March 2013

The 39th Medium-Term Economic Forecast (2012FY—2025FY)

Japan's Changes in Industrial Structure and Economic Growth

— Twin Deficit Concerns Arising

JCER Medium-Term Economic Forecast Team

The Japan Center for Economic Research released its 39th Medium-Term Economic Forecast for 2012FY through 2025FY. According to our forecast, the growth of the Japanese economy will become slower in fiscal 2021-25 and Japan will likely record a twin deficit, meaning both the fiscal and current account balances will be in the red. Consequently, this situation may lead to a rise in interest rates and the potential risk of a sovereign debt crisis. Our economy requires drastic growth strategies, such as more open trade policies and the urgent reform of the nation's tax and social security systems.

Economic Growth
Industrial Structure

The economic growth rate will decline to 0.0~0.5% in the early 2020s.

Due to Japanese manufacturers shifting their operations overseas, the share of sectors of high productivity will decline. In contrast, because of the country's issue of rapid aging, the share of sectors of low productivity such as health and long-term care services will expand, pushing down Japan's economic growth. The decrease in the labour force will also put downward pressure on the growth rate; on average, it will slow from 0.8% in the 2010s to 0.4% in the early 2020s.

Japan's population will decrease from approximately 128 million in 2010 to 120 million in 2025, and one in every 3.3 people will be 65 and over. Consequently, the number of workers in the health and nursing care sectors will increase from 7 million to 10 million people, meaning one in six workers will be employed in these sectors. On the other hand, the number of workers in the manufacturing industry will decrease from 9.2 million in 2010 to 7.2 million in 2025.

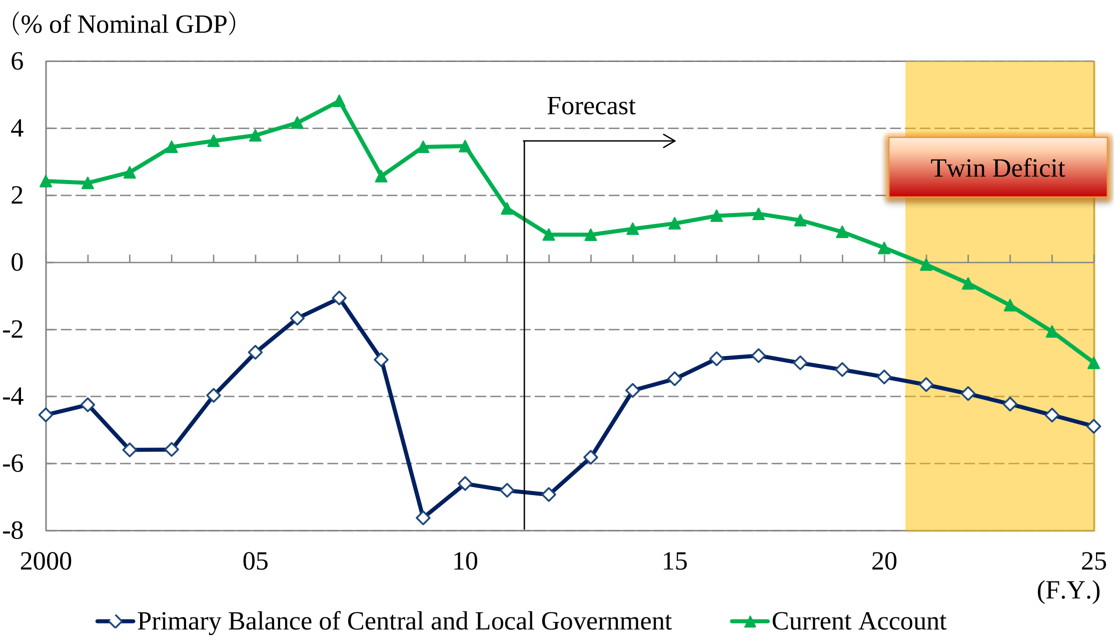
Current Account
Energy Issues

The current account balance will be in deficit due to the surge in fossil fuel prices and its substitution by thermal power.

With the Great East Japan Earthquake as a turning point, the trade and services balance has fallen into the red. In additon to Japanese manufacturers shifting their operations to other countries, and the increase in imports of products owing to a weakening supply capacity, the rise in fossil fuel imports due to fuel price hikes and the switchover to thermal power generation will widen the deficit in the trade and services balance. Consequently, the current account balance is expected to run into the red when it exceeds the surplus in its income balance (16.7 trillion yen in the red by 2025FY.)

As power conservation awareness rises in Japan, with further efforts made, we estimate that a 10%+ power cut can be achieved. If renewable energy is promoted, it could minimize fossil fuel imports and CO2 emission increases, which have been on the rise due to the replacement of nuclear power generation by thermal power.

Figure: Outlook for the Primary Balance and Current Account



Note: The primary balance data reflects the impact of factors such as transfers from the fiscal investments and loans special account.
Sources: Ministry of Finance,Cabinet Office

Public Finance

A twin deficit may cause the long-term interest rate to surge and lead to a potential sovereign debt risk in the early 2020s.

Although the deficit will narrow tentatively, the GDP ratio of the national and local governments' primary balance will not become positive even if the consumption tax rate is raised to 10%. Social welfare expenditures such as health and nursing care will continue to increase as the baby-boom generation will reach age 75 in the early 2020s. Additionally, tax revenues will be also sluggish because nominal GDP growth rate stagnate from the prolonged deflation. Consequently, the fiscal deficit will expand to 26.7 trillion yen in 2025 and gross government debt to 1,387 trillion yen (258.2% as a share of nominal GDP.)

Japan will likely record a twin deficit, which means that both the fiscal and current account balances will be in the red. The ratio of the national and local governments' primary balance deficit and current account deficit to GDP will stand at 5.5% and 3.4% respectively. This situation is similar to or even worse than that of the United Sates in the 1980s. Japan's debt has long been financed mostly by the nation's abundant household assets deposited at financial institutions, which are used to buy government bonds. However, if the debt continues to swell, it will eventually exceed domestic investors' capacity to absorb any additional debt. This points to a growing necessity for foreign capital flow to finance the budget deficit. If foreign investors start to demand a higher sovereign debt risk premium that is commensurate with the country's government debt level, interest rates may potentially rise and Japan could face a sovereign debt crisis.

World Economy

China's economic growth rate will decline to 5-6% in the early 2020s.

In the medium term, growth rates in advanced countries will deteriorate since labor force participation rates will decline with the retirement of baby boomers. Growth rates of the United States and the European Union will slow to about 2% and 1% respectively. In China, the working age population (15-64 years old) will start to decrease in the late 2010s due to the nation's one-child policy. The absence of factors that contributed to its high economic growth will lead to a declined growth rate (5-6% in the early 2020s.) According to these forecasts, while the share of world GDP of developed countries will shrink, emerging countries, which will maintain relatively high growth rates, will boost their presence. The share of Japan's GDP in the world will shrink from 8.5% in 2011 to 4.4% in 2025, whereas that of China's GDP will expand from 10.6% to 15.7% during the same period, closing in on the United States, which has the largest share in the world (16.3% in 2025.)

Policy Proposals

In Japan, it is difficult to transfer parts of the production process and the "hollowing out" of industries occurs easily, because there are high barriers to transact with other countries. Trade rules should be created in the context of the Trans-Pacific Partnership (TPP) and Economic Partnership Agreement (EPA) negotiations in a positive manner to facilitate the international fragmentation of production. These policies can prevent the manufacturing industry, a leading industry, from moving production plants overseas. Furthermore, the substantial reduction of the corporate tax rate for manufacturers will be required.

In order to restrict the surge in labor demand for health and nursing care sectors, we should make use of information technology and robotic technologies agressively. It is essential that women and elderly people be encouraged to participate in the labor market. Furthermore, we need to consider the option of employing more foreigners to overcome the labor shortage.

As for fiscal problems, further reviewing and reformation regarding various aspects of revenues and expenditures is needed, including the consumption tax rate hike and social security cuts. An increase in the environmental tax rate could be a measure that would "kill two birds with one stone", because it could contribute to further power conservation. Thus, we need to examine this policy, while taking the competitiveness of manufacturing industry into consideration.

Table: Main Economic Indicators
The 39th Medium-Term Forecast of the Japanese Economy (2012FY-2025FY)

Forecast

	01-05FY	06-10FY	11-15FY	16-20FY	21-25FY
Real GDP growth rate (2005 prices)	1.2	0.2	1.0	0.7	0.4
Private demand (contribution to change)	0.9	▲ 0.2	0.7	0.3	0.1
Public demand (contribution to change)	▲ 0.1	0.1	0.3	0.1	0.2
Net exports (contribution to change)	0.4	0.4	▲ 0.0	0.3	0.0
Potential GDP growth rate	0.9	0.7	0.7	0.5	0.3
GDP gap ※	▲ 0.1	▲ 3.2	▲ 0.8	0.3	1.1
Nominal GDP growth rate	▲ 0.2	▲ 1.0	0.4	0.2	0.2
Consumer Price Index (change from previous year)	▲ 0.4	▲ 0.1	0.8	0.5	1.1
Primary balance (Nominal GDP ratio) ※	▲ 2.7	▲ 6.6	▲ 3.5	▲ 3.4	▲ 4.9
Government debt (Nominal GDP ratio) ※	142.2	172.3	206.8	233.4	268.8
Current accounts (Nominal GDP ratio) ※	3.8	3.5	1.2	0.4	▲ 3.0
Real GDP per capita (year on year)	1.1	0.2	1.3	1.2	1.0
Compensation of employee per capita (year on year)	▲ 1.3	▲ 1.1	0.1	0.1	0.7
Household sector saving rate ※	0.9	2.4	▲ 3.1	▲ 5.6	▲ 9.0
Labor force population (year on year)	▲ 0.3	▲ 0.1	▲ 0.6	▲ 0.4	▲ 0.6
Unemployment rate ※	4.3	5.0	4.0	3.8	3.6
10-year Government bond rate ※	1.4	1.2	1.1	1.3	2.2
Yen / U.S. Dollar exchange rate ※	113.3	85.7	86.6	75.8	72.3
Crude oil price ($ per barrel, calendar year) ※	56.7	79.6	109.3	147.2	197.1
U.S., Real GDP (year on year, calendar year)	2.4	0.7	2.2	2.2	2.0
China, Real GDP (year on year, calendar year)	9.8	11.2	8.2	7.0	5.9
World real GDP growth rate (calendar year)	4.1	4.5	4.2	4.2	3.6
CO2 emisisons (% change from 1990FY level)	13.5	6.1	8.2	11.8	13.9

Notes : 1. Figures are in percentages if not otherwise specified.
2. Potential GDP, GDP gap and world real GDP have been calculated by JCER.
3.All figures denoted by ※ are those of the end year , not averages.
4. Primary balance and government debt are those of central and local governments.

Source : Cabinet Office "National Accounts"

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