

07 Finance

Public Finance

The national budget for fiscal 2007 amounted to ¥82.9 trillion, representing an increase of 4.0% over the previous year. The budget was characterized more than anything else by a marked reduction in government borrowing thanks to brisk tax revenues from booming corporate earnings. New bond issues amounted to ¥25.4 trillion, the lowest in 16 years and down ¥4.5 trillion from fiscal 2006, the largest cut ever. Dependence on bond issues dropped by 6.9 percentage points from the previous year to 30.7%. Excluding those from bond issues, revenues from taxes and other sources amounted to ¥57.5 trillion, while the general expenditure, which excludes debt servicing costs and local allocation taxes, amounted to ¥46.9 trillion, up 1.3% from the previous year. As a result, the primary balance came to a deficit of ¥4.4 trillion, a drastic decrease of 60% from fiscal 2006, and it looked certain that equilibrium in the primary balance would be achieved ahead of the government's target of fiscal 2011.

Although public works investment decreased 3.5% from the previous fiscal year to less than ¥7.0 trillion, in sixth consecutive yearly declines, social security expenditures continued to increase, by 2.8%, to ¥21.1 trillion, or 45% of the total general expenditures and are expected to continue to swell in the future as the elderly population grows. Outstanding national government bonds at the end of March 2008 are expected to reach about ¥547 trillion, or the equivalent of 148% of the nation's GDP, by far the largest among the major industrial countries, with comparable figures for the United States, the United Kingdom, Germany, and France below 80%.

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 2007 budget, the government earmarked ¥14.16 trillion for the program, 5.6% down from the year before, marking the eighth straight year of decrease and about 65% down from the peak of ¥40.53 trillion in fiscal 1996.

Scale of Public Finance and Fiscal Deficit by Country, 2005

(%)

	Ratio of expenditures to GDP	Ratio of fiscal surplus or deficit to expenditures	Ratio of fiscal surplus or deficit to GDP
UK ^a	30.8	- 12.1	- 3.7
USA ^b	20.1	- 12.9	- 2.6
France ^d	17.3	- 15.2	- 2.6
Japan ^a	17.2 ^c	- 38.6	- 6.6 ^c
Germany ^d	11.6	- 12.1	- 1.4

Source: Ministry of Finance.

a. April 2005–March 2006.

b. October 2004–September 2005.

c. Estimate.

d. January–December 2005.

General Account, FY 2007

REVENUES	Amount (¥ billion)	Share (%)	Increase over previous year (%)
Tax and stamp duties	53,467	64.5	16.5
Government bonds	25,432	30.7	- 15.2
Others	4,010	4.8	4.6
Total	82,909	100.00	4.0
EXPENDITURES	Amount (¥ billion)	Share (%)	Increase over previous year (%)
1. General expenditures	46,978	56.7	1.3
Social security	21,141	25.5	2.8
Public works	6,947	8.4	- 3.5
Education and science	5,274	6.4	0.1
National defense	4,802	5.8	- 0.3
Economic cooperation	691	0.8	- 4.2
2. Subsidies to local governments	14,932	18.0	2.6
3. National debt servicing	20,999	25.3	11.9
Total (1–4)	82,909	100	4.0

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	42.4
1995	12.6	17.7	225.2	45.4
1996	21.0	28.0	244.7	48.1
1997	16.7	21.6	258.0	50.3
1998	15.6	20.0	295.2	58.7
1999	31.1	37.9	331.7	66.4
2000	32.6	38.4	367.6	72.9
2001	28.3	34.3	392.4	79.5
2002	30.0	36.9	421.1	86.0
2003	36.4	44.6	457.0	92.6
2004	36.6	44.6	499.0	100.1
2005	34.4	41.8	526.9	104.7
2006	30.0	37.6	536.9	105.1
2007	25.4	30.7	547.1	104.8

Source: Ministry of Finance.

Note: Figures for fiscal 2006 and fiscal 2007 are estimates.

Tax System

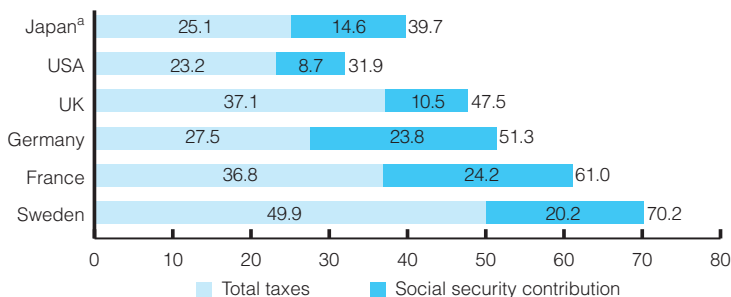
Japan's tax system in the post–World War II period has been characterized by heavy dependence on direct taxes and a steeply progressive income tax. In an attempt to strike a better balance between the income, consumption, and property taxes, taking into account the rapidly aging Japanese population, a radical change of the tax system was carried out in 1987 and 1988. As a result, the taxation structure of the personal income tax was revised, changing the former 15 stages ranging from 10.5% to 70% to 5 stages from 10% to 50%. The fiscal 2006 tax reform introduced 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%. A 3% consumption tax, a form of value-added tax, was imposed in April 1989, and the rate was raised to 5% in April 1997. With social-security-related expenses swelling as the society is rapidly aging, when and by how much the consumption tax should be further raised has emerged as a major issue of political debate.

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-

bined) in order to stimulate the stagnant economy. With business recovery in progress, however, a tax reform package to phase out the 1999 tax break was decided in January 2006. It also called for a transfer of tax revenue sources of ¥3 trillion from national income tax to local residence tax.

National Burden of Major Countries

(%)



Source: Ministry of Finance.

Note: Figures are for 2004.

a. FY 2007, 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	23.7	14.2	13.6	37.3
2001	23.7	13.8	14.3	38.0
2002	22.3	12.9	14.5	36.8
2003	21.8	12.7	14.5	36.3
2004	22.5	13.3	14.4	36.9
2005	23.7	14.2	14.5	38.2
2006	24.5	14.8	14.6	39.2
2007	25.1	14.4	14.6	39.7

Source: Ministry of Finance.

Note: FY 2006: estimate; FY 2007: forecast.

National Taxes (Estimated Revenues), FY 2007

	Amount (¥ billion)	Share (%)
1. Direct taxes	34,407	64.4
Income tax	16,545	30.9
Corporate tax	16,359	30.6
Inheritance tax	1,503	2.8
2. Indirect taxes	19,060	35.6
Consumption tax	10,645	19.9
Gasoline tax	2,135	4.0
Liquor tax	1,495	2.8
Stamp duties	1,219	2.3
Customs duties	929	1.7
Tobacco tax	926	1.7
Automobile tonnage tax	716	1.3
Others	995	1.9
Total	53,467	100.0

Source: Ministry of Finance.

Financial Administration

As part of the 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 three former UFJ executives for allegedly obstructing the FSA's investigations into the bank's financial conditions by hiding or destroying documents to make the bank's bad loans look smaller than they actually were. The tough action by the FSA was seen as the start of a new era in the relationship between Japanese financial institutions and their regulators, which had often been described as collusive and interdependent.

Nonperforming Loans and Japanese Banks

In the wake of the bursting of the bubble economy in the early 1990s, a string of management failures occurred at banks, securities houses, and insurance companies in Japan, leaving most financial institutions saddled with massive nonperforming loans. In an attempt to restore confidence in the financial system, the government made repeated 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

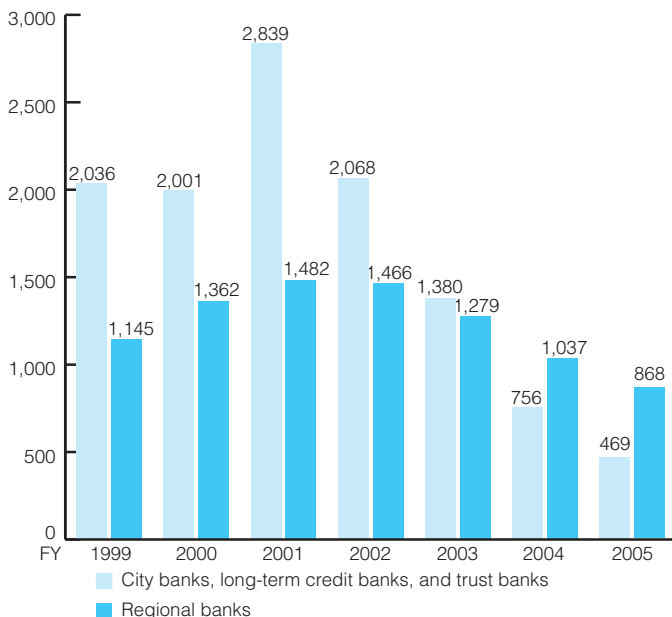
Insurance Business Law to expand the scale of public funding for the stabilization of the financial system to ¥70 trillion.

To accelerate the write-off 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.

According to the Financial Services Agency, the amount of nonperforming loans at all banks in Japan stood at ¥12.3 trillion in the first fiscal half ended September 30, 2006, marking a decrease of ¥3.6 trillion from a year earlier and a drop of about 71.5% from the 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 2.7% in the same period, indicating that the bad-loan problem had largely been solved.

Transition of Nonperforming Loans

(¥10 billion)



Source: Financial Services Agency.

Note: Figures are based on the Financial Reconstruction Law.

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. The law was amended in June 1997 to give the BOJ greater independence from the government, with the revision coming into effect from April 1998. As the Japanese economy is recovering slowly from a prolonged slump through early 2002, the central bank has been holding fast to its policy of keeping money very easy and interest rates extremely low in view of the alleged vulnerability of the recovery.

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 in current accounts kept by commercial banks at the central bank, in order to quell fears of a global recession. With the pace of Japanese economic recovery being slow under deflationary pressure, the BOJ maintained its ultra-low discount rate and lifted the target range for the 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, although it reiterated that interest rates would remain virtually zero for the foreseeable future. Later in that year, as it was judged evident that Japan's economy had regained enough strength, the BOJ decided to end this five-year-old "zero-interest rate" policy and raised its benchmark overnight lending rate to 0.25% on July 14, 2006, and further to 0.50% on February 21, 2007.

Financial Services

The landscape of Japan's financial services industry has undergone sweeping changes in the aftermath of the Japanese version of the "Big Bang" (a series of major financial market deregulations modeled on the British reform) and the serious crisis that shook the entire financial system in the late 1990s. 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.

Until the 1980s, Japan's banking sector had been crowded with 21 major banks (16 city banks and 5 trust banks). As a result of realignment on a major scale, they were regrouped into four large entities: the Mizuho Financial Group, UFJ Holdings, Sumitomo Mitsui Financial Group, and Mitsubishi Tokyo Financial Group (MTFG). A further development took place in July 2004 when, to the surprise of the world's financial community, the MTFG and UFJ announced their agreement to merge 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.

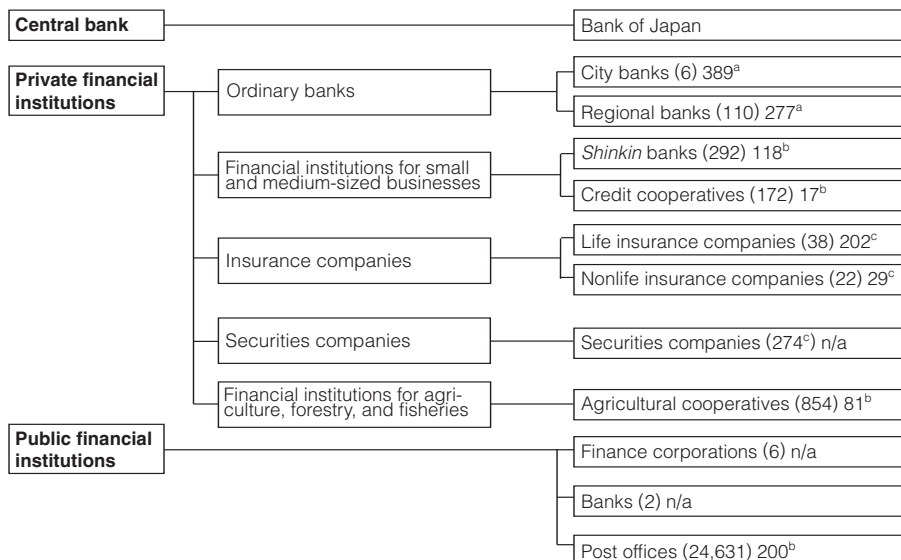
In order to secure profitability, the Japanese banking sector is aiming at a lean and fit management structure. According to a survey by Teikoku Databank, as of the end of March 2005, the nation's 121 banks employed 262,100 workers, a decrease of 11,220 persons or 4.1%, from a year earlier; 111 of the 121 banks cut their number of employers during the year. 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 banking services

Postal Savings

Post offices are administered by Japan Post, a new government-owned public corporation launched in April 2003. In addition to mail services, Japan's postal system, with 24,631 post offices (as of March 2006) is engaged in such financial services as savings, life insurance, and pension plans. While postal savings consist mainly of small household deposits, their huge numbers provide this system with deposits larger than those held by any private-sector financial institution. As of the end of March 2007, the outstanding balance of postal savings stood at ¥187.0 trillion, down 6.5% from a year earlier, a decrease for seven straight years. But the amount was still equal to 77% of the amount of deposits held by the six major city banks combined (¥242.1 trillion) and accounted for more than 12% of the nation's total personal financial assets of about ¥1,541 trillion.

Under the privatization program legislated in 2006, Japan Post was split in October 2007 into four entities that will each handle different functions under a holding company: postal savings, postal life insurance, mail delivery, and various over-the-counter services. The privatization process will be completed by March 2017, when all the shares of the postal savings and life insurance companies and two-thirds of the shares of the holding company will have been released by the government on the stock market.

Japan's Financial Institutions, 2007



Source: Bank of Japan; Japan Post, *Statistics of Japan Post*, FY 2005; 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 February 2007.

b. As of March 2006.

c. As of December 2006.

Stock Market

The Japanese stock market rebounded strongly in 2005 in reflection of the recovery of the domestic economy, the higher profitability of Japanese firms, and growing expectations for an end to the deflationary trend. The 225-issue Nikkei Stock Average jumped 40.2% in 2005 to close at 16,111.43, the broadest advance in 14 years. The index stood at a level 112% higher than the post-bubble low of 7,607.88 recorded in April 2003. Another index, 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.

In 2006, the Nikkei average fluctuated between the 14,000 and 17,000 levels because of a flurry of scandals involving Livedoor Co. and Murakami Fund and a suspension of trade at the TSE due to an overload of orders caused by the Livedoor incident. The index closed the year at 17,225.83, up 6.9% from a year earlier, while the TOPIX rose slightly to 1,681.07. The total market capitalization as of the end of 2006 amounted to ¥538.6 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 2006 also reached a record high of ¥644.3 trillion, a jump of 40.3% from 2005. This was largely attributed to active trading by foreign investors and individual investors,

who became major market players through the popularization of Internet trading. Net buying of shares by foreign investors in 2006 amounted to ¥8.1 trillion, and their net purchasing of securities as a whole, including government and corporate bonds, reached ¥14.6 trillion.

One major development in Japan's stock market in recent years was the launching of the Jasdaq Securities Exchange in December 2004, after 40 years of serving as an over-the-counter market. Jasdaq became Japan's sixth securities exchange (the five others are Tokyo, Osaka, Nagoya, Sapporo, and Fukuoka), the first securities exchange to open in 54 years, and the third largest stock market after Tokyo and Osaka. Following 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 joint stock companies in April 2001, November 2001, and April 2002, respectively. Jasdaq was also established as a joint stock company.

New markets were also created to provide startup businesses with access to funds at an early stage of their development and to provide investors with more diversified investment products. The TSE in November 1999 established a new market named "Mothers" (Market of High-Growth and Emerging Stocks), and the OSE inaugurated the Nippon New Market—Hercules in December 2002, taking over the operation of Nasdaq Japan. Sapporo and Fukuoka have also created new markets for startups.

Tokyo Stock Exchange (First Section)

	Trading volume (million shares)	Transaction value (¥ billion)	Nikkei Stock price index	Average (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	121,596	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
2006	477,894	644,309	17,226		1,681.07	1,710

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
2006	239,137	233,534	150,548	104,267

Source: Tokyo Stock Exchange; Japan Securities Dealers Association.