Japan's Public Finances Lack Reserve Capacity

On January 17, the Cabinet Office released the Economic and Fiscal Projections for Medium to Long Term Analysis. The previous projections, published last July, attracted attention with the outlook that the goal of having a surplus in the primary balance (PB: an index showing whether policy expenditures can be covered by tax revenues, etc.) could be achieved in fiscal 2025. However, the projections this time flip (from a surplus of 0.1% of nominal GDP in the previous projections to a deficit of 0.7% in the current projections) and conversely predict that the PB will record a deficit in fiscal 2025 and that the achievement of a surplus will be delayed until fiscal 2026 (see Figure 1). As reasons for this, the Cabinet Office noted that expenditures accompanying the implementation of the economic measures drafted last year will occur in fiscal 2025 and that the decline in revenues from increasing the income tax basic exemption will exceed the upswing in tax revenues, etc.

The projections show achievement of a PB surplus in and after fiscal 2026 under both the transition to growth case (with a real GDP growth rate around 1.5% and a nominal GDP growth rate in the upper 2% range) and the projection of past trend case (with a real rate around 0.5% and a nominal rate between 0.5% and 1.0%). Under the projection of past trend case, however, the PB returns to a deficit in fiscal 2034.

What is important is that while the projections indicate a surplus, we should not be overly optimistic and must make the path to fiscal reconstruction, albeit slight, certain. In particular, it is important to achieve the goal of returning the expenditure structure, which greatly expanded with the Covid-19 pandemic, to normal as presented in last year's Basic Policy on Economic and Fiscal Management and Reform. Japan's general expenditures were less than ¥64 trillion in fiscal 2018 and 2019 prior to the pandemic, but rose to more than ¥100 trillion in fiscal 2020 and 2021. They subsequently decreased somewhat, but remain high at ¥80–90 trillion in fiscal 2024. The fiscal 2025 initial budget is set at the ¥68 trillion level, but unlike the previous years, it is highly likely to be revised upwards through consultations between the ruling and opposition parties, and moreover it will certainly be increased by a supplementary budget which has become commonplace each year, so achieving the goal will not be easy.

The ultimate goal of fiscal rehabilitation is to decrease the outstanding government debt. Under the transition to growth case, the outstanding debt of the central and local governments, which was more than 200% of nominal GDP, will gradually decrease and reach around 170% in fiscal 2034 (see Figure 2). Under the projection of past trend case, however, the debt will not fall below 200% through fiscal 2034 and the internationally exceptionally high level of debt will continue for a long time. To begin with, maintaining the real GDP growth rate around 1.5% for 10 years is by no means easy. Moreover, with the Bank of Japan having decided to increase its policy interest rate (from 0.25% to 0.5%) on January 24, upward pressure on long-term interest rates is intensifying, and it is no longer possible to avert an increase in national debt service. The dashed lines in Figure 2 present the scenarios under which the Cabinet Office presumes a rise in interest rates, and for the projection of past trend case, the ratio of outstanding public debt to GDP ends up rebounding to the levels during the Covid-19 pandemic. The viewpoint that public finances will continue to lack reserve capacity is more realistic.

We must keep in mind that a large-scale disaster such as the Nankai Trough megaquake or an infectious disease epidemic may occur within the projection period through fiscal 2034. Also, even without drawing on the example of the UK, if the market shows doubts regarding the sustainability of Japanese government finances, for example, an event like a downgrading of Japanese government bonds could result in a rise in interest rates far more drastic than that presumed in Figure 2. Under such an environment, even if high growth is not achieved as expected, it is critical to secure reserve fiscal capacity so that the government would be able implement a timely and appropriate increase in expenditures when risk turns into reality. Such efforts would prevent a further increase in national debt service beforehand. Such an argument invites the counterargument that fiscal austerity measures would derail growth. Nevertheless, one cannot argue against the importance of thoroughly examining the general expenditures which became bloated under the Covid-19 pandemic, identifying expenditures whose mission can be deemed to have been achieved and expenditures that should never have been incorporated in the budget to begin with, and resolutely shrinking expenditures.

What is expected of both the ruling and the opposition parties is to return the expenditure structure to normal and to resolutely maintain a stance to not lightly set forth measures that increase expenditures that lack funding sources.

Figure 1: Projection of the primary balance of the central and local governments (ratio to nominal GDP)

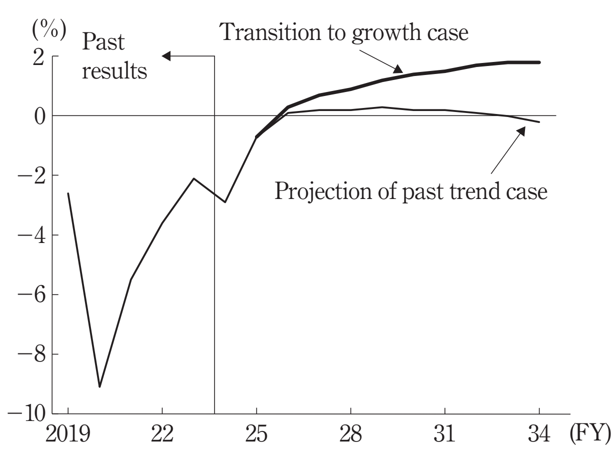
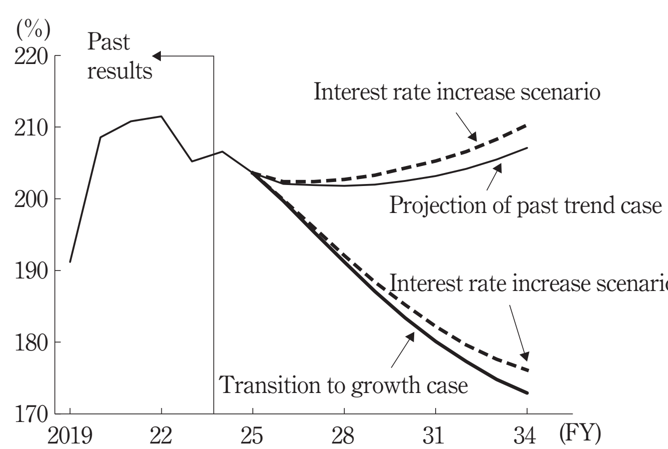


Figure 2: Projection of the outstanding debt of the central and local governments (ratio to nominal GDP)



Source: *Economic and Fiscal Projections for Medium to Long Term Analysis* by Cabinet Office