

Japanese Economy Revived: Challenges and the Way Ahead
- Fiscal consolidation is the biggest remaining challenge -

Addressed by H.E. Sadakazu Tanigaki, Minister of Finance
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1. Introduction

Ladies and gentlemen:

It is my great pleasure to have this opportunity to speak before you at Japan Society today.

This is going to be the first time that a Japanese finance minister gives a speech in the United States since 1999 when Mr. Miyazawa, a statesman I have deep respect for, spoke in Washington, D. C. I was State Secretary for Finance at that time, supporting Minister Miyazawa. Looking back at those days, I feel as if I had been in a totally different world. The Japanese economy was right in the middle of an unprecedented crisis at the time, beset with serial breakdowns of some of its leading financial institutions. We were haunted by a notion of being the witness to the loud crumbling of the foundation of our economic prosperity that we had been striving to build for many years since the end of the Second World War, and the attendant uncertainty was giving us the shivers. All that, however, belongs to history. Japan is back. I am delighted that I can deliver the good news of the revival of our economy before this audience today.

2. The Current State of the Japanese Economy

(Economic recovery led by private-sector demand)

The most notable feature of the economic recovery this time around is that it is primarily led by private-sector demand. Under the policy of "No reform, no growth" adopted by the Koizumi administration, structural-reform programs have been under way in the fields of finance, regulation, taxation, and government spending; The current economic recovery represents the culmination of such efforts.

(Normalization of situations aggravated by non-performing-loans)

Aggressive efforts at removal of non-performing-loans have made it possible for our leading banks to reduce their NPL ratio from 8.4 percent in March, 2002, down to 2.4 percent in September, 2005, a level quite comparable to other leading industrialized countries. Thus, I can safely conclude that Japan's financial system has now overcome its problems and become healthy again.

(Elimination of triple excesses)

Meanwhile, the corporate sector has gone through strenuous restructuring process. Japanese corporations liquidated their negative legacy piled up in the wake of the collapse of the economic bubble, and have become much healthier and leaner. The so-called "triple excesses," namely, excessive employment, excessive investments in plant and equipment, and excessive debts, that hampered the growth of our economy for many years have now been virtually eliminated. The profitability of Japanese corporations has been restored to a level higher than that recorded during the economic bubble in the 1980s.

(Corporate-sector spearheading the recovery)

Under these circumstances, business managers are no longer on the defensive, but turned aggressive once again. Investments in plant and equipment have been recovering steadily, exceeding the level of depreciation expenses since last year, and the stock of productive capacity that was steadily dwindling for some time is on the rise once again.

Our banks' loan balance, which was also declining for many years since the collapse of the economic bubble, reverted to a positive growth over the preceding year in August, 2005, and has continued to grow since. This, I believe, is an indication of an enhanced lender willingness on account of regained financial health of our banks, and an onset of recovery in corporate demand for funds against the backdrop of a reinvigorated economy.

(Recovery spreading to the household sector)

Strengths of the corporate sector are now filtering down to the household sector through increased employment and wages, as can be seen in the increase in year-end bonus payments by businesses for three years in a row. These positive developments surrounding the households have led to a pickup in consumer spending.

As a result, financial assets worth more than 1,400 trillion yen in the household sector, which were kept timidly inactive because of financial uncertainties, have started to move in favor of risk taking. The latest flow of funds statistics showed that while deposits declined 0.6 percent from the previous year, investment trusts registered a hefty increase of 28.4 percent over the previous year. This is a clear indication that households have once again started to take risks in their asset allocation.

(Effects on asset prices)

These improvements in the real economy have naturally rippled onto asset prices.

Stock prices have attained a level that is roughly double of what they were in early spring of 2003. And Japanese stocks registered the highest rate of price increase among the leading industrialized countries last year.

As for real-estate prices, although they are still on a generally declining trend, the pace is getting slower, while land prices of some areas in central Tokyo have started to rise for the first time in fifteen years since 1990, a harbinger of a possible rebound in general real estate prices. Once there is a reversal in real estate prices, I believe, that we can safely conclude that we've put an end to the prolonged economic adjustment process of the post-bubble era.

3. Challenges for the Japanese Economy

-Three short-term risks and two structural challenges-

(Three short-term risks)

As I have described so far, the Japanese economy has gained a new life. However, the surrounding world economy is faced with three risks in the short run, whose effects we have to watch closely.

(Petroleum prices)

The first risk lies with oil prices. Although upward trends in oil prices have quieted down of late, persistent high prices or further price increase could decelerate economic growth of many emerging market economies with high degrees of oil dependency, potentially exerting adverse effects on the entire world economy.

(Interest rates)

The second risk is related to interest rates. Unusually low interest rates have been prevalent across the world in the recent past, making abundant capital available at low costs in international financial markets, and also enabling them to move around freely around the world. Nevertheless, interest rates in some industrialized countries have started to rise, which could potentially alter the international flow of funds in favor of the safer markets in advanced countries, including the United States. We cannot preclude the possibility that such a reversal of capital flow might adversely impact the availability of funds for emerging countries.

(Emerging market economies)

The two risks that I have just mentioned, namely oil prices and interest rates, would probably have larger impact on emerging market economies than on mature economies. Hence, the third risk pertains to emerging market economies themselves. Since emerging countries including BRICs, namely Brazil, Russia, India and China, are now assuming a larger role in the world economy and trade than in the past, they are capable of having greater impact on the global economy. The rise of a number of other Asian economies, in particular, is truly amazing. Meanwhile, the economic structure of these countries still remain fragile, and as seen in the recent daring revision of GDP statistics by the Chinese authorities, assessing the true condition of such economies could still be difficult. We must remain attentive in this regard.

(Coping with the risks)

We have been working on these risks in various international fora including G7 and G20. As the lack of sufficient information on production, demand, inventory, and other aspects of the crude-oil trade kept the price formation opaque and caused speculative dealings to proliferate, countries have worked together for increased transparency. We in Japan are convinced that we can contribute to a constitutional remaking of the world economy by offering our world renowned energy-saving technology.

Even though the savings rate in Japan is on a declining trend due to its ageing population, Japan is expected to remain a major provider of capital for some time to come, enabling us to play a role in mitigating the adverse effects of contraction of capital flows caused by higher interest rates across the world.

For the sake of emerging market economies, we must make sure that the international community is able to respond quickly to cases where the reversal and rise of interest rates in the world adversely affect the capital procurement on the part of emerging economies. For example, we will have to work toward further strengthening of the IMF surveillance, and establish precautionary arrangements to prevent international financial crises. In the Asian region where Japan enjoys deep and broad relations, we are putting a great deal of effort into programs for regional cooperation in financial fields, such as the "Chiang Mai Initiative (CMI)," designed for mutual lending of short-term funds in the event of a currency crisis. Another endeavor is the "Asian Bond Market Initiative (ABMI)," aimed for developing local bond markets in order to fully utilize the abundant savings in the region.

(Two major structural challenges)

Even if we were to be successful in dealing with these short-term risks, Japan would still have to face a pair of major structural changes.

The first one has to do with the changes in the terms of world-wide competition brought about by economic globalization. Since the end of the Cold War, former socialist countries have been joining the market economy in quick succession, while large countries such as China, India and Brazil are gaining economic strength very rapidly these days, all ushering in an era of unprecedented competition on a global scale.

The second is the start of a declining trend of population in Japanese society. Our country is said to have entered an era of declining population last year, and it is expected that a rapid reduction will occur in the overall population due to ever declining birth rate, and also in the labor force on account of retirements of the "baby boom" generation.

4. Two Sets of Efforts to Meet the Two Structural Challenges

What should Japan do to deal with these major structural challenges?

(1) Making Japan a more attractive country

First, we have to turn Japan into a more attractive country.

We have to enhance Japan's attractiveness as a country, so that we can draw in people, goods, money, and information from around the world. With Japan now entering an era of declining population, it is crucial for us to achieve this to survive in this new era of global competition.

(Building an open society)

Many people tend to think that Japan is a closed society. It is imperative for us to do our utmost in pursuit of an "open society," so that we can absorb funds and know-how from all over the world. One of the most important factors is direct investment, and our "Invest Japan" campaign is seeking to double the balance of direct investment from abroad in five years. On the human side, our welcome mat must be spread (not only for Bobby Valentine but also) for engineers and technologists of high caliber abroad, and our "Yokoso Japan" campaign aims to lure ten million foreign visitors by 2010.

(Building a society open to all and full of opportunities)

The key ideas in our efforts to attract people, goods, money, and information, I believe, are transparency, accountability, and flexibility. In other words, we have to build systems that are transparent and easily understandable, to clearly show where the accountability lies, and to be flexible in reviewing and revising systems and their operation in response to changing circumstances. These qualities are crucially important for Japan to be more inviting to people from abroad. It is necessary, above all else, for us to step up our programs of deregulation in various fields, so that we can build an economy that is equipped with high degrees of transparency and accountability, and also that is open to all with full of opportunities.

(Improving education and advancing science and technology)

Meanwhile, Japanese people themselves must become more attractive. Being a country with little natural resources, its people, who are known to be industrious, hard workers and good team players, might be the only asset that Japan possesses. We will have to develop types of Japanese who will be able to succeed at the global level, and education plays a vital role in this endeavor.

For this purpose, we must first induce young people in Japan to turn their attention and interest to the outside world. It will be increasingly necessary for Japan to have young men and women armed with strong challenging spirit who are willing to seek the stage for their activity anywhere in the world, relying solely on their capability.

In the world of sports including baseball, we are encouraged to find many Japanese athletes, upon becoming one of the top players in Japan, embark on a new challenge by making their debut on the global stage. (I'm sure many of you are familiar with the successes enjoyed by Japanese major-league ballplayers like Matsui, Ichiro, and Iguchi.) I hope that more Japanese will be able to succeed at the global level in economic and business fields as well.

While being exposed to global competition, we must not let go of our good traditional attributes handed down for generations in our society. The foremost among Japanese virtues is industriousness, and hard-working Japanese craftsmen are renowned for unparalleled quality of their handiwork. Our people are very good at adaptation; For instance, they can use their know-how and ingenuity to make things better by adding precious little something to them for more value and utility. It is important for us to keep fostering these and other strong points of Japanese people and culture.

In view of the need to cope with competition from emerging market economies, it is also necessary for us to devote further efforts to the advancement of science and technology, a crucial factor in generating high value added that are distinctively Japanese.

(2) Efforts towards fiscal reform

Even with enhanced attractiveness of our country and people, we cannot hope for a steady and stable economic growth, if the sustainability of our national finances, the very foundation upon which all economic activities are carried out, is called into question. Faced with a declining trend in population, we cannot afford to bequeath fiscal burdens to our future generations, but will have to squarely grapple with the fiscal reform as the last unfinished task before us.

As a first step, the government aims at achieving a primary surplus by the early 2010s, when baby-boomers start claiming pension benefits. In other words, we have to build a fiscal framework where expenditures, excluding interest payment and debt redemption, in a given year will have to be met by tax revenues of that year alone, without leaving burdens in the form of fiscal deficits to our children and grandchildren.

Nevertheless, this effort alone will not be enough to check the ballooning public debts. Worse still, if long-term interest rates should exceed the nominal rate of economic growth, the ratio of outstanding debt to GDP may increase and even become divergent. Thus, achieving primary surplus is merely a milestone in the long path towards fiscal consolidation. We must not lose sight of the need for constant efforts to reduce the public-debt outstanding as a percentage of GDP and, further still, to cut back on the amount of public debt itself.

In preparing our annual budget for 2006, which was completed at the end of last year, we put the whole range of fiscal spending under rigorous scrutiny and incorporated many results of our efforts devoted to various reforms. Those include the medical-care system reform, the so called "three-part reform package," and the reform of special accounts, just to name a few. The "three-part reform package" aims at reforming local government finance through a combination of cuts in state subsidies and local allocation taxes, and transfer of tax sources from the central government to local governments, providing the latter with greater fiscal flexibility along with increased responsibilities. As a result, we were able to limit the size of the general-account budget to below 80 trillion yen for the first time in eight years. We were also able to reduce the government bond issues by the largest amount in history to a level below 30 trillion yen. This was made possible in part by our efforts to augment revenues, which include the repealing of a proportional across-the-board tax credits on individual income tax and local inhabitants tax, introduced in 1999.

Nevertheless, Japan's total public debts of both national and local governments amount to more than 150 percent of GDP, the highest among industrialized countries. It still relies an alarming 37.6 percent on debt issuance to finance the general account budget in FY2006. These facts indicate that we still have a very hard path to follow for some time to come. I am bracing myself and renewing my determination at the thought of a tall and steep mountain that we will have to conquer in this context for many years to come. Standing on the firm platform that we have built with the 2006 budget, we are determined to engage ourselves in energetic deliberations for an integrated reform plan covering both expenditure and revenue, so that we can work out a road map of fiscal reform by the middle of this year.

In implementing this integrated expenditure-revenue reform plan, the first step we are going to take will naturally be a thorough spending cut. Given the present state of public finance, however, it is clear that it will be next to impossible to accomplish fiscal consolidation by just reducing expenditures. We cannot shy away from necessary measures on the revenue side. Being mindful of the need for an equitable sharing of common social cost and for a sustained revitalization of our economy and society, we will have to engage ourselves in public debate, both deep and broad, on reforming the entire tax system including the consumption tax, while of course closely monitoring trends in economic activities.

5. Where Japan Should Be Headed

(The way forward for Japan)

As I have just described, Japan will have to deal boldly with a whole array of reforms, starting with the one to overhaul its fiscal structure. The society that lies ahead of these reforms, however, must not be a cold-hearted society solely in search of efficiency, allowing the strong to feed on the weak.

The direction that we must aim for is establishing a society that allows us to strike a good balance between our sense of value nurtured and inherited through many generations on one hand, and a new set of values that we now have to adapt to on the other. I firmly believe that Japanese are by nature capable of honoring the relationship with their neighbors and supporting each other in their living. Firmly believing in their self identity and individuality, our people can improve themselves through mutual learning and competition, while supporting and helping each other under the sense of what I call "Kizuna" in Japanese. "Kizuna" is something like family ties and solidarity among community members, an inborn attribute of our people. I would like to build such a society, full of vitality and mutual trust, and held together with these "Kizunas."

Many of us tend to view the concepts of "state" and "people" in an adversarial light. But many challenges facing our "state" and our "people" should not be dealt with by the government or the political leaders alone. Rather, each individual citizen must also participate on his or her own in overcoming these challenges. In the new society that I aim for, individual citizens will honor and respect the sense of "public" and actively play "public" roles. Meanwhile, the state will have to have its people's ideas properly reflected in the decision-making process for collective setting of the direction of societal progress. I would like to build a new "Kizuna" founded on the relationship of trust between the state and its people. As a society that lies ahead of structural reforms, I will strive for building a society that is held together with such "Kizunas."

(Harmony with international community)

As the world economy becomes truly global, the interdependence among nations grows broader and stronger, while collaborations among nations become increasingly important. Amidst all this, Japan and the United States enjoy the most important bilateral relationship in the world bar none, to borrow the words of the late Ambassador Mike Mansfield, and we have been able to maintain an unfailingly strong linkage between our two countries since the end of the Second World War. Japan and the United States together account for 40% of the GDP of the entire world, enabling us to share responsibility and work closely together in many fields of endeavor, including international finance and development assistance.

Japan and the United States, located on the far sides of the Pacific Ocean, stand in a solid alliance, sharing fundamental values of liberty, democracy, and market economy. Maintaining and furthering this relationship between us is undoubtedly indispensable, in my assessment, not only for our mutual interest but also for the prosperity and stability of the whole world. By leveraging this strong relationship between our two countries, and by listening carefully to the voices of the world around us, we want to continue working toward prosperity of the world economy.

Fortunately, I can say that the Japan-U. S. relations are now in the best shape ever in the post-war years. And against the backdrop of this good relationship, the economic partnership between our two countries has never been better. It is very important that countries are linked closely together for collaboration, like ours, so as to enjoy the fruits of globalization to the maximum extent.

6. Conclusion

Your Japan Society has served as a bridge between Japan and the United States for one hundred years since your founding in 1907. You have been playing very important roles in making Japan's attractiveness publicized widely by introducing Japanese culture and history to Americans; and also in constructing strong links of trust between the people of the two countries by providing opportunities, as you're doing right now, for interchange between us. In other words, your Society has been practicing for one hundred years what I proposed to do today. In closing my remarks, please allow me to pray that Japan Society may continue to prosper by playing its many important roles to the fullest extent.

Thank you very much for your attention.