We think the IMF's assertions are correct

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IMF assertions

➢ **The IMF asserts that "fiscal reforms dependent on tax hikes will result in a number of adverse effects".**

"Spending-based adjustments are less contractionary than tax-based adjustments."

"In the case of tax-based programs, the effect of a fiscal consolidation of 1 percent of GDP on GDP is –1.3 percent after two years. In the case of spending-based programs, the effect is –0.3 percent after two years, and is not statistically significant."

" In the case of spending-based measures, domestic demand falls by about 0.9 percent after two years, whereas the decline exceeds 1.8 percent in the case of tax-based packages."

"Spending-based adjustments have relatively benign effects if they involve cuts to politically sensitive items, such as transfer programs, or government consumption, such as the public sector wage bill."

"In the case of tax-based packages that include indirect tax hikes, the output costs are particularly large."

Source: IMF," World Economic Outlook: Recovery, Risk, and Rebalancing", October 2010, p.102

Other empirical studies

➢ The IMF analysis is supported by a lot of research

"The analysis of the present paper suggests that primary spending needs to be kept under tight control otherwise increasing taxes running after ever increasing spending will not work."

Alesina, Alberto and Silvia Ardagna, 2010, "Large Changes in Fiscal Policy: Taxes versus Spending," *Tax Policy and the Economy*, Vol. 24, ed. By Jeffrey R. Brown (Cambridge, Massachusetts: National Bureau of Economic Research).

"Tax-driven budget adjustments have proved very damaging for growth but large, expenditure-driven budget adjustments have tended to boost growth."

Broadbent, Ben, and Kevin Daly, 2010, "Limiting the Fall-Out from Fiscal Adjustment," Goldman Sachs Global Economics Paper No. 195 (New York: Goldman Sachs).

➢ Globally, the trend is toward not relying on higher taxes as a fiscal austerity measure.

Over the next ten years, the US government plans to cut spending by $2.4trn. In Greece, of the $25.2bn improvement in the fiscal balance expected during FY2011-FY2015, increased taxes is expected to account for $6.1bn(24% of the total).

Long history for concerns of fiscal crisis

➢ 1997 Fiscal Structure Reform Council (Chair: Prime Minister Ryutaro Hashimoto)

"Fiscal structural reform and rebuilding Japan's finances are key tasks. We have no time to lose. If we fail to change our fiscal structure and our wasteful deficit grows, Japan's economy and quality of life will inevitably collapse."

The government has been saying "we have no time to lose in fiscal reform" and has been worrying about a rise in long-term rates for 14 years.

Many economists have been saying that Japan is at imminent risk of a fiscal crisis over the past ten years. These "Cassandras" repeatedly noted, "we must quickly hike the consumption tax."

In reality the more outstanding JGBs have increased, the more long-term rates have fallen. A wolf has not come yet.

What are they fundamentally misreading?

Balance sheet of the government

➢ **Low net debts**

The total debt is ¥1,019trn, which is more than double of GDP (at end-March 2010). However, we see virtually no risk in the near future that Japan will collapse fiscally and suffer a sharp rise in interest rates. This is because net debt is just ¥372trn, or 75% of GDP.

➢ **Large financial assets**

Financial assets are ¥462trn (71% of total). Public pension assets total ¥121trn and foreign currency reserves ¥82trn.

Financial statement of the government (FY2009)

Assets	¥trn	Liabilities	¥trn
Cash and deposits	19	Short-term government securities	97
Marketable securities	92	Government bonds	721
Accounts receivable	14	Borrowings	22
Loans receivable	155	Deposits	9
Money in Trust	121	Deposits received of public pensions	130
Allowance for doubtful accounts	-3	Reserves for retirement benefits	12
Tangible fixed assets	185	Others	28
Intangible fixed assets	0	**Total liabilities**	1,019
Investments	58	Difference between assets and liabilities	
Others	5	Difference between assets and liabilities	372
Total Assets	647	**Total liabilities and difference between assets and liabilities**	647

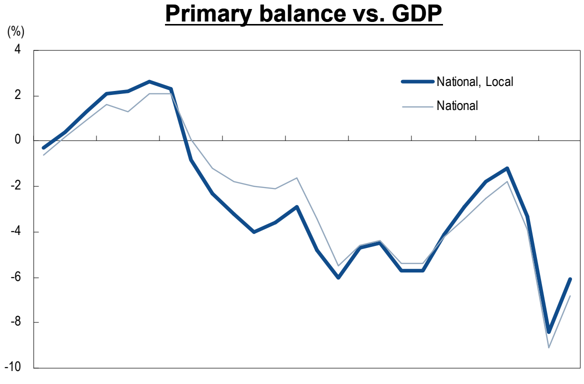
Source: MoF, Citigroup Global Markets Japan.

Conclusion

➢ **The primary balance as a percentage of GDP improved to -1.2% in FY2007 from -5.7% in FY2002 without major tax hikes.**

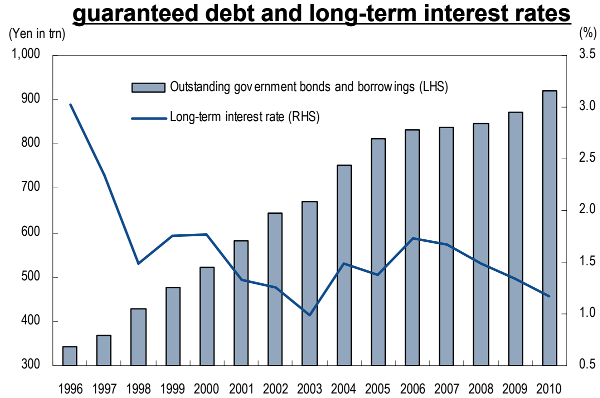
➢ **Economic growth strategy + structural balance sheet reform + structural spending reform (e.g. raising the retirement age to 75, pension, health care, nursing care) + structural revenue reform = Fiscal reform**

Primary balance vs. GDP



Source: MoF, Citigroup Global Markets Japan Inc

Balance of JGBs, borrowings, and government-guaranteed debt and long-term interest rates



Source: MoF, Datastrean, Citigroup Global Markets Japan Inc

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