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Kan Learns Fiscal Discipline as Leadership Beckons (Update2)  
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(Updates with ministers backing Kan in seventh paragraph.)

By Toru Fujioka and Kyoko Shimodoi

June 3 (Bloomberg) -- Naoto Kan, the front-runner to become Japan's prime minister, has begun leading a drive to contain the world's largest public debt just months after warning it would be a "challenge" to maintain fiscal discipline this year.

Kan's change reflects his deepening anxiety over the budget deficit after participating in meetings of Group of 20 and G-7 that were dominated by Europe's debt crisis, a Finance Ministry official said on condition of anonymity. Kan, 63, surprised ministry officials and Prime Minister Yukio Hatoyama last month by extending a pledge to cap bond sales through next year.

The impact of Kan's shift on policymaking may be magnified should he succeed Hatoyama, who announced his resignation yesterday after deepening tensions over the U.S. military's presence in Okinawa. Kan would seek to distinguish himself from the previous four leaders since 2006 by pushing for more fiscal discipline and a higher sales tax, according to Barclays Capital.

"People used to think Kan was very much inclined to economic stimulus measures when he became the finance minister," said Kazuhiko Sano, chief strategist in Tokyo at Citigroup Global Markets Japan Inc., who predicts Kan will be selected as prime minister. "He's been changing his tone and stance toward fiscal discipline" after sovereign-debt risks climbed, he said.

Hatoyama, 63, is quitting after less than nine months in office as campaign finance scandals and indecision over where to move a U.S. military base sent the Cabinet's approval rating down to around 20 percent in public opinion polls.

#### Yen Drop

The yen fell to a two-week low yesterday after the announcement left unclear who will lead Japan weeks before an election of the upper house of parliament. It traded at 92.25 per dollar at 1:36 p.m. in Tokyo. Kan developed a reputation of favoring a weak yen after saying Jan. 7 on his first day in office that he wanted the currency to fall "a bit more."

Kan, a devotee of the Japanese strategy game "go," told reporters in Tokyo he's running for the top job. He won support today from Foreign Minister Katsuya Okada and Transport Minister Seiji Maehara.

Kan is deputy prime minister and a former leader of the Democratic Party of Japan, which in September ended a half century of almost unbroken rule by the Liberal Democratic Party.

After replacing former Finance Ministry veteran Hirohisa Fujii as head of the agency in January, Kan said on Jan. 7 that taxes would only be raised after politicians got rid of "wasteful" spending.

## Tax Increase

Kan changed gears a month later after Standard and Poor's cut its outlook for Japan's AA debt rating and he attended a G-7 meeting that discussed the European crisis. He said Feb. 14 that officials would start debating whether to raise the 5 percent sales tax. In May, he pledged to keep new bond sales in the 2011-12 fiscal year under the current period's 44.3 trillion yen (\$483 billion), an undertaking that Hatoyama later said was too early to commit to.

"We have no excuse to increase debt," Kan said on May 2 after meeting with Asian counterparts in Tashkent, Uzbekistan. "That's why we need to consider tax reforms to secure funds."

The Finance Ministry didn't immediately respond to a request for an interview with Kan.

With National Strategy Minister Yoshito Sengoku, Kan is working on a roadmap to reduce a government debt burden that the Organization for Economic Cooperation and Development says is approaching 200 percent of gross domestic product, the highest among its 31 members.

## Moody's Watching

"If he's really gotten fiscal religion from these meetings of the G-20 that would bode well," said Thomas Byrne, a senior vice president at Moody's Investors Service in Singapore who in January said Kan's appointment as finance chief raised "doubts" about the bond sales cap. "The only way to judge this is to see" the fiscal plan due this month, he said.

Byrne said Moody's, which has an Aa2 rating for Japan's sovereign debt, will be looking for a "credible plan that will assure market confidence." Past proposals that were encouraging included targets for deficit reduction and debt compared with GDP, and "hard" rules for taxes and spending cemented in legislation, Byrne said yesterday.

Sengoku and Vice Finance Minister Yoshihiko Noda are among potential candidates to become finance chief if Kan's leadership bid succeeds. Noda would "reinforce the view that the government is moving toward fiscal health," said Masamichi Adachi, senior economist at JPMorgan Chase & Co. in Tokyo.

## Opportunities 'Enhanced'

Should Sengoku retain a key Cabinet post, "the opportunities for fiscal reconstruction will likely be enhanced," said Junko Nishioka, chief Japan economist at RBS Securities Japan Ltd. in Tokyo.

Hatoyama's successor faces a political test just weeks into his term, with an upper house election that may see the ruling coalition lose ground, making it tougher to pass legislation, said Kyohei Morita, chief Japan economist at Barclays in Tokyo.

"Even if Kan becomes prime minister, it doesn't change the main scenario that the DPJ will suffer a severe result in the election," Morita said. "The hurdle for a higher sales tax is extremely high" if you consider the likely numbers of seats for the ruling coalition after the contest, he said.

The new leader will also take over amid signs that the economy is losing momentum after growing at the fastest pace in three quarters in the first quarter. Unemployment rose in April, household spending fell and deflation deepened.

Kan is no stranger to taking on controversial battles. He established a reputation as a maverick by taking on bureaucrats as a Cabinet member in 1996, when he forced his subordinates at the welfare ministry to surrender documents that shed light on their role in causing thousands of Japanese to contract AIDS through HIV-contaminated blood products.

"He will make more progress than Hatoyama" on restoring fiscal health, said Takao Komine, a professor at Hosei University in Tokyo, who previously worked at the government's Economic Planning Agency. "The issues have gone straight to his heart and he understands caution must be exercised."

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--With assistance from Yoshiaki Nohara, Tatsuo Ito and Christopher Anstey in Tokyo. Editors: Russell Ward, Chris Anstey