

"Lessons from the European Sovereign Debt Crisis to Japan"

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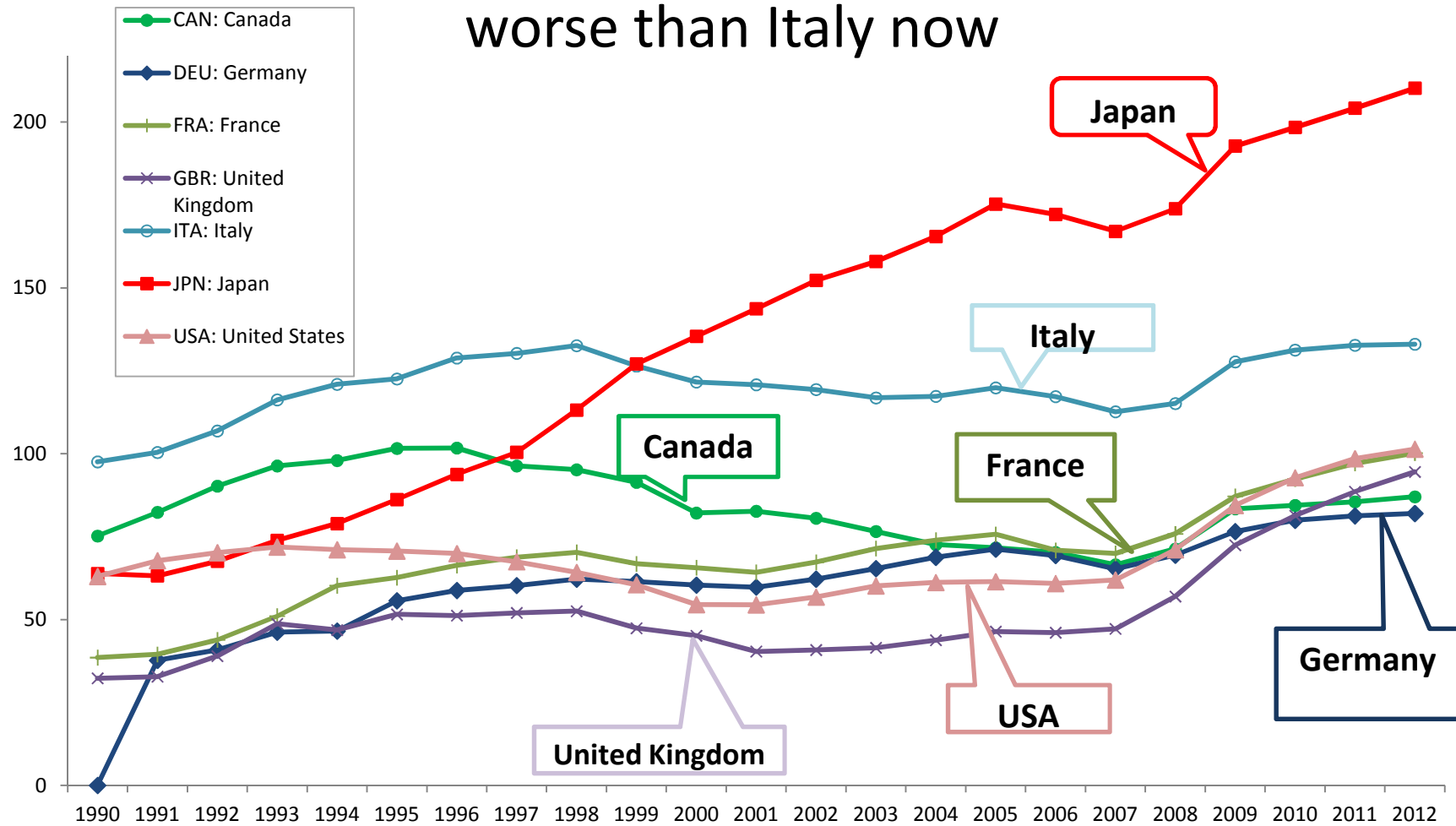
Outline

- Introduction
- European Debt Crisis
- Japanese Debt Crisis (in future?)
- Demographic problem
- Puzzle. Why is the interest rate so low?
- Japan's fiscal consolidation efforts
- Italy and Japan: common challenges

Introduction

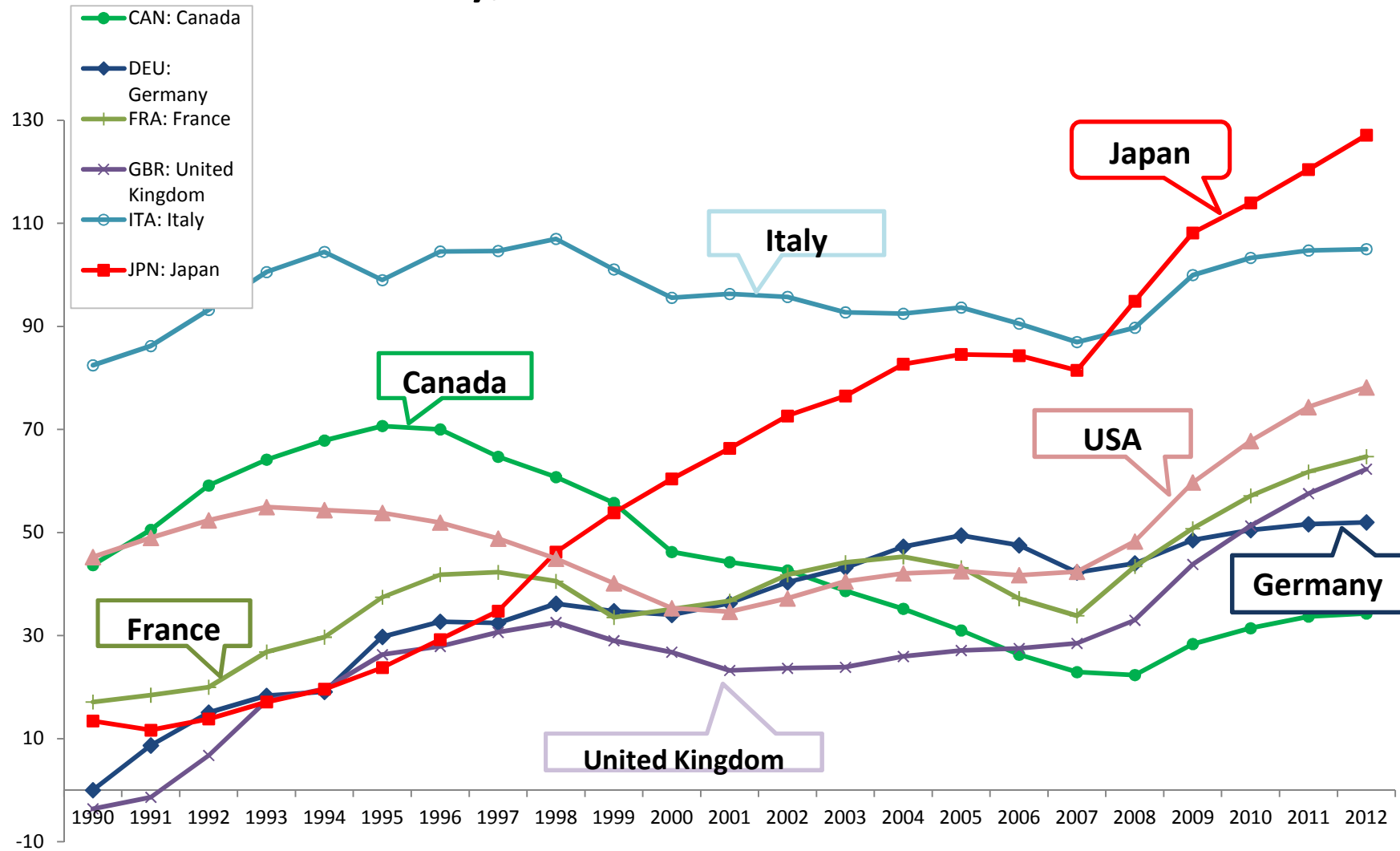
- **Italy and Japan**, similarities and differences
 - Similarity: **High debt-GDP ratio**
 - Fiscal deficits and debt-to-GDP ratio
 - Japan is now much worse now
 - Similarity: **Demographic Problem**
 - Low fertility
 - Demographic deficits
 - Difference: **Exchange Rate**
 - Italy in the Euro Area
 - Japan independent float

Gross Government Debt-GDP ratio Japan used to be respectable, not anymore. Japan is much worse than Italy now



Net Debt-GDP ratio

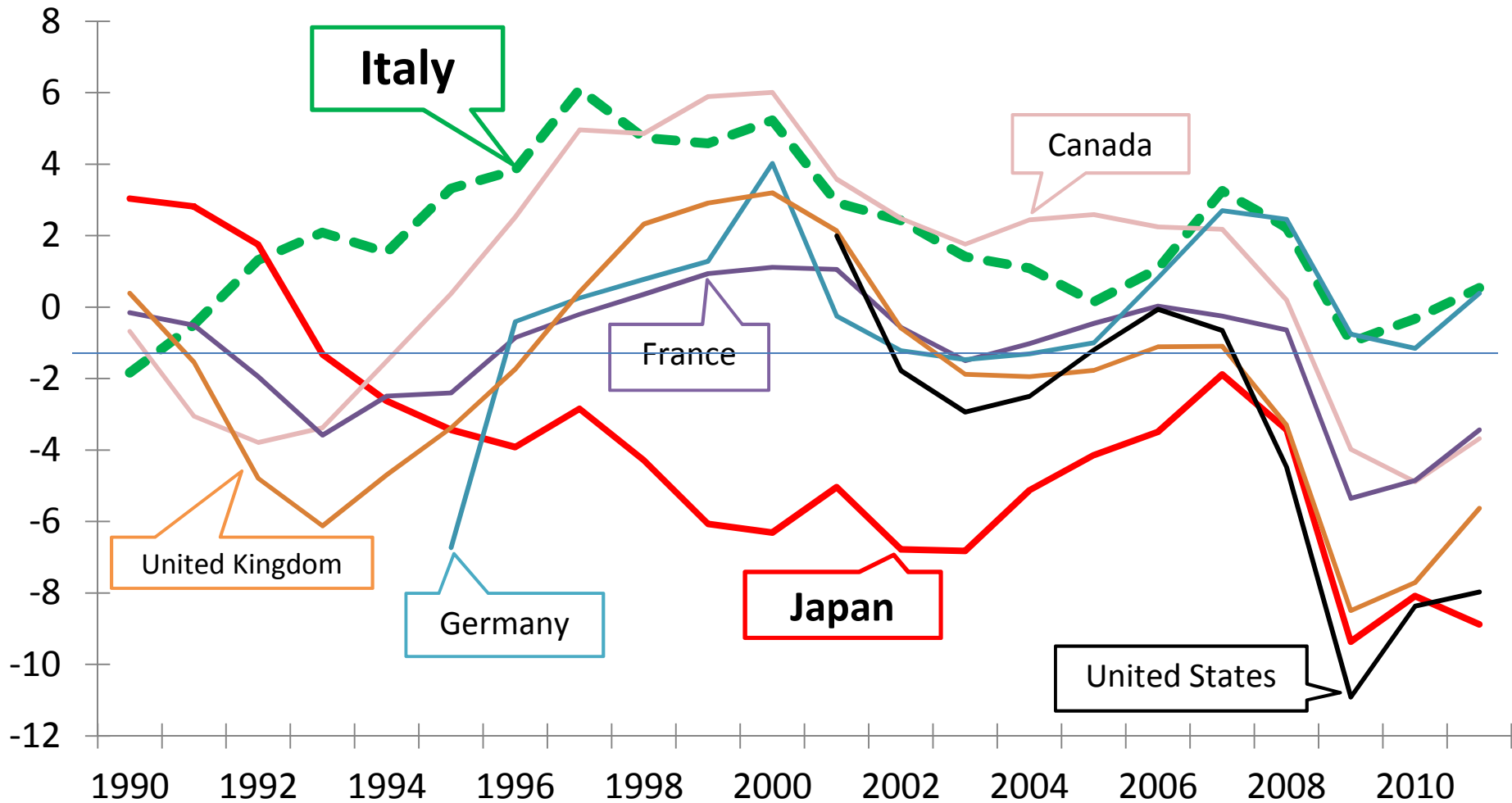
Similarly, in the “Net” measure



General Government primary surplus (G7)

A key indicator for sustainability. Italy is not bad at all

(Percent of GDP)

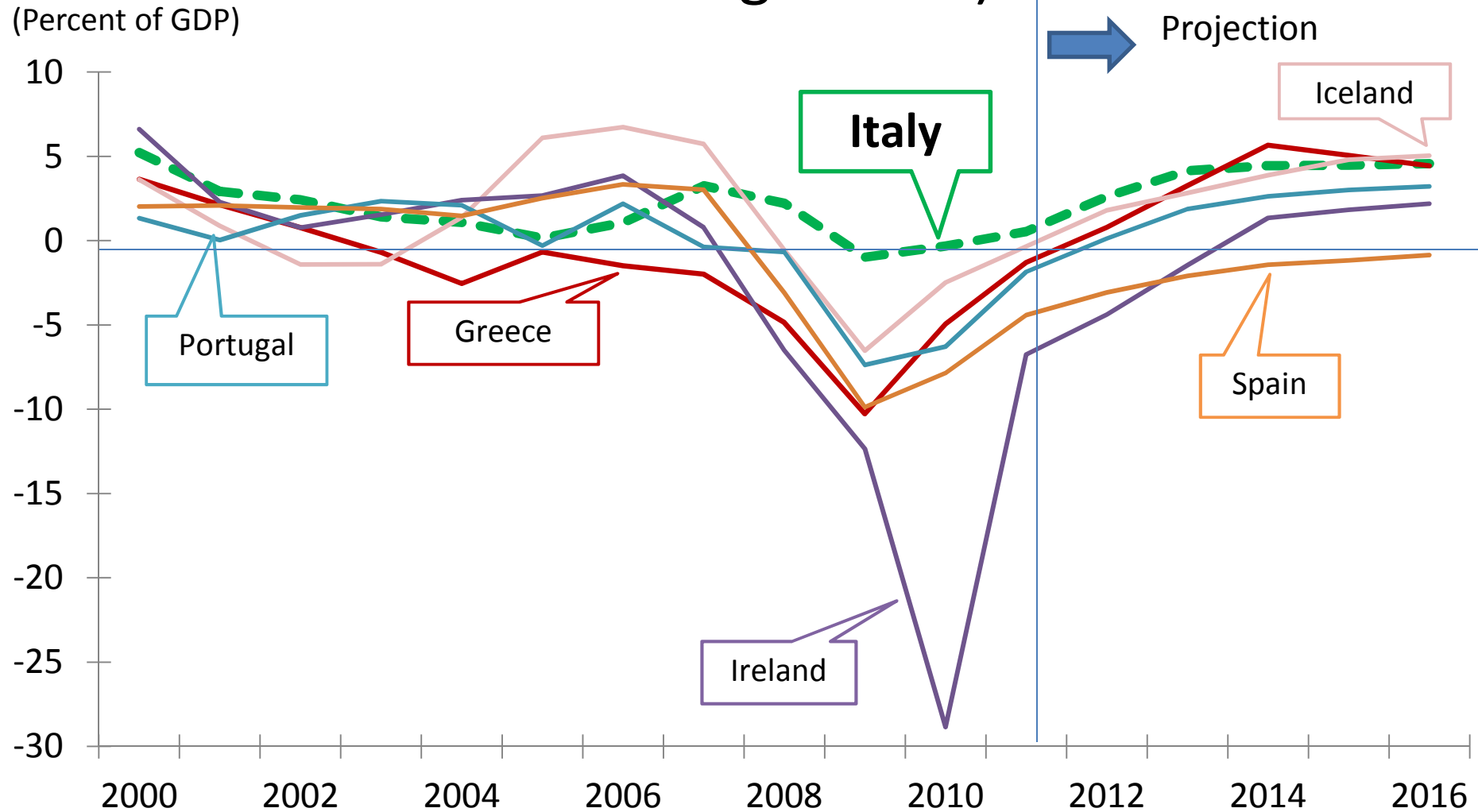


Source: International Monetary Fund, World Economic Outlook Database, September 2011.

European Debt Crisis

- Started with the Greek crisis
 - Critical points of time: October 2009; May 2010; May 2011; July 2011; and December 2011
 - Why couldn't Greece, EU and IMF solve the crisis quickly?
- Crisis spread to Ireland, Portugal, Spain, and Italy
 - **But very different fundamentals among the Five**
 - Italy has primary surpluses; Spain has low debt-to-GDP ratio
 - Why couldn't EU, IMF & ECB **prevent contagion?**
- Classic view: Can we separate the fundamental crisis and contagion? Let the former default if debt overhang is too much; and assist the latter with Lender of last resort
 - In sum, ring fence Greece, when Greek debts go default
 - Why has this not been applied in Europe?

General Government, primary surplus (Euro Area countries with large debts)



Source: International Monetary Fund, World Economic Outlook Database, September 2011.

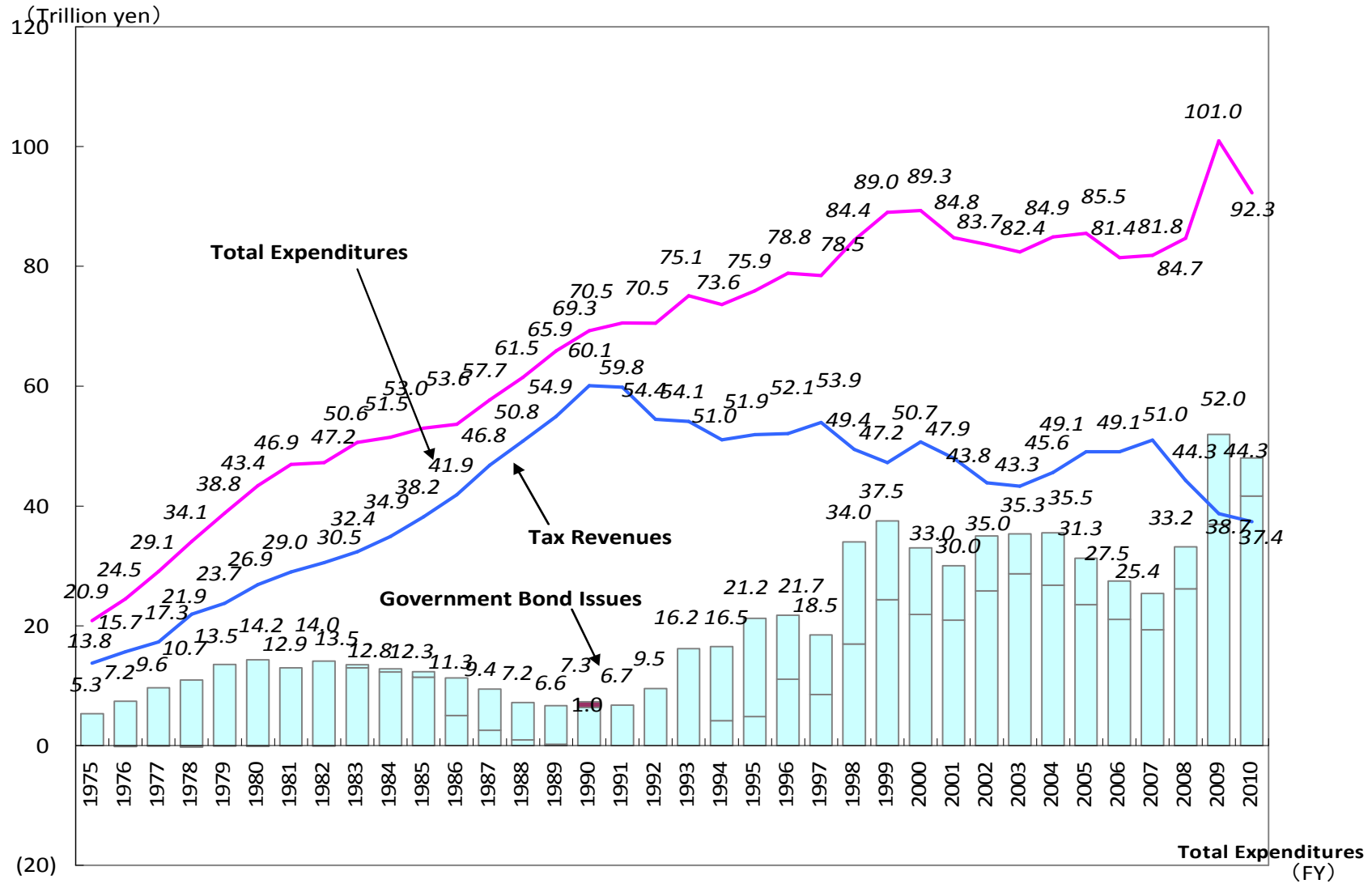
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Japan

- Trend of the government finance: 1990s and 2000s
 - Expenditures continue to rise
 - Tax revenues fell in the 1990s and 2000s
 - Income tax and corporate income tax fell
 - VAT (consumption tax) stable
- Last three years:
 - 40% of Expenditure is financed by new bond issues
 - New bond issues exceeds tax revenues
 - **Not sustainable as is → Needs fiscal consolidation**
- Current government plan
 - VAT 5% → 8% in April 2014;
 - and 8% → 10% in October 2015
 - **A step in the right direction**

Revenue and expenditure

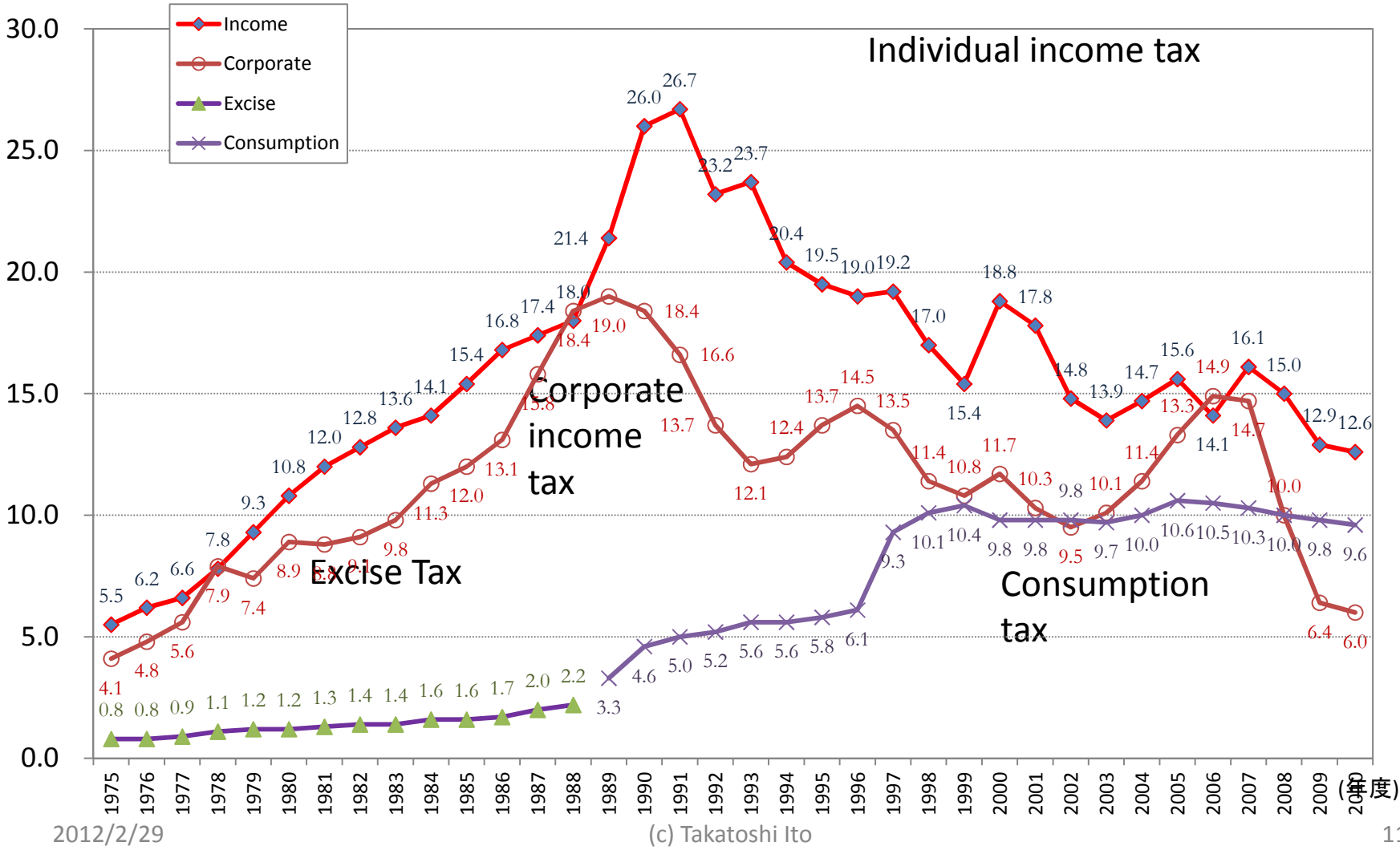


(Note) FY1975-2009: Settlement, FY2010: Initial budget

Tax Revenues by category, VAT is a best bet

Various Taxes

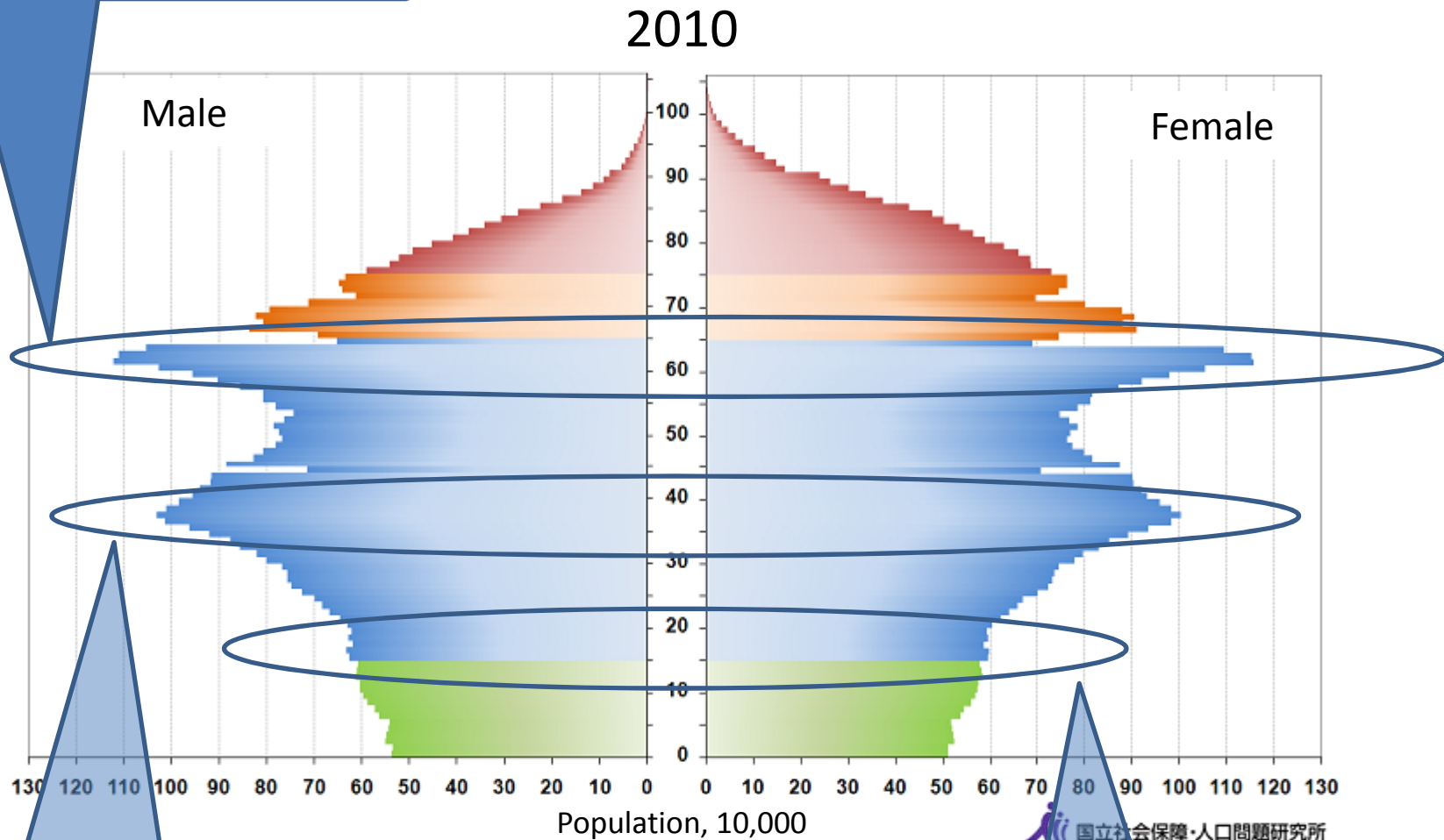
(trillion yen)



Demography

- **Demography matters**
 - Pension system sustainability
 - Growth potential is adversely affected
- Contents of government expenditure changes
 - **More medical; More pension**
- How to affect debt dynamics
 - Social security payments increase
 - Effective kind of taxes change
- Intergeneration transfer becomes a key
 - **Pay-as-you-go pension systems are quite unfair to younger generation**
 - **If relied on income tax, the baby boomer will escape taxation for sustainability → Unfair to the younger generation**

Baby boomer generation is about to retire



資料：1920～2010年：国勢調査、推計人口、2011年以降：「日本の将来推計人口（平成24年1月推計）」。

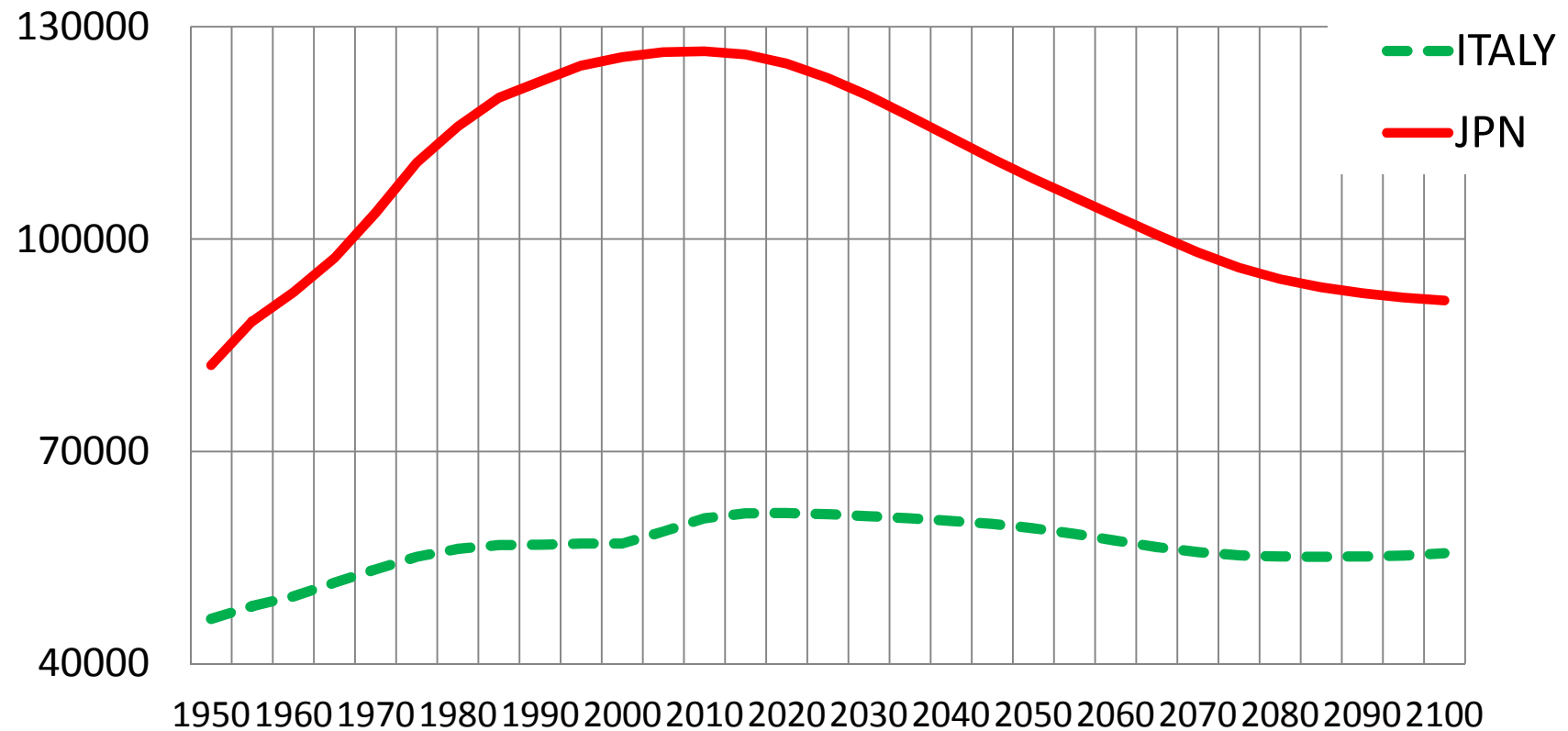
Second Baby boomer generation, sons and daughters of the first

No third baby boom

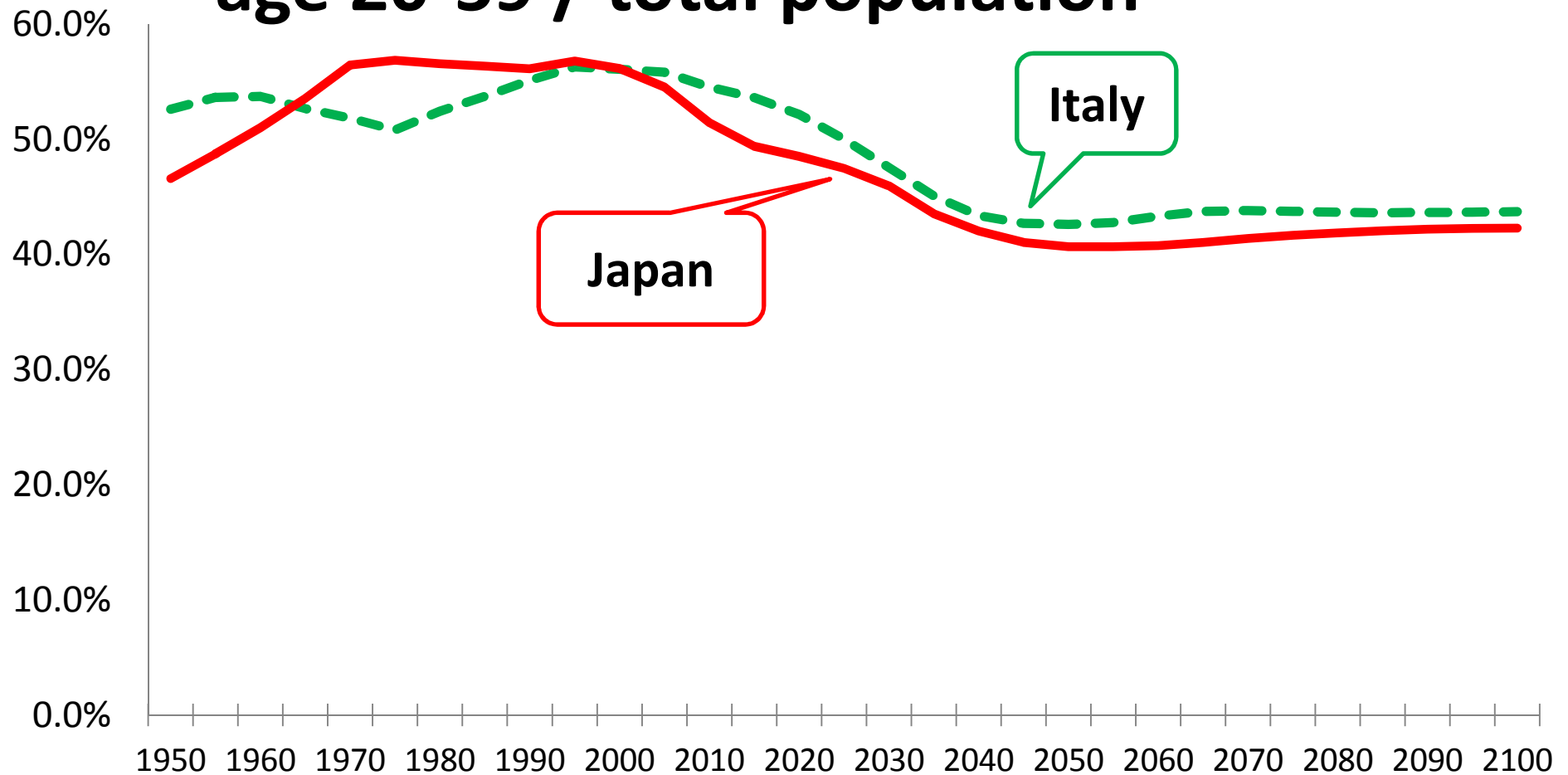
Demographic deficits

- Both Japan and Italy faces
 - a sharp decline in the working age population ratio
 - A sharp increase in the retired population ratio
- Japan will also faces the rapid decline in total population

Total population; Italy and Japan Total

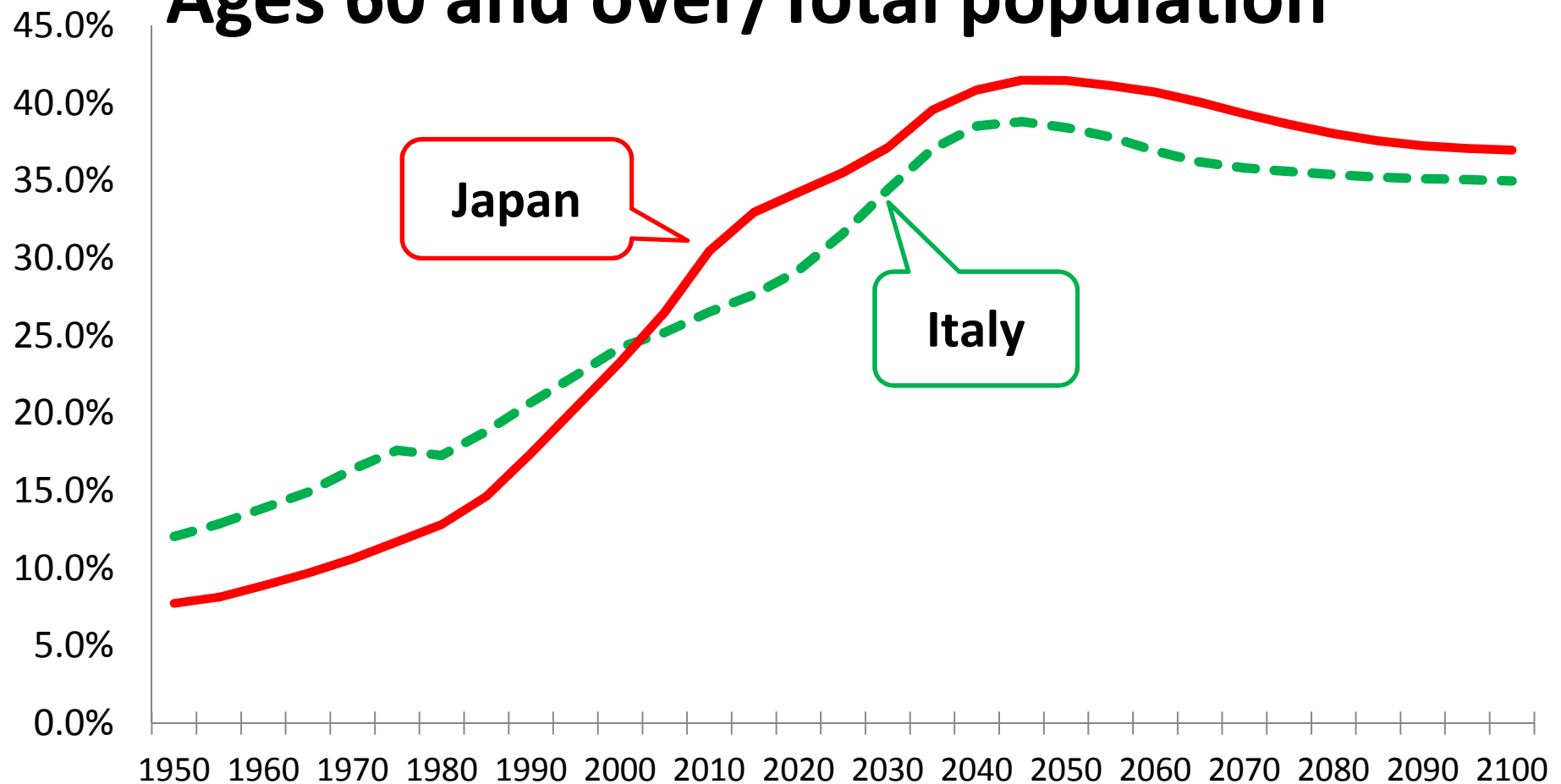


Working age population ratio: age 20-59 / total population



Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat,
World Population Prospects: The 2010 Revision

Retired population ratio: Ages 60 and over/Total population



Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2010 Revision

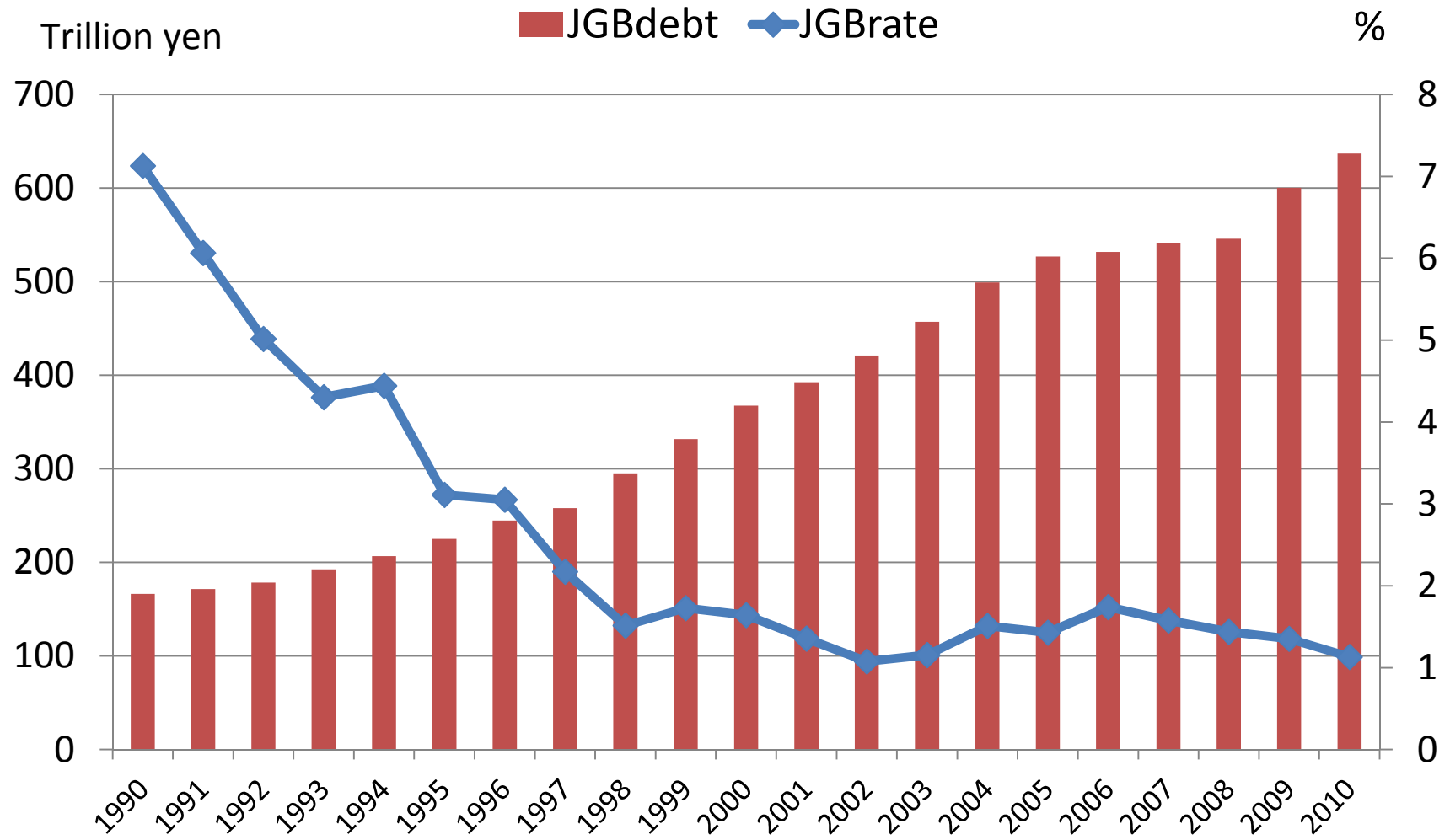
How to restore fiscal sustainability

- Europe
 - Positive Element of the Euro Zone
 - Bond rate convergence (until October 2009)
 - Discipline by the Euro Area, the “troika”
 - Negative Element
 - Cannot depreciate the currency, difficult to restore growth
 - Discipline by the Euro Area, or the “troika”
- Japan
 - Long-time complacency motivated by
 - Low JGB interest rate
 - Room of maneuver
 - Taxes have to be increased, quickly
 - Intergenerational inequity, getting worse
 - Not much room for expenditure cut, except social security expenditure cut

Japanese Debt Crisis (to come)

- Very bad situation (worse than Italy and Spain)
 - Deficit/GDP ratio
 - Debt-to-GDP ratio,
- **Puzzle:** Then, why no crisis yet? (JGB yield < 1%)
 - Japanese residents hold 95% of JGBs
 - Japan has current account surpluses (although trade account turns negative recently)
 - Vast room for tax increases
- The sooner the better
 - Demographic change is very adverse

Puzzle, Debt and interest rate



A solution by Tax increase in Japan

- Increase VAT (consumption tax) rate from 5% to 25% will solve government deficit problem
 - New Bond issues: 44 trillion yen
 - 20% point increase in VAT will generate 45-50 trillion yen
- Personal income tax increase will miss baby boomer generation to be taxed.
- Corporate income tax increase will hasten hollowing out—bad for growth

Italy and Japan, common challenges

fiscal crisis

- What did Italy learn from the European Sovereign debt crisis?
 - Is it just a **bad spillover from Greece?**
 - Italy got hit despite its primary budget surpluses
 - Does it need **“discipline” from outside?**
 - Why it took so long and so much for Italy to convince investors that Italy is sustainable (assuming it is).
 - Can the **“technocrats government”** do a better job than politicians?
 - Why do politicians fail to make right decisions?

Italy and Japan, common challenges

fiscal crisis

- What can (should) Japan learn from the current European crisis?
 - When a crisis happens, **it gets worse quickly**
 - What takes to calm the market **once the crisis occurs requires much more austerity** than restoring sustainable path during the non-crisis time
 - Hence, it is much more **desirable to adopt austerity while the sovereign bond market is calm**
 - Once the crisis occurs, political disputes (politicking) is very costly. Grand coalition or a technocrat government with broad mandate is the best

Italy and Japan, common challenges

Growth Policy

- **Growth policy.** Growth is better than austerity.
 - Where are growth engines?
 - Japan: agriculture, bio-medical-health care, education?
 - Italy: What is a consensus among Italians?
 - Take advantage of “globalization”: Skill premium
 - EU-Japan FTA will be a key for growth in both economies
- **Low fertility rate**
 - **Japan**, Korea, Hong Kong, Singapore and **Italy**?
 - Will immigration be an answer?