

## The 31<sup>st</sup> Medium-term Forecast of the Japanese Economy (FY2004 - 2015)

# Challenges to Revitalizing the Japanese Economy

- *The Post-deflation Economy and Responses to Globalization* -

**Research Director: Masaaki KAWAGOE**

**Release Date: December 1, 2004**

### **The Japanese Economy to FY2015**

In this forecast, we examine the future Japanese economy to FY2015. Major assumptions made in the forecast are: The world economy will grow by about 4%, oil prices would drop to \$28/barrel, and the yen would gradually appreciate by about 10%. In other words, the terms of trade that have deteriorated significantly this fiscal year will gradually look better. We also assume that to recover sustainability of government finances, the consumption tax rate will be raised by 3 percentage points in FY2008, and 2 in FY2013. Under these assumptions, the Japanese economy should be able to attain growth of about 2%.

In the first term of the forecast period (FY2004-2006), the slowdown in the economy will not be enough of a “recession” to mark lower growth than the potential growth rate, and the economy will recover in FY2006. This is because the overseas economies will support the economy, lower oil prices will help improve the terms of trade and corporate profits will improve quite briskly. Prices will stop falling and become flat. A resulting decline in real interest rates should help sustain the economy.

In the middle term of the forecast period (FY2007-2010), consumer prices will begin to actually rise (in FY2007) under an economic expansion led by domestic demand. The Bank of Japan will terminate its policy of quantitative easing in FY2007, but will maintain a relatively easy monetary stance in terms of real interest rates until FY2008. The end of deflation will improve business sentiments, thereby stimulating corporate sector activities. This pick-up will be amplified by the demand creation effects of regulatory reform centered in the non-manufacturing industries. Employee compensation growth will be restrained due to continued corporate efforts to improve profitability, but consumption will grow by an average 2% due in part to the increase in property income.

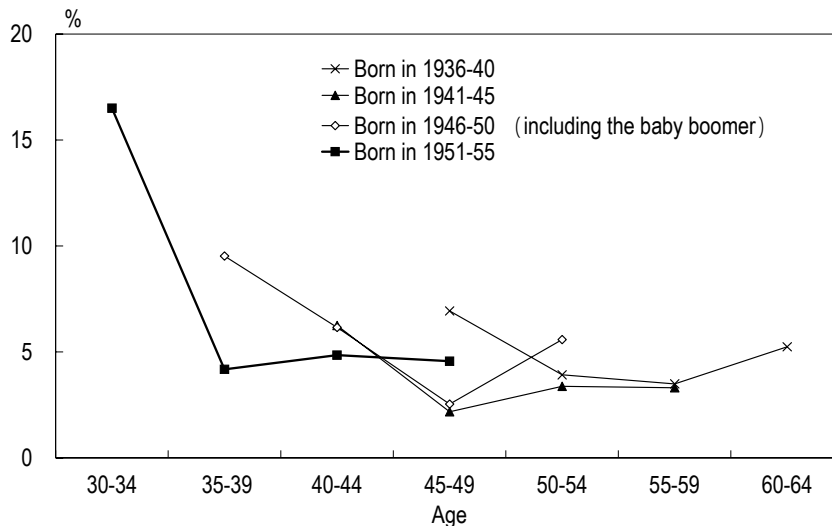
In the last term of the forecast period (FY2011-2015), growth of just under 2% may be attained. This is an expansion centered on domestic demand and led by consumption and business fixed investment of the non-manufacturing industries.

The macroeconomic policies in the first and middle terms of the forecast period must be very carefully managed in order to eliminate deflation. The petering-out of deflation will lead to lower real interest rates. The economy is estimated to be stimulated by a gradual increase in nominal interest rates.

As for fiscal policies, we assume a special tax reduction will be shrunk by only 2 trillion yen in FY2006-2007 for central and local governments, i.e. a change for

FY2005 under discussion will be postponed. Currently there are an increased number of households with no savings, and this same trend can be seen in households that are soon facing retirement (Figure 1). Because there is a possibility that many households would like to save, but were unable to do so, it is a smarter strategy to increase taxes after households have enough income.

**Figure 1. The share of households with savings of less than 1 million yen  
( by the generation )**



(Note) Figures by age of households head in 1985, 1990, 1995, and 2000

(Source) Ministry of Internal Affairs and Communication " Family Income and Expenditure Survey "

Moreover, Figure 1 also tells that households with insufficient savings before retirement may not be able to retire. Then an increase in the propensity to consume occurring from the aging population should be kept at a gradual pace. Furthermore, as an expected correction of fiscal deficits further increase savings in excess of investment, the current account surplus relative to nominal GDP should be maintained around the 3.5-4.0% level.

Surely, there are some risks to this forecast. First, the US current account deficit may not shrink as expected (to 3.7% of nominal GDP by FY2015). In this instance, the dollar may depreciate. We must pay attention to the unstable situation that in 2003, over 40% of the current account deficit of the US was financed by Asian monetary authorities.

The second risk factor is that oil prices may rise further. Although the actual income transfer effects through the increase in oil payments would be limited, the effects on consumer and business sentiment would be worrisome.

### Challenges to Fiscal Consolidation

Fiscal consolidation will still be a challenge even in FY2015. Net debt of the general government will steadily increase, reaching about 100% of nominal GDP in FY2015. Although gross debt is at a higher level, it is likely to temporarily decline from FY2006. This is caused by drawing on some pension reserves, and therefore, does not indicate an

improved financial condition.

Discretion in allocating fiscal resources will be more limited, which is exemplified by interest payments amounting to more than 4 % of nominal GDP. We envisage fiscal consolidation measures worth about 6% of nominal GDP in total in FY2015 compared to FY2004, which will be partially offset by effects of aging population and, hence, improve the balance by about 5.4% (Table 1). We forecast an improvement of 2.5% of nominal GDP come from increases in taxes, and 2.5% from expenditure reductions, and a 1.0% improvement from asset disposals.

**Table 1. The Improvement of the Fiscal Balance from FY2004 to FY2015**

(% of Nominal GDP)

Fiscal Deficit	3.2
Interest Payments (Net)	▲ 3.0
Primary Balance	6.2
Cyclical Factor	0.9
Structural Factor	5.4
Increase in Expenditure due to the Aging Population (Net)	▲ 0.5
Tax Increase (Cut in Special Tax Reduction, Consumption Tax Increase)	2.5
Reduction in Expenditures	2.5
Government Consumption (excluding Social Benefits)	1.5
Public Investment	1.0
Others (Asset Disposals etc.)	1.0

(Notes) 1. Negative figures show deterioration of the fiscal balance.

2. "Increase in Expenditure due to the Aging Population" shows  $C - B$ , where  $C$  is social security contributions and  $B$  is social security benefits.

If we set a goal of the consolidation to stabilize the net government debt at FY2015 levels, then a primary balance surplus of about 1.4% of nominal GDP will be required. Because structural primary balance surplus is estimated to be about 0.2%, an additional rationalization of government spending or increased taxes totaling over 1% will be needed.

In this forecast, we assume that further businesses will be privatized as market testing proceeds, and assets of the general government will be sold. Market testing and re-delineating boundaries of public sector activities will be useful for the consolidation and raise potential growth rates. However, the effects on revenues are only temporary. A further reduction in public investment (though only maintenance is incorporated in the forecast) and a further tax increase are needed.

### Effects of Globalization

Let us take a look at effects of globalization as it affects this medium-term forecast. Note Japan's economy has lower openness (sum of imports and exports as a share of nominal GDP) than the US, and there is still a lot of room to benefit from globalization.

If we conduct a statistical test of the real interest parity, the financial markets of Japan and the Asian Countries' are being integrated. The integration is likely to force the corporate sector to increase their rates of return on capital that are currently at low levels

internationally. Real wage growth will be kept lower than productivity growth, decreasing the labor share by about 3 percentage points during this forecast period as a result.

On the other hand, the international competitiveness of the manufacturing industry will be pretty much sustained at current levels. Based on a multiple-good Ricardian model, we expect no great change in comparative advantage by industry against China and Korea in the forecast period. Thus, terms of trade is unlikely to deteriorate as a result of a decline of export prices precipitated by intensified competition.

Although in this way, the manufacturing sector does exert its utmost efforts, the potential growth rate of the economy remains relatively low, which confirms once again importance of increasing productivity in the non-manufacturing industries. In this forecast, we incorporate a 10 trillion yen benefit of regulatory reform in seven sectors, starting with a lifting of the ban on “mixed” healthcare. However, further regulatory reform must be promoted.

Smaller labor force will work to lower the potential growth rate mainly in the 2010s, but there are risks associated with trying to eliminate the labor shortage by allowing more foreign workers. We must be aware of a possibility that the increase in the income levels in China may intensify the potential supply pressure of migrant workers. The number of latent unemployed persons in China is estimated to be over 200 million people.

It is more realistic to accept skilled workers selectively. A society such as Japan's with the structure of wages of managers and workers not differing greatly, may find it difficult to attract highly qualified foreign workers. Although the immigration system has many areas that need to be improved, the corporate sector will also be required to make some adjustments.

Furthermore, it is necessary that the effectiveness of R&D investment is improved in order to improve total factor productivity growth. If Japan were to increase the R&D investment in the service industries (that lag greatly behind other countries), this should be effective in enhancing productivity in the non-manufacturing sectors. Moreover, the trend towards the “introvertedness” of Japan as suggested by a decline in the number of international strategic technical alliances needs to be addressed and rectified.

Although foreign technology and human resources may be more easily accessed through globalization, economic performance will differ by the way in that they are utilized. The reason that IT is not more actively utilized in Japan is largely due to internal organizations of firms, and this can be also said about utilizing foreign skilled workers and R&D development. In this regard, it is necessary to construct an organization that can better benefit from the effects of globalization.