

Japan

R&I Affirms AAA, with Rating Outlook “Negative”

August 28, 2006

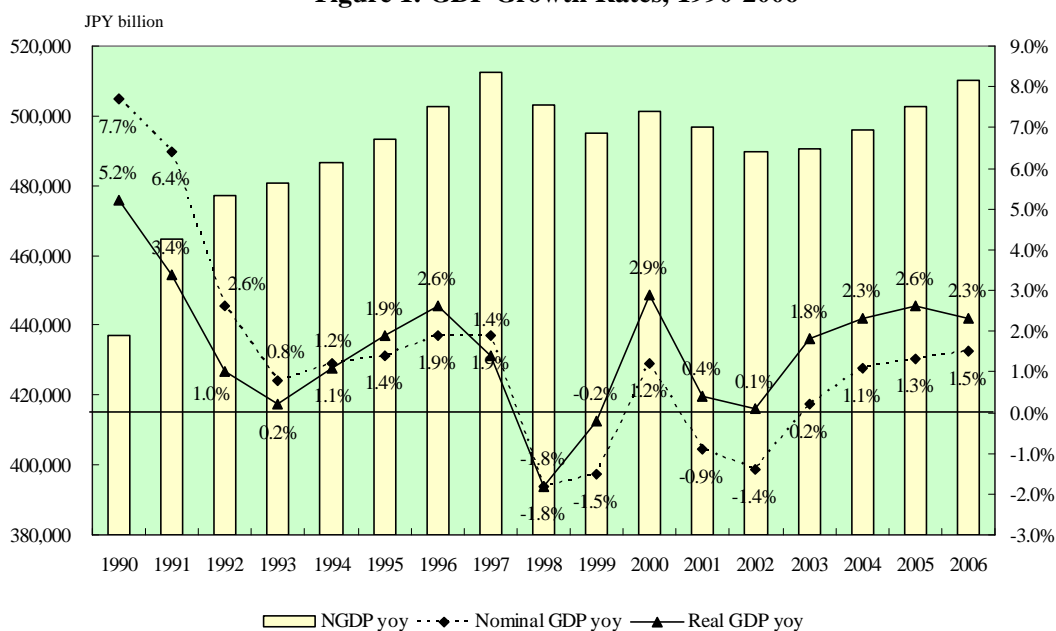
			Rating	Rating Outlook
Foreign Rating	Currency	Issuer	AAA	Negative

Japan's economy, which escaped from its long adjustment phase and has been on a recovery track since 2002, still continues to grow. Although fiscal conditions still requires special attention, the government is maintaining its stance to seriously undertake measures to restore fiscal health. Considering factors such as Japan's strong economic base, the excellent tax-bearing capability of the private sector, the low national burden rateⁱ compared with advanced European countries and ample

domestic savings, R&I judges there is a sufficient possibility for Japan to improve fiscal condition to a sustainable position. Based on these considerations, R&I has affirmed the Domestic Currency Issuer Rating and Foreign Currency Issuer Rating both at AAA.

Nevertheless, the ratio of outstanding general government debt to nominal gross domestic product (GDP), which exceeds 170% and already is the highest among advanced countries, is forecast to continue rising for a number of years, and the fiscal framework remains vulnerable to an increase in interest rates. To the extent Japan's government does not clearly devise specific measures to boost revenues, including drastic reform of

Figure 1: GDP Growth Rates, 1990-2006



the tax system centered on a consumption taxⁱⁱ increase, retaining confidence in Japan's fiscal reconstruction efforts will be difficult. As a result, the Rating Outlook continues to be Negative.

After bottoming out in January 2002, domestic business conditions began to recover and Japan now enters an autonomous expansion phase (Figure 1). As asset prices started to recover, the non-performing loan problems at financial institutions, which were strongly related to property prices and for a long period were shackles on Japan's economy, are not likely to shake stability in the financial system.

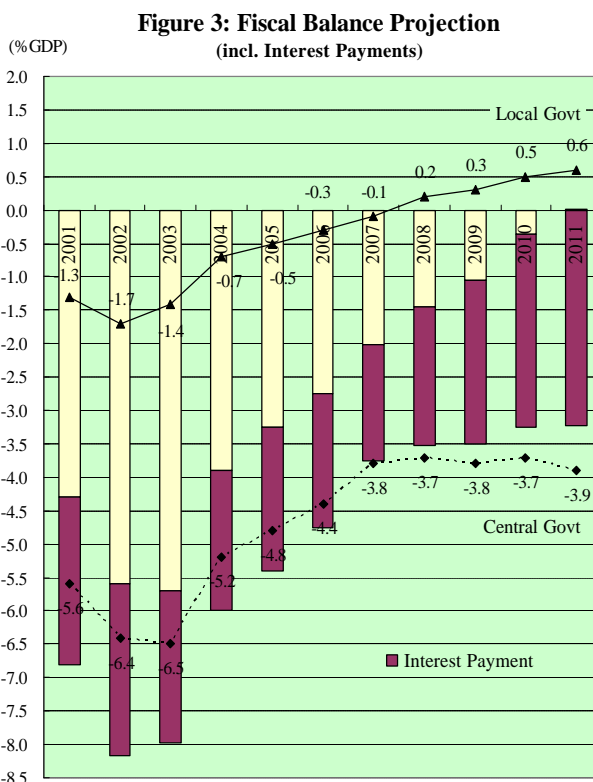
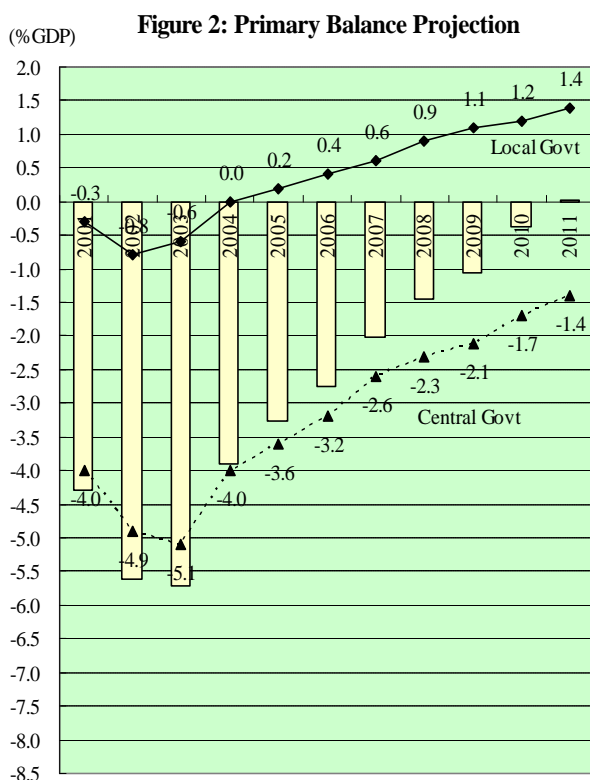
By getting out of the so-called three excesses in employment, production capacity and debt, Japanese firms have achieved even leaner, stronger constitutions, centered on globally competitive industries such as automobiles and electronics. For the past several years the real GDP growth rate, which languished at less than 1% on average over the ten years from 1992 until 2001 when

the collapse of the IT bubble ushered in a recession, has been in the 2% range.

Since early 2006, both the domestic corporate price index and the consumer price index have been increasing compared with the same month of the previous year, and there is a clear sense, particularly in Tokyo and other major metropolitan areas, that real estate prices are no longer declining.

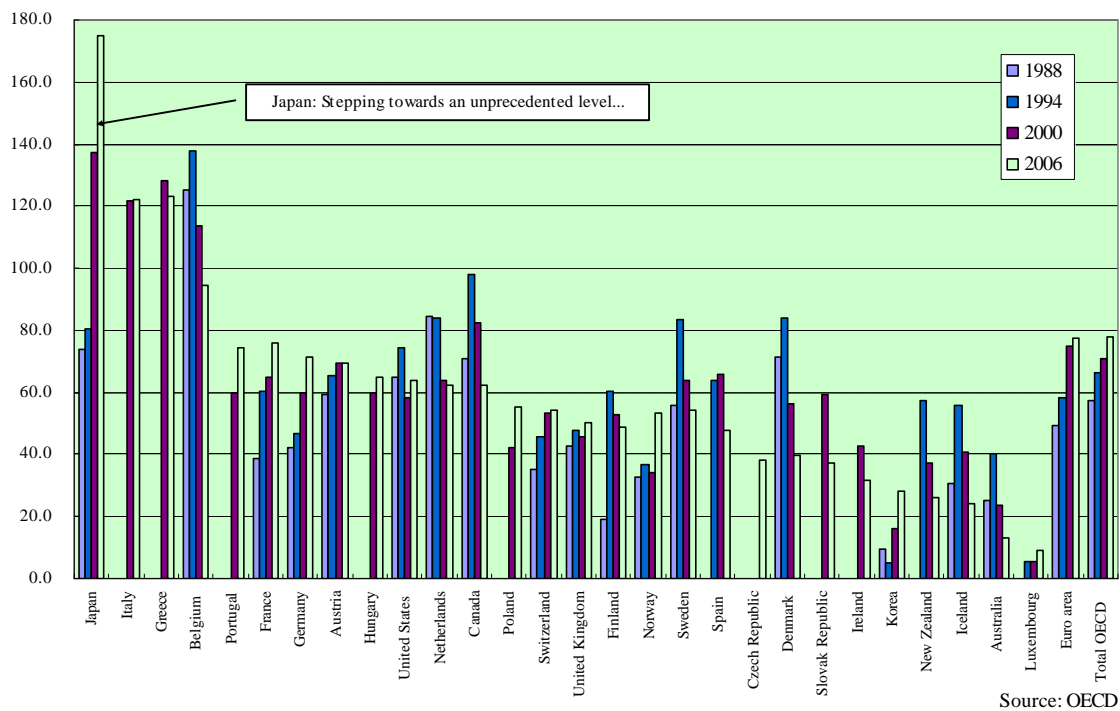
This economic climate has made it possible at last to map out a course towards fiscal reconstruction. Needless to say, in order to hold the ratio of outstanding general government debt to nominal GDP at a constant level and achieve sustainable fiscal circumstances, Japan must restrain the rate of increase in public debt and improve the rate of growth in nominal GDP.

As mentioned above, although still inadequate, the circumstances of the latter continue to improve. The former has advanced a step as well, with the Council on Economy and Fiscal Policyⁱⁱⁱ indicating its stance in the



Source: the Council on Economy and Fiscal Policy

Figure 4: General Government Debt, %GDP



“Basic Policies 2006”^{iv} to return the central and local government primary fiscal balance to surplus by fiscal 2011, and focus on reductions to outstanding debt thereafter as well (Figure 2). In fact, the pace of fiscal balance improvement has begun to pick up, thanks to higher tax revenues as a result of the economic recovery’s solid footing.

Fiscal reconstruction, however, will not be easy. Of the 16.5 trillion yen needed to achieve a surplus in the primary fiscal balance in fiscal 2011, the government assumes it will cut expenditures by 11.4 trillion to 14.3 trillion yen (Table 1).

Yet the government has not obtained a national consensus on reductions in central government support for local finances^v, or restraints on the pace of growth in

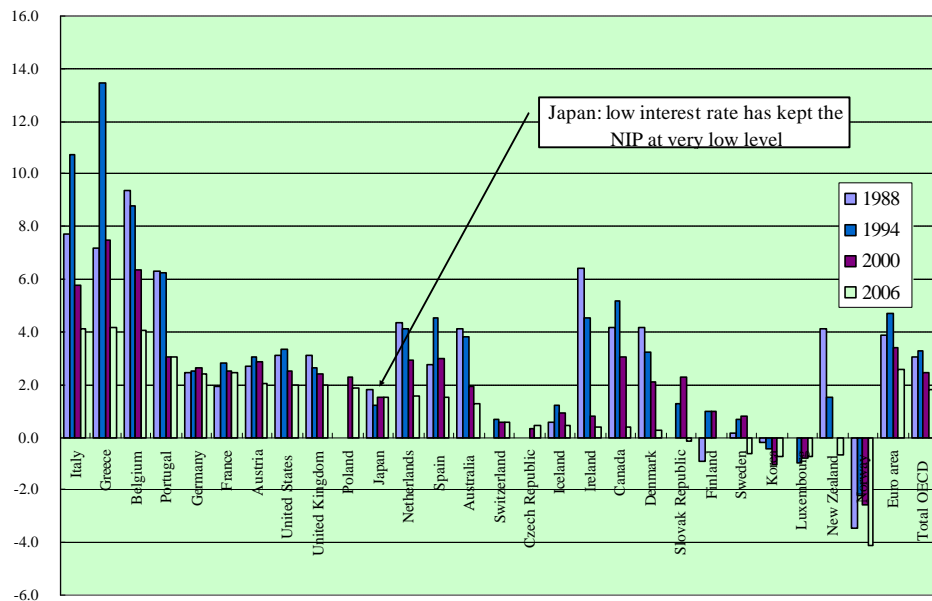
Table 1: Fiscal Expenditure Reform Framework by FY2011

JPY Trillion

	FY2006	FY2011	FY2011	Reduction	Reduction/Growth in Major Items
		Baseline	With Reform		
Social Security	31.1	39.9	38.3	-1.6	
Personnel	30.1	35.0	32.4	-2.6	
Capital Spending	18.8	21.7	H 17.8	-3.9	Capital Spending: Reduction between 1% to 3%
			L 16.1	-5.6	Local Gov't Investment: Reduction between 1% to 3%
Others	27.3	31.6	H 28.3	-3.3	Outlays for promoting science and technology: Increase between 1.1% to the GDP growth rate
			L 27.1	-4.5	Official Development Assistance (ODA): Reduction between 2% to 4%
Total	107.3	128.2	H 116.8	-11.4	
			L 113.9	-14.3	
Reduction Target:				-16.5	

Source: the Council of Economy and Fiscal Policy

Figure 5: Net Interest Payments, %GDP



Source: OECD

Social Security outlays. The government also has avoided any commitment to raising the consumption tax rate, perhaps out of consideration for the upcoming House of Councilors election in 2007, where the ruling coalition have only a razor-thin majority.

Until now, thanks to low interest rate, government interest expense kept low (Figure 5), but with long-term yields expected to rise along with the nominal growth rate, an increase in interest payment expense is likely to gradually weigh heavily on fiscal policy.

A decision to revise Japan's Rating Outlook to Stable will depend on whether the favorable economic and business climate continues, and on whether the government steadily implements expenditure reduction and tax increase measures in line with the Basic Policy. For that reason alone, should economic growth slow because the U.S. economy stalls, or growth in newly emerging economies slows^{vi}, or for any other reason, there is a possibility the government will find it more difficult to adopt tax increase measures, and hopes of fiscal reconstruction will fade, putting further downward

pressure on Japan's creditworthiness. Together with the economic trend, R&I will follow whether the government more specifically hammers out a fiscal reconstruction plan and is able to build a national consensus on that plan.

ⁱ The national burden rate, defined as the ratio of tax and social security contribution to national income, is 44% in 2006.

ⁱⁱ A kind of value added tax, introduced in 1989 at the rate of 3%, and increased to 5% in 1997.

ⁱⁱⁱ The Council on Economy and Fiscal Policy is an organization which was set up in 2001 to strengthen the prime minister's political leadership.

^{iv} This will be the last revision of the annual policy recommendation under the Prime Minister Koizumi, as he will step down in September 2006.

^v In Japan, local governments' expenditures account for more than a half of the general government total expenditures.

^{vi} Japanese exports to China and Hong Kong, China account for 19%, which is second to the US.