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"Basic Policy 2018" Fall Short of Providing Clear Guidance for Fiscal Consolidation

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The Basic Policy on Economic and Fiscal Management and Reform for 2018, released by the Cabinet Office on June 15, presented targets for fiscal consolidation of (i) achieving a surplus of primary balance in FY2025, (ii) steady reduction of debt outstanding[1] to GDP. Further, as a target to be achieved in the interim period by FY2021 it included three goals of (i) reducing the primary fiscal deficit to around 1.5% of GDP, (ii) restraining the debt outstanding to GDP within the first half of the 180% range and (iii) budget deficit of less than 3% of GDP.

These goals for fiscal consolidation have two problems, however. The first is that no numerical goals have been set to restrain the social welfare spending which will see a most rapid natural increase from now on. Three years ago, a rough indication was given in the Basic Policy for 2015, stating that the government would curb the growth of social welfare spending for FY2016-18 within ¥1.5 trillion, or ¥500 billion a year. This guideline actually worked as a brake and it is considered that without this guideline the three year growth of such cost would have expanded to ¥1.94 trillion. Therefore, the expectation was high that the same kind of numerical target would be incorporated in the Basic Policy 2018 as an expected increase for FY2019-21.

The second concern is that the intermediate target for FY2021 can be relatively easily achieved. In preparing the Basic Policy 2018, the Cabinet Office revealed on January 23 two scenarios on the fiscal prospect up to FY2027, one for the high growth scenario and one for the baseline scenario[2]. This estimate assumes no new belt-tightening measures except for consumption tax hike to 10%, yet in both scenarios the goal (i) is almost within a reach of achieving, and the goals of (ii) and (iii) can also be fully achievable[3]. In other words, these

[1] Strictly speaking this is outstanding of public bonds and therefore its coverage is smaller than the public debts outstanding which the IMF and other institutions have tended to focus.

[2] Assumed economic growth rates are around 2% in real term and the first half of 3% range in nominal term for the high growth scenario, and 1.2% in real term and the latter half of 1% range in nominal term for the baseline scenario.

[3] The fiscal deficit for primary balance, debt outstanding and budget deficit for FY2021 are estimated at 1.7%,

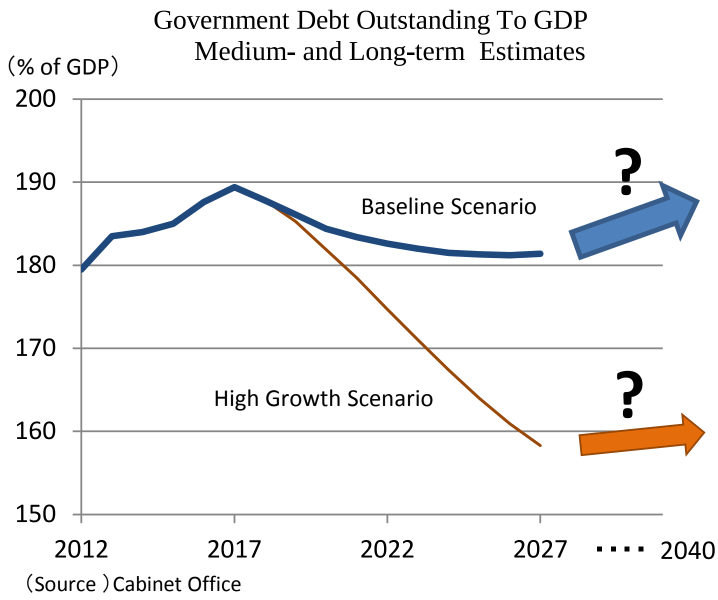
interim goals can be easily achieved even in a natural way. Looking over the span to FY2025, however, it is concerned that the government postpones necessary efforts after FY2021 despite that such efforts should be made to achieve the goals since the primary deficit will not turn to surplus even in a high-growth scenario.

In these circumstances, the next focal point will be on the reform roadmap for FY2019-2021 which will be formulated toward the end of the year. The roadmap will flesh out the specifics of the Basic Policy 2018, and on June 15, Mr. Toshimitsu Motegi, Minister of State for Economic and Fiscal Policy, expressed that "the government intends to make a firm guidance for expenditure cuts and to set numerical goals by the end of the year." The Basic Policy 2018 included various measures to be implemented to curb the social security-related expenditures, such as an introduction of fixed amount payment by outpatient visits, and expansion of coverage of the elders who are required to pay 30% of their own treatment costs. In the reform roadmap, the implementation schedules of such measures will be decided, and it will gather attention whether or not the numerical targets will be set for curbing the gross amount of social security related expenditures.

Simply setting the numerical targets for FY2019-2021 will not be sufficient to achieve the fiscal consolidation goals. Stepped up measures will be indispensable in order to realize the goal of "steady reduction of debt outstanding to GDP" over the long run, as is shown in the goal (ii) above. According to the tentative estimates shown by the Cabinet Office on January 23, the debt outstanding to GDP is expected to stabilize not only on a high growth scenario but also on a baseline scenario, but the outstanding may rise further again (Figure below), since the social security related expenditures and interest payment costs on the government bonds will increase rapidly. Social security related expenditures are estimated to increase by ¥22-28 trillion between FY2025 and FY2040[4]. Also in an environment of rising yields, an increase of interest payment costs will be unavoidable as the government bonds issued with low coupon rate will be refinanced year by year by new bonds with higher coupon rates. In the Cabinet Office estimates of January 23, 10 year bond yields are expected to rise to 2.2% in FY 2027 in the baseline scenario and 3.8% in the high growth scenario.

178.5% and 2.6% of GDP respectively for the high growth scenario, and 1.8%, 183.4% and 2.8% of GDP for the baseline scenario.

[4] Document 4-1 distributed at the 6th meeting of the Council on Economic and Fiscal Policy (May 21, 2018)



The Basic Policy 2018 also incorporated in it such important initiatives of the government as "Human Resources Development Revolution", "Productivity Revolution" and "Work Style Revolution". These policies aim at raising potential growth rates through improved labor productivity (especially of total factor productivity) and increased participation of the elders and women, and they are duly appreciated to some extent. However, the Basic Policy failed to incorporate more fundamental fiscal restraint policies, such as increase of consumption tax to 10% or raising the starting age for receiving pension payments (from 65 years old to 70 years old).

In the Basic Policy 2018, it is explained that the medium term target for the budget deficit of less than 3% of GDP (as noted (iii) above) was based on the EU practice that it uses as a yardstick in trying to prevent the government from running excessive deficits. If the Japanese government cites the example of the EU, it also should refer to the fact that the EU makes it a ultimate target to lower the public debt outstanding to GDP to less than 60%. Although the actual figures on the debt outstanding (IMF standard) for 2017 show a large overshooting of the target in some of the member states like Greece (182%), Italy (131%) and Portugal (126%), they are still far below the Japanese figure (236%). In other regions, Lebanon (153%) and Yemen (141%) have an excessively high outstanding, but they are also far below the Japanese case.

Looking squarely at the reality, much attention should be given in the future not only to the reform roadmap to be formulated by the end of this year but also to the possibility when and where the fundamental austerity measures that were not included in the Basic Policy 2018 would be seriously discussed.