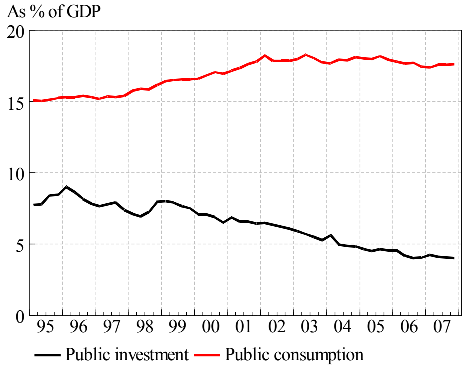
CONTINUED REDUCTION OF PUBLIC INVESTMENT



Source: Cabinet office

In reaction to the improved government finance situation, rating agencies upgraded the sovereign note in Japan’s local currency (debt in foreign currency is nonexistent). On April 23rd 2007, *Standard & Poor’s* raised its AA- rating to AA (stable outlook); Moody’s raised its rating from A2 to A1 (stable outlook) on October 11th 2007; and Fitch has confirmed its AA- rating several times since November 2002.

This upgrade in the sovereign rating is motivated by the progress made in terms of economic and fiscal performance that began under the Koizumi government, and by Japan's exceptionally strong net foreign position (271 trillion yen end 2007 – 52.2% of GDP), constantly reinforced by a structural current account surplus. Nonetheless, agencies are keeping a very close watch on public finances and economic and financial risk factors weighing on activity.

A primary budget surplus will be hard to obtain by FY 2011 without structural reform

Fiscal consolidation is slowing down

The government’s objective to generate a primary budget surplus for central and local governments by fiscal year (FY) 2011 involves the dogged pursuit of controlling public spending. The Ministry estimates the total fiscal consolidation necessary to realise this objective at about 16.5 trillion yen, equivalent to 3% of 2007 GDP.

In the general guidelines for Economic and Fiscal Policy and the structural reform of July 7th 2006, the government announced it wanted to create a virtuous circle in which improved growth potential and fiscal consolidation strengthen each other.

There were to be three phases:

Phase 1: 2001 – 2006 fiscal years: under the Koizumi government, the reestablishment of the Japanese economy and structural reforms have substantially reduced the public deficit since 2004.

Phase 2: 2007 fiscal year – start of 2010s fiscal years:

- keep up the same efforts at fiscal consolidation as in phase 1
- reach a primary surplus balance by fiscal year 2011.

Phase 3: start of 2010s fiscal years - middle of 2010s fiscal years

- ensure a primary balance surplus that will put an end to increases in the debt ratio
- reduce public debt/GDP ratio and keep it stable.

¾ The late 2007 political crisis resulted in a break in fiscal consolidation

In September 2006, Shinzo Abe succeeded Koizumi, and stayed in power for nearly a year, during which time the Democratic Liberal Party (DLP) lost the majority in the Upper House of Parliament to the Democratic Party of Japan (DPJ), and the government was hit with numerous financial scandals (pensions…) and ministers' resignations.

The Abe administration's 2007 budget proposal showed budgetary discipline, but, given the impact of the financial crisis, the growth scenario on which it was based (2%) was revised sharply downward (1.3%). Because of this, budget projections made in December 2006 for FY 2007 appeared too ambitious ex post. According to OECD estimates, the primary government deficit was deepened by 5 trillion yen at end March 2007, and could not be reduced by two-thirds as hoped. Budgetary spending would increase in a limited fashion, via the continued effort to shrink public investment, and the unfavourable growth profile would not allow for growing tax revenues. However, such revenues would benefit from the maturity of temporary business support measures especially involving income taxes[4].

Bond issues shrank by two trillion yen in 2007 to cover 30.3% of budget spending, down from 33.7% in 2006. More than ¾ of new issues involve bonds meant to cover general expenditures (Special deficit-financing bonds), with the rest (Construction bonds) destined to finance the government’s investment spending.

Shinzo Abe’s resignation on September 12th 2007 ushered in a phase of political “transition” with the appointment in the Diet of moderate conservative Yasuo Fukada as Prime Minister. The political situation has been delicate since mid-2007: the coalition led by the DLP no longer holds the majority in the Senate, but has more than 2/3 of the seats in the Lower House. The opposition is demanding early legislative elections and rejects the DLP’s economic and fiscal proposals, particularly the extension of the temporary gasoline tax[5], as well as the nomination of T. Muto and then K. Tanami proposed by the government to the head of the BoJ. Hence a period clearly unconducive to implementing structural reforms and consolidating the budget.

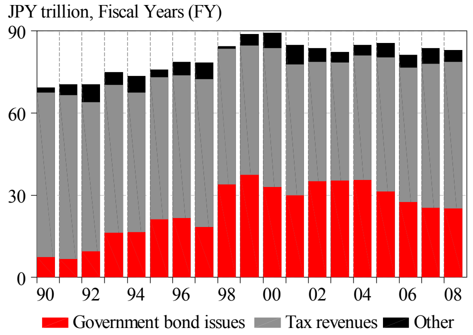
¾The budget for FY 2008, proposed by the Fukuda administration, is not a real break with the past

The total estimated budget for FY 2008, beginning in April, is very slightly higher, at 83.06 trillion yen (+0.2% from the 2007 budget proposal). 53.55 trillion yen will be funded by tax revenues (65% of the total), 4.16 trillion by other revenues, and 25.35 trillion by bond issues (30.5 % of the total).

[4] In 1999, tax deductions were introduced, giving taxpayers a 20% abatement on their income taxes.

[5] The gasoline surcharge was instituted by a special temporary law, renewed once every five years or so since its enactment in 1974. It amounts to twice the original price and is meant to fund road construction and maintenance. The DLP wants to renew this surcharge (which expires on March 31st) for ten years, while the opposition wants to abolish it when oil prices shoot up and hit consumers. Revenues from this surcharge are estimated at 2.6 trillion yen per year. Abolishing this surcharge would mean a 25-yen drop per litre of gasoline.

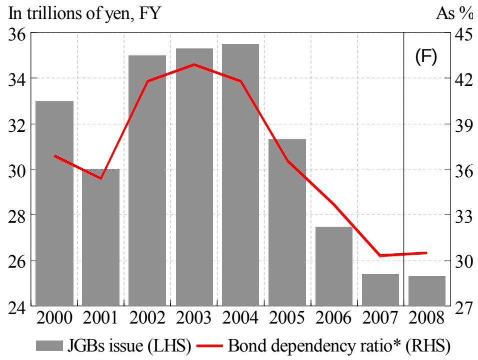
STABILISATION OF TAX REVENUES AND GROSS JGBs ISSUES IN 2008



FY 1990 - FY 2006: realized ; FY 2007: revised ; FY 2008: budget
Source: MOF 12/2007 - "Highlights of the Budget for FY2008"

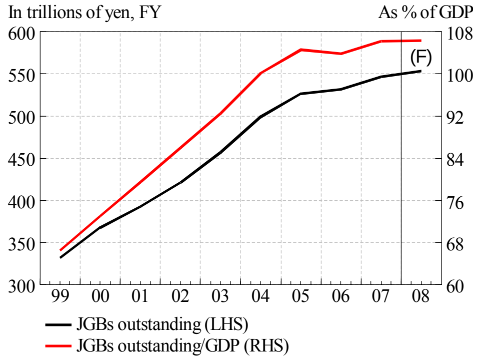
Because of a less-favourable economic backdrop, the government predicts virtual stability in tax revenues and bond issues (-0.3%). Thus, the bond dependency ratio (Gv. bond issues/total expenditures including debt servicing) would rise marginally to 30.5% in 2008. Total outstanding JGBs would increase by about twenty trillion yen, reaching 553 trillion yen in 2008, approximately 10 years' worth of tax revenues.

DECREASE OF JGBs ISSUES



Source: MoF ; FY 2000-06: settlement, FY 2007: revised, FY 2008: budget
** Ratio = Gv bond issues/Total expenditure*

RISE IN TOTAL JGBs OUTSTANDING

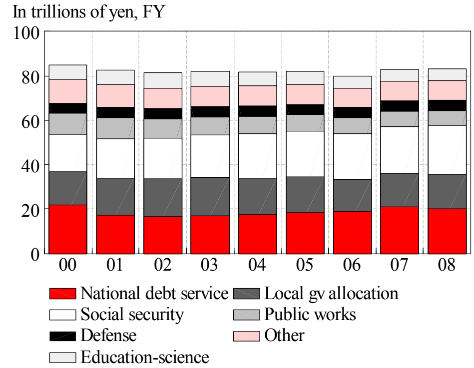


FY 1999-2006: settlement ; FY 2007-2008: estimates
Source: MoF

On the expenditures side, debt servicing (interest payments and amortisation), which covers 24.3% of the total budget, would be reduced by 4%. In the interest of reducing this line item, 9.8 trillion yen of the Fiscal Loan Program Funds will be allocated to debt repayment, in accordance with special accounts reform.

As for general expenditures (57% of the total), they would increase at a moderate pace.

BREAKDOWN OF BUDGET EXPENDITURES



Source: MoF ; initial budget values

The government has identified three priority areas that will benefit from a credit increase: improving growth potential (improving productivity via developing SMEs, building infrastructures…), promoting economic growth by revitalising local governments (revitalising rural areas, increasing subsidies, correcting unequal distribution of allocations between regions…), quality of life and safety of fellow citizens (medicine, earthquake and epidemic responses, improved security…).

By contrast, expenditures allocated to defence and public works will continue to be cut. Finally, 19% of planned expenditures overlap transfers to local governments.

Ultimately, the budget, voted in by Parliament at end February, does not show a real change from the budget presented a year earlier.

BUDGET FOR FISCAL YEAR 2008

In trillions of yen	FY 2007 (initial)	FY 2008 (initial)	FY 2008/FY 2007 (initial)
Revenues			
Tax revenues	*53.47*	*53.55*	*0.1%*
Non-tax revenues	*4.01*	*4.16*	*3.7%*
Government Bond issues	*25.43*	*25.35*	*-0.3%*
Total	**82.91**	**83.06**	**0.2%**
Expenditures			
General expenditures	*46.98*	*47.28*	*0.6%*
Of which :			
Social Security	*21.14*	*21.78*	*3.0%*
Public Works	*6.95*	*6.73*	*-3.2%*
Science & Education	*5.28*	*5.31*	*0.6%*
National Defense	*4.80*	*4.78*	*-0.4%*
*Other**	*8.81*	*8.67*	*-1.5%*
National Debt service	*21.00*	*20.16*	*-4.0%*
Local Allocation Tax Grants…	*14.93*	*15.61*	*4.6%*
Total	**82.91**	**83.06**	**0.2%**

Source: Ministry of Finance

** Including pensions, economic assitance, promotion of SMEs, energy and food supply measures, industrial investment and contingencies*

The pace of budget consolidation is expected to weaken markedly, as public deficit must come down from 4% of GDP in 2007 to 3.8% in 2008 (not including one-off measures); gross debt would amount to 182% of GDP. As such, the objective of a combined primary budget surplus for the central government and local governments by FY 2011 will be very difficult to achieve, if no significant reductions in expenditures and/or increases in revenues [6] is established, which will prevent any decrease in government debt.

[6] *Total revenues for public administrations are 33.1% of GDP in 2007, below average for OECD nations.*

The government, caught up in various political conflicts with the DPJ and the approaching elections in the Lower House, which are slated for September 2009, appears reluctant to undertake any reforms, be it a consumption tax increase[7], – but it is true that consumption lacks momentum and that short-term economic outlook is uncertain – or reforms to improve the quality of public services while reducing their costs.

Various factors will make it more difficult to consolidate public finance

¾An economic slowdown in 2008

Stabilisation, then reduction of the debt/GDP ratio, requires strong, lasting growth. An increase in nominal GDP must exceed the increase in outstanding debt. Since 1992, Japanese public debt has been increasing at 6.7% annually, which exceeds, by far, the very slow growth of nominal GDP (+0.6% per year on average).

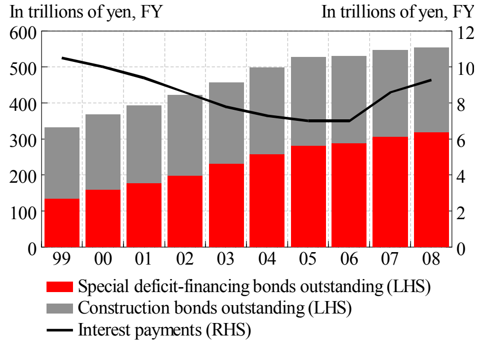
Growth will be weaker than forecast in the government's 2006 projections, which means they would not reach their objectives: according to our forecast, economic growth will be lower than 1½% in 2008, and those estimates will likely have to be revised downward. Tax revenues will be penalised, specifically by weakened corporate profits, as they are hit by the shrinking export market and the fast-climbing yen, as well as the flat job market.

In January 2008, authorities revised their medium-term budget plan. Based on a macroeconomic scenario that now appears quite optimistic (average 2.4% growth in real GDP from FY 2008 to FY 2011), the primary balance would be almost at equilibrium in FY 2011 (-0.1% of GDP), with gross GDP-related central and local government debt stabilising. This scenario is based only on limiting public spending [8] (healthcare, pensions, public works…), not including specific revenue enhancement measures. According to the "risk" scenario (average 1.5% growth in real GDP from FY 2008 to FY 2011, a now more realistic assumption), and not including corrective measures, specifically not including increased deductions, primary fiscal balance would not be achieved (primary deficit of 0.6% of GDP), and debt would continue to swell.

¾ Eventually, rising interest charges

The Ministry of Finance mainly issues long-maturity JGBs. In 2007, average maturity was estimated at seven years, and the government foresees lengthening maturity to 7 years 4 months for bonds issued in 2008, due to the increasing demand from life insurance companies and pension funds. The slight upward trend in 10-year rates since 2003 was reflected gradually in outstanding debt, but long rates have fallen back since the financial crisis broke out in summer 2007 due to renewed interest in risk-free investments. The end of the zero interest rate policy and the increase in debt also weighed on debt charges. Thus, interests paid on JGBs went from 7 trillion yen in 2006 to 8.6 trillion yen in 2007 (1.7% of GDP); according to the budget, they should increase to 9.3 trillion yen in 2008 (1.8% of GDP).

RISE IN INTEREST PAYMENTS ON JGBs

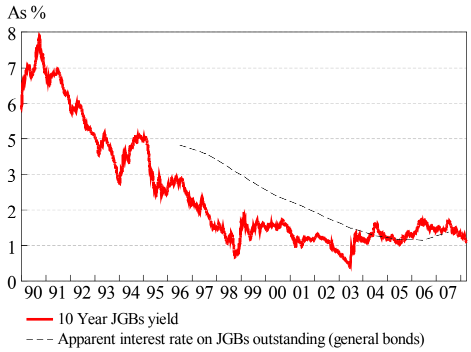


FY 1999-2006: realised ; FY 2007-2008: estimates
Source: MoF

Indeed, the apparent interest rate on JGBs outstanding (general bonds), which should only amount to 1.6% for FY 2007, as well as the apparent rate on total debt (near 1%) will, eventually, increase.

Exceptional factors that maintained short- and long-term rates at historic lows – the BoJ's quantitative policy and zero interest rate policy, persistent deflationist expectations – have in part dissipated. The monetary authorities still want to raise their leading rate, which is still abnormally low (currently 0.5%), especially since rising oil and commodity prices are reflected in consumer prices. However, they are currently maintaining the status quo as a result of the impact of the financial crisis and the uncertainties it is creating. Furthermore, the BoJ is waiting for its next governor to be appointed.

APPARENT INTEREST RATE ON DEBT
SHOULD GO UP



Sources: Datastream, SG calculations

Whatever the case, the extraordinarily high debt level leaves the country's fiscal position vulnerable to any interest-rate increase.

According to an August 2007 FMI study, a 100-bp increase in real interest rates as of 2010 would result in an increase in the net public debt burden, bringing it to 106% of GDP in 2025, up from 86% in 2006. With a 0.75% of GDP adjustment of the primary deficit on average between 2007-2012, or about 0.5% more of GDP that what is involved in the reference forecast, *Reforms and forecast in January 2006,* debt would stabilise at around 87% of GDP.

Thus, the international institution recommends more marked fiscal consolidation than that on which government projections are based, in order to strengthen the government's credibility and manage flexibilities to contend with unforeseen shocks and the ageing population.

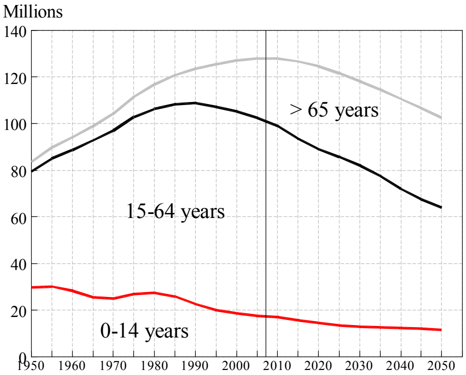
[7] Currently only 5%, it is the lowest consumption tax rate of most countries.
[8] 14.3 trillion yen drop in public spending from 2007 to 2011.

¾ *In the medium-long term, the ageing population will also be a factor*

The ageing of the Japanese population is the most advanced in the world. This is explained by a scissor effect: a low fertility rate (1.3 children per woman), much lower than the net rate of reproduction (2.1) since the start of the 1970s, and the longest life expectancy in the world (86 years for women and 79 for men). Thus, the working-age population has been shrinking since the end of the 1990s, especially since migratory flows remain negligible.

According to the latest UN projections, the working-age population (15-64 years old) will fall from 84.9 million people in 2005 to 52.3 million in 2050, while the number of people over age 65 will increase from 25.3 to 38.6 million. In 2025, Japan will have only two working people per retiree. In 2050, this ratio will be 1-1.

A RAPIDLY AGEING POPULATION



Source: World Population Prospects, The 2006 Revision - UN

The accelerated ageing of the population will affect public finance in two ways:

- The marked shrinkage in the working-age Japanese population will result in a reduced labour force, which could be slightly compensated for only by the entry of more women, and immigration. It seems unlikely that the shrinking labour force will be offset by an adequate increase in apparent labour productivity (increased capital per head; increased overall productivity of factors). Therefore, potential growth should sag misleadingly. Moreover, the household savings rate, which has hit a low (3.2% in 2007, down from 8.6% in 2000), should fall further still;
- Increasing longevity and the mass retirement of the baby boom generation will result, not including reforms, in a marked increase in retirement and healthcare/dependency spending. Already, the social security account has been weakened, going from a surplus of 1.6% of GDP in 1998 to a deficit of 0.5% in 2007.

According to the Ministry of Health's latest projections, social expenditure, in value, will increase from 90 trillion yen to 141 trillion yen (about half of which will go to retirees) between 2006 and 2025 – an increase of two percentage points of national income. Although the country successfully reformed the pension system in June 2004, by keeping expenditures down to 9% of GDP (0.35 point yearly increase in contributions; drop in replacement rate according to demographic changes; government funding of pensions increasing from 1/3 to 1/2 in 2009), the issue of funding pensions is still open. New structural reforms are therefore necessary to build an efficient social security system while preserving the viability of government finance, whose situation is still a concern.

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