ECONOMIC SURVEY OF JAPAN 2006

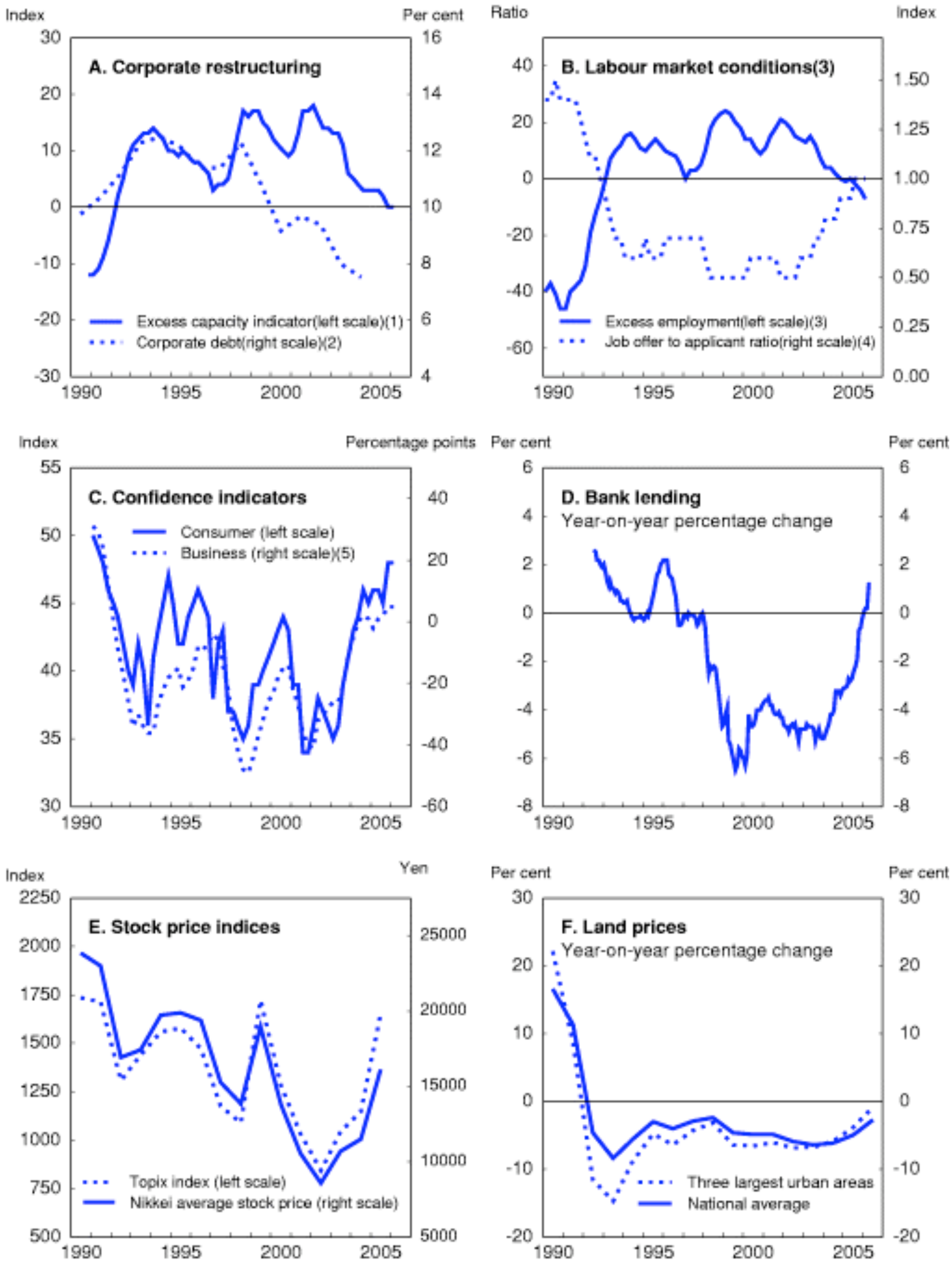
KEY CHALLENGES TO SUSTAINING JAPAN'S IMPROVED ECONOMIC PERFORMANCE

The following OECD assessment and recommendations summarise the E*conomic Survey of Japan 2006* published on 20 July 2006.

I. POST-BUBBLE OBSTACLES TO GROWTH HAVE BEEN LARGELY OVERCOME…

Japan has finally emerged from an extended period of economic stagnation following the collapse of the asset price bubble in the early 1990s. Factors that had weighed on activity such as falling asset prices and declining bank lending have been slowed or reversed, while corporate restructuring to reduce employment, capacity and debt has largely run its course. This has allowed the initial export-led upturn in 2002 to develop since early 2005 into a full-fledged expansion driven by domestic demand. The strength and duration of this upturn pushed some measures of inflation into positive territory in the first quarter of 2006 and business and household confidence have now reached their highest levels since the early

1990s. The government's reform measures have played an important role in laying the foundation for sustained and robust growth, in particular by strengthening the banking system. The positive trends in business investment and private consumption are expected to continue, making the current expansion the longest in Japan's post-war history, with output growing between 2 and 3% in 2006 and 2007.



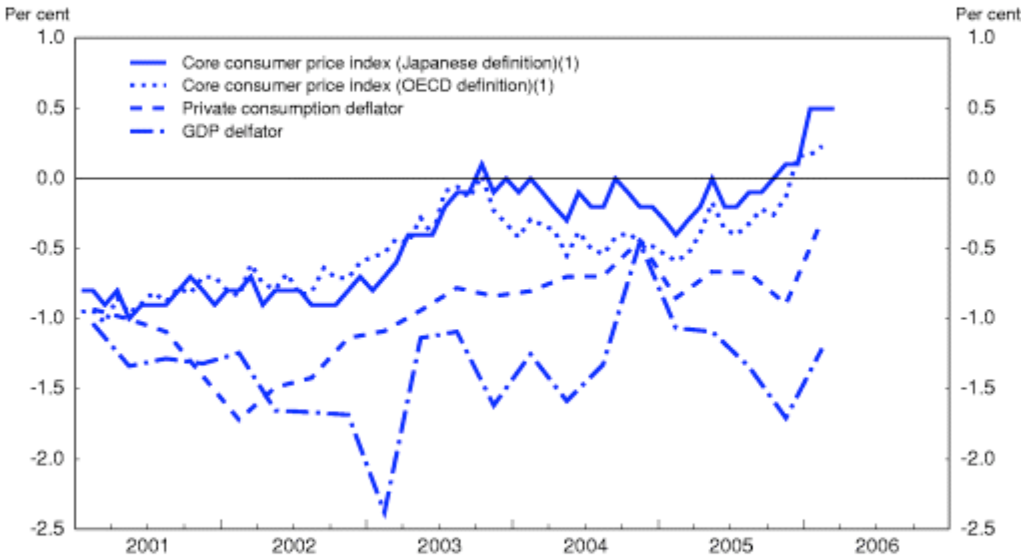
II. ENSURING A DEFINITIVE END TO DEFLATION AND SUSTAINING THE SOUNDNESS

The new monetary policy framework announced following the end of quantitative easing…

Inflation turned positive in the first quarter of 2006, with the core consumer price index (the OECD definition, which excludes food and energy) rising by 0.2% year on year. However, the continued decline in other price measures, notably the private consumption and GDP deflators, suggests that some deflationary pressures remain. In March 2006, the Bank of Japan ended the quantitative easing policy introduced in 2001, which had supported the economic expansion by keeping the short-term interest rate at zero and long-term rates at low levels, while forestalling financial-sector instability by providing enormous liquidity to banks. With the end of quantitative easing, the central bank unwound the run-up in reserves since 2001 and then started to move away from a zero short-term interest rate with a 0.25% hike in July 2006. The Bank plans to continue purchasing long-term government bonds at an unchanged rate, which is likely to help maintain financial-market stability. The Policy Board also announced that 0 to 2% is its understanding of what constitutes price stability in the medium to long term, the first time that it has specified an inflation range.

Deflation is coming to an end

Year-on-year percentage change



1. Japanese core CPI excludes fresh food only, while the OECD core CPI excludes food and energy products.

Source: OECD Economic Outlook 79 database, Ministry of Internal Affairs and Communications and Cabinet Office.

…should be revised to ensure a definitive end to deflation

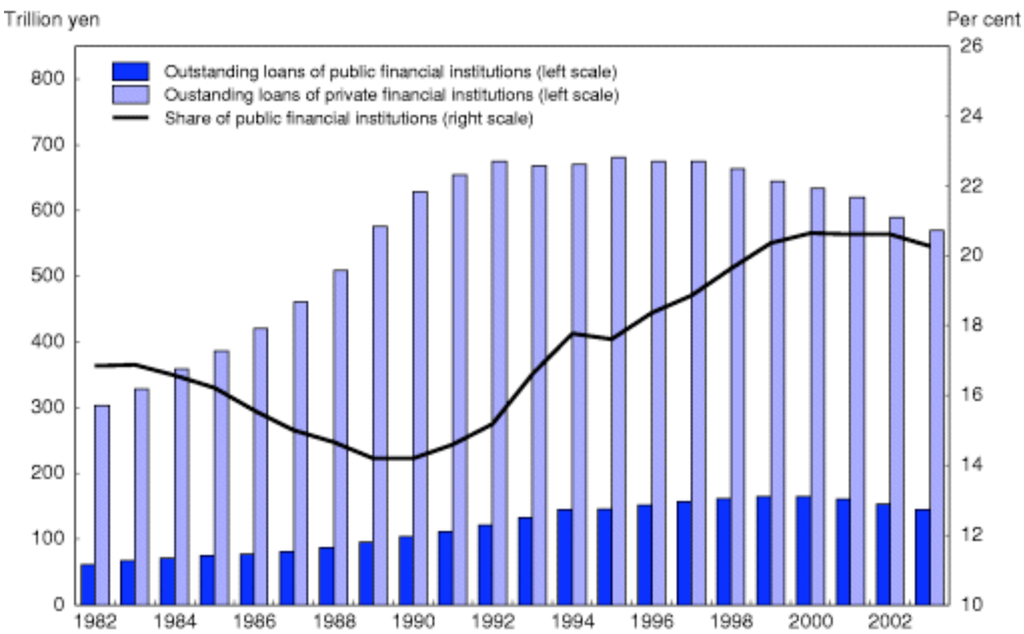
The exit strategy from quantitative easing and zero interest rates is a special challenge for the Bank of Japan. While the announcement of the Board Members' understanding of price stability enhances transparency, the fact that the inflation range will be reviewed each year makes it less useful as a guide for market expectations over the medium term. The framework announced in March also allowed considerable flexibility to the Bank in moving away from zero interest rates in order to limit long-term risks. Given uncertainty about the rate of potential growth and the size of the output gap as the economy emerges from deflation, the Bank should be cautious in raising interest rates. It needs to be sure that inflation is sufficiently positive to minimise the risk that a negative shock could push Japan back into deflation. Although the Bank ended the zero short-term interest rate in July, waiting until inflation moves further above zero – such as a 1% rate of increase in the core consumer price index – before raising interest rates further would also support the expansion. This suggests that the Bank should review the understanding of price stability and increase the lower end of the range to give an adequate buffer against deflation, as the zero floor is too close to deflation for comfort. Such an approach to monetary policy would reduce market expectations of interest rate hikes, which helped to drive up the long-term interest rate from 1.6% when the quantitative easing policy ended in March to 2% in May, accompanied by exchange rate appreciation. Avoiding a premature rise in long-term interest rates while the GDP deflator is still declining is also important for progress in fiscal consolidation.

Further reform of the banking sector is essential to a sustained economic expansion

Avoiding a substantial, premature rise in the long-term interest rate would also be beneficial to banks, whose holdings of long-term government bonds increased significantly during the quantitative easing period. Maintaining the improved financial health of banks is important to sustain the upward trend in bank lending, which recently turned positive for the first time since

1996. There has been considerable progress in reducing the non-performing loans of the major banks. The supervisory authorities should maintain pressure on the banking sector to strengthen its capital base and encourage the regional banks to continue reducing non-performing loans. While regional banks play an important role in lending to small and medium-sized enterprises, the government should avoid moral hazard that would create additional non-performing loans. In addition, the profitability of the banking sector would be improved by scaling back the role of public financial institutions. Perhaps the top priority is the privatisation of Japan Post, the largest financial institution in the world. The authorities should achieve a complete divestiture of the government's holdings in Postal Savings and Postal Life Insurance by 2017 at the latest. A level playing field with private financial institutions should be established before restrictions on the activities of Postal Savings and Postal Life Insurance are removed. The rationale for public financial institutions, whose lending amounts to almost one-fifth of that of private financial institutions, should be carefully examined and their activities should be reduced and subjected to clear budget constraints. Such an approach would reduce unfair competition with private financial institutions, while helping to cut wasteful government spending.

The share of public financial institutions in total loans has risen since 1990



Source: Bank of Japan.

III. A STRATEGY FOR FISCAL CONSOLIDATION

The progress in fiscal consolidation…

Limiting the growth of government spending is the priority in addressing the serious fiscal problem. The FY 2001 *Structural Reform and Medium-Term Economic and Fiscal Perspectives* set an objective of freezing public expenditure at 38% of GDP through FY 2006, and this target is likely to be achieved. Such spending restraint, which was achieved in part through cuts in public investment, aimed at the goal of a primary budget surplus for the combined central and local governments in the early 2010s. On a general government basis, the primary budget deficit has fallen from 6.7% of GDP in 2002 to an estimated 4% in 2006, with about half of the decline due to structural factors, and the rest accounted for by the economic expansion.

…should be continued to achieve a primary budget surplus…

The *Reference* Projection for the FY 2005 *Reform and Perspectives* shows a primary budget balance for the combined central and local governments in 2011. However, a balance would not be adequate to stabilise the level of public debt relative to GDP in the long run if the nominal interest rate on government debt exceeds the growth rate of nominal output. While the economic expansion and an end to deflation may push the nominal growth rate above the interest rate in 2006, assuming that growth remains higher would not be prudent for setting a medium-term fiscal objective. Indeed, population ageing will tend to slow output growth while possibly increasing the interest rate. In sum, stabilising the public debt to GDP ratio is likely to require a primary budget surplus for the general government of between ½ and 1½ per cent of GDP. To achieve this target by the early 2010s would require that the pace of fiscal consolidation accelerate somewhat to around 1% of GDP per year. Achieving such a target would stabilise the public debt ratio sooner and at a lower level. Moreover, it would help maintain public confidence in the government's fiscal consolidation efforts, thereby limiting the possibility of a rise in the risk premium and preventing a substantial deterioration in the budget deficit.

…based on a more detailed medium-term plan

A credible medium-term plan is also important to sustain public confidence. A number of steps should be taken to improve the Reform and Perspectives:

- *Adopt a ceiling for the government expenditure level through the early 2010s in accordance with the latest Reference Projection. Set specific spending targets by category to show how the ceiling can be achieved.*
- *Make the spending targets more binding on the government's actual annual outlays and introduce a feedback mechanism that shows how the plan will evolve if outcomes diverge from those targets.*
- *Ensure the sustainability of the social security fund. The Reform and Perspectives' target for central and local governments should not be achieved through a deterioration in the social security account.*

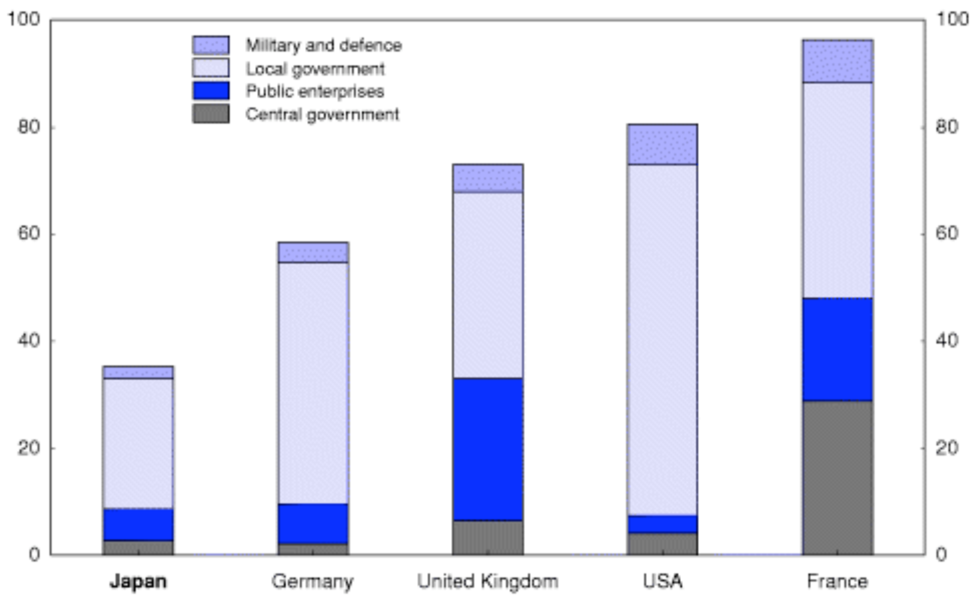
Furthermore, continued efforts are needed to increase the transparency of the budgetary system, thereby enhancing fiscal discipline and achieving consolidation.

While there is some scope for further cuts in public investment and the size of the government…

Much of the spending restraint to date has been achieved by cutting public investment from 8.4% of GDP in 1996 to 5% in 2004. Given that it still remains significantly above the OECD average of around 3% of GDP, there appears to be scope for further reductions, which should be accompanied by a better allocation of investment to enhance its productivity. However, the rising cost of maintaining existing infrastructure is crowding out new growth-enhancing public investment. It is important therefore to develop a comprehensive plan, in the context of a declining population, to close less useful infrastructure. The government plans to reduce expenditure by cutting the number of central government employees over five years as a first step to halving their total compensation during the next decade. Given the inefficiency of across-the-board cuts, budget savings should instead be achieved by reducing low priority activities and using market testing to determine which tasks can be better performed by the private sector. In addition, increasing efficiency in the public sector, in part by relaxing the rigid employment system, could generate savings. The efforts to reduce spending should be extended to include local governments, public enterprises and government-affiliated organisations, which account for more than 80% of public-sector employment. In any case, the scope for expenditure cuts may be limited by the fact that public-sector employment per population in Japan is well below the level in other major OECD economies, suggesting the need to achieve spending reductions in other areas as well.

Public-sector employment in Japan is relatively low

Employees per 1 000 population



Source: Ministry of Internal Affairs and Communications

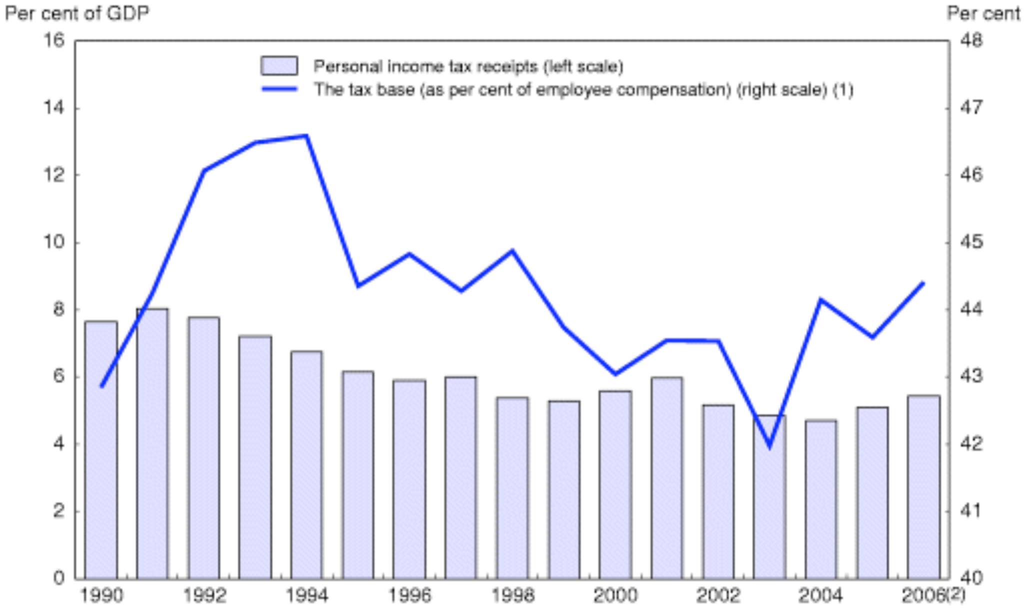
… public pension and healthcare spending are key to controlling government outlays

Population ageing raises pressure for increased outlays on pensions and healthcare. The FY 2004 reform is expected to keep pension payments constant at around 9% of GDP through the end of the decade by allowing the replacement rate to fall from 59% to 50%. Any slippage from this spending target should be met by a hike in the pension eligibility age, rather than by a further rise in the contribution rate, which is to be increased from 13.6% in FY 2004 to 18.3% by FY 2017. A rising contribution rate risks further boosting the evasion rate, which at 33% for those not part of the employee pension system, is already well above the level assumed in the government's projections. As for healthcare, a large cut in medical fees and the introduction of a new insurance scheme for those over the age of 75 is expected to help keep spending at around 5½ per cent of GDP through 2010. Much of the expected spending restraint, however, depends on reducing the demand for healthcare by preventing lifestyle-related diseases. Given the difficulty of achieving such savings, additional reforms are needed. The key to achieving higher quality and greater efficiency in healthcare, as well as in long-term nursing care, is to make greater use of the dynamism of the private sector, in part by allowing companies to manage hospitals and nursing homes.

Fiscal consolidation will require increased tax revenues

Even with these reforms, it will be difficult to reduce government spending as a share of GDP, in part due to rising interest payments. Consequently, achieving the necessary improvement in the government budget position – around 5% of GDP will require additional revenue. Given that less than one-half of wage earnings are taxed and only one-third of corporations pay income tax, broadening tax bases is important to raise additional tax revenue, while enhancing economic efficiency and growth. In addition, measures to increase tax compliance, such as a taxpayer identification number, would enhance efficiency and fairness, while increasing tax revenue. A hike in the consumption tax rate may also be necessary to achieve fiscal consolidation.

Less than one-half of wage earnings are subject to the personal income tax



1. Share of taxable salaries after deducting various exemptions. Initial budget base.

2. OECD estimates for 2005 and 2006.

Sources: OECD and Ministry of Finance

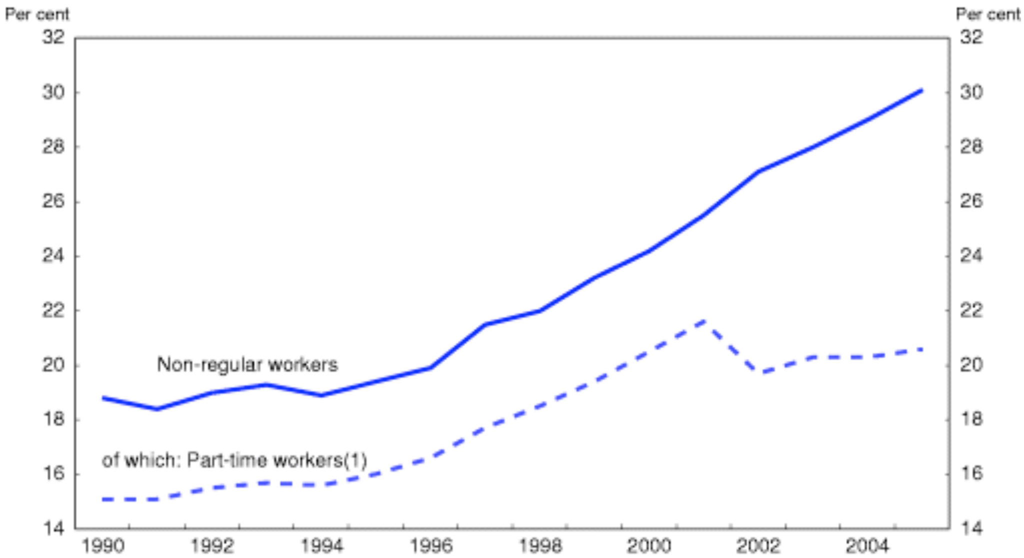
IV. INCOME INEQUALITY, POVERTY AND SOCIAL SPENDING

Addressing the rise in inequality and relative poverty requires measures to reduce labour market dualism…

Reform of the tax system should take into account its potential impact on income distribution, which has become more unequal for the working-age population in recent years. Indeed, the Gini coefficient measure has risen significantly since the mid 1980s from well below to slightly above the OECD average and the rate of relative poverty in Japan is now one of the highest in the OECD area. Population ageing is partly responsible for boosting inequality as it raises the proportion of the labour force in the 50 to 65 age group, which is characterised by greater wage variation. However, the key factor appears to be increasing dualism in the labour market. The proportion of non-regular workers has risen from 19% of employees a decade ago to over 30%. Part-time workers earn on average only 40% as much per hour as full-time workers, a gap which appears too large to be explained by productivity differences. Although the increase in non-regular workers has been partly caused by cyclical factors, there is a risk that labour market dualism will become entrenched, given that thus far only a small proportion of non-regular workers have become regular workers. One important key to reversing the rise in inequality and poverty is to reduce labour market dualism. This requires a comprehensive approach including reducing employment protection for regular workers and thereby weakening the incentives of firms to hire non-regular workers. In addition, it is important to increase the coverage of temporary workers by social insurance and to enhance the employment prospects of non-regular workers.

The share of non-regular workers is rising

As percentage of total employed persons



1. The significant fall in the number of part-time workers in 2002 and the rise in the other categories is thought to be due to a change in the questionnaire.

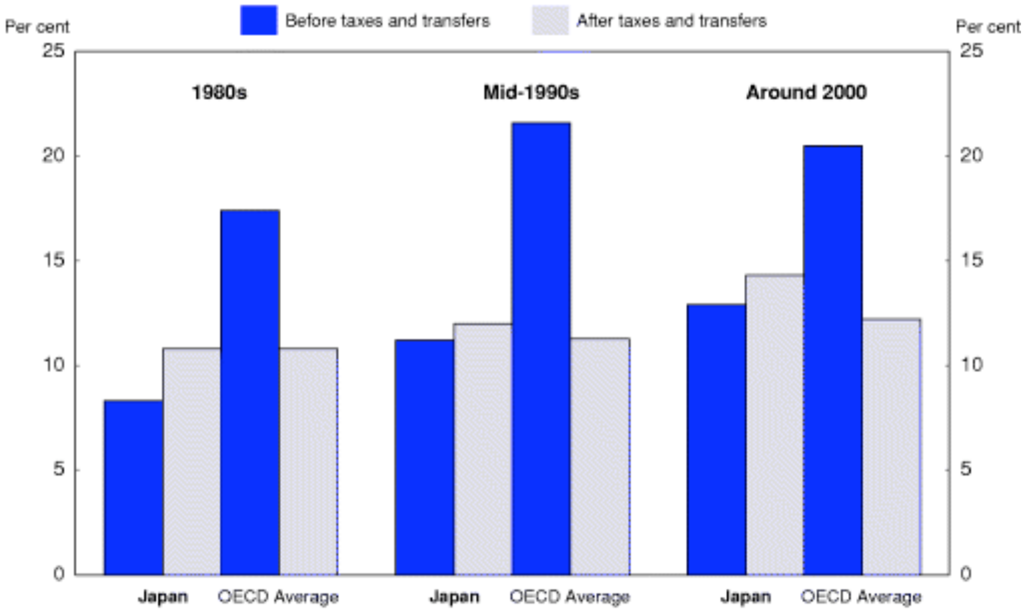
Source: Ministry of Internal Affairs and Communications.

… and increase the share of social spending on low-income households

The serious fiscal problem limits the scope for boosting social spending to reduce relative poverty. It is necessary, therefore, to reallocate social spending to increase the share received by low-income households, while taking care to limit the creation of poverty traps and work disincentives. About three-quarters of social spending is allocated to the elderly. More than half of single working parents were in relative poverty in 2000, compared with an OECD average of around 20%. Moreover, Japan had a higher poverty rate for single parents who work than for those who are not employed. In 2002, the government reformed the single parent allowance to provide work incentives. Significant poverty among single parents is a factor boosting the child poverty rate to 14% in 2000, well above the OECD average. Given the relatively high proportion of education costs borne by the private sector, it is essential to ensure that children in low-income households have adequate access to high-quality education to prevent poverty from being passed to future generations. The increasing stratification in educational outcomes in Japan found by the PISA study should be addressed.

Child poverty in Japan is above the OECD average

Per cent in poverty before and after taxes and transfers



Source: Whiteford and Adema (2006).