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The 37th Middle-Term Economic Forecast (2010—2020)

Exports to Narrow the Supply-and-Demand Gap

—Gap to Be Closed in or after Fiscal 2014 ;

Expansion of Government Debt to Continue—

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Main Points

• The key is to make good use of growth in Asian economies

• Even hiking the consumption tax to 10% will not eliminate the deficit in the government's primary balance

• A lively growth strategy is needed to overcome deflation as soon as possible

The Japanese economy is grappling with a number of serious issues. Economic growth has remained sluggish since the turn of the century, averaging less than 1% per year; deflation has resumed, with prices registering declines since fiscal 2009 (April 2009 to March 2010); and the public debt (central and local governments combined) reached 165% of gross domestic product (GDP) at the end of fiscal 2009. With the population aging and globalization continuing, moreover, economic situations in Japan are to be expected to change dramatically over the years to come.

Our latest medium-term forecast, which rests on the premise that the Japanese economy will continue to demonstrate the responsiveness it has acquired by surmounting various difficulties up to now, projects the outlook until fiscal 2020, paying special attention to the following key questions: What will serve as the engine of economic growth over the next 10 years? When can Japan expect an end to deflation and the supply-and-demand gap (i.e. the "GDP gap" between potential and actual GDP)? And can fiscal bankruptcy be averted?

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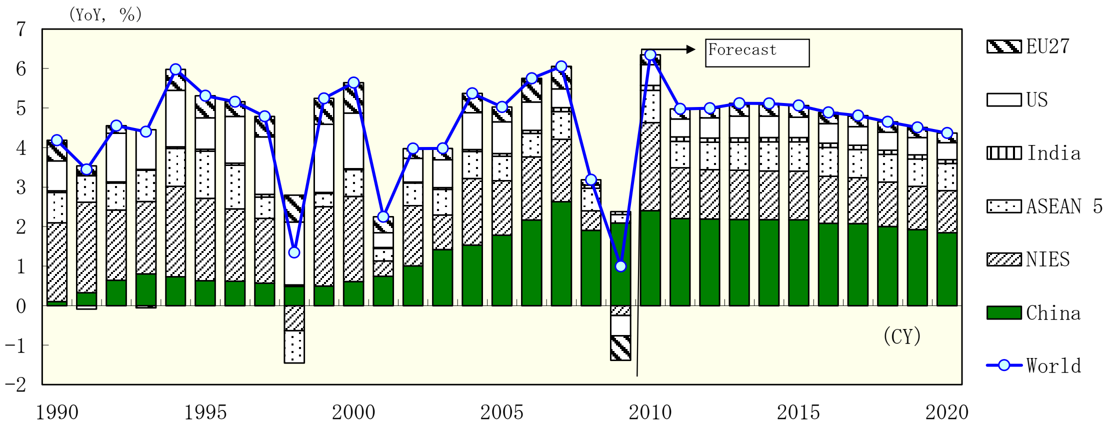
We assumed that Asia's presence will continue to grow with China racing along at a 9% clip during the first half of the forecast period (2011–15, calendar years for overseas economies). As a result, the world economic growth rate measured as the weighted average of Japan's export markets will move along at a fast pace of 5.0% , and will continue at 4.3% in the second half of the forecast period (2016–20) (figure 1).

Figure 1: World GDP growth rate(measured as the weighted average of Japan's export markets)



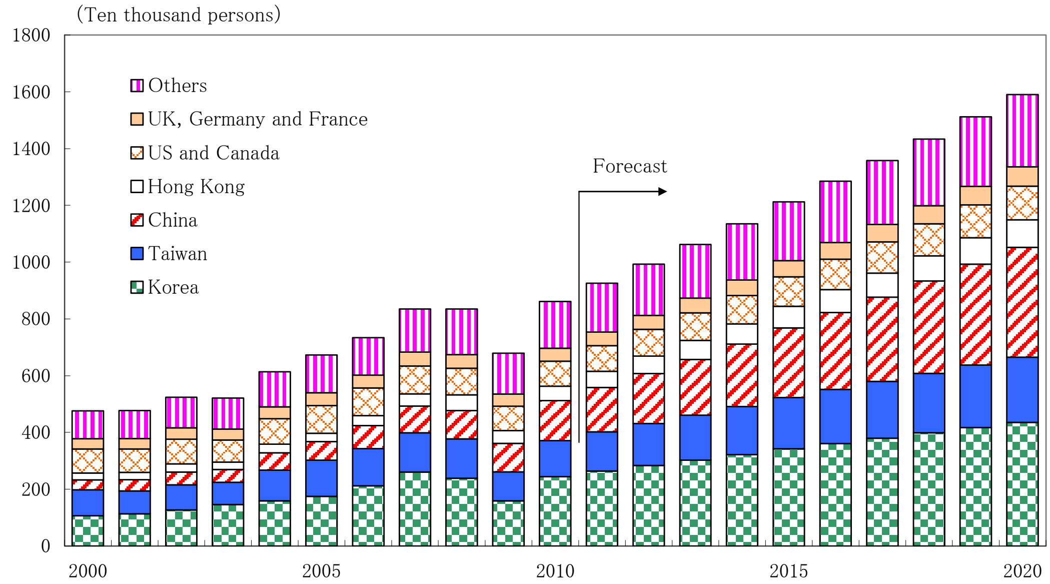
Note:The figures after 2009 are forecasted by JCER.
Source:IMF "World Economic Outlook October 2010".

Western countries will be slow to bounce back from the global financial crisis. Consumer spending in the United States is not expected to regain vigor quickly, as household sectors are struggling to deal with their debts, while employment is recovering only slowly. The major European countries, meanwhile, are likely to be cutting back on government spending and taking other steps to regain healthy fiscal positions. During the first half of the forecast period, accordingly, the real growth rates of the advanced Western countries are expected to fall below the past average (1990–2007).

Asian countries, by contrast, are likely to register faster growth rates during the same period compared with their past average. This is because their domestic demand has gained ground, making them less susceptible to the impact of any stagnation among Western economies, and their governments have no need to make large cuts in spending for regaining a better fiscal balance. Of special note is that China's industrial structure is much similar to that of Japan in the mid-1950s with respect to the composition of employees; this means that China has ample room for speeding up growth through the movement of labor into more productive industries. The surplus of labor force in the primary industries for this transition will last at least until 2015 before it dries up.

The key to support economic growth in Japan lies in how this growth in Asian economies is put to use. Tourism presents one promising field. Foreign visitors to Japan are projected to climb swiftly from 8.6 million in 2010 to 15.9 million in 2020 (figure 2). The number of Chinese tourists will almost triple, increasing from 1.4 million in 2010 to 3.9 million in 2020. In addition, the market for household appliances in Asian region is promising, while Japan's own market has become saturated. Because in Asian countries, the levels of income are rising and more women are entering into the labor markets, the diffusion of appliances that reduce housework will greatly grow up.

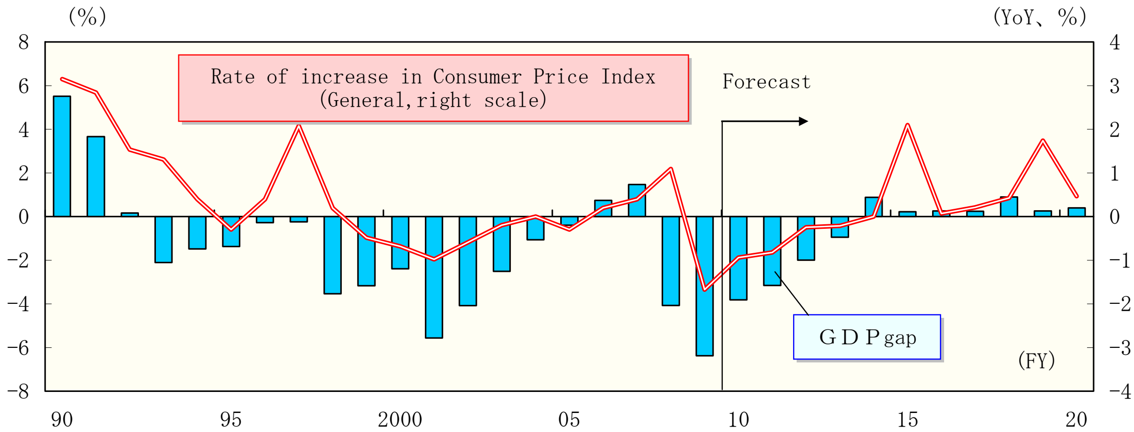
Figure 2: The number of visitors to Japan



Note .The figures after 2010 are forecasted by JCER.
Source:Japan National Tourism Organization

Japan's potential growth rate is expected to be slightly below 1% even after taking increases in total factor productivity and capital accumulation into account. This is because the labor force is shrinking in the context of a graying population with relatively few children.

Figure 3: GDP gap and Rate of increase in Consumer Price Index



Note 1. The figures include negative effects by revision of base period and the weight reference period, which will be held in 2011.
2. We assume that the consumption tax rate will be raised by 3% in FY2015 and 2% in FY2019.
Source Cabinet Office "National Accounts" , Ministry of Internal Affairs and Communications "Consumer Price Index"

Currently Japan has a huge supply-and-demand gap, standing at a negative 3.8% as of fiscal 2010. In the forecast period, we can expect the GDP gap to narrow steadily(figure 3) because (1) the world economy will enjoy smooth growth, permitting steady expansion of Japanese exports, and (2) with the help of price stability, consumption will register sound growth and capital investment, buoyed by favorable corporate profits, will also follows an upturn. Even in that case, however, not until in or after fiscal 2014 will the gap vanish, unless a hike in the consumption tax triggers a surge in demand before the new rate takes effect. The economic growth rate is expected to be in the vicinity of 1%, or 1.4% in the fiscal 2011–15 period and 0.9% in the fiscal 2016–20 period. Because the population will be contracting, however, the real per capita growth rate will exceed that of the fiscal 2001–10 period.

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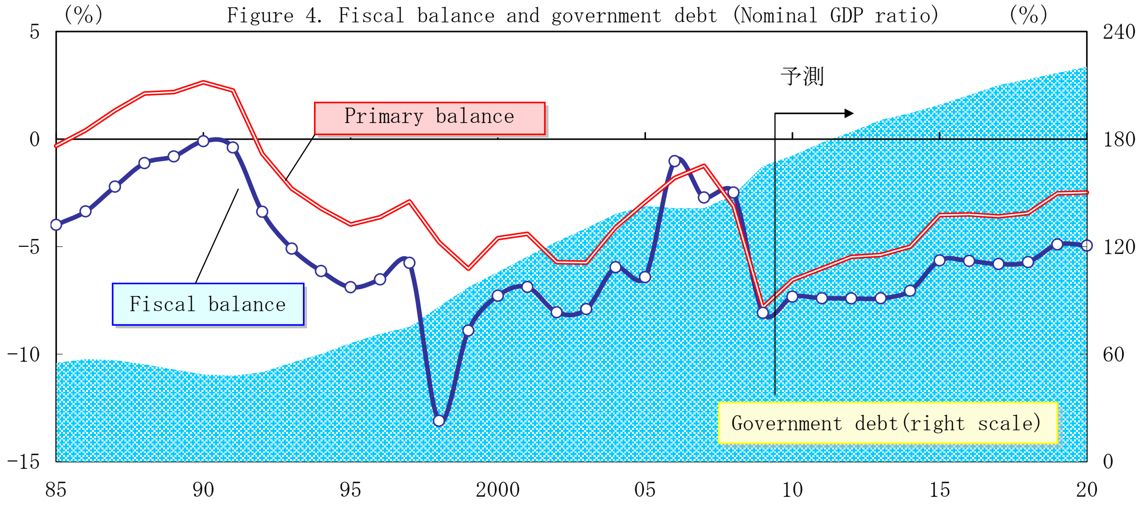
When companies regain vigor with the help of the world economic growth, economic trends will be strongly influenced by the choices corporate managers make among the options before them and the emphasis they place on each. Managers must decide on how to distribute available funds among such uses as wages, dividends, export price markdowns, domestic capital investment, and overseas investment. One needs to bear in mind that while domestic demand can be expected to swell if businesses channel funds into wages and domestic plant and equipment investment, there is a danger it will be weak if funds are not used in such ways.

The unemployment rate rose as far as 5.2% in fiscal 2009, but unemployment should gradually fall as the supply-and-demand gap diminishes. In an accompanying movement, compensation of employee per capita (wages) can be expected to rise, after having remained essentially flat for a while. Excluding the effects of a possible hike in the consumption tax, we expect the deflationary situation to continue during the first half of the forecast period. Because the GDP gap will still not be fully closed, prices will continue to decline. The speed of the descent should gradually slow down as the gap narrows, however, and prices should begin to rise in the second half of the forecast perio

Putting these trends together, we expect the nominal growth rate, which adds the rate of change in prices to the real growth rate, to move no higher than slightly above the level recorded in the second half of the 1990s. Nominal GDP in the final year of fiscal 2020 is estimated at ¥509.7 trillion, still below the most recent peak in fiscal 2007. Long-term interest rates will remain low in the first half of the period, reflecting weak corporate appetite for borrowing, but with the shift to rising prices in the second half, they will begin to move up.

Because tax revenue will increase smoothly in the first half of the period along with the steady recovery, the red ink in the primary balance (the difference between revenues and expenditures excluding new government bond issues and debt-servicing costs) will gradually contract as a percentage of GDP for the central and local governments combined. With social security costs continuing to mount, however, the primary balance will not reach a surplus position even if the consumption tax is hiked from 5% to 10%. As of fiscal 2020, the deficit should be 2.5% of GDP (figure 4). While the government's debts will continue to increase, there is little likelihood of insolvency in public finance before fiscal 2020 because the total debts will remain within the range of what can be covered by households' net financial assets (246% of GDP). To be sure, the risk of bankruptcy will not completely disappear, as the total outstanding debts of the central and local governments will edge upward as a percentage of GDP (reaching 220% of GDP at the end of fiscal 2020).

Figure 4: Fiscal balance and government debt (Nominal GDP ratio)



Note:1. All figures are those of central and local government combined.
2. Primary and fiscal balances exclude irregular items.
Source:Ministry of Finance, Cabinet Office "National Accounts"

Given the aging of the population, there is no way to avoid a growing bill for public pensions, medical care, and nursing care. While efforts must be made to improve efficiency, it has become clear that a radical tax reform is required for securing the necessary financial resources. Our forecast this time has reconfirmed that securing revenue to pay for social security expenses and achieving a balance in public finance cannot be accomplished merely by hiking the consumption tax to 10%.

As for the balance of saving-investment, companies and households will remain in the black, while the government will continue to run up deficits. The balance of trade and services will shift into deficit in the second half of the period, but the current account will remain in the black thanks to the surpluses of the balance on income.

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It is clearly desirable to stop deflation as quickly as possible, since it adversely affects the economy by, for instance, blocking reduction of real interest rates and increasing the burden of debts. In the absence of some sort of policy response, however, arresting deflation is likely to be a lengthy process, as already discussed. Still, since Japan is soon to have an aging society of the sort unprecedented in human history, no time must be lost in overcoming deflation and opening up a path forward by enhancing potential growth and taking advantage of overseas economy. Toward that end, monetary policy should be further relaxed, and a lively growth strategy must be intensively implemented.

Growth can be achieved by creating an ongoing supply of attractive goods and services. In order to enhance growth potential, technological innovation and fostering of human resources are indispensable. Making good use of its technological strength, Japan needs to promote innovation with the focus on the environmental sector and other industries expected to be important sources of demand in the future.

Our forecast rests on the assumption of no change in the rate of participation in the labor force by women and others. But if more women can be encouraged to take jobs by creating workplaces in which they feel more comfortable working, one may anticipate not just a slower decline in the size of the labor force but also a growing supply of unprecedented goods and services in various fields.

In other respects as well, the nation must ready favorable systems and a beneficial environment for corporate efforts to supply goods and services. With regard to the Trans-Pacific Strategic Economic Partnership (TPP) as well, the debate should not just center on whether Japan should participate, but also on how Japan can take advantage of overseas economy through its participation.

Nihon Keizai Shimbun, “Economics Classroom,” February 2, 2011

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