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The 38th Middle-Term Economic Forecast (2011—2020)

Urgent Fiscal Reform Needed to Avoid Government Default

— Tax hike of 5% inadequate

— Build business environment to foster productivity

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Key Points

- Household capacity to fully subscribe government debt issues maxed out
- Piecemeal tax hikes best given tepid growth outlook
- International trade rules needed on investment and IP as well

In our forecast for the Japanese economy through fiscal year 2020 (April, 2020 - March, 2021), we have taken account of global economic conditions, the impact of the Great East Japan Earthquake and associated nuclear accidents, reconstruction, and the government’s timetable for coordinated reform of the social security and tax systems. Our forecast indicates that Japan will maintain a growth rate of around 1% (see table) thanks to the recovery following the global financial crisis and earthquake and to enhanced productivity gained from technological innovations. For the present, sovereign credit concerns are likely to remain a drag, but we expect the global economy as a whole to grow steadily, led by emerging nations, with Japanese exports increasing firmly and domestic demand also showing slow but stable growth.

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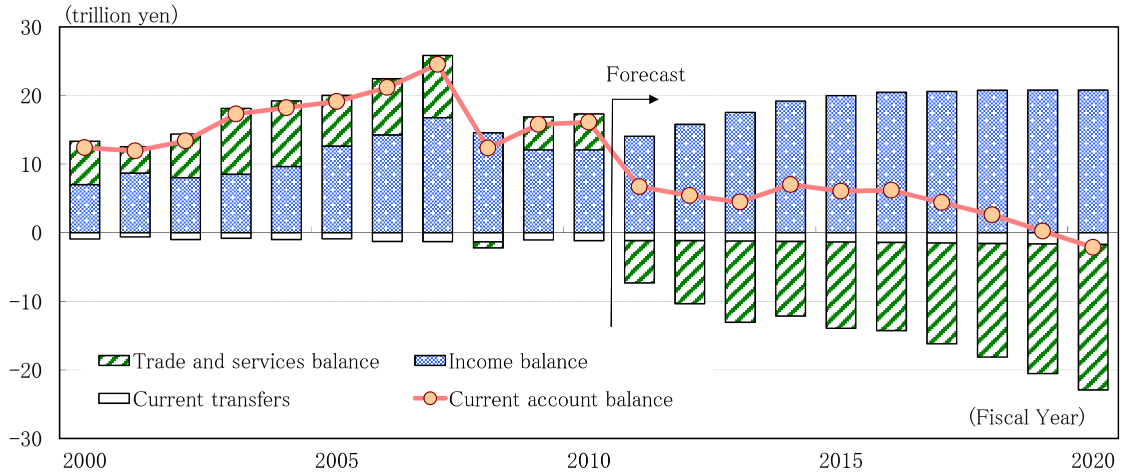
A key condition underlying this outlook is fiscal reform. Thus far, the government has been able to rely on domestic savings to finance the fiscal deficit, but this will be increasingly difficult as the current account balance deteriorates. If Japan runs a deficit in its current balance, domestic investment (expenditures) will exceed domestic savings, and capital inflows from abroad will become necessary to finance the fiscal deficit. This is why fiscal reform is so urgent.

Exports will increase, but imports will rise even more due to increasing crude oil prices and the switchover to thermal power generation. As a result, the deficit in the balance of trade and services will widen. Even if Japan maintains a surplus in its income balance thanks to interest and dividend payments, a deficit can still be expected to arise in the current account balance by the latter half of the decade (Figure 1). In the event that all nuclear power plants in Japan remain offline from and after FY2012, electric power shortages will constrain production activity and fossil fuel imports will increase further, pushing the current account balance into the red even earlier.

Figure 1: Outlook for current account



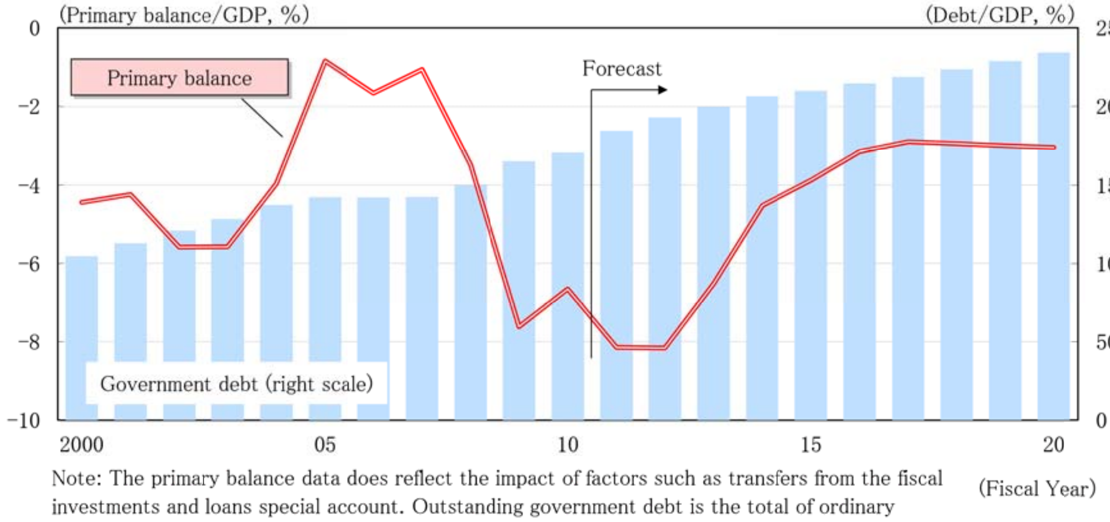
Sources: Ministry of Finance and Bank of Japan, *Balance of Payments Statistics* (Forecast by JCER)

Japan's household savings rate has fallen with the aging of the population and is expected to turn negative in the latter half of the decade. The 2011 current balance and direct external investment are almost evenly matched, and the fiscal deficit has grown to such a point that it will soon be impossible to finance with domestic savings. The balance of Japanese government securities and local government securities held by foreign investors was just 6% versus GDP as of the end of December last year, but on a flow basis, foreign investors bought about 30% of the increased portion of short- and long-dated Japanese government securities in FY2010, or about ¥45 trillion.

Yields on Japanese government securities are presently low, but the cost of credit default swaps on Japanese sovereign debt has been rising. That cost represents the market's view of the credit risk on Japanese government securities. The divergence of these two indicators is thought to arise from differing views on the part of foreign and Japanese investors regarding the state of Japanese government finances. As Japan becomes dependent on foreign investors as a source of capital, however, yields on Japanese government securities will be increasingly sensitive to the views of foreign investors, which suggests that yields are in danger of turning higher.

Our forecast anticipates that, in the course of its coordinated reform of the social welfare and tax systems, the government will raise the consumption tax to 8% by April of 2014 and to 10% by October of 2015. We expect the primary balance to GDP ratio for the national and local governments to be 3.2% in FY2016, when the impact of the tax hike will be felt, thus essentially achieving the target of cutting the ratio by half versus FY2010 levels (Figure 2). But this will not be sufficient to cover social welfare spending, which will rise owing to the aging of the population. And since the primary balance will remain in the red, the debt to GDP ratio will continue to rise, as will the risk of government default.

Figure 2: Projection of fiscal situation (Nominal GDP ratio)



Note: The primary balance data does reflect the impact of factors such as transfers from the fiscal investments and loans special account. Outstanding government debt is the total of ordinary Japanese government bonds (JGBs), local government bonds and the outstanding balance of local allocations and transfers.
Sources: Ministry of Finance, Cabinet Office, National Accounts.

Although fiscal reform is necessary, consideration should be given to the manner in which the consumption tax rate is raised. The FY2014 hike will be equivalent to about 1.5% of GDP. At a time when a growth rate of only about 1% can be expected, a sudden hike in the tax rate by 3% could deliver a huge shock to the economy. In view of the fact that, as in 1997, there will be a huge upsurge of demand ahead of the hike and a corresponding contraction afterwards, growth in FY2014 could very well be zero. Raising the tax rate in smaller increments might therefore be desirable with a view to easing the impact on the economy.

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In order to preserve the vitality of the Japanese economy, it will also be important to harness the latent vitality of Japanese business firms and build an environment that will enhance productivity. Toward that end, it should be noted that Japanese companies will unavoidably have to develop their operations globally and in that context decide which operations to retain in Japan.

Localization will very likely extend not just to production activities but to investment in research and development as well. With regard to R&D, we have examined the outlook separately for market-oriented products conforming to local specifications and technology-oriented products which leverage new knowledge and technology, and we believe there will be an inevitable increase in market-oriented products as Asian countries continue to grow. We also believe that increasing researcher numbers and educational levels in Asia will boost the relative weight overseas of technology-oriented products, but coping with this trend will be possible. Exactly because the decline in technology-oriented production within Japan will slow the growth rate, environment which fosters young researchers within Japan will be needed.

It will be important for business firms to choose the best sites for product development, production and marketing, selecting those locations in which institutional and other conditions affecting the business environment will assure optimal benefits and returns.

In the manufacturing industry today, the production process is fragmenting across national boundaries. The strength of Japanese-style manufacturing lies not so much in processes based on “modular architecture” (employing modules combining a number of components into a single functioning unit) but in those based on “integral architecture.” But since the institutions and environment of each country differ, Japanese companies may be forced to shift even these processes offshore unless they are able to fragment their operations internationally without constraints. Thus in order to retain in Japan production of those components and products in which Japanese companies excel, trade rules should be created in the context of the Trans-Pacific Partnership negotiations to facilitate the international fragmentation of production, with attention given to investment and intellectual property as well.

An overview of the domestic Japanese manufacturing industry shows that, given the rise in exports, the aging of Japanese society and wider use of outsourcing, we can expect output to increase in the manufacturing and assembly industries and in services such as medical care, nursing care for the aged and services provided to business establishments. But since an increase in productivity in the manufacturing industries will slow any increase in employment, the jobs will come in those service industries which are labor intensive and in which an increase in activity easily leads to an increase in jobs. This would mean that jobs will shift to industries in which labor productivity is low, threatening to slow the growth rate. Thus in order to achieve a high rate of growth for the country as a whole, it will be important to boost the productivity of these industries as well, as through the exploitation of digitalization and robotic technologies.

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As Japan’s working population declines, raising productivity will be key to maintaining a growth rate of about 1%. In addition to fiscal reform, strategies to ensure rising productivity in a variety of ways will also needed.

Table: Main Economic Indicators Forecast

	FY'2001～10 : Averages			FY2011～20 : Averages		
		01～05	06～10		11～15	16～20
Real GDP growth rate (2005 prices)	0.7	1.2	0.1	0.9	0.8	1.1
Net Exports (contribution to change)	0.4	0.4	0.4	0.3	0.1	0.5
Potential GDP growth rate (three year backward moving average)	0.9	0.9	0.9	0.5	0.5	0.6
Nominal GDP growth rate	▲ 0.6	▲ 0.2	▲ 1.1	0.2	0.1	0.2
Consumer Price Index (general, year on year)	▲ 0.3	▲ 0.4	▲ 0.1	0.3	0.5	0.1
Primary Balance(nominal GDP ratio) ※		▲ 0.8	▲ 6.7		▲ 3.9	▲ 3.0
Government debt (Nominal GDP ratio) ※		142.2	170.7		210.0	234.4
Current Accounts (Nominal GDP ratio)※		3.8	3.4		1.3	▲ 0.4
Household Sector Saving rate ※		0.9	2.5		0.1	▲ 4.2
Labor force population (year on year)	▲ 0.3	▲ 0.4	▲ 0.2	▲ 0.6	▲ 0.6	▲ 0.6
10-years Government Bonds Rate ※		1.4	1.2		1.4	1.7
Yen / U.S. Dollar exchange rate ※		113.2	85.7		81.6	78.4
Crude Oil Price ($ per barrel, calender year) ※		56.7	79.6		120.8	154.1
World real GDP growth rate(calendar year)	4.3	4.1	4.5	4.6	4.7	4.5

Notes : 1.% if not otherwise specified.
2. Potential GDP and World real GDP are calculated by JCER.
3.All figures denoted by ※ are those in the final year ,not averages.
4. Primary balance and government debt are those of central and local governments.

Source : Cabinet Office "National Accounts"

Nihon Keizai Shimbun, "Economics Classroom," April 6, 2012

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