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The 40th Medium-Term Economic Forecast (2013FY—2025FY)

Scenario for Achieving Both Economic Growth and Fiscal Consolidation

— Verifying Japan's Economic Fundamentals

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<Summary>

The Japan Center for Economic Research released its 40th Medium-Term Economic Forecast for 2013FY through 2025FY. The Japanese economy currently faces concern that not only the population but also capital stock is declining and aging. In this economic situation, fiscal consolidation has become a burning issue. Although a decision to raise the consumption tax rate from April next year has been made, and a second increase in 2015 is also on the horizon, further consumption tax hikes are unavoidable in view of projections of population decline and population aging. This medium-term economic forecast verifies whether, assuming consumption tax is increased further to achieve fiscal consolidation, Japan's economic fundamentals are strong enough to withstand this.

Fiscal consolidation

The consumption tax rate needs to be raised in annual increments of 1% from FY2017 (reaching 19% in 2025).

- ✓ If the consumption tax rate is increased in annual increments of 1% from FY2017, economic growth of around 1.0% will be achieved from FY2013 to FY2025, and it will be possible to turn the central and local governments' primary balance positive in FY2025. On the other hand, under a consumption tax rate not exceeding 10%, economic growth of around 1.1% would be achieved from FY2013 to FY2025, but the primary balance would remain in negative territory, showing a deficit of around 3% of nominal GDP, and the sovereign default risk would rise.

Escape From Deflation

Although Japan will escape from deflation, it will fail on the 2% price stability target, and fundamentals of the demand side will be weak.

- ✓ Further consumption tax hikes will add to the household burden, and the decline in the household savings rate is expected to steepen. Consequently, it will be difficult for consumption to grow.
- ✓ Because consumption will be restrained, upward pressure on prices will remain weak, making it difficult for the Bank of Japan to achieve its 2% price stability target, even with the projected consumption tax hikes. If wages were increased, consumer prices would also rise accordingly and, with the consumption tax hikes factored in, the price stability target would be achieved.
- ✓ The national savings rate, which was in a downward trend, will stabilize due to the reduction in the fiscal deficit. The increase in national savings - together with the correction of the strong yen and low real interest rates brought about by Abenomics - will support growth in exports and investment.

Supply Capacity

Supply capacity supported by world's highest skilled adults: But there is still much room for improvement.

- ✓ Private capital stock, which forms the foundation for production capacity, will be maintained at a level commensurate with the size of the economy because private investment will grow.
- ✓ Although demand for replacement investment will increase significantly in the future, public capital stock will generally remain at a stable level compared with the size of the economy until FY2025, provided the level of government fixed capital formation recorded in FY2010 is maintained. However, there will be regional differences, necessitating selection of the public capital to be maintained.
- ✓ The Survey of Adult Skills of the Organization for Economic Co-operation and Development (OECD) published in October 2013 showed that Japan boasts the highest quality adults among the participating countries. On the other hand, considering there is no difference between men and women in adult skills, opportunities for women in Japanese society are limited, and the high level of adult skills is not being translated into economic outcome. There remains much room for improvement.
- ✓ Conclusion of the Trans-Pacific Partnership (TPP) will not only improve the export environment, it will also encourage investment in Japan. Corporate tax cuts are also needed to bring about expansion of investment in Japan and the introduction of more superior technologies.

Tokyo Olympics

Total increase in demand will be 2.2 trillion yen.

- ✓ While Japan's hosting of the Tokyo Olympics and Paralympics is also expected to bring economic benefits, due to the large overlap with the existing social infrastructure development plans of the Tokyo Metropolitan Government, the total increase in demand, including the years running up to the games and beyond, will be around 2.2 trillion yen, which is limited given that Japan's annual gross domestic product (GDP) is around 500 trillion yen. Benefits such as the promotion of sport and the improvement in people's mental and physical health, social connections and international friendship achieved through sport will not necessarily be reflected directly in GDP, but it is hoped that, in the long-term, the games will have the effect of raising levels of welfare and also productivity.

Global Economy & Energy

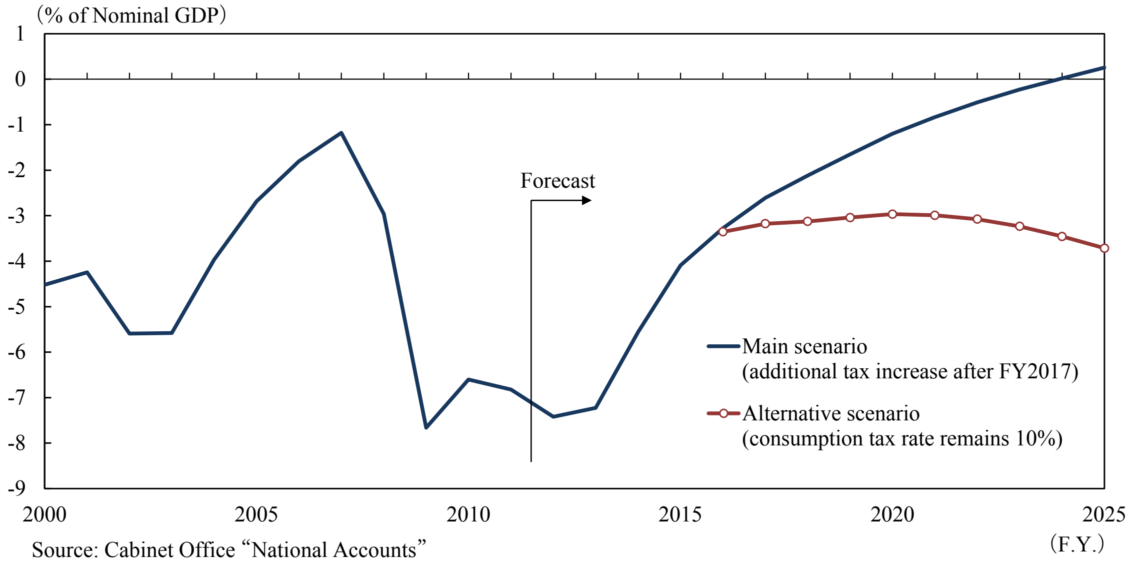
Global growth will be 3%.

- ✓ Largely due to the shale revolution, the energy price outlook is slightly more soothing. Further power savings will be made, and this forecast expects that, in 2030, power consumption will be 20% lower than the 2010 level.
- ✓ The Chinese economy is in the same situation as Japan 40 years ago and South Korea 20 years ago, and its pace of growth is expected to slow in the future and will probably be around 3% from 2020 onwards.
- ✓ Global growth will be around 3% over the period of the forecast, and will generally be on a par with the 2000s. Global growth weighted by the shares of Japan's export destinations will be 4% in the early 2010s, 3.7% in the late 2010s, and 3.1% in the early 2020s, maintaining a high level of growth due to the comparatively high growth of Asian markets and other main export destinations.
- ✓ Due to factors such as improvement in the export environment and low growth in imports as a result of restrained consumption, a current deficit is avoidable over the period of the forecast.

Policy Proposals

- ✓ Without further consumption tax hikes, sovereign default cannot be avoided.
- ✓ In the event of further consumption tax hikes, it is advisable that wages are raised and the strain of increased tax payments on households is reduced. Wage increases are important because they will ensure that Japan escapes from deflation.
- ✓ Utilization of human capital through greater support for female labor force participation, the efficient selection of public capital stock and development of ways to maintain and manage it are also essential to support growth.
- ✓ Market access and improvement of the export environment through the conclusion of the TPP is a prerequisite for economic growth. Corporate tax cuts are also necessary to increase investment in Japan.
- ✓ The restriction of growth by energy concerns should be avoided through measures such as more efficient use of energy through the promotion of power saving and clarification of the positioning of nuclear power generation.

Figure: Outlook for the Primary Balance



Source: Cabinet Office "National Accounts"

Table: Medium-Term Forecast of the Japanese Economy (2013FY-2025FY)

Indicator	Unit	2006～10	2011～15	2016～20	2021～25
Real GDP	growth rate, %	0.2	1.2	0.9	0.7
Nominal GDP	growth rate, %	-1.0	1.0	0.9	0.7
Public capital stock	ratio to GDP	1.5	1.5	1.4	1.4
Private capital stock	ratio to GDP	2.4	2.4	2.4	2.5
Consumer Price Index	growth rate, %	-0.1	0.9	1.4	1.5
Compensation of employee per capita	growth rate, %	-1.1	0.5	0.8	1.0
Household sector saving rate ※	%	2.4	-3.4	-5.2	-6.2
Primary balance[1] ※	% of Nominal GDP	-6.6	-4.1	-1.2	0.3
Current accounts ※	% of Nominal GDP	3.5	1.4	1.2	1.0
Unemployment rate	%	4.4	4.1	3.6	3.4
Crude oil price（WTI）[2] ※	$ per barrel	79.6	97.9	128.0	165.7
World real GDP[2,3]	growth rate, %	4.5	4.0	3.7	3.1
CO_2 emissions ※	change from 1990FY level, %	6.1	12.3	8.4	6.1

Notes: 1. Primary balance of central and local governments.
2. Crude oil price and World real GDP growth rate are calendar year, the others are fiscal year.
3. World real GDP is an average weighted by exports from Japan.
4. All figures with ※ are those of the end year, the others are period averages（growth rates are annualized）.

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