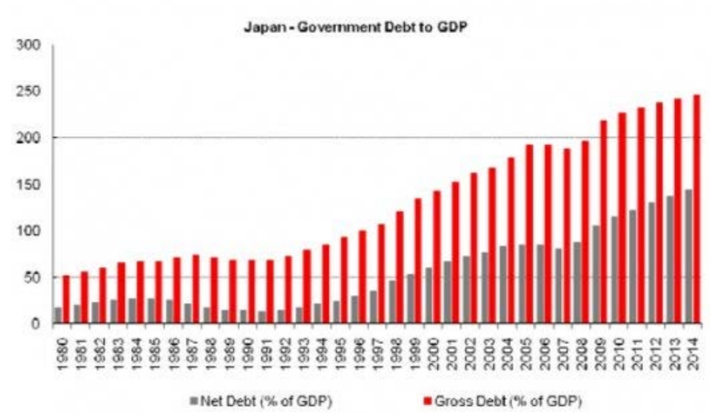
Nathan Lewis
Newworldeconomics.com

# Japan 2012

*While the government struggles to save one crumbling enterprise at the expense of the crumbling of another, it accelerates the process of juggling debts, switching losses, piling loans on loans, mortgaging the future and the future's future. As things grow worse, the government protects itself not by contracting this process, but by expanding it.*
--Ayn Rand, 1974

About once a year, I spend some time to find out what has been happening in Japan recently. This is partially practical: it is the only large, developed-world stock market that is genuinely cheap, so beaten-down that we have finally killed off all the hopefuls with their "generational low buying opportunity" claims, and thus a worthy place to look for opportunities, especially if the macro framework is turning in our favor. Also, it serves as a good laboratory for what has been happening in Europe, the U.K., the U.S. and so forth. Finally, it is a personal enjoyment and perhaps an old habit, since I used to follow things in Japan a lot more closely.

I missed it last year – how did 2011 go by so fast? – which means that we now have more material to ponder. In the past, I came about it more as a political narrative, as the entire picture is a wonderful tale of brilliance and failure, finally degenerating into the most miserable groveling incompetence today, somewhat like Western Europe's leaders but with an extra decade or two of proven failure under their belts. However, this time I think I will start with the numbers side, as this helps put the political developments in perspective.

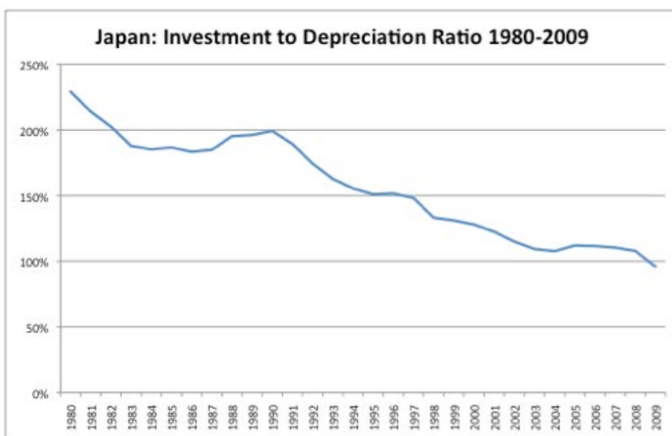


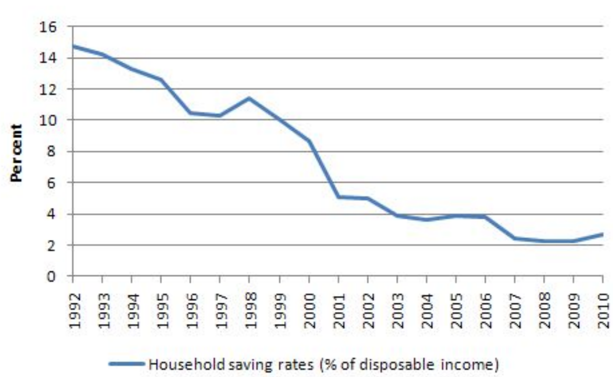

Source: Variant Perception

Japan's era of malaise began on the first day of 1990 – not only did the Nikkei stock market index peak the day before, but on that day some draconian tax changes regarding the treatment of capital gains on property were unveiled, specifically intended to "pop the property bubble." This was preceded by similar policies over the two or three years previous, and followed by even more aggressive bubble-squashing policies later. They worked.

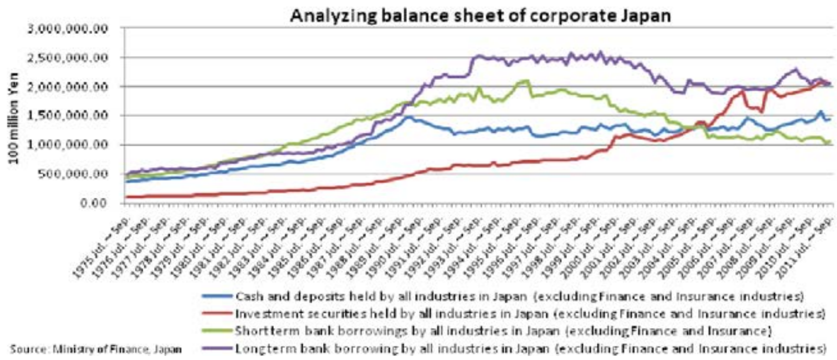
At the time, the Japanese government's debt load was fairly manageable, and especially on a net basis which deducts such things as bonds held by the public pension system (as with our Social Security Trust Fund, this is an intra-governmental accounting convention, which, to my mind, doesn't really exist in a meaningful way), the Bank of Japan, other public pensions, and foreign exchange reserves. Net debt has recently exceeded 100%, and gross debt has exceeded 200%, both figures well beyond what has historically been the point of no return. Thus, Japan's government spent itself into oblivion, more or less in response to the continuing economic deterioration there. At this point, the future of this debt trajectory (nothing good) is the primary economic issue to my eyes; you can't make any kind of long term business plan, or long-term investment, when the government is plainly on the road to default, and whatever chaos and stupidity (especially rising taxes, capital controls and printing-press finance) may accompany that. Keep your head down and wait until the smoke clears. No matter how cheap Japanese assets may be today, you can be sure that they will be cheaper during and soon after this crisis. (Besides, there is that little issue of Tokyo becoming uninhabitable due to radiation.)

This seems to me to be well understood in Japan, which is why corporations haven't been making many net investments as a whole, just keeping up with depreciation. Corporate cashflow is being used to build up cash reserves (handy in a crisis) and pay down debt. Thus, in an inversion of the normal state of affairs, corporations have been net savers, while households' formerly impressive savings rate – the engine of high investment and ultimately wealth-creation – has dwindled to near-zero.



The impressive thing about this is not only where it is, but where it came from: 15% in 1992, and over 20% in the mid-1970s.

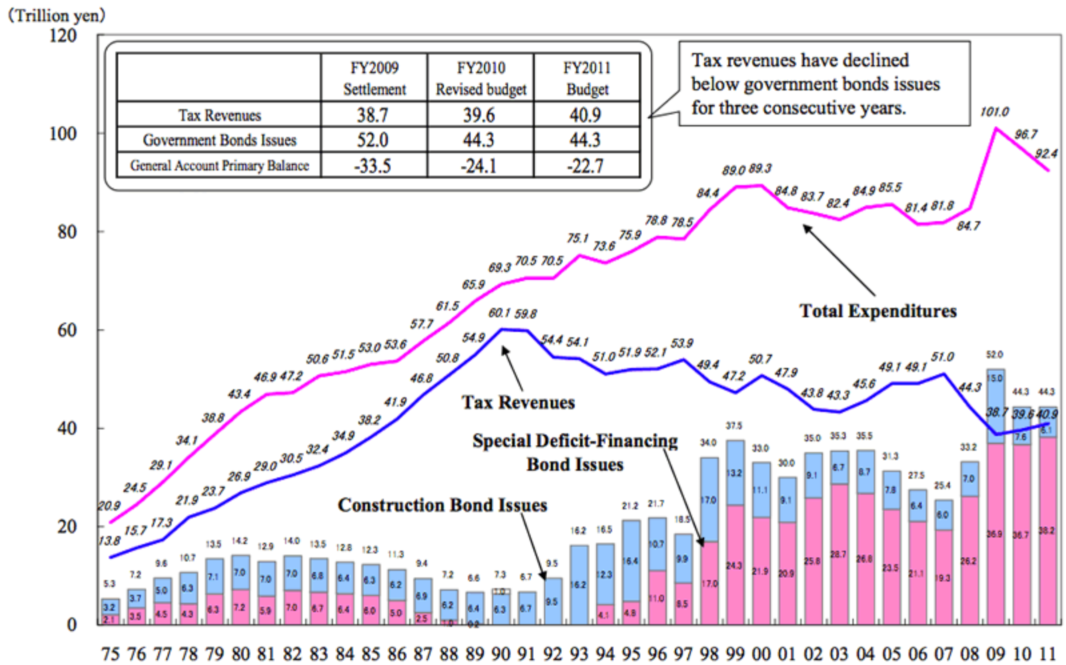



Corporations have been accumulating cash – government bills instead of bank deposits, since who trusts banks? They have also been paying down bank debt.

| Country | 2012 Bond, Bill Redemptions ($) | Coupon Payments |
|---|---|---|
| Japan | 3000 billion | 117 billion |
| U.S. | 2783 billion | 212 billion |
| Italy | 428 billion | 72 billion |
| France | 367 billion | 54 billion |
| Germany | 285 billion | 45 billion |
| Canada | 221 billion | 14 billion |
| Brazil | 169 billion | 31 billion |
| U.K. | 165 billion | 67 billion |
| China | 121 billion | 41 billion |
| India | 57 billion | 39 billion |
| Russia | 13 billion | 9 billion |

*Source: Mish's Global Economic Trend Analysis, January 3, 2012.*

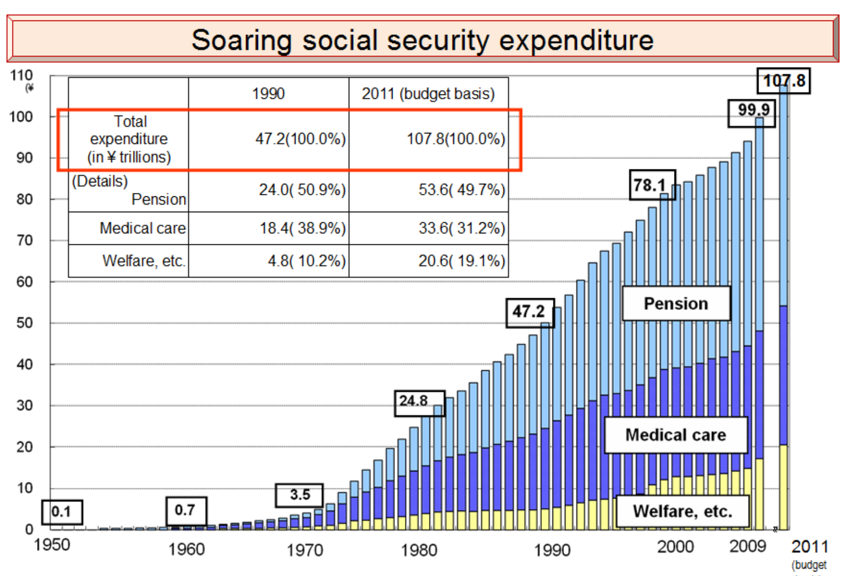
The government's general budget looks something like this:




*source: Ministry of Finance*

Government spending has risen from ¥69.3 trillion in 1990 to ¥92.4 trillion in 2011, an increase of ¥23.1 trillion or 33%. However, nominal GDP has risen only to ¥475 trillion in 2010 from ¥451 trillion in 1990, an increase of 5.3%.

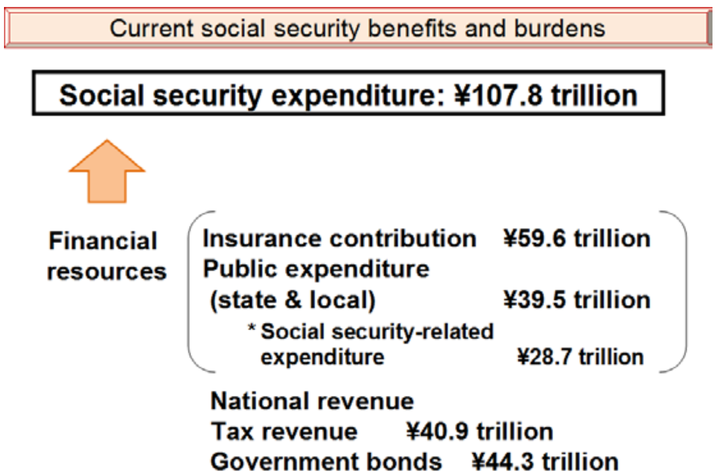
The astute observer may note that the official government tax revenues, of 8.6% of GDP, are well below the ratio of total government tax revenues as a percentage of GDP, estimated at 28.3% for 2012 by the Heritage Foundation. The gap is accounted for largely by the Ministry of Health, Labour and Welfare, which is responsible for Japan's public health and public pension (Social Security) systems. The MHLW takes in revenue in the form of payroll taxes, which it calls "insurance contributions."




*Source: Ministry of Health, Labour and Welfare*

Here we can see that expenditures on these items have risen by around ¥60 trillion since 1990, while nominal GDP is nearly flat. ("Social Security" here refers to public pensions – what we call 'Social Security'—plus the medical care system and welfare.)

To the Japanese government's credit, note that the present universal single-payer medical care system costs ¥33.6 trillion per year, or about 7.1% of GDP. This is actually less than the roughly 7.7% of GDP already being spent by Federal, state and local governments in the United States for healthcare. We're already paying for a universal healthcare system, we're just not getting it. If the U.S. could manage to do what Japan has done, then we would have a universal single payer system, corporations and families would have little additional healthcare costs, and it wouldn't cost any more money than we are already spending. I bet the U.S. healthcare industry, at 17% of GDP, wouldn't like that though, so we will have quite a bit of struggle between now and then.

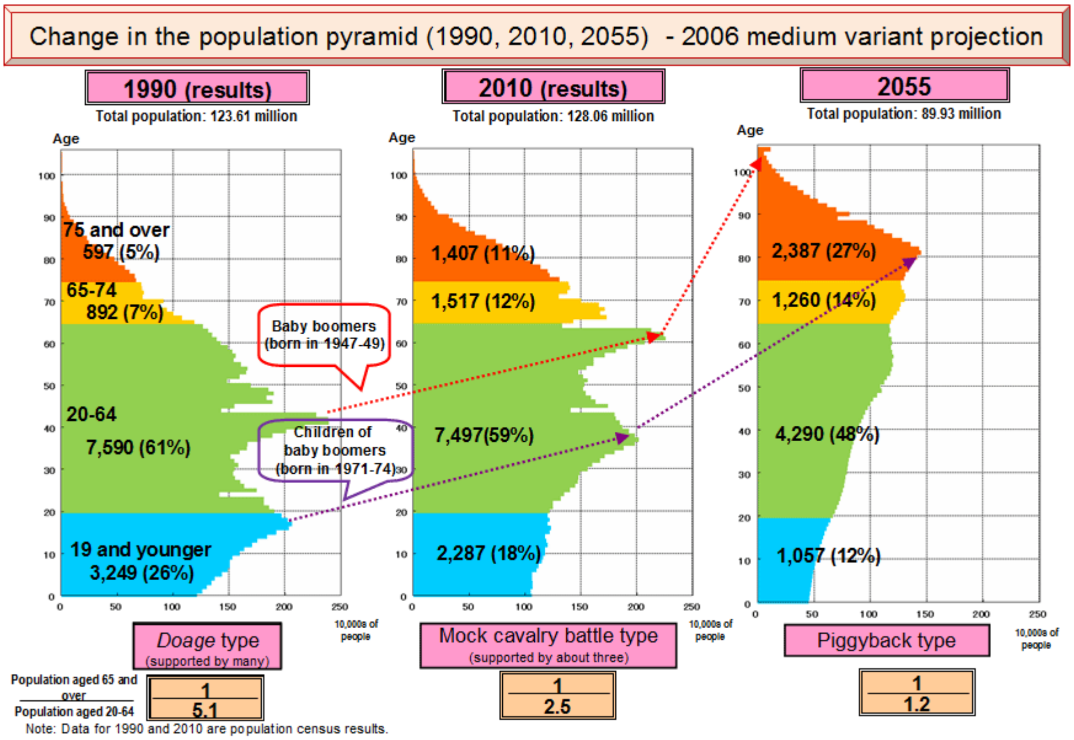



*Source: Ministry of Health, Labour and Welfare*

"Insurance contributions" (payroll taxes from both employer and employee sides) amount to around ¥59.6 trillion, more than all other national-level taxes combined. Some is paid by regional governments. The spillover (¥28.7 trillion) ends up in the general budget.

Thus, to use U.S.-style accounting which incorporates Social Security, Medicare and welfare on the national budget, along with revenue from payroll taxes, the national government's revenue is really more like ¥59.6+¥40.9=¥100.5 trillion, which makes the bond issuance of ¥44.3 trillion (9.3% of GDP) not so large as a percentage of total expenditures (30.5%). Still pretty big, though.

The Japanese government's budget difficulties are related to the aging of the population, which is really no different than problems elsewhere in the developed world, but a little more serious in Japan than elsewhere. Ultimately, demographics suggest that working-age people will have to support more non-working-age people. This will be true whatever the government does, or even if the present government exists in ten or twenty years. We will probably see some basic responses to this: a broader cohort of people will be working, perhaps up to age 70 and beyond; and, the cost of supporting a non-working person must decline. "Working" does not necessarily mean working full-time at a paying job. We can find new roles for the elderly, such as taking a more involved role in child-raising, or, for that matter, caring for other elderly. As for the cost of supporting a non-working person, that suggests that a lot more elderly will be moving in with their kids, which is really the way things have always been done, in all cultures. (Or, maybe grown children will live in their parents' house, this becoming quite common and acceptable.) It might also mean spending a lot less money and time on childrens' education, with the present university system very much in the crosshairs there.




*Source: Ministry of Health, Labour and Welfare.*

I might note that the annual budgets do not include "supplemental budgets," which are often added on as a form of "stimulus" or whenever the politicians feel like they need to make some more friends by handing out money. In 2011, there were no fewer than four (!) supplemental budgets, in part due to the earthquake and nuclear disaster in March 2011. The budgets were for ¥4.0 trillion, ¥2.0 trillion, ¥12.1 trillion, and ¥2.5 trillion, totaling ¥20.6 trillion.

Although 2011 was a special year due to the earthquake, I am always bemused with the carefree ease with which the politicians hand out ¥5 trillion here and ¥10 trillion there – these "supplemental" budgets happen every year, sometimes several in a year. Plus, there are the various giveaways from election time that get put into the general budget. Consider, for example, that the corporate income tax – at a 35% rate – is expected to generated ¥7.8 trillion of revenue in 2012, and the personal income tax is expected to generate ¥13.5 trillion. The existing 5% consumption tax (national sales tax) is earmarked for ¥10.2 trillion. So, the politicians are happy to hand out amounts equivalent to the entire revenue of the corporate or personal income taxes, basically just to buy friends. (The "supplemental budget" for 2010 was ¥4.9 trillion.) You'd think they could make even more friends simply by cutting the corporate and personal income tax rates to 20%, which would probably generate more revenue in both the short and long term. Every corporation and household would love them. This is precisely what happened at over a dozen countries that adopted "flat tax" systems in the last ten years, as I have documented elsewhere. But they never think of that.

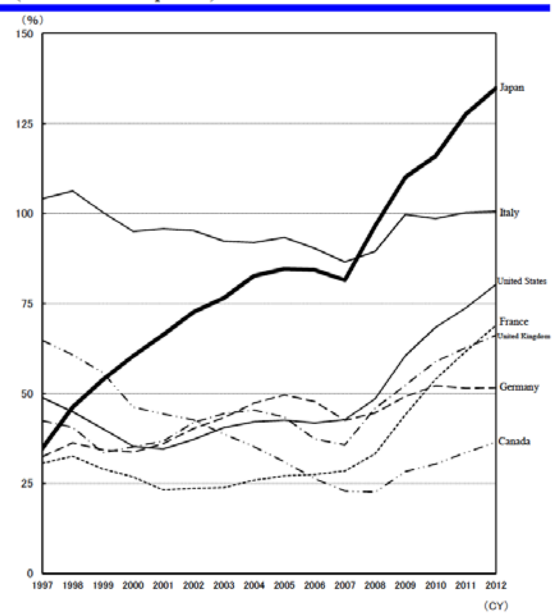
## (Reference 3) General Government Net Debt (International Comparison)

(%)

| CY | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|---|---|---|
| Japan | 34.8 | 46.2 | 53.8 | 60.4 | 66.3 | 72.6 | 76.5 | 82.7 |
| U.S. | 48.8 | 44.9 | 40.2 | 35.3 | 34.6 | 37.2 | 40.5 | 42.1 |
| U.K. | 30.6 | 32.6 | 29.0 | 26.8 | 23.2 | 23.7 | 23.9 | 25.9 |
| Germany | 32.5 | 36.3 | 34.4 | 33.7 | 36.1 | 40.3 | 43.3 | 47.3 |
| France | 42.4 | 40.6 | 33.6 | 35.2 | 36.7 | 41.9 | 44.4 | 45.4 |
| Italy | 104.1 | 106.3 | 100.3 | 95.0 | 95.7 | 95.2 | 92.3 | 92.0 |
| Canada | 64.7 | 60.8 | 55.8 | 46.2 | 44.3 | 42.6 | 38.7 | 35.2 |

| CY | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|---|
| Japan | 84.6 | 84.3 | 81.5 | 96.5 | 110.0 | 116.0 | 127.6 | 134.8 |
| U.S. | 42.5 | 41.8 | 42.7 | 48.5 | 60.5 | 68.4 | 73.8 | 80.3 |
| U.K. | 27.1 | 27.5 | 28.4 | 33.3 | 44.1 | 53.9 | 61.7 | 68.9 |
| Germany | 49.6 | 47.7 | 42.5 | 44.6 | 49.1 | 52.2 | 51.5 | 51.6 |
| France | 43.4 | 37.4 | 35.7 | 45.9 | 52.3 | 58.9 | 62.7 | 66.2 |
| Italy | 93.4 | 90.3 | 86.6 | 89.5 | 99.7 | 98.6 | 100.2 | 100.6 |
| Canada | 31.0 | 26.3 | 22.9 | 22.6 | 28.3 | 30.4 | 33.6 | 36.6 |

(Source) OECD "Economic Outlook 90" (December, 2011)
(Note 1) Figures represent the general government-based data (including the central/local governments and the social security funds).
(Note 2) FY2012 draft budget is not reflected in the above data.




*source: Ministry of Finance*

Here's what the budget for 2012 looks like:

### Framework of FY2012 Budget

(Unit: billion yen)

| | FY2011 Budget | FY2012 Budget | FY2011→FY2012 | Notes |
|---|---|---|---|---|
| (Revenues) | | | | |
| Tax revenues | 40,927.0 | 42,346.0 | 1,419.0 | |
| Other Revenues | 7,186.6 | 3,743.9 | △3,442.7 | Transfer the remaining reserves (¥996.7 billion) from the Special Account for Fiscal Investment and Loan Program to Special Account of Government Debt Consolidation Fund as refunding Reconstruction Bonds |
| Secured by Special Acts | 2,489.7 | — | △2,489.7 | |
| Government Bond Issues | 44,298.0 | 44,244.0 | △54.0 | Bond Dependency Ratio: 49.0% (FY2011: 47.9%) Medium-term Fiscal Framework: "Make every effort to ensure that the amount of new government bonds issuance in FY2012 does not exceed that in FY2011 (approx. ¥44 trillion)" |
| Construction Bonds | 6,090.0 | 5,909.0 | △181.0 | |
| Special Deficit-Financing Bonds | 38,208.0 | 38,335.0 | 127.0 | |
| Total | 92,411.6 | 90,333.9 | △2,077.7 | |
| (Expenditures) | | | | |
| National Debt Service | 21,549.1 | 21,944.2 | 395.1 | |
| Primary Balance Expenses | 70,862.5 | 68,389.7 | △2,472.8 | Medium-term Fiscal Framework: "Primary balance expenses will not, in substance, exceed that of the previous fiscal year" |
| Social Security | 28,707.9 | 26,390.1 | △2,317.7 | Excludes the amount required to ensure one-half support for basic pension expense by national government contribution in FY2012 which would be financed by government compensation bond reimbursed by fiscal revenues acquired by drastic reform of the taxation system |
| Local Allocation Tax Grants, etc. | 16,784.5 | 16,594.0 | △190.5 | (Reference) The total amount of local allocation tax in expenditure basis in the Special Account for Local Allocation and Local Transfer Tax (¥17,454.5 billion, up ¥ 81.2 billion over FY2011) |
| Contingency Reserve for Economic Crisis Response and Regional Revitalization | 810.0 | 910.0 | 100.0 | |
| Transfer to Special Account for Reconstruction from the Great East Japan Earthquake | — | 550.7 | 550.7 | |
| Others | 24,560.1 | 23,944.8 | △615.3 | |
| Total | 92,411.6 | 90,333.9 | △2,077.7 | |

(Note 1) Figures may not add up to the totals due to rounding.
(Note 2) Figures of revenues and expenditures above include expenses related to payments to patients of Type-B Hepatitis
(Note 3) Revenues and expenditures for recovery and reconstruction from the Great East Japan Earthquake are allocated to Special Account for Reconstruction from the Great East Japan Earthquake (tentative)

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*source: Ministry of Finance*

As we can see, once we consider the public pension, healthcare and welfare payments from the MHLW, plus the National Debt Service and Local Allocation Tax Grants, there really isn't much left to cut – just ¥24 trillion of "other."

The "debt service" line is a funny thing. The amount there is much higher than the interest payments on the debt. The difference is mostly "debt redemption."

### (4) Breakdown of Government Debt-related Expenditures in the General Account

(Unit : billion yen)

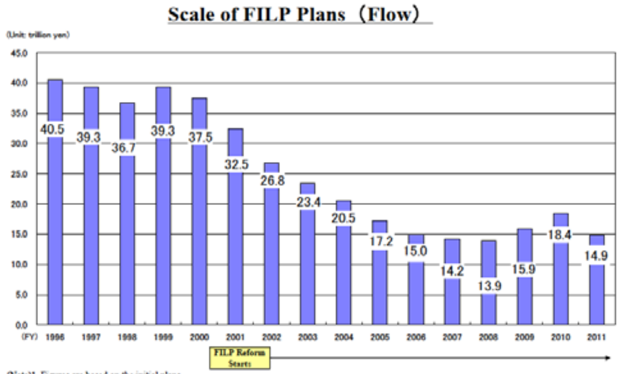
| Category | FY2010(initial) | FY2011(initial) | changes |
|---|---|---|---|
| Debt redemption expenses | 10,840.4 | 11,590.3 | 749.9 |
| JGB redemption | 9,835.1 | 10,585.8 | 750.7 |
| Transfer fund by the 60-year redemption rule | 8,883.6 | 9,572.6 | 689.1 |
| Tranfer fund from Industrial Investment Special Account | 90.6 | 89.6 | ▲1.0 |
| Transfer fund needed for redemption of special bonds issued for a tax reduction | 256.8 | 256.8 | – |
| Transfer fund by the budget | 604.2 | 666.7 | 62.6 |
| Borrowing redemption | 1,005.3 | 1,004.6 | ▲0.7 |
| Transfer fund by the 60-year redemption rule | 281.2 | 265.7 | ▲15.5 |
| Transfer fund by the budget | 724.1 | 738.8 | 14.7 |
| Interest payment and discount expenses | 9,756.7 | 9,923.8 | 167.2 |
| JGB interest payment | 9,202.0 | 9,475.5 | 273.5 |
| Borrowing interest payment | 344.7 | 298.4 | ▲46.3 |
| Financing Bills discount expense | 210.0 | 150.0 | ▲60.0 |
| Administration expense | 52.0 | 34.9 | ▲17.1 |
| Total | 20,649.1 | 21,549.1 | 900.0 |

Note: Figures may not sum up to the total because of rounding

*source: Ministry of Finance*

While the Ministry of Finance has indeed been buying back some bonds in the open market (notably inflation-indexed bonds … hmmmm), the amounts have been smaller, around ¥220 billion a month. I suspect that most of the redemptions are in effect the unwind of the Postal Savings system. Basically, the Postal Savings system, a government bank, financed a bunch of silly public projects – white elephants like museums, sports stadiums and impressive but largely unnecessary bridges and tunnels – via the "Fiscal Investment and Loan Program" or "FILP." This was known for years as the "shadow government budget," and estimates of losses on those loans are in the region of 50%. FILP underwent some reforms about ten years ago and the Postal Savings system is being wound down, with deposits gradually declining. FILP's debts were converted into "FILP bonds," a type of JGB of which there are about ¥118 trillion outstanding. I suspect that these "JGB redemptions" are primarily purchases of FILP bonds, because FILP itself is unable to pay them. Indeed, outstanding FILP bonds fell from ¥140 trillion outstanding in 2007, to ¥131 trillion in 2008, ¥122 trillion in 2009 and ¥118 trillion in 2010; in other words, in line with "JGB redemptions" noted above. Also, there are about a trillion yen in "borrowing redemptions," which are direct borrowings from the Fiscal Loan and Investment Fund.

**Scale of FILP Plans（Flow）**




(Note)1. Figures are based on the initial plans.
2. Figures before FY2000 are counted on the general FILP (excluding the independently managed funds by Postal Savings, Pension Funds, and etc.)

(Reference1) The outstanding balance of FILP at the end of FY2011 is estimated to be 186.6 trillion yen. (193.9 trillion yen at the end of FY 2010).
(Reference2) The issues of FILP bonds are planned to be 14.0 trillion yen. (15.5 trillion yen in FY2010).

*source: Ministry of Finance*

After several reorganizations and name changes over the past ten years, the Postal Savings system (now the Postal Savings Bank) reports deposits of ¥174 trillion. This is down from ¥224 trillion in deposits and ¥126 trillion in life insurance policies in 2005, estimated to be 25% of all household assets at the time. In other words, the government is on the hook to make up those losses, and I suspect that the very high "debt service" costs are related to that. The whole issue of the Japan Postal Savings/FILP unwind and losses has been kept very hush-hush.

Here's what it looked like in 2003-2005:

Column

## Fund Management of Postal Savings and Postal Life Insurance

### (1) Balance Sheets of Postal Savings and Postal Life Insurance

The balance sheets of Postal Savings and Postal Life Insurance appear in disclosure brochures published by Japan Post. The outline is shown below.

**A. Postal Savings**

(Unit : billion yen)

| Items | End of FY2003 | End of FY2004 | End of FY2005 | Items | End of FY2003 | End of FY2004 | End of FY2005 |
|---|---|---|---|---|---|---|---|
| Assets | | | | Liabilities | | | |
| Cash and deposits | 6,675.7 | 6,088.1 | 6,833.5 | Postal money order | 9.7 | 10.2 | 9.8 |
| Call loans | — | 100.0 | 100.0 | Postal giro | 4,343.0 | 5,193.9 | 5,800.5 |
| Receivable under resale agreements | 780.2 | 209.9 | 159.4 | Postal savings | 220,049.8 | 210,908.6 | 198,094.9 |
| Money held in trust | 3,776.0 | 3,388.0 | 3,321.3 | Borrowings | 43,200.3 | 38,200.0 | 33,200.0 |
| Securities | 109,160.5 | 132,546.1 | 152,241.5 | Other liabilities | 8,577.3 | 4,580.8 | 2,975.8 |
| Deposits to the fiscal loan fund | 156,095.4 | 117,611.9 | 79,896.9 | Reserve for employees' bonuses | 33.3 | 34.0 | 33.9 |
| Loans | 2,786.1 | 3,708.4 | 4,126.9 | Reserve for directors' bonuses | — | 0.0 | 0.0 |
| Other assets | 417.7 | 411.1 | 414.8 | Reserve for employees' retirement benefits | 673.0 | 665.0 | 655.9 |
| Premises and equipment,net | 878.4 | 818.1 | 669.3 | Reserve for directors' retirement benefits | 0.0 | 0.0 | 0.0 |
| Allowance for doubtful accounts | -17.2 | -17.0 | -14.1 | Total liabilities | 276,886.6 | 259,592.7 | 240,771.1 |
| | | | | Capital | | | |
| | | | | Difference of assets and liabilities at the time of establishment of Japan Post | 1,804.4 | 1,804.4 | 1,804.4 |
| | | | | Retained earnings | 2,275.5 | 3,485.0 | 5,415.5 |
| | | | | Net unrealized losses on securities | -413.6 | -17.2 | -241.2 |
| | | | | Total capital | 3,666.3 | 5,272.1 | 6,978.6 |
| Total assets | 280,553.0 | 264,864.9 | 247,749.7 | Total liabilities and capital | 280,553.0 | 264,864.9 | 247,749.7 |

**B. Postal Life Insurance**

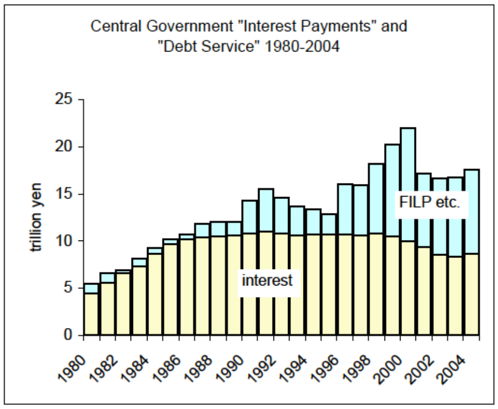
(Unit : billion yen)

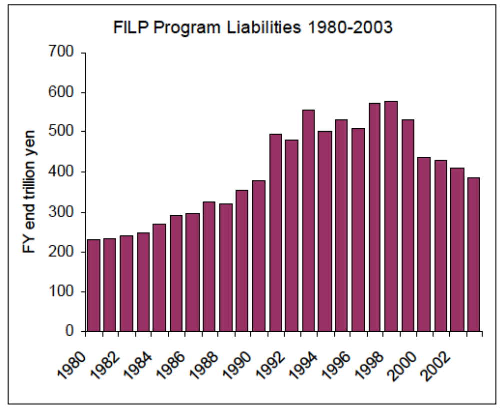
| Items | End of FY2003 | End of FY2004 | End of FY2005 | Items | End of FY2003 | End of FY2004 | End of FY2005 |
|---|---|---|---|---|---|---|---|
| Assets | | | | Liabilities | | | |
| Cash and deposits | 2,392.3 | 2,390.5 | 1,946.7 | Policy reserves | 119,735.4 | 118,689.9 | 115,907.2 |
| Call loans | 48.9 | 174.9 | 367.2 | Other liabilities | 116.8 | 108.7 | 125.8 |
| Monetary claims bought | 44.9 | 130.9 | 59.9 | Reserve for employees' bonuses | 23.3 | 23.2 | 22.4 |
| Money held in trust | 11,718.8 | 8,930.0 | 9,151.7 | Reserve for employees' retirement benefits | 539.0 | 530.8 | 520.9 |
| Securities | 81,670.7 | 84,731.3 | 84,850.6 | Reserve for directors' retirement benefits | 0.0 | 0.0 | 0.0 |
| Loans | 24,755.3 | 23,898.5 | 22,757.1 | Reserve for price fluctuations | 4.1 | 525.4 | 577.3 |
| Premises and equipment, net | 718.9 | 666.9 | 515.2 | | | | |
| Other assets | 563.3 | 346.7 | 315.0 | Total liabilities | 120,418.8 | 119,878.1 | 117,153.7 |
| Allowance for doubtful accounts | -1.4 | -1.3 | -1.4 | Capital | | | |
| | | | | Difference of assets and liabilities at the time of establishment of Japan Post | 42.6 | 42.6 | 42.6 |
| | | | | Retained earnings | — | — | — |
| | | | | Net unrealized losses on securities | 1,450.5 | 1,348.0 | 2,765.9 |
| | | | | Total capital | 1,493.1 | 1,390.6 | 2,808.5 |
| Total assets | 121,911.9 | 121,268.8 | 119,962.3 | Total liabilities and capital | 121,911.9 | 121,268.8 | 119,962.3 |

Source : Postal Savings and Postal Life Insurance Disclosure Brochures (FY2005 edition), Japan Post website.

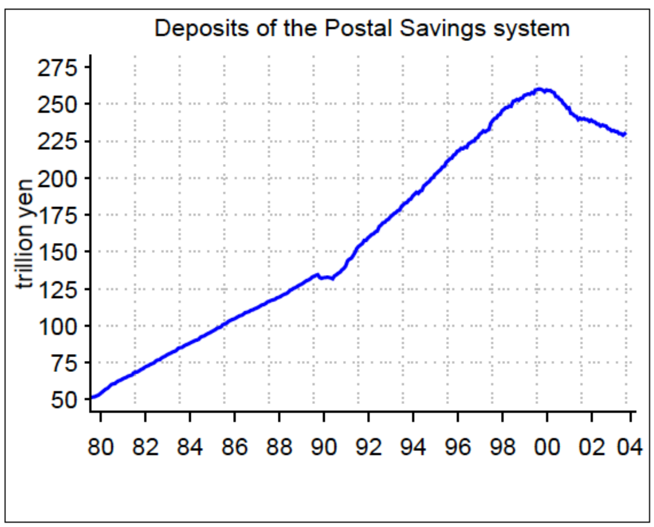
*Source: Ministry of Finance*

Here’s a little history of “debt service” and “interest payments” in the general budget:




We can see here that “debt service” begins to diverge from “interest payments” at exactly the point at which bad debts expand throughout the economy, and then get a lot bigger just before the FILP reforms of 2001. (The balance of the Fiscal Loan Fund today is ¥159 trillion.)




This is down to ¥174 trillion today.

I’m sure you are saying “enough of FLIP … I mean FILP” by this point, so we will move on but I think it is an interesting topic.

Let’s also take a quick look at prefectural and local-level finances. In the General Budget is a funny item for “local allocation tax grants etc.” Actually, it’s not so funny, it’s a ¥26 trillion item. About ¥15 trillion is the local allocation tax grants, a straight payment to regional governments. Where does this money go?

**Table 4.3**

**Local Government Finance** [1] (Ordinary account)

(Billion yen)

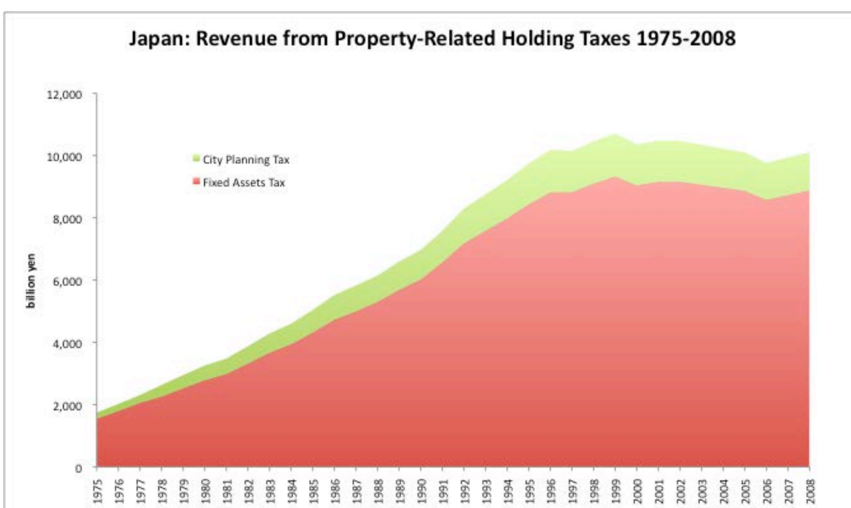
| Item | FY2004 | FY2005 | FY2006 | FY2007 | FY2008 |
|---|---|---|---|---|---|
| **Revenue** | 93,442 | 92,936 | 91,528 | 91,181 | 92,213 |
| Local taxes | 33,539 | 34,804 | 36,506 | 40,267 | 39,559 |
| Local allocation tax grants | 17,020 | 16,959 | 15,995 | 15,203 | 15,406 |
| Treasury disbursements | 12,350 | 11,778 | 10,416 | 10,222 | 11,583 |
| Local government bonds | 12,375 | 10,376 | 9,622 | 9,584 | 9,922 |
| **Expenditure** | 91,248 | 90,697 | 89,211 | 89,148 | 89,691 |
| General administration | 8,941 | 8,737 | 8,618 | 8,906 | 8,920 |
| Public welfare | 15,132 | 15,693 | 16,259 | 16,976 | 17,821 |
| Labor | 359 | 317 | 296 | 276 | 663 |
| Sanitation | 5,785 | 5,707 | 5,510 | 5,436 | 5,390 |
| Civil engineering work | 15,235 | 14,417 | 13,853 | 13,391 | 12,871 |
| Education | 16,910 | 16,578 | 16,472 | 16,432 | 16,147 |

1) Settled figures of the net total of prefectural and municipal government accounts after deducting duplications.

Source: Ministry of Internal Affairs and Communications.

Local finances are actually quite hefty, with ¥89 trillion in expenditure in FY2008. Most of this goes to welfare (payments to MHLW "Social Security" as described earlier), education, and "civil engineering work." This is of course the public works budget. Only about ¥4 trillion of public works is in the national-level general budget. Most of it is on the books at the regional level. Although the "local allocation tax grants" are not necessarily directed at public works spending, I think it is suggestive that the amount of the local allocation tax grants and the local public works budget is about the same size. The Japanese government's public works spending has come way down in recent years, but it is still probably about twice the size it should be. After decades of excessive public works funding, everything is in tip-top shape.

Another interesting topic in local government finance is the revenue from property holding taxes. Here it is:



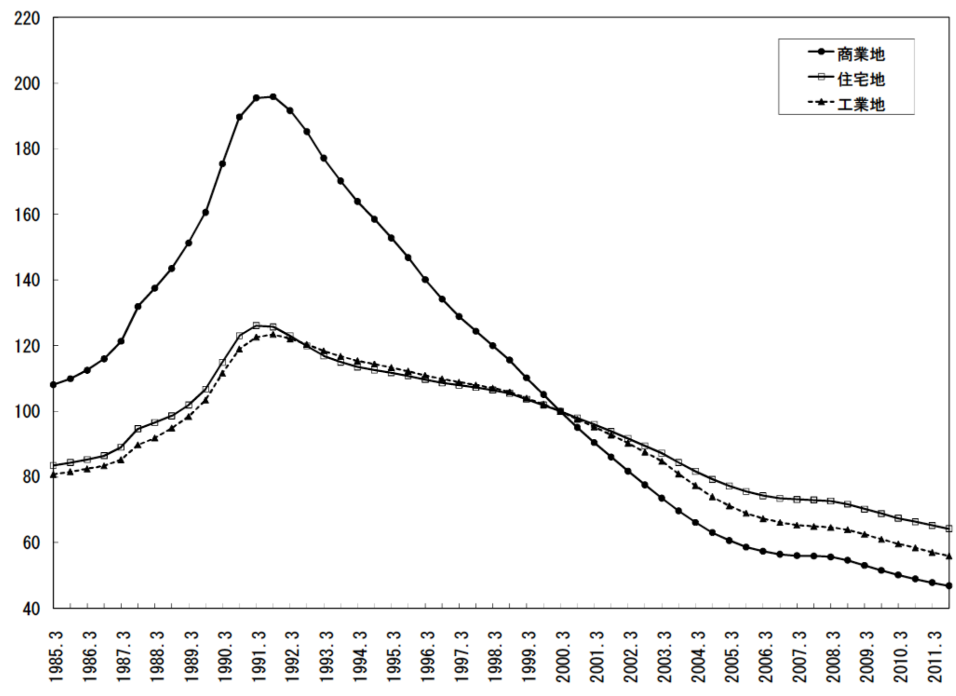

*source: Ministry of Internal Affairs and Communications*

In addition to these, I think there are some other property-related taxes, such as an "office tax." However, these are the biggies I think. As we can see, they are quite large, generating about ¥10 trillion of revenue combined. But, the funny thing is that revenue from these sources went *up* in the 1990s while property values went *down*. In other words, effective property taxes rose by very large amounts.

平成12年3月末 (End of Mar. 2000) = 100

| 月末 End of Month | | 商業地 Commercial | 前期比 (%) *1 | 前年同期比 (%) *2 | 住宅地 Residential | 前期比 (%) *1 | 前年同期比 (%) *2 | 工業地 Industrial | 前期比 (%) *1 | 前年同期比 (%) *2 | 全用途平均 Average of Three Categories | 前期比 (%) *1 | 前年同期比 (%) *2 | 最高価格地 The Highest Price Lot | 前期比 (%) *1 | 前年同期比 (%) *2 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 昭和60.3 | Mar. 1985 | 108.1 | 1.5 | 3.1 | 83.5 | 1.3 | 2.7 | 80.8 | 1.1 | 2.4 | 91.5 | 1.3 | 2.8 | 121.3 | 2.1 | 4.0 |
| 平成02.3 | Mar. 1990 | 175.4 | 9.2 | 15.9 | 114.9 | 7.7 | 12.8 | 111.6 | 7.9 | 13.4 | 133.9 | 8.3 | 14.1 | 226.1 | 10.6 | 18.8 |
| 07.3 | Mar. 1995 | 152.8 | -3.6 | -6.8 | 111.8 | -0.7 | -1.5 | 113.3 | -1.0 | -1.8 | 126.1 | -1.9 | -3.7 | 185.9 | -5.6 | -10.2 |
| 12.3 | Mar. 2000 | 100.0 | -4.8 | -9.2 | 100.0 | -1.9 | -3.5 | 100.0 | -2.1 | -3.9 | 100.0 | -3.1 | -5.8 | 100.0 | -6.5 | -12.3 |
| 18.9 | Sep. 2006 | 56.4 | -1.6 | -3.9 | 73.5 | -1.1 | -2.7 | 66.1 | -1.8 | -4.2 | 64.8 | -1.4 | -3.5 | 50.6 | -1.2 | -3.4 |
| 19.3 | Mar. 2007 | 56.0 | -0.6 | -2.2 | 73.2 | -0.4 | -1.6 | 65.3 | -1.1 | -2.9 | 64.4 | -0.7 | -2.1 | 50.7 | 0.2 | -1.0 |
| 19.9 | Sep. 2007 | 55.9 | -0.2 | -0.8 | 73.0 | -0.2 | -0.7 | 64.9 | -0.6 | -1.7 | 64.2 | -0.3 | -1.0 | 51.0 | 0.5 | 0.7 |
| 20.3 | Mar. 2008 | 55.6 | -0.5 | -0.7 | 72.7 | -0.5 | -0.7 | 64.6 | -0.5 | -1.1 | 63.9 | -0.5 | -0.8 | 51.1 | 0.2 | 0.7 |
| 20.9 | Sep. 2008 | 54.6 | -1.8 | -2.3 | 71.7 | -1.3 | -1.8 | 63.9 | -1.1 | -1.6 | 62.9 | -1.5 | -1.9 | 50.2 | -1.8 | -1.6 |
| 21.3 | Mar. 2009 | 53.0 | -3.0 | -4.7 | 70.2 | -2.1 | -3.4 | 62.5 | -2.2 | -3.3 | 61.4 | -2.5 | -3.9 | 48.4 | -3.5 | -5.2 |
| 21.9 | Sep. 2009 | 51.5 | -2.8 | -5.7 | 68.8 | -2.0 | -4.1 | 61.0 | -2.4 | -4.5 | 59.9 | -2.4 | -4.8 | 46.8 | -3.2 | -6.6 |
| 22.3 | Mar. 2010 | 50.1 | -2.7 | -5.4 | 67.4 | -2.0 | -3.9 | 59.6 | -2.3 | -4.6 | 58.5 | -2.3 | -4.6 | 45.4 | -3.1 | -6.2 |
| 22.9 | Sep. 2010 | 48.9 | -2.4 | -5.0 | 66.3 | -1.7 | -3.6 | 58.4 | -2.1 | -4.4 | 57.3 | -2.1 | -4.3 | 44.2 | -2.6 | -5.6 |
| 23.3 | Mar. 2011 | 47.8 | -2.4 | -4.7 | 65.2 | -1.7 | -3.4 | 57.0 | -2.3 | -4.4 | 56.1 | -2.1 | -4.1 | 43.0 | -2.7 | -5.3 |
| 23.9 | Sep. 2011 | 46.8 | -2.0 | -4.4 | 64.2 | -1.5 | -3.2 | 55.9 | -1.9 | -4.1 | 55.1 | -1.8 | -3.8 | 42.1 | -2.2 | -4.8 |

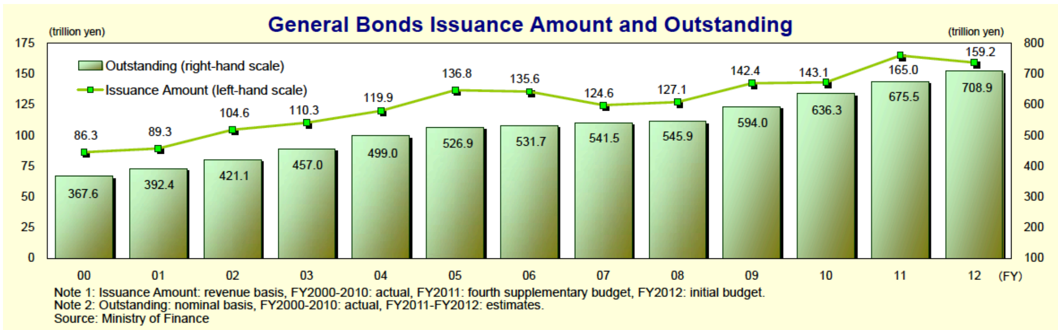
*1 percent change from previous half-year *2 percent change from previous year

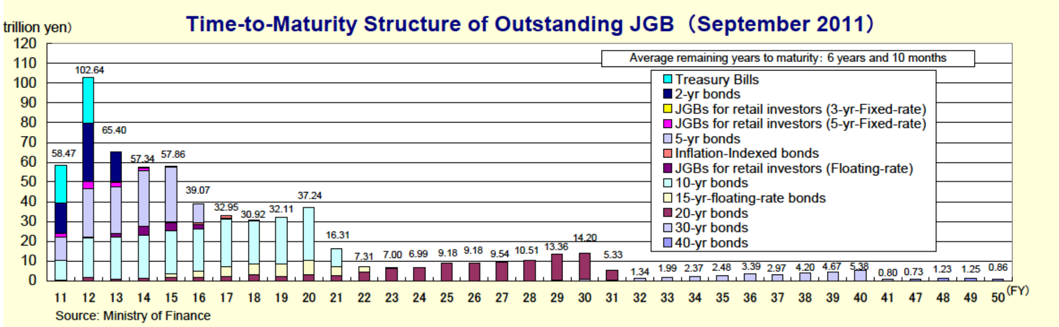



*source: Japan Real Estate Institute*

Thus we see that in 1990, the peak of the property boom, the national index was at 133.9 while total property tax revenue was ¥6,974 billion. In 2008, the national index was at 55.1 while the revenue was at ¥10,101 billion. It works out to a 3.52x increase in effective property taxes. Which, you might surmise, would be a little bad for property values, and consequently for bad debts at banks, activity in the real estate industry, and all the related functions.

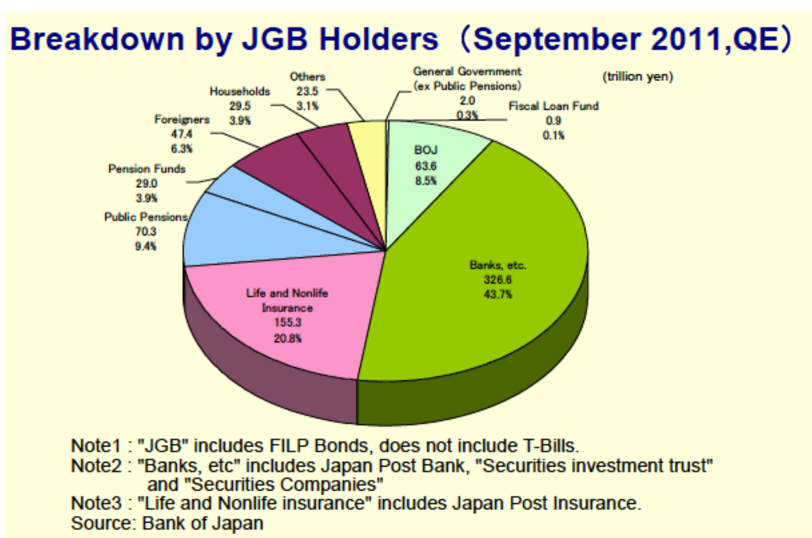
In addition to the bond issuance noted in the general budget, the Government Pension Investment Fund – their equivalent to the U.S. government's Social Security Trust Fund – will sell ¥8.8 trillion of its JGB holdings in fiscal 2012, up from about ¥6 trillion in 2011 and ¥4 trillion in 2010. Since I am considering these holdings to be a hypothetical intragovernmental accounting convention, this issuance is equivalent to issuance of new JGBs.



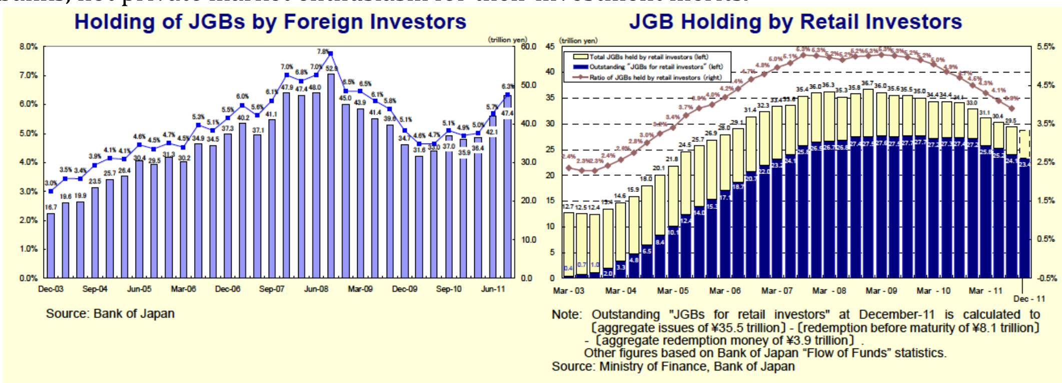

*Source: Ministry of Finance*

Contrary to popular belief, the Japanese retail investor doesn't own many government bonds. Actually, they hold only 3.9% of the amount outstanding, including indirectly through mutual funds etc. This is actually less than foreigners, who hold 6.3%.




*Source: Ministry of Finance*

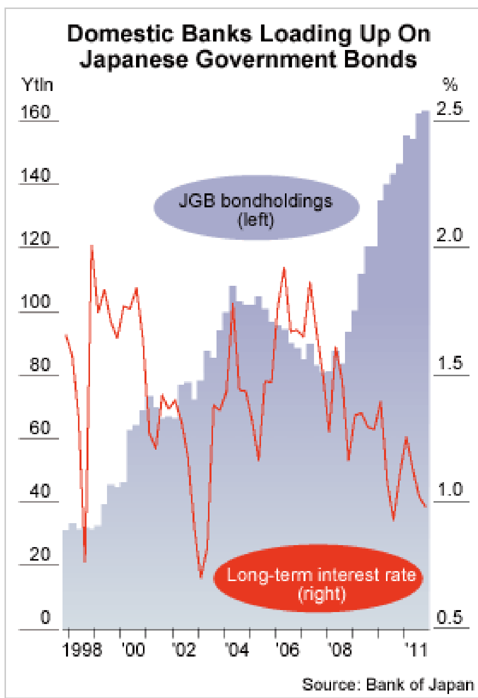
Even from these low levels, Japanese households have been reducing their JGB holdings, which is quite sensible given the situation. Foreigners have actually been expanding their JGB holdings a bit in recent years, which I suspect is primarily “diversification” by other central banks, not private market enthusiasm for their investment merits.




*Source: Ministry of Finance*

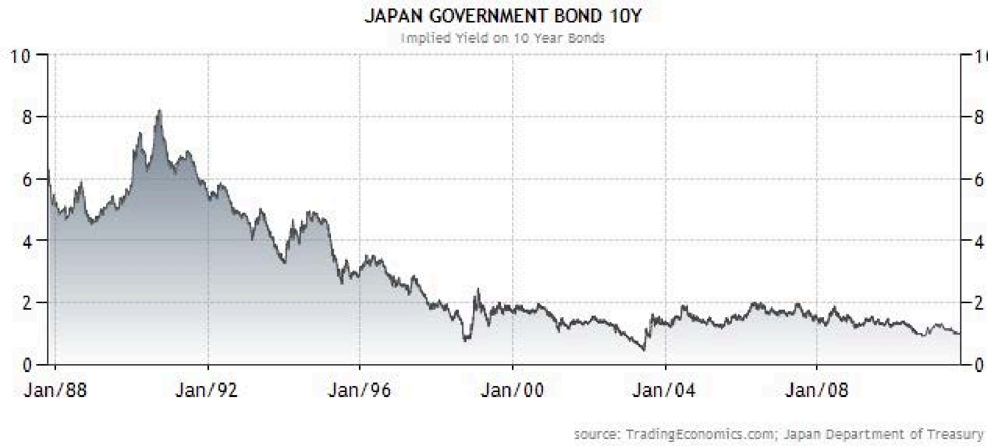
Indeed, almost all of the bonds are held either by government agencies – public pensions, the BoJ – and large Japanese financial institutions, banks and insurers.

As I have said, the government could get virtually the entire JGB market in a room around a conference table. And then, you could work out some deals. You could make the banks a deal they can’t refuse: buy our bonds, at a yield of 1%, or else.



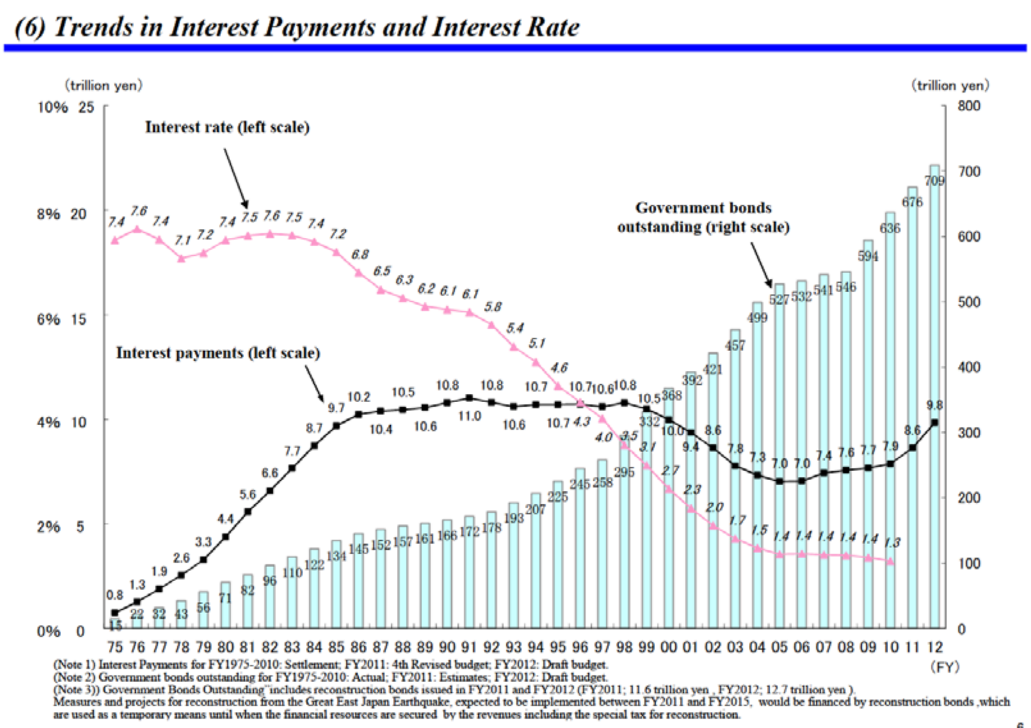

*Source: Nihon Keizai Shimbun*

I don’t think the JGB market is a natural market at all, but rather just the public face of a collusion between the government and the large financial institutions, indeed no different than what we have seen in recent months in Italy and Spain, as bank holdings of government bonds balloon there too.




*source: businessinsider.com*

We see that the JGB's rather unnatural flatlining of yield, for over ten years, begins right when banks' holdings of JGBs begin to soar around 1999.

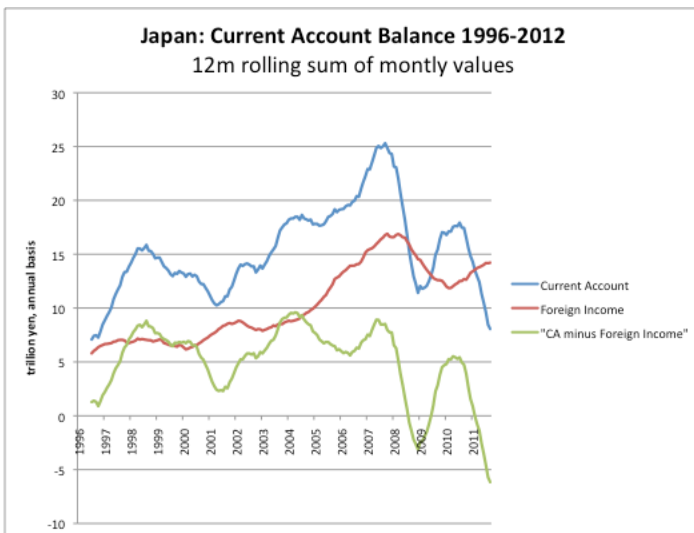



*source: Ministry of Finance*

The government has been able to keep its interest costs down because, over the past ten years, it has been able to refinance essentially all of its debt at these low rates. In recent years, new issuance has overwhelmed any further advantage from refinancing the existing debt at a lower yield, so total payments are rising again. If interest payments were to increase from an average 1.3% to, perhaps, the 5% that Spain is struggling with today, interest payments would increase by 3.8x, to ¥37 trillion from ¥9.8 trillion estimated for 2012, an increase of ¥27 trillion per year. Which is a little difficult when the revenue from all of your taxes, not including the payroll tax, is ¥40 trillion. This assumes, of course, no increase in debt outstanding. Ha ha ha. I think they have painted themselves into a corner, and they know it.

This works for as long as banks have funds to buy the bonds with. With the household savings rate now near zero, the cash has been coming from corporations, who are paying down their debt and building up their cash (and not making many investments, which is one reason the employment picture stinks.) This works for as long as corporations have operating cashflow, which in turn depends on domestic and international economic conditions. Oddly, corporations' disaster-preparedness activities are in practice postponing the denouement here.

The limit comes when available savings in the economy are insufficient to finance the government's bond issuance. That is indicated by the current account balance. A current account surplus basically indicates that domestic savings is in excess of domestic investment, so excess capital flows overseas. A current account deficit shows the opposite: that domestic investment is in excess of domestic savings, so the difference is made up by foreigners.




*source: Ministry of Finance*

Actually, it is a little more complicated than that: the Current Accounts also include income from foreign investments, which, like income from domestic investments, can be used to finance domestic investment. If not for Japanese institutions' extensive holdings of overseas assets, they would already be unable to fund the government's deficit. As it is, it appears that they have about a ¥7 trillion cushion for now, which is not that much in the scheme of things (1.5% of GDP). However, the government's borrowing needs were increased by the natural disasters in 2011, so maybe their borrowing will also abate somewhat.

There is another player in this game of course: the Bank of Japan, which is buying JGBs as part of its asset-purchase program. Some BoJ LTROs coming up? Why not.


Bank of Japan monetary base
*source: Bank of Japan*

**As for politics:** In 2005, I was chit-chatting with the manager of a large fund, who was pondering the bullish case for Japan. The stock markets there had already had large gains, particularly in the left-for-dead smallcap sector. But was it just the beginning of a bull market that might stretch a couple decades? This was a sensible hypothesis; the bear market had gone on long enough, and valuations were at bear-market-bottom kinds of levels. Naturally he asked my opinion, and I blurted out: "they will tax themselves to death." This was not a very well considered outburst; usually it is best to hedge at least a bit when you are making multi-year predictions.

But here it is, now seven years later, and "they will tax themselves to death" is about all you need to know about what has gone on in that time, and what is continuing to happen. Spending up; tax rates up; tax revenues down; and a moribund economy as people rightfully conclude that there's nothing but trouble up ahead, somewhere.

In the past, I've described the Japanese government's long history with trying to raise the consumption tax. (See our 3Q09 letter for example.) Clearly, this is being pushed by the Ministry of Finance, which pulls strings and twists arms to get politicians to back it. For politicians, this has been the kiss of death: every politician that backed the plan, starting with prime minister Masayoshi Ohira in 1979, is soon removed from office. This reflects a broader struggle, the desire of the Japanese public to maintain a (relatively) small government/low tax environment, which has been the case in Japan since the Meiji Restoration – when nearly all existing taxes (1500 of them!) were eliminated and replaced with a single property tax. The government was also slashed in size, with the samurai class, former warriors that had become a class of generationally sinecured government bureaucrats in the years of peace since 1600, summarily fired. They didn't take this lightly, resulting in the Satsuma Rebellion in 1877, which was dramatized in the movie *The Last Samurai* with Tom Cruise. (My mother's family descended from one such samurai family, from Toyama Prefecture, that became entrepreneurs, investors and speculators.) Today's bureaucrats, on the other hand, want to impose a big government/high tax environment, mimicking their peers in Europe, and are quite frank about it if you ask them.

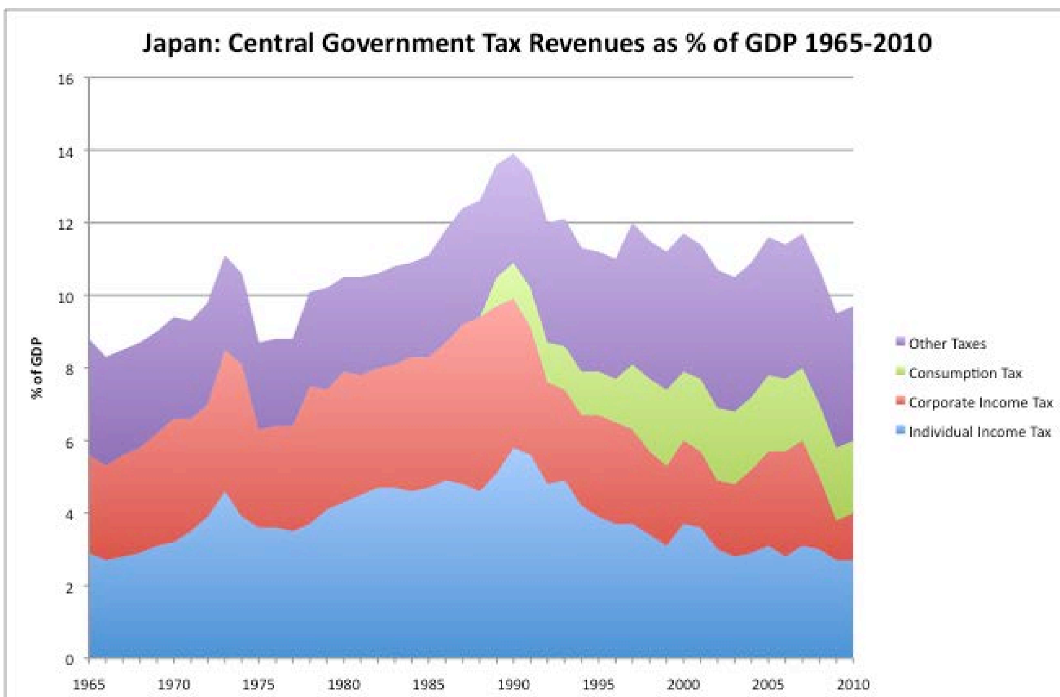
> I personally think Japan should take the road to a European-model big government. That would entail raising the consumption tax 10-15 percentage points to around 20%.

-- former Ministry of Finance chief bureaucrat Eisuke Sakakibara, *Nihon Keizai Shimbun*, August 10, 2010.

The latest sucker is current prime minister Yoshihiko Noda, who, last month, signed a bill to raise the consumption tax to 8% (from 5%) in April 2014 and 10% in October 2015. The bill now needs to pass the two houses of Parliament, where it may be killed. If the bill doesn't pass, it is generally recognized that Noda's term as prime minister would end. Whether that happens or not, often a personal scandal erupts around this time, regarding bribes or women or whatever, that accomplishes the same thing.

The consumption tax hike plan threatened to split Noda's own party, the Democratic Party of Japan, which has many opponents to the tax hike. Also, the opposition Liberal Democratic Party soon voiced its opposition to the plan. The LDP, however, backed an identical plan of its own just a few years ago, to raise the tax rate to 10%. Within the DPJ, party leader Ichiro Ozawa has said that he opposes the plan, but Ozawa had just such a proposal to raise the consumption tax rate in his book *Blueprint for a New Nation* in 1993. These guys are endless flip-floppers. If anything, the rate of flip-flopping has accelerated, giving the impression that it will reach some singularity soon, where everyone is both in favor and opposed simultaneously. (The LDP, doing its best imitation of a pancake chef, has already decided that it is now in favor of the tax hike plan.)

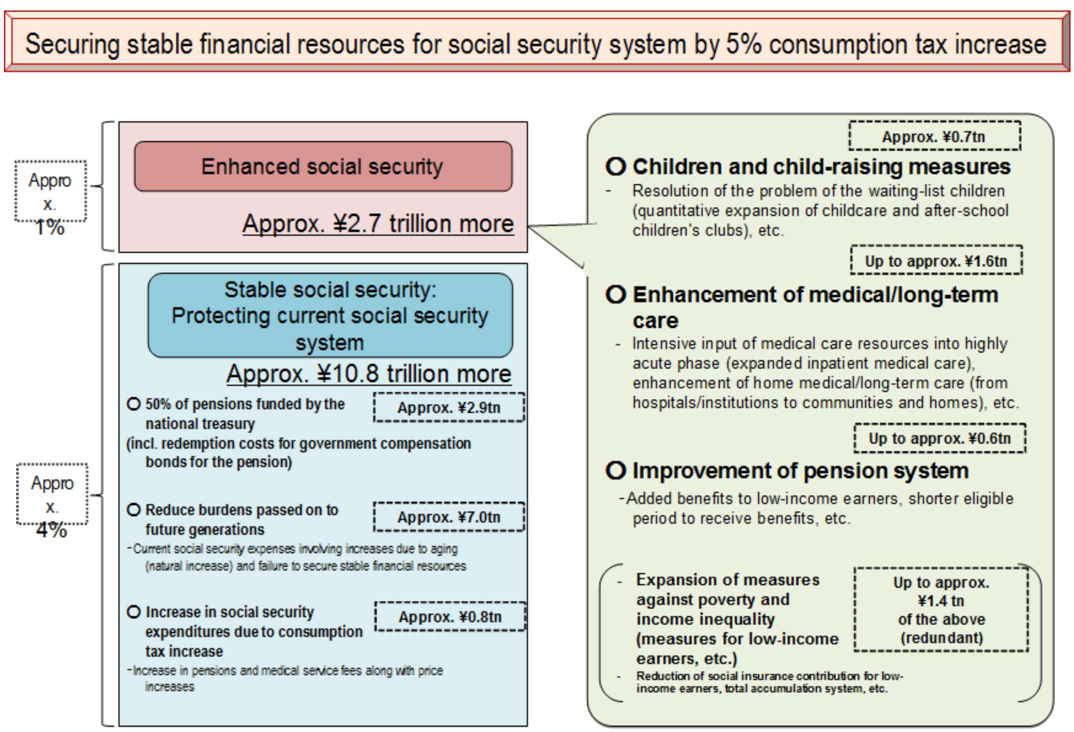
The present 5% consumption tax generates about ¥10 trillion annually, and you know the bureaucrats are already rubbing their hands on the prospects of getting all that new loot. However, I suspect that the result would be that total tax revenues, as a percentage of GDP, actually don't go up much at all. This has long been the case in Japan, and is usually the case in any country in these situations, as we see in Greece today for example.




Even with the assumption that total tax revenue goes up as much as MOF thinks it will, this would hardly make even a dent in the government's broader fiscal difficulties. "Even if the consumption tax were raised to 25% by 2030, the ratio of net government debt to gross domestic product would rise to about 210%, from 130% today," opined Kazuo Ueda, professor of economics at the prestigious University of Tokyo. The Ministry of Finance itself issued an analysis that, even with the tax hike, new bond issuance would be ¥45.4 trillion in 2015.

Discussions of the tax hike have included the complaint that it falls disproportionately on lower incomes. Solution? Higher taxes on upper incomes, naturally. Apparently, the tax hike bill includes language to raise the top income tax rate by five percentage points, to an effective 55% when including prefectural-level taxes. The top inheritance tax rate would also rise to 55%, from 50%. "Environmental taxes," notably a tax on gasoline, are also expected to be raised. To supposedly lessen the burden of the tax increase on lower income households, politicians are now discussing an annual cash disbursement, i.e. a check in the mail, labeled a "tax credit." Early indications of this potential tax credit are on the order of ¥1 trillion, although some politicians would like a higher figure. The auto industry has also begun lobbying for the elimination of the automobile acquisition tax and automobile weight tax, arguing that piling the consumption tax hike upon these existing taxes would reduce automobile demand.

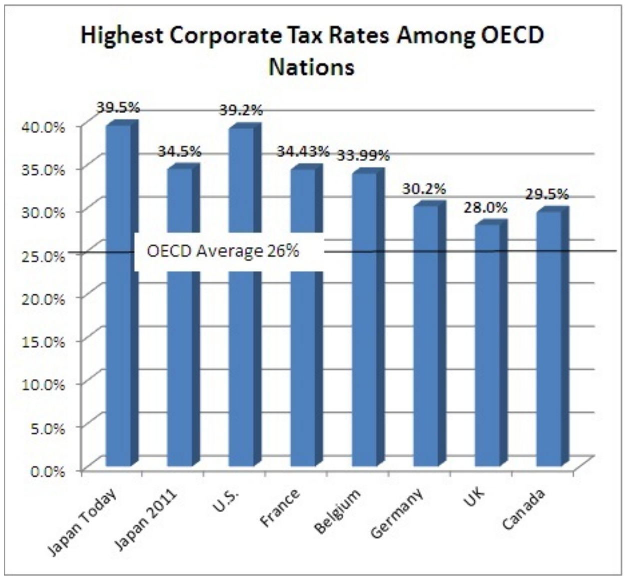
Supposedly, the purpose of the consumption tax hike would be to help fund the swelling expenses of the existing entitlement programs. Naturally, in this crisis situation, the government also wants to … add new entitlements. The MHLW plans to use its (probably non-existent) new funds from the consumption tax hike to fund ¥2.7 trillion of "enhanced social security":




*Source: Ministry of Health, Labour and Welfare*

At the same time, a number of other tax hike plans are waiting around in the wings. Payroll taxes have been going up steadily every year, as part of a plan to raise them from 13.6% in 2003 to 18.7% in 2017. This is paid by both employee and employer, and has no upper income limit. Also, the capital gains tax on equities may rise soon to 20%, from 10%. This was actually passed in 2010, but it was postponed. This capital gains tax was first introduced at 10% in 2003. Previously, Japan effectively had no capital gains tax on equities dating back to when it was eliminated in 1953. The general trend has also been toward the reduction and elimination of exemptions and deductions, for increasing patient co-payments for medical services, and so on and so forth.

A little hope has been raised by the reduction of the basic corporate income tax rate to 35% for 2011 from 40%, which had been the highest in the developed world. (The award now goes to the United States.) However, this was paired with various measures to "broaden the tax base," in other words, eliminating deductions and exemptions.




*source: taxfoundation.org*

"Meanwhile, the fiscal 2012 budget bill devised by the Noda administration signals the coming of more pork-barrel spending. For example, the costs of building three new routes for shinkansen bullet train service are included in the bill …" notes the *Nihon Keizai Shimbun*. "Some experts believe that the budget bill, rife with pork-barrel spending, is a conciliatory gesture from the ruling party to influential opposition party lawmakers, with the consumption tax discussion and a possible formation of a coalition government in mind."

And so it goes merrily along, until it doesn't anymore.

**So what's coming up in Japan:** There doesn't seem to be any urge to vary from the present trends among Japan's leaders. They have been alternating between "austerity" (higher taxes) and "stimulus" (more spending) for twenty years. I sense an air of give-up. Taxes will rise gradually, until there is a more pressing fiscal crisis, at which point they will rise more dramatically. Some talk will ensue about cutting spending, although not much will be cut, especially since this would mean a reform of the big social welfare programs to achieve meaningful size. The end result will be much like European governments have had with their own "austerity" strategies. The Ministry of Finance will stuff the banks with government paper until the banks choke. Hmmmm. That menu sounds like some other countries I know. At some point, the Bank of Japan will likely become more active with printing-press finance. It may reprise its role from the late 1940s when it financed the government's deficit with the printing press, leading to a decline in the value of the yen from about 7/dollar at the end of the war in 1945 to 360/dollar when it was repegged to the dollar (and thus gold) in 1949. There will be a great "reset," which Japanese people actually understand, more than Americans, to be a normal and common historical process, and life experience. They have had "resets" in the past, with the Meiji Restoration, the Great Tokyo Earthquake of 1923 and

World War II the biggies, but also much more commonly at the personal level, such as those people whose homes, businesses, friends and relatives were washed away by the recent tsunami. I see the possibility of a renewal of the political scene, in which today's bureaucrats, who have been in place essentially since the Meiji Restoration, are flushed *en masse* by the politicians. And then … the stage is open for the next act.