

Public Finance

The government budget for fiscal 2006, which passed the Diet in March 2006, is generally conceived as a modest but serious first step toward redress of Japan's gargantuan public debts, which pose a serious threat to the health of its economy.

Considered as a culmination of Prime Minister Junichiro Koizumi's reform agenda so far, the budget amount for fiscal 2006 decreased 3.0% from the previous year to ¥79.69 trillion, marking the first drop in four years and also the first time in eight years that the figure was below ¥80 trillion. Bond issuance was held down to ¥29.97 trillion, below the ¥30 trillion mark, a level Prime Minister Koizumi promised when he took office in 2001 but was unable to keep in the following years. Public works investment decreased 4.4% from the previous fiscal year, representing the fifth consecutive yearly decline to a level even lower than fiscal 1990, on the eve of the collapse of the bubble economy. All these figures were construed to point to the prime minister's goal to achieve small government and replenish the nation's heavily indebted coffers.

However, the ratio of dependence on bonds is still at a high level of 37.6%, and the outstanding national government bonds at the end of March 2007 are expected to reach about ¥542 trillion, or the equivalent of 150% of the nation's GDP, by far the largest among the major industrial countries, with comparable figures for the US, the UK, Germany, and France below 80%. When the debts of local governments are added, the amount will rise to about ¥755 trillion.

In January 2006 the government decided on a medium-term economic and fiscal outlook, "Structural Reform and Medium-Term Economic and Fiscal Perspectives—Fiscal 2005 Revision." The report forecasts that GDP will attain a nominal growth rate of 2% or over (1.5% or over in real terms) in fiscal 2006 to bring the economy out of deflation and that the country's primary balance (basic fiscal balance for central and local governments combined) will register a surplus in the early 2010s.

Fiscal Investment and Loans

Japan has a large government investment and loan program called *zaisei toyushi* (fiscal investment and loans), which is often dubbed "Japan's second budget." The funds for the program originate with government-run savings, including postal savings, pensions, and life insurance programs, and are pooled into a special account at the Ministry of Finance. These investments and loans are believed to have contributed to social well-being in the past through housing and highway construction, improving the environment, and adding to social capital through governmental financial institutions, public corporations, and local governments. However, the efficiency and integrity of these special corporations came under severe criticism, and in May

2000 the Diet passed a package of bills designed to revamp the investment and loan program into a leaner, market-oriented system. In the fiscal 2006 budget, the government earmarked ¥15.00 trillion for the program, 12.5% down from the year before, marking the seventh straight year of decrease and about 63% down from the peak of ¥40.53 trillion in fiscal 1996.

Scale of Public Finance and Fiscal Deficit by Country, 2004 (%)

	Ratio of expenditures to GDP	Ratio of fiscal surplus or deficit to expenditures	Ratio of fiscal surplus or deficit to GDP
UK ^a	29.9	- 10.8	- 3.2
USA ^b	19.8	- 18.0	- 3.6
France ^d	17.6	- 15.6	- 2.8
Japan ^a	17.2 ^c	- 42.1	- 7.2 ^c
Germany ^d	11.6	- 17.1	- 2.0

Source: Ministry of Finance.

a. April 2004–March 2005.

b. October 2003–September 2004.

c. Estimate.

d. January-December 2004.

General Account, FY 2006

REVENUES	Amount (¥ billion)	Share (%)	Increase over previous year (%)
Tax and stamp duties	45,878	57.6	4.3
Government bonds	29,973	37.6	- 12.8
Others	3,835	4.8	1.3
Total	79,686	100.00	- 3.0
EXPENDITURES	Amount (¥ billion)	Share (%)	Increase over previous year (%)
1. General expenditures	46,366	58.2	- 1.9
Social security	20,574	25.8	0.9
Public works	7,201	9.0	- 4.4
Education and science	5,267	6.6	- 8.0
National defense	4,814	6.0	- 0.9
Economic cooperation	722	0.9	- 2.5
2. Subsidies to local governments	14,558	18.3	- 9.5
3. National debt servicing	18,762	23.5	1.7
4. Others	-	-	-
Total (1–4)	79,686	100	- 3.0

Source: Ministry of Finance.

Government Bond Issues

	Volume of issues (¥ trillion)	Ratio of government bonds to general account (%)	Outstanding government bonds (¥ trillion)	Ratio of outstanding government bonds to GDP (%)
1988	8.8	15.6	156.8	40.5
1989	7.1	11.8	160.9	38.8
1990	5.6	8.4	166.3	37.0
1991	5.3	7.6	171.6	36.3
1992	7.3	10.1	178.4	36.9
1993	8.1	11.2	192.5	40.1
1994	13.6	18.7	206.6	42.1
1995	12.6	17.7	225.2	45.0
1996	21.0	28.0	244.7	47.6
1997	16.7	21.6	258.0	49.6
1998	15.6	20.0	295.2	57.6
1999	31.1	37.9	331.7	65.3
2000	32.6	38.4	367.6	71.6
2001	28.3	34.3	392.4	78.3
2002	30.0	36.9	421.1	84.6
2003	36.4	44.6	459	92.0
2004	36.6	44.6	505	100.0
2005	34.4	41.8	538	105.0
2006	30.0	37.6	542	105.4

Source: Ministry of Finance.

Note: Figures for fiscal 2005 and fiscal 2006 are estimates.

Tax System

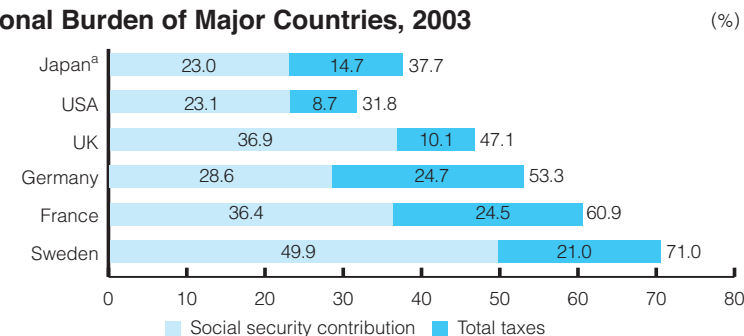
Japan's postwar tax system has been characterized by heavy dependence on direct taxes and a steeply progressive income tax. In 1987 and 1988 the government carried out a radical revision of the tax system with the aim of striking a better balance between the income, consumption, and property taxes, taking into account the rapidly aging Japanese population. The tax rate structure of the personal income tax was revised, with the former 15 stages from 10.5% to 70% being changed to 5 stages from 10% to 50%. The government's fiscal 2006 tax reform will introduce a new income tax rate structure of 6 stages from 5% to 40% in 2007. The corporate tax rate, which used to be 42%, was lowered in stages to 37.5% by 1990, while the maximum inheritance tax rate was lowered from 75% to 70%. In April 1989 a 3% consumption tax, a form of value-added tax, was brought in, and in April 1997 the rate was raised to 5%. With social-security-related expenses swelling as the society is rapidly aging, there are active discussions over when and by how much the consumption tax should be further raised.

In its tax reform plan for fiscal 1999, the government introduced what was called a "permanent tax cut" exceeding ¥6 trillion (personal and corporate income tax com-

binated) in order to stimulate the stagnant economy. The maximum personal income tax rate was lowered from 50% to 37%, and the maximum personal residence tax (local tax) rate from 15% to 13%. Corporate taxes (corporate tax plus business tax plus corporate residence tax) were lowered to an effective rate of 40.87%.

With business recovery in progress, however, the government decided in January 2006 on a tax reform package to phase out the 1999 tax breaks and to transfer tax revenue sources of ¥3 trillion from national income tax to local residence tax.

National Burden of Major Countries, 2003



Source: Ministry of Finance.

a. FY 2006, forecast.

Trends of Tax and Social Security Contribution as Percentage of National Income

FY	Tax burden	National tax burden	Social security contribution	Total
1970	18.9	12.7	5.4	24.3
1975	18.3	11.7	7.5	25.7
1980	22.2	14.2	9.1	31.3
1985	24.0	15.0	10.4	34.4
1990	27.6	18.0	10.6	38.2
1995	23.7	14.7	12.5	36.2
2000	23.8	14.2	13.6	37.4
2001	23.7	13.8	14.4	38.0
2002	22.3	12.9	14.5	36.8
2003	21.8	12.7	14.5	36.2
2004	22.6	13.3	14.4	37.1
2005	23.1	13.7	14.7	37.8
2006	23.0	13.6	14.7	37.7

Source: Ministry of Finance.

Note: FY 2005: estimate; FY 2006: forecast.

National Taxes (Estimated Revenues), FY 2006

	Amount (¥ billion)	Share (%)
1. Direct taxes	27,226	59.3
Income tax	12,788	27.9
Corporate tax	13,058	28.5
Inheritance tax	1,380	3.0
2. Indirect taxes	18,652	40.7
Consumption tax	10,538	23.0
Gasoline tax	2,156	4.7
Liquor tax	1,572	3.4
Stamp duties	1,217	2.7
Tobacco tax	940	2.0
Customs duties	906	2.0
Automobile tonnage tax	737	1.6
Others	586	1.3
Total	45,878	100.0

Source: Ministry of Finance.

Financial Administration

As part of financial system reform, the Financial Services Agency (FSA) was established in July 2000 by integrating the Financial Supervisory Agency under the Prime Minister's Office and the Financial System Planning Bureau of the Ministry of Finance, which was in charge of devising policies relating to banks and other financial institutions. In January 2001 the FSA absorbed the Financial Reconstruction Commission (FRC), which had been primarily responsible for dealing with failed banks put under state control, and thus became a full-fledged financial industry watchdog.

In October 2004 the FSA filed a criminal complaint against UFJ Bank, then Japan's fourth largest banking group, and its three former UFJ executives for allegedly obstructing the FSA's investigations into the bank's financial conditions by hiding and destroying documents to make the bank's bad loans look smaller than they actually were. The tough action by the FSA is seen as the start of a new era for the relationship between Japanese financial institutions and their regulators, which was often described as collusive and interdependent.

Nonperforming Loans and Japanese Banks

Following the bursting of the bubble economy in the early 1990s, a series of management failures of banks, securities houses, and insurance companies occurred in Japan, and private financial institutions were burdened with massive non-performing loans. In order to restore confidence in the financial system, the government repeatedly made capital injections of public funds into leading banks from 1998 to 2003.

In May 2000 the Diet passed bills to amend the Deposit Insurance Law and the

Insurance Business Law, expanding the scale of public funding for the stabilization of the financial system to ¥70 trillion.

To accelerate the disposal of bad loans, the government announced the Program for Financial Revival in October 2002. The program proposed, among other things, adopting a tougher method of assessing the quality of bad loans, injecting public money into undercapitalized banks, and creating a new organization to support companies threatened by bad-loan write-offs. The government also released in December 2004 the Program for Further Financial Reform, proposing strategic use of IT for strengthening the competitiveness of financial institutions, further development of a financial system that is internationally open, and other measures.

According to the Financial Services Agency, the amount of nonperforming loans held by all banks in Japan stood at ¥15.9 trillion in the first fiscal half ended September 30, 2005, marking a decrease of ¥8.0 trillion from a year earlier and a drop of about 63.2% from a peak of ¥43.2 trillion registered in fiscal 2001 (ended March 31, 2002). The ratio of nonperforming loans to total lending dropped from 8.4% to 3.5% in the same period, indicating that the bad-loan problem had largely been solved.

Bank of Japan and Monetary Policy

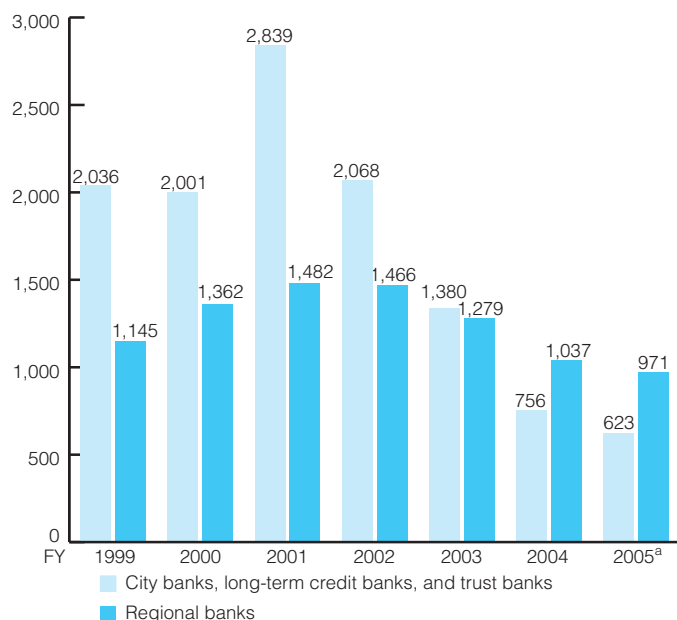
The functions and operations of the Bank of Japan (BOJ), Japan's central bank, are governed by the Bank of Japan Law, revised in June 1997 to give it greater independence from the government, with the revision put into effect from April 1998. With the Japanese economy recovering slowly from a long slump, the central bank has been holding fast to its policy of keeping money very lax and interest rates extremely low, in what is called a "zero interest policy," so that industries, still feeling the lingering impact of the prolonged slump, feel reasonably safe.

Following the terrorist attacks in the United States in September 2001, the Bank of Japan decided to further ease monetary policy by cutting the official discount rate by 0.15 point to a historic low of 0.10% and by increasing the outstanding balance of current accounts deposited at the BOJ, in order to quell fears of a global recession. With the Japanese economic recovery being slow in pace under deflationary pressure, the BOJ maintained its ultra-low discount rate and lifted the target range for commercial banks' balance of current accounts at the central bank to ¥30 trillion to ¥35 trillion in January 2004.

With the Japanese economy recovering steadily and the consumer price index turning positive, the governing policy board of the BOJ on March 9, 2006, decided to end its quantitative monetary easing policy, while reiterating that interest rates will remain virtually zero for the foreseeable future.

Transition of Nonperforming Loans

(¥10 billion)



Source: Financial Services Agency.

Note: Figures are based on the Financial Reconstruction Law.

a: As of September 2005.

Financial Services

Following the implementation of the Japanese version of the "Big Bang" (a major series of financial market deregulations) and the serious crisis that shook the whole financial system in the late 1990s, there have been sweeping changes in Japan's financial services industry. A large number of city and regional banks, *shinkin* banks, credit cooperatives, securities firms, and insurance companies have merged and concluded joint venture or tie-up agreements with other Japanese or foreign financial institutions so as to ensure their survival and to bolster their capital bases.

In the 1980s Japan's banking sector was crowded with 21 major banks (16 city banks and 5 trust banks). As a result of the large-scale realignment, they were regrouped into four large entities: the Mizuho Financial Group, UFJ Holdings, Sumitomo Mitsui Financial Group, and Mitsubishi Tokyo Financial Group (MTFG). For the 10 years from March 1994 to March 2004, the number of workers employed by the nation's banks also decreased by 35% (160,000) to 302,000, and the number of banking offices by 18% (3,000) to 14,060. In July 2004 the MTFG and UFJ surprised the world's financial community by announcing that they had agreed to join

their operation to become the world's largest bank in terms of assets with ¥195 trillion. The new Mitsubishi UFJ Financial Group (MUFG) was inaugurated on October 1, 2005.

The diversification of financial services is also in progress. Financial institutions are now actively engaged in banking services through the Internet, and some companies in the distribution and manufacturing sectors have entered into the banking services industry.

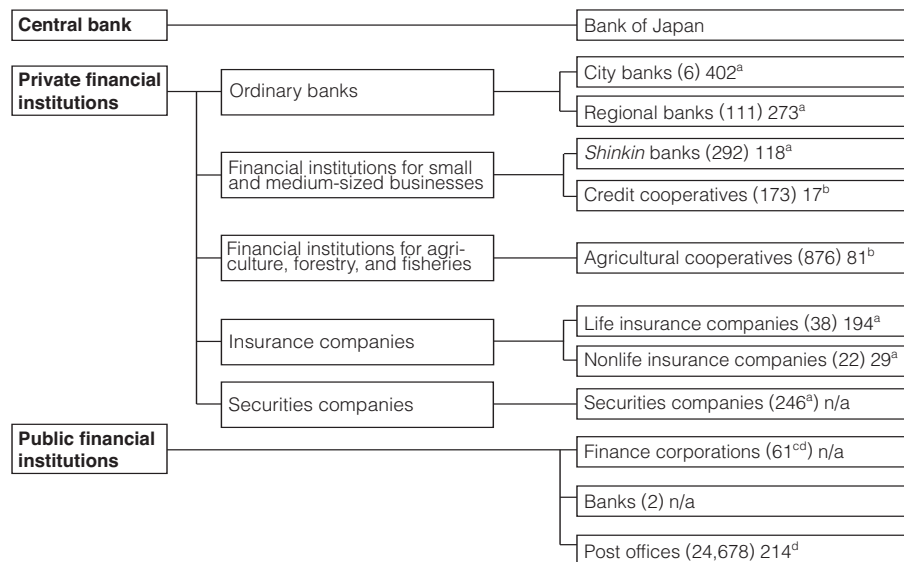
Through the various measures taken by the government for strengthening the financial system, the major commercial banks are making steady progress in reducing their nonperforming loans. According to the Financial Services Agency, the combined balance of bad loans held by all banks in Japan in the first fiscal half ended September 30, 2005, was ¥15.9 trillion, down from a peak of ¥43.2 trillion in fiscal 2001 (ended March 31, 2002), indicating that the banks' bad-loan problem in general had been solved.

Postal Savings

Post offices are administered by Japan Post, a new government-owned public corporation launched in April 2003. In addition to their postal services, Japan's 24,678 (as of March 2005) post offices handle savings, life insurance, and pensions. Postal savings consist mainly of small household deposits, but because so many people are depositors, this system has a larger balance of deposits than any other financial institution. As of February 2006, postal savings amounted to ¥202.4 trillion, over 80% of the amount of deposits held by the six major city banks combined, and accounted for over 13% of the total personal financial assets of about ¥1,500 trillion.

The government plans to split Japan Post in April 2007 into four entities that will each handle different functions under a holding company: postal savings, postal life insurance, mail delivery, and over-the-counter services. The privatization process will be completed by March 2017 by selling all the shares of the postal savings and life insurance companies and two-thirds of the shares of the holding company.

Japan's Financial Institutions, 2006



Source: Bank of Japan; Japan Post, *Statistics of Japan Post*, FY 2004; The Life Insurance Association of Japan; The General Insurance Association of Japan; Japan Securities Dealers Association.
 Note: Figures in parentheses show number of institutions and are followed by total assets in trillions of yen.
 a. As of January 2006.
 b. As of December 2005.
 c. Includes 52 credit guarantee corporations across the country.
 d. As of March 2005.

Stock Market

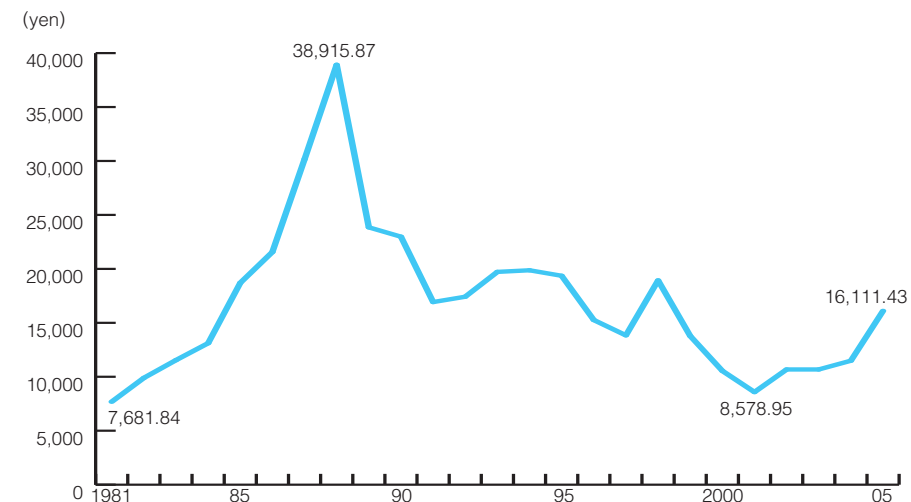
Reflecting the recovery of the Japanese economy, the higher profitability of Japanese firms, and growing expectations for the ending of deflationary trends and progress in structural reform, the 225-issue Nikkei Stock Average in 2005 jumped 40.2%, the highest advance in 14 years, to close at 16,111.43. The figure represented an increase of 112% from the post-bubble low of 7,607.88 recorded in April 2003. The Tokyo Stock Price Index (TOPIX), covering all First Section issues of the Tokyo Stock Exchange (TSE), also climbed 43.5% to 1,649.76. The total market value as of the end of 2005 amounted to ¥522.1 trillion, the highest only after the ¥590.9 trillion recorded in 1989, the last year of the bubble period. The total volume of trading on the TSE in 2005 also reached a record high of ¥459.1 trillion. This largely was attributed to active trading by foreign investors and individual investors, who became major market players through the spread of Internet trading. Net buying of shares by foreign investors reached ¥10.2 trillion, topping ¥10 trillion for the first time, and their net purchasing of securities, including government and corporate bonds, reached ¥18.9 trillion, the highest ever.

However, the remarkable recovery of the Japanese stock market in 2005 was marred by a series of infrastructure problems of the TSE, including paralysis of its computer system in November and failure to respond adequately to suspend a misplaced order in December. In January 2006 the news on the alleged breaching of the Securities and Exchange Law by the high-profile Internet firm Livedoor caused a suspension of trade due to an overload of orders, exposing the shortcomings and deficiencies of the TSE. There were also calls for improving surveillance and supervisory functions of the securities market.

In December 2004, after 40 years of serving as an over-the-counter market, the Jasadq Securities Exchange relaunched as Japan's sixth securities exchange (the five others are Tokyo, Osaka, Nagoya, Sapporo, and Fukuoka). It was the first securities exchange to open in 54 years, and the third largest stock market after Tokyo and Osaka. Following the revision of the Securities and Exchange Law in 2000, the Osaka Securities Exchange (OSE), the TSE, and the Nagoya Stock Exchange (NSE) were reorganized from mutual associations into stock companies in April 2001, November 2001, and April 2002, respectively.

Japan has also seen the creation of new markets to provide startup businesses with access to funds at an early stage of their development and to provide investors with more diversified investment products. In November 1999 the TSE established a new market named "Mothers" (market of high-growth and emerging stocks), and the OSE inaugurated Nippon New Market-Hercules in December 2002, taking over the operation of Nasdaq Japan. Sapporo and Fukuoka have also created new markets for startups.

Trends in Nikkei Stock Average



Source: Nihon Keizai Shimbun, Inc.
 Note: Figures are as of the end of the year.

Tokyo Stock Exchange (First Section)

	Trading volume (million shares)	Transaction value (¥ billion)	Nikkei Stock Average price index (points)	Tokyo Stock Price Index (TOPIX)	Number of listed companies
1986	193,601	155,902	18,701	1,556.37	1,075
1987	259,410	245,575	21,564	1,725.83	1,101
1988	278,607	279,735	30,159	2,357.03	1,130
1989	218,352	325,827	38,915	2,881.37	1,161
1990	119,033	176,310	23,848	1,733.83	1,191
1991	91,722	107,108	22,983	1,714.68	1,223
1992	65,438	58,881	16,924	1,307.66	1,229
1993	84,619	83,685	17,417	1,439.31	1,234
1994	81,132	82,517	19,723	1,559.09	1,235
1995	88,900	78,617	19,868	1,577.70	1,253
1996	96,170	97,097	19,361	1,470.94	1,293
1997	105,533	106,427	15,258	1,175.03	1,327
1998	121,595	96,001	13,842	1,086.99	1,340
1999	151,200	178,041	18,934	1,722.20	1,363
2000	169,599	242,632	13,786	1,283.67	1,445
2001	199,532	199,844	10,543	1,032.14	1,484
2002	207,282	190,870	8,579	843.29	1,495
2003	307,194	237,906	10,677	1,043.69	1,530
2004	357,034	323,918	11,489	1,149.63	1,593
2005	508,310	459,136	16,111	1,649.76	1,665

Source: Tokyo Stock Exchange; Nihon Keizai Shimbun, Inc.

Note: Figures for the Nikkei average and TOPIX are as of the end of the year.

Portfolio Investments in Japan by Foreigners

(¥ billion)

	Stocks (First Section, Tokyo Stock Exchange)		Bonds	
	Purchases	Sales	Purchases	Sales
1995	17,597	14,018	46,768	24,874
1996	22,703	19,542	49,128	26,123
1997	28,206	26,834	60,119	28,137
1998	25,767	26,211	81,271	52,377
1999	50,882	42,418	78,368	55,186
2000	67,502	69,914	77,426	47,463
2001	64,898	63,785	63,003	46,742
2002	55,584	54,961	66,950	52,345
2003	68,384	61,191	76,291	57,277
2004	101,241	93,823	107,058	64,386
2005	146,174	136,412	112,096	78,925

Source: Tokyo Stock Exchange; Japan Securities Dealers Association.