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No Magic Path to Fiscal Reconstruction

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- Government bond issuance now exceeds tax revenue – Low interest rates are propping up Japan's public finances
- An increase in interest rates based on expectations of economic recovery would result in a further deterioration in the fiscal balance
- Financing expenditures by issuing government currency notes or interest-free, inheritance tax-exempt government bonds and by tapping reserves and surpluses from special accounts will ultimately increase the burden on the nation's citizens

Conspicuous increases in the outstanding amount of national debt often give rise to schemes and contrivances that appear at first to be clad in the armor of science. For example, almost three centuries ago Britain exchanged its national debt for stock in the South Sea Company and France did likewise with the Mississippi Company. These companies were granted rights to conduct foreign trade, mint coins, issue paper notes, and levy taxes, and their stock prices increased rapidly based on their prospects for trade in the New World. Eventually, however, investors realized that the undertakings of these companies were fraudulent and the speculative bubbles collapsed, throwing both Britain and France into economic turmoil.

While perhaps not on the same scale as these erstwhile ventures in public deception, the government of 21st century Japan is a widespread illusion that issuing government currency notes and interest-free, inheritance tax-exempt bonds, tapping reserves and surpluses from special accounts, and exposing wasteful expenditures constitutes fiscal reconstruction. This contemporary artifice has been downplayed somewhat since the widely publicized budget screening process in 2010 failed to uncover enormous amounts of reserves, surpluses or wasteful expenditures. But it seems likely that the government will once again be tempted to dazzle the citizenry with "buried treasure" when it confronts the inevitable necessity to propose large-scale reductions in expenditure and tax increases in order to restore Japan's fiscal soundness.

Here, I would like to discuss why Japan's public finances have not collapsed despite its present historically unprecedented level of national debt and how citizens will actually suffer if the government continues to pursue the use of government-issued currency notes, interest-free,

inheritance tax-exempt government bonds, and reserves and surpluses in the attempt to pursue fiscal soundness without increasing the burden on taxpayers.

1. Japan's public finances are extremely vulnerable to interest rate increases

Japan's fiscal 2010 budget projects bond issuance of 44 trillion yen and tax revenues of 37 trillion yen. This is only the third time in Japan's history that bond issuance has outweighed tax revenues; the previous occurrences were in the abnormal circumstances of the early Meiji period and the immediate postwar period. Even more serious today is the fact that outstanding bonds are coming to maturity in quick succession and, without sufficient tax revenues to redeem them, the government must issue large sums of so-called refunding bonds—amounting to 102 trillion yen in fiscal 2010. Added to the 44 trillion yen in new financial resource bonds, this fiscal year the Japanese government must issue almost 150 trillion yen in government bonds, close to four times its expected tax revenues.

With Japan's public finances in this state, what will happen when expectations of a recovery in the Japanese economy increase? If the economy improves, tax revenues will increase, but interest rates will also rise. On one hand, if nominal economic growth increases by 1% per year, tax revenues will increase by about 0.4 trillion yen per year. On the other hand, if interest rates also rise by 1%, interest payments on the 150 trillion in newly issued bonds will increase by 1.5 trillion yen. Because the average maturity for Japanese government bonds is approximately seven years, interest payments will continue to increase cumulatively over the next seven years. In other words, the more that people are convinced that the economy will recover, the greater the deterioration in the nation's fiscal balance. The primary budget balance (which excludes interest payments from expenditure) will improve, but the overall fiscal balance will deteriorate.

In 1982, Prime Minister Zenko Suzuki declared a state of fiscal emergency in Japan. At that time, issuance of refunding bonds was low and tax revenues significantly exceeded the amount of bond issuance, so the subsequent economic expansion had a positive impact on the country's fiscal soundness. However, each year since fiscal 1998, total bond issuance including refunding bonds has exceeded tax revenues.

Japan's public finances have not collapsed despite this grave situation because of the decline in interest rates. At the end of fiscal 1998, Japan had 295 trillion yen in outstanding government bonds and interest payments amounted to 10.8 trillion yen. At the end of fiscal 2010, the 637 trillion yen of government bonds outstanding was more than double the amount in 1998, but interest payments were actually lower, at only 9.2 trillion yen.

Interest rates on Japanese government bonds have declined because investors both in Japan and throughout the world believe that the nation's deflationary state will continue and that its economy will not improve. Following the end of the Cold War, inflation expectations decreased to a greater extent in Japan than in other advanced nations, and deflation continues. In this process, the inefficient sectors of the Japanese economy were preserved and productivity growth declined significantly. In addition, with Japan's working population expected to decline in future by 0.7% per year, it is difficult to expect a strong resurgence in domestic demand.

Because the outlook for the economy is so pessimistic, interest rates on Japanese government bonds have remained low, and the nation has been able to stave off fiscal collapse. However, the effect of these low interest rates has reached its limit. Interest payments on Japan's outstanding government debt began to increase after reaching a low of 7.0 trillion yen in fiscal 2005. The large amount of government bonds outstanding makes Japan extremely vulnerable to even a minor increase in interest rates. Indeed, since the ratio of outstanding government debt to GDP and the ratio of bond issuance to tax revenue are both higher than was the case in Greece before the debt crisis there, Japan's finances must be considered highly exposed to interest rate increases.

If the long-awaited full-fledged recovery of the Japanese economy ever occurs, or if bond markets for any reason lose confidence in Japan, and the nation experiences even an incidental risk of significant inflation, interest rates on Japanese

government bonds will begin to increase, and the harmful effects of the prolonged buildup in national debt will be felt full force.

2. Government-issued currency notes will cause inflation and interest-free, inheritance tax-exempt bonds favor the wealthy and encourage unlawful transactions

Whether because of recognition that Japan's public finances are vulnerable to increases in interest rates or awareness that interest payments on government debt are set to increase, some officials have proposed issuing government currency notes or interest-free government bonds that are exempt from inheritance taxes as ways to raise funds to finance government expenditures without incurring additional interest or repayment obligations.

First, consider the proposals for issuing government currency notes (distinct from the banknotes issued by the Bank of Japan) for use along with tax revenues to finance government expenditures. Proponents reason that the printing of government currency notes to finance expenditures will make it unnecessary to increase taxes or issue more government bonds.

Japan previously issued government currency notes at the time of the Boshin War and the Satsuma Rebellion. From 1881 to 1882, the value of these paper notes declined to approximately 60% of the value of silver currency. The so-called greenback paper currency issued by the U.S. Treasury during the Civil War had suffered a similar steep decline against the price of gold in 1864. In both cases, without a central bank to control the supply of liquidity, the policy of paying for fiscal expenditures with government-issued currency notes rather than coin created a significant inflation tax to be borne by the public.

Today, for the Japanese government to raise funds to finance public expenditures by issuing currency notes, the Bank of Japan (BOJ) would need to purchase these notes and then issue banknotes of equivalent value. The BOJ would then be under pressure to offset the constriction in liquidity resulting from issuing the banknotes by loosening monetary policy. But doing so would produce inflation. Thus, in practice, government-issued currency notes are not a magic path to financing government expenditures without imposing a burden on the public.

Similarly with interest-free, inheritance tax-exempt government bonds. One reason proponents give for issuing such bonds—bonds that pay no interest in exchange for exemption from inheritance tax—is to draw out private-sector money that is not being put to work, such as money kept at home “under the mattress.” In order to judge how much money could be activated in this way, we must recognize that there are perfectly rational reasons for private-sector actors to retain non-working funds. For example, people may keep money out of circulation as a reserve against unforeseen accidents or illness or because they have some reason to hide it.

Including funds obtained unlawfully, the pool of non-working private-sector funds that could potentially be activated for government expenditures by issuing these interest-free, inheritance tax-exempt government bonds is huge. But the amount of funds that would actually be activated is probably much smaller, in particular because of the effect of the Act on Prevention of Transfer of Criminal Proceeds which was passed in March 2008. Intended to combat bank remittance fraud and other crimes by North Korean and other terrorists, this law imposes strict requirements to identify the individuals involved in financial transactions. This act has presumably significantly reduced the scale of underground money held in Japan. It would also probably discourage holders of unlawful funds from purchasing the interest-free, inheritance tax-exempt bonds, since it requires traders to identify purchasers of registered book-entry bonds. On the other hand, if these proposed bonds were physical bonds with no identification requirement, by selling them the government would be condoning money laundering and the bonds themselves would encourage unlawful transactions.

As long as the strict clampdown on underground money under the 2008 Act remains in effect, the only motivation for holding the proposed interest-free, tax-exempt bonds would be to avoid inheritance tax. A precedent for issuing inheritance tax-exempt government bonds

is found in the *rente Pinay* issued by France beginning in the 1950s. *Rente Pinay* issued in 1952 provided funds for the French Indochina War and those issued in 1958 enabled the government to protect the franc during the unrest in Algeria. However, because the purchase of these bonds was limited to the extremely wealthy, they were increasingly criticized as unfair. In addition, they resulted in reduced tax revenues because it became common to convert a person's assets into *rente Pinay* just prior to death and then for the heirs to sell the bonds as soon as they were inherited. Because of this, France terminated issuance of *rente Pinay* in 1973 and required holders of the bonds to convert them into standard government bonds.

Japan would face these same problems today if it issued similar inheritance tax-exempt bonds. Purchasers of the proposed zero-interest tax-exempt bonds will be people for whom the inheritance taxes avoided by holding them are greater than the interest income foregone (coupon rate multiplied by expected lifespan). For the nation as a whole, the reduction in inheritance tax revenues would be greater than the interest payments on normal government bonds, meaning the fiscal balance would deteriorate further. In addition, because the incentive to purchase these bonds would be greater the greater the inheritance taxes that could be avoided, they would be most attractive to the wealthy, and ordinary citizens would not be likely to consent to their issuance.

3. Tapping reserves and surpluses from special accounts will increase the issuance of FILP and refunding bonds

The fiscal 2011 budget was formulated on the basis of maintaining General Account expenditures excluding bond issues (primary balance expenditures) at no more than the fiscal 2010 level of 71 trillion yen and issuance of new financial resource bonds at no more than 44 trillion yen. Even if the government does keep to this 44 trillion yen limit, however, it will face an overall budget shortfall of 6 trillion yen. Expenditures will exceed revenues by approximately 50 trillion yen unless primary balance expenditures are actually reduced below 71 trillion yen.

While the government established 71 trillion yen as the ceiling for primary balance expenditures, it did not issue guidelines on how to reduce expenditures or increase efficiency with respect to the two largest budget categories—social security-related spending and the allocation to local governments. In fact, the government should target increased efficiency of social security expenditures as a way to limit or reduce primary balance expenditures. In addition, it should be possible to reduce the amount of national tax revenues allocated to local governments at least by the amount their own local tax revenues are expected to increase. Further reductions in tax allocations could be achieved if regional governments pursued greater efficiency in expenditures in the same way as the national government.

In addition, with interest payments on government bonds projected to decrease for fiscal 2011, the difference between revenue and expenditure *could* be kept below 50 trillion yen if tax revenues were significantly increased. Despite this possibility, the difficulty of constraining bond issuance to 44 trillion yen will surely tempt the government to depend on heretofore untapped reserves and surpluses.

In the fiscal 2010 budget, the government was able to keep bond issuance to approximately 44 trillion yen—the level following the primary supplementary budget for fiscal 2009—by tapping into large off-budget reserves and surpluses. Among these were 4.8 trillion yen from the Fiscal Investment and Loan Program (FILP) Special Account and its expected fiscal 2009 surplus as well as 2.9 trillion yen from the Foreign Exchange Fund Special Account (including the entire expected surplus for fiscal 2009 and the projected surplus for fiscal 2010).

Continuing to mine the FILP Special Account, which is a reserve against interest rate fluctuations, will almost completely deplete this surplus by the end of fiscal 2010. If this happens, not only primary balance expenditures but also FILP lending will be vulnerable to any increase in interest rates. Moreover, if the FILP Special Account goes into the red, funding for small and medium-sized enterprises and scholarships will suffer because there is no provision in fiscal law

regarding the transfer of funds from the General Account.

Unlike the FILP Special Account, the surplus in the Foreign Exchange Fund Special Account is mainly generated by differences in interest rates between Japan and the United States, and involves a complicated bit of bookkeeping. The short-term foreign government securities, mainly U.S. bonds, that the government purchases in foreign exchange operations earn interest in foreign currencies, mainly in U.S. dollars. If, in order to use this interest revenue, the government were to directly sell these dollars for yen, the forex market would perceive the operation as an attempt to strengthen the yen. Instead, the government books the yen value of the foreign currency-denominated interest revenue as an asset, issues short-term government securities in an equivalent amount, and treats the proceeds as a surplus. It is important to recognize, therefore, that an enormous amount of yen-denominated debt stands behind the Foreign Exchange Fund Special Account surplus.

Under the BOJ's zero-interest rate policy, the government could carry out this type of operation at almost no cost and it generated enormous income in the Foreign Exchange Fund Special Account. At the same time, however, yen appreciation created a capital loss in the Foreign Exchange Fund Special Account. At the end of fiscal 2009 the market value of this account was negative 26.3 trillion yen, against a book value of 20.6 trillion yen. This loss of market value is a national burden produced by attempts to control the rapidly rising yen in order to boost the economy and in particular to support Japanese companies that conduct export. It should, inherently, have been paid for by transferring tax revenues from the General Account to the Foreign Exchange Fund Special Account. Instead, the existence of an accumulated surplus on the books of the Foreign Exchange Fund Special Account appeared to justify appropriating these funds for government expenditures on the General Account.

Moreover, the accumulated funds in the Foreign Exchange Fund Special Account are deposited in the Special Account of the FILP and they become resources for issuing FILP bonds, the proceeds of which FILP uses to finance loans to students, local governments, and small and medium-sized businesses. Hence, when the government appropriates the surplus in the Foreign Exchange Fund Special Account as "buried treasure" instead of depositing it in the FILP Special Account, the FILP will have to issue more of its own bonds to offset the depletion in FILP resources.

The market treats new financial resource bonds, refunding bonds, and FILP bonds identically as government bonds. If the government issues more FILP bonds in order to avoid breaking the 44 trillion yen cap on the issuance of new financial resource bonds, the market will probably recognize this strategy as a retreat from fiscal discipline, perceiving that the government's tapping of surpluses and reserves removes the incentive to control expenditures.

In addition to attempts to tap the reserves of the Foreign Exchange Fund and the FILP surplus there have also been calls to exploit the National Debt Consolidation Fund Special Account in a similar way. At the time of settlement in fiscal 2009 this account showed a surplus of 20.7 trillion yen made up of 12.5 trillion yen in a sinking fund reserve for redeeming government bonds and 8.1 trillion yen from front-loading refunding bonds. All of these funds are earmarked for the redemption of government bonds from fiscal 2010 onwards. Thus, tapping the surplus in the National Debt Consolidation Fund Special Account to finance General Account expenditures will diminish the resources available to redeem government bonds, in the end making it necessary to issue even more refunding bonds.

In other words, this proposal simply amounts to a strategy of issuing more refunding bonds in order to hold the issuance of new financial resource bonds at 44 trillion yen. The National Debt Consolidation Fund was originally created to maintain confidence in Japanese government bonds. In the mid-1970s, when the country's fiscal position was solid, transfers from the General Account to the National Debt Consolidation Fund Special Account were suspended, but now Japan's financial situation has severely worsened. Confidence in Japanese government bonds is wavering, as the recent downgrades by rating agencies makes clear, and the importance of retaining sufficient reserves in the National Debt Consolidation Fund is

increasing.

4. Selling loans held by the Fiscal Investment and Loan Program will increase the burden on the nation's citizens

The sale of government-held financial assets has also been proposed as a source of funds for government spending. For example, it was suggested that selling the loans held by the FILP, which totaled 146 trillion yen at the end of fiscal 2009, would obviate the need to raise an equivalent amount through taxes. In fact, Prime Minister Koizumi's 2006 Basic Economic Policy proposed, and eventually initiated, the sale of FILP loans as part of a restructuring of assets and liabilities intended to reduce the government's balance sheet.

Unfortunately, however, this sale created a new burden for Japanese citizens. In carrying out the sale, the FILP loans were securitized and special bonds were issued by a special purpose vehicle. In addition to service fees, the market required these special bonds to carry a higher rate of interest than FILP bonds. This process was completely irrational—it amounted to redeeming FILP bonds by issuing high-interest special bonds. Given the excessively high costs, the scheme was suspended in August 2008 following only two asset sales.

Normally, private enterprises use securitization as a way to procure funds at lower cost by splitting off more creditworthy assets. But it is innately impossible for the government to reduce its procurement costs through securitization because it procures funds by selling government bonds, which have the highest creditworthiness and are the most liquid securities in the market. Not only must we question why the FILP loans were securitized, but we must also wonder whether in the future the government will issue more high-interest special bonds in order to limit the issuance of new financial resource bonds.

In addition to FILP loans, other financial assets held by the government that could be targeted for sale in this way include foreign currency securities (foreign currency reserves) in the Foreign Currency Special Account and pension reserves. As may be expected, against the background of the strong yen, no voices are heard urging the sale of foreign currency reserves, but there have been calls to make the government's pension reserves emulate the sovereign wealth funds of oil-producing countries and to operate them actively by buying and selling stocks.

Part of the national pension reserves is already passively operated on a stock basis. This operation recorded enormous losses amounting to 5.5 trillion yen in fiscal 2007 and 9.3 trillion yen in fiscal 2008. From fiscal 2009, the state-funded portion of pension payments was increased from one-third to one-half, and in fiscal 2009 and fiscal 2010 approximately 2.5 trillion yen was transferred to the Pension Special Account from the General Account. The public has become concerned that these transfers are being used to cover the pension reserve's operating losses. Furthermore, if public pension funds are more actively managed than is the case at present, taxpayers and pensioners will be exposed to greater risk, and confidence in the pension system may be shaken even further. It should be pointed out here that all of the U.S. public pension funds are operated using non-market government bonds.

5. Towards a budget compilation process that will win the confidence of the market

As this paper has explained, using the surpluses and reserves in the Fiscal Investment and Loan Program, the Foreign Exchange Fund, the National Debt Consolidation Fund, and other funds makes it appear possible to limit the issuance of new financial resource bonds, but at the same time it will increase the issuance of FILP bonds and refunding bonds. If the government taps these funds, fiscal discipline will be relaxed, no progress will be made toward reducing government expenditures, and ultimately the issuance of new financial resource bonds will not be reduced.

Furthermore, markets will react to a budget that relies on huge amounts of reserves and surpluses by judging all Japanese government bonds more harshly. If market confidence in Japanese government bonds wavers, rising interest payments will begin to move Japan, like Greece, towards financial collapse. We must not forget that Japan's fiscal situation is even more vulnerable to interest rate increases than Greece's was.

Instead of attempting to make funds appear by magic, Japan needs to follow a more realistic path to fiscal soundness. The budget screening process which the government undertook in April 2010 revealed, for example, that the Japan Railway Construction, Transport and Technology Agency holds approximately 2 trillion yen in pension reserves for former railway employees and 1.3 trillion yen in retained earnings. Such surplus funds should not be managed by a single ministry; rather, they should be put to work for the general benefit of all taxpayers. To achieve fiscal reconstruction, Japan needs to carefully reassess all government-related entities including the Special Accounts and independent administrative agencies, abolishing unnecessary ones and transferring surplus capital and idle reserves to the national treasury.

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