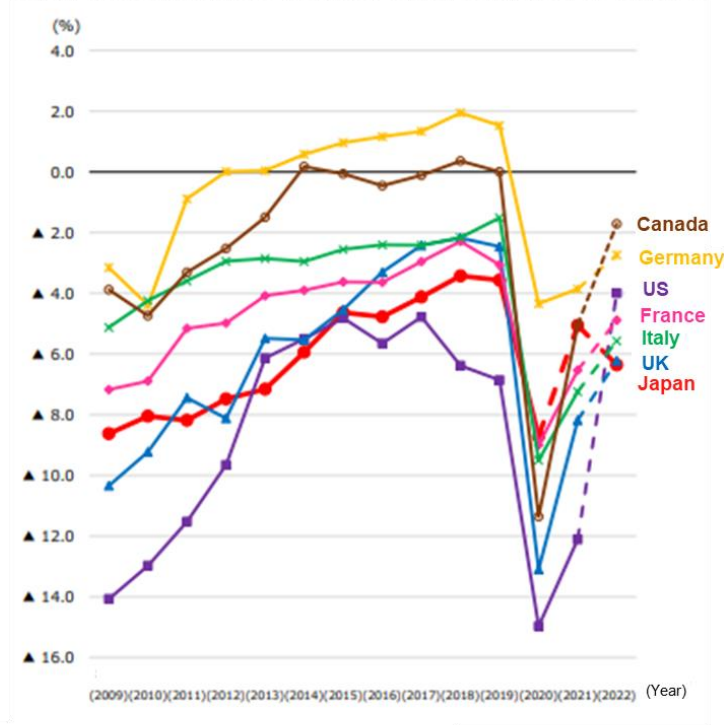


Note 1: The amount of government debt for each fiscal year is the amount of government bonds and borrowings outstanding as of each fiscal year end (March 31) based on data provided in Annual Report on Government Bonds, etc. Note that the figures for FY 2022 are based on the budget after the revision, and that the outstanding amount of fiscal loan fund bills, foreign exchange fund bills, and food financing bills among the government's short-term bills is the maximum amount of issuance (¥210 trillion in total). Note that the debt-to-GDP ratio for FY 1945 could not be calculated because GNP data are not available due to the end of World War II.

Note 2: Debt is measured against gross national expenditures provided in the so-called "Okawa-Takamatsu-Yamamoto estimates" until FY 1929, nominal GNP provided in the Historical Statistics of Japan from FY 1930 to FY 1954, and nominal GDP figures provided in the Annual Report on National Accounts from FY 1955 onward (from FY 1955 to FY 1979, based on 68 SNA; from FY 1980 to FY 1993, based on 93 SNA; from FY 1994 onward, based on 08 SNA). However, the figures for FY 2022 are based on the Cabinet Office's Estimates of Medium- and Long-Term Economic and Fiscal Performance, July 29, 2022.

Source: Ministry of Finance, *Nihon no zaisei kankei shiryō* (Data on Japan's national finances), October 2022, P59 https://www.mof.go.jp/policy/budget/fiscal_condition/related_data/202210_01.pdf

Figure 2: Japan's fiscal balance (against GDP) compared to other countries

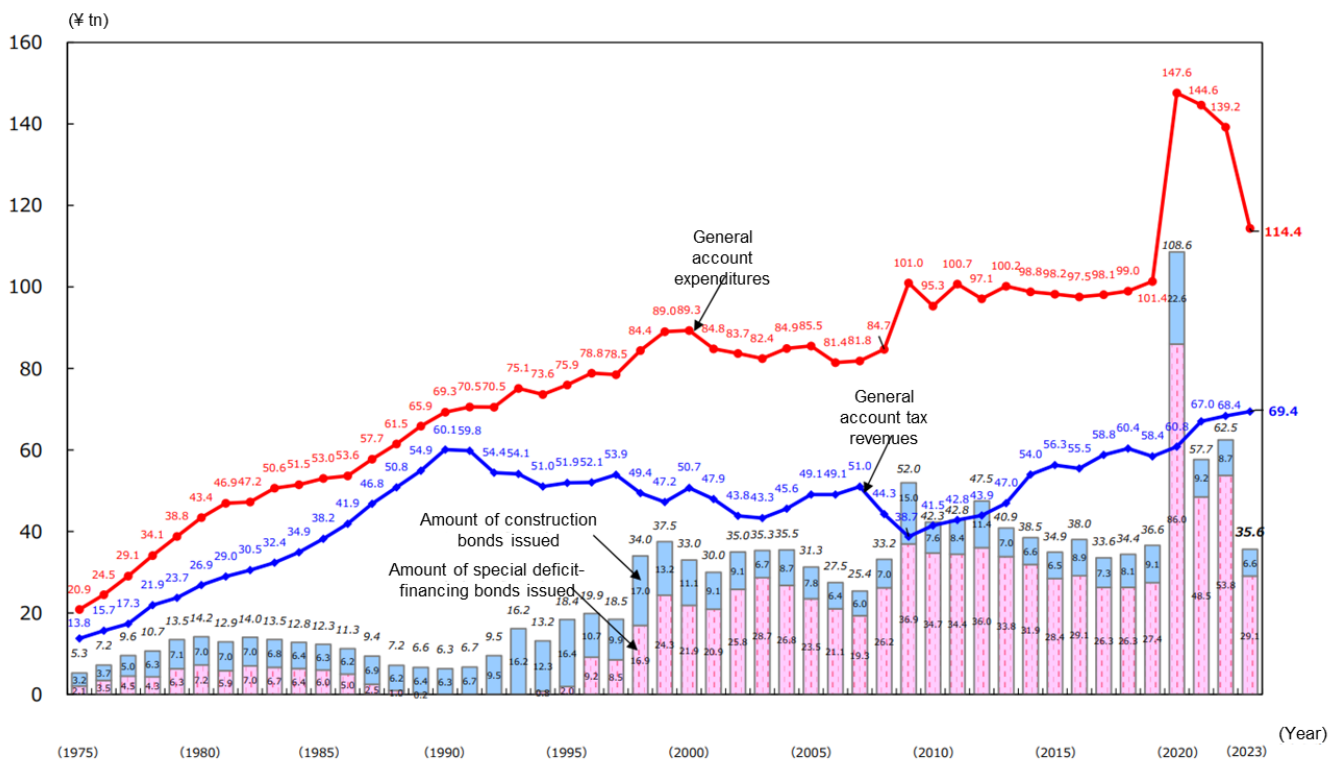


Source: OECD Economic Outlook No. 112, November 22, 2022
 Note 1: Figures are based on general government data (central government, local government, and social security funds combined). However, data for Japan excludes social welfare funds and data for the US excludes social security trust funds.
 Note 2: Figures are estimates for Japan for 2021 and 2022, and for other countries, for 2022. It should be noted that the fiscal deficit expected to be generated due to the Japanese government's proposed budget for FY 2023 is not reflected.

Source: Ministry of Finance, Budget Bureau, Japan's financial situation, (FY 2023 draft budget), P11
https://www.mof.go.jp/policy/budget/budger_workflow/budget/fy2023/seifuan2023/04.pdf

- As the country has been hit by not just two, but at least three major national disasters over the past dozen or so years — namely, the financial crisis of 2008, the Great East Japan Earthquake, and the COVID-19 pandemic — the entire nation must develop a common crisis awareness and a sound understanding of the need to “maintain a surplus during normal times and be prepared for emergencies,” and structural reforms in both spending and revenue are vital.
- Since the bubble economy era, the budget deficit has ballooned, and the two line graphs illustrating trends in income and expenditures (Figure 3), commonly referred to as the “crocodile's mouth” by those within the Ministry of Finance (MOF), continue to show an “open mouth” situation.

Figure 3: Japan’s general account tax revenues, total expenditures, and bond issuances



Note 1: Figures are based on financial statements for years up to FY 2021, the budget after the second revision for FY 2022, and the draft budget for FY 2023.
 Note 2: The amount of bonds issued excludes the one-off extraordinary bonds issued to finance the support for peace restoration activities in the Persian Gulf region in FY 1990, the special tax reduction bonds to compensate for the decrease in tax revenue due to the tax cut implemented prior to the increase in the consumption tax rate from 3% to 5% in FY 1996–1998, the reconstruction bonds to finance measures implemented for reconstruction after the Great East Japan Earthquake in FY 2011, and the special pension financing bonds to finance one-half of the national treasury's contribution to the basic pension fund in FY 2012 and FY 2013.
 Note 3: Expenditures for FY 2023 include ¥3.4 trillion to be transferred to the Defense Reinforcement Fund (tentative name), which will be used as a source of funds for expenses for the Defense Improvement Program from FY 2024 onward.

Source: Ministry of Finance, Budget Bureau, Japan's financial situation, (FY2023 draft budget), P3
https://www.mof.go.jp/policy/budget/budger_workflow/budget/fy2023/seifuuan2023/04.pdf

- Since interest rates are now virtually zero, some argue that now is the time to increase GDP through significant fiscal stimulus by issuing a bold and massive amount of government bonds. They maintain that this would increase the denominator of the “outstanding government bonds/GDP” equation and thus improve financial health, but they are mistaken. An increase in fiscal stimulus will increase GDP, but it will also expand outstanding government bonds, which are the numerator of GDP, so the financial situation will worsen without limit.
- It is not possible to know how far away the Titanic is from making impact, but it is certain that Japan is heading fast toward an iceberg. It is necessary to face up to this “inconvenient truth” and deal with it in the most sensible way, without putting off remedial action.

2. THE DEBATE SPARKED BY YANO'S ARTICLE

2-1. Reactions from the political and business worlds

The magazine article became a hot topic of discussion in political and business circles because its publication came just before the elections for the House of Representatives held on October 31, 2021. Finance Minister Shunichi Suzuki said Yano had obtained prior approval for publishing the article from his then-boss former Finance Minister Taro Aso, and that “this is not something that goes against existing government policy in its basic aspects”. In contrast, then-LDP policy chief Sanae Takaichi strongly expressed her disapproval, saying, “That's a very rude thing to say. There is nothing more absurd than to be obsessed with the primary balance and not help those who are truly in need, or not invest in the children who are our future”. Prime Minister Fumio Kishida stated, “Various discussions are fine, but once the direction we will follow is decided, I expect all related parties to cooperate with the party line.” Natsuo Yamaguchi, the representative of the Komeito Party, also

expressed his displeasure¹. Further, there was a flurry of rebuttals from the opposition parties, and members of the business community voiced their arguments for and against Yano's views.

The fact that the opinion piece was published just before the Lower House elections drew criticism from Diet members, with House of Representatives member Minoru Kiuchi stating, "It is no exaggeration to say that this is 'election interference' against the pro-expansionary fiscal policy factions of the ruling and opposition parties"². Conversely, Hiroya Masuda, former Minister of Internal Affairs and Communications and current President of Japan Post Holdings, voiced his support by noting, "A top administrative vice minister of the Ministry of Finance has contributed an article to an influential magazine at pre-election time. This is very unusual. That fact alone made it controversial ... I take a positive view of it because it has sparked a national debate"³.

2-2. Reactions from academia

(1) Arguments of reflation advocates⁴

Economist Koichi Hamada, who served as a special advisor in the second administration of late Prime Minister Shinzo Abe, said, "It is not appropriate to assess the weight of debt solely based on a comparison with annual income (economic scale) ... A Fiscal Monitor report for 2018 published by the International Monetary Fund (IMF) estimates how rich governments are, taking into account real assets ... I have a very different impression from Yano's claim that we are 'worse off than any other developed country.'" He also asserts that "a further increase in the national debt would be all well and good, even if it were to reach a debt-to-GDP ratio of 1,000%."⁵ The Ministry of Finance, on the other hand, is of the opinion that "it should be noted that much of the assets held by the government may not be suitable for sale in the market, or even if they are, their value may decline in the event of a financial crisis"⁶.

(2) Arguments of Modern Monetary Theory (MMT)⁷ proponents

Modern monetary theorists criticize Yano's views, reflecting their conviction that "A country that issues its own currency will not go bankrupt. If the government issues money as needed, the insolvency can be eliminated". Theoretically, if the government issues new government bonds and the BOJ purchases them, there should be no shortage of financing for the country. However, if the government continues to make use of public finances, there will be no end to inflation, and strong fiscal austerity and monetary tightening will be required thereafter, placing a heavy burden on people's lives. In other words, the counterargument is that even if it does not lead to an actual financial collapse, economic and fiscal measures of such great magnitude imply a de facto financial crisis, and to call it a "financial collapse" would not be an overstatement⁸.

¹ Finance Minister Shunichi Suzuki's comments were made at a post-Cabinet meeting press conference on October 12, 2021; then-LDP Policy Research Council Chair Sanae Takaichi's comments were made on NHK's "Sunday Debate" broadcast on October 10, 2021; Prime Minister Fumio Kishida's comments were made on Fuji Television Network's "Sunday News THE PRIME" broadcast on October 10, 2021; and Komeito Party Natsuo Yamaguchi's comments were made in a group interview with media companies.

² Minoru Kiuchi's public website: <https://www.m-kiuchi.com/archives/13148> (accessed May 18, 2023; same for all other online references cited in this report)

³ *Bungei Shunju*, December 2021 issue: 'Yano Paper' sparks great controversy! (2): Welcome the bureaucrats who speak out, says Japan Post President Hiroya Masuda [in Japanese] <https://bungeishunju.com/n/n51a695f9161d>

⁴ Those who seek to promote monetary and fiscal policies to achieve reflation (an economic state where deflation has been overcome but has yet to reach a state of inflation).

⁵ *Bungei Shunju*, December 2021 issue: 'Yano Paper' sparks great controversy! (1): The national debt has room to grow, says Koichi Hamada, the father of Abenomics [in Japanese] <https://bungeishunju.com/n/nc953088c9ac3>

⁶ Ministry of Finance, Data on Japan's national finances, April 2023, P16 [in Japanese] https://www.mof.go.jp/policy/budget/fiscal_condition/related_data/202304_00.pdf

⁷ Modern Monetary Theory. One of the macroeconomic theories that has gained global attention since the second half of the 2010s. The theory contends that a nation having the right to issue its own currency can freely create money to pay its debts, making it unnecessary to collect taxes to secure financial resources, and the nation will not go bankrupt due to budget deficits, and there is no problem with issuing any amount of government bonds, as long as it does not lead to inflation.

⁸ Momma Kazuo, The invisible truth of the Japanese economy, Nikkei BP, P.251 [in Japanese]

(3) Former MOF bureaucrat Yoichi Takahashi's assertions

Yoichi Takahashi, an economist and former MOF bureaucrat, echoes the sentiments of abovementioned fellow economist Hamada, by arguing that attention should be focused on assets and liabilities (BS) rather than profit and loss (PL) for each fiscal year. "Saying that Japan's finances are at risk of collapse is like saying that when there is a forecast for 0% chance of rain, we should not go out on that day because a typhoon is coming", he criticized⁹. However, there is an opposing argument to this in that caution is warranted because the market can be abruptly exposed to sudden and unexpected upheavals, as described in the case of the UK discussed later in this report.

Economist Keiichiro Kobayashi, who also serves as a member of the MOF's Fiscal System Council, expressed his support for Yano's opinion piece, saying "I agree with the main points. I share the same concerns [about the financial collapse that Yano envisions]."¹⁰

3. A DISCUSSION OF THE YANO PAPER IN LIGHT OF THE DEBATE

3-1. Financial market turmoil in the UK

On September 23, 2022, the newly installed UK administration under then-Prime Minister Liz Truss announced tax cuts including an increase in the issuance of government bonds, causing the pound sterling and British stocks to plummet and interest rates to spike on fears of fiscal slippage. On September 28, the Bank of England announced an emergency purchase of UK government bonds, and on October 3, the then Chancellor of the Exchequer, Kwasi Kwarteng, announced the government's decision to reverse its plan to abolish the top rate of income tax. However, the market turmoil did not stop. Prime Minister Truss announced her resignation on October 20, and new Prime Minister Rishi Sunak took office on October 25. This is a case study that should serve as a "lesson to be learned" for Japan, as it illustrates the reality that if government policies lose the confidence of the market, they can quickly lead to a crisis and put people's lives and assets at risk. Looking around the world, large-scale financial failures have occurred in countries such as Russia in 1998 and Argentina in 2001, so this is not a far-fetched scenario.

3-2. What measures can be taken to avoid financial collapse?

Steady reform of income and expenditures is important to improve Japan's financial situation. As for income, besides promoting economic growth and increasing tax revenues, the key is how to reform income tax, corporate tax, and consumption tax schemes. A high income tax rate discourages work and creates intergenerational inequity because the working generation with income pays income tax, while the retired generation with assets but no income is not required to bear the tax burden. As the corporate tax rate in Japan is already one of the highest in the world¹¹, it is difficult to raise the rate further. Therefore, an important option is to raise the sales consumption tax, which is still low compared to other countries, and such taxation offers few opportunities for tax evasion and tax savings and allows for fair taxation of retirees.

With regard to expenditures, there is little room for further reductions in expenditures other than social welfare spending, such as for public works and education, even though such spending has already been cut substantially in past fiscal restructuring efforts. With social welfare spending accounting for one-third of the budget, the most attention will be paid to how this spending is handled. Specifically, it will be necessary to further reform public pensions and the medical and long-term nursing care systems.

⁹ J-CAST News, "Yoichi Takahashi's Kasumigaseki watch: Why the vice finance minister's 'financial crisis' op-ed is flawed," [in Japanese] October 14, 2021 <https://www.j-cast.com/2021/10/14422477.html?p=all>

¹⁰ *Bungei Shunju*, 2022 New Year's Special Edition, "Was this the extent of the understanding? — 'Yano Paper' criticizing fiscal stimulus provokes clash between fiscal reconstruction camp and opposition camp!" [in Japanese] <https://bunshun.jp/articles/-/50684>

¹¹ The effective corporate tax rates of some of the leading industrialized countries are as follows: Japan 29.74%, Germany 29.83%, the US 27.98%, France 25.0%, and the UK 25.0%.

3-3 Conclusion

As described in this report, Japan's current financial situation, in so far as income and expenditures are concerned, is by far the worst it has ever been, compared to the past, and also when compared to other countries around the world. There is little room for bold fiscal policy to end deflation and achieve stable economic growth. While there are differences of opinion as to whether Japan's finances are in crisis and just how far away from the "iceberg" it really is (is bankruptcy imminent?), the fact is that the situation is getting worse every day. Moreover, there is no indication that it is on a path toward improvement. Economist Takatoshi Ito, who has conducted simulations on when a financial crisis could occur, states that "a financial crisis could occur in the mid-2020s if the rate of the sales consumption tax is not raised to at least 15%." It is advisable to go into business with a full understanding of these current conditions and, at the same time, to contemplate, on a personal level, about what you can leave behind for your children and grandchildren."¹²

¹² Takatoshi Ito, "Japan's Finances: The Last Choice" [in Japanese], 2015, Nihon Keizai Shimbun Publishing Co.