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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 this April 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 Japan's economic fundamentals, assuming consumption tax is increased further to achieve fiscal consolidation.

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 0.9% 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.

Inflation Rate

Although inflation rate will be positive, it will fail on the 2% price stability target: 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. It is not easy to achieve the Bank of Japan's price stability target.
- ✓ 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 makes it possible to sustain the correction of the strong yen and low real interest rates brought about by Abenomics for medium-to-long-term and it will support growth in exports and investment.

Current Account

Current account will not turn steadily negative in 2010s, conditioned on the further tax hike: The tax hike will push up the national savings

- ✓ The recent fall of the current account surplus is largely due to the increase of imports to fill the last-minute demand before the consumption tax hike.
- ✓ In the main scenario, where the consumption tax rate is raised to 19%, fiscal consolidation will support the national savings, and as a result, current account deficit is put off for the time being. In the scenario where the consumption tax rate stays 10%, the current account will turn deficit in late 2010s.
- ✓ Due to the shift of production site to overseas and a hollowing-out of the consumer electronics equipment production, structural changes may be occuring that curb exports and increase imports. If the current account turns negative, the ratio of government securities holding by foreign investors increases and it may destabilize the market.

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

Production inducement effect will be 3.9 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, production inducement effect, including the years running up to the games and beyond, will be around 3.9 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

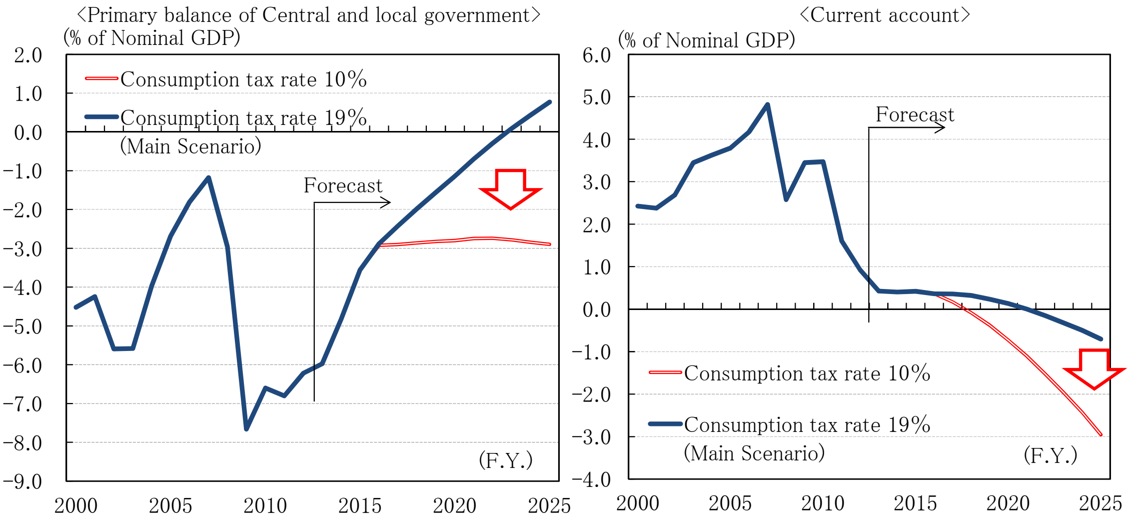
Global growth will be 3%.

- ✓ 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 will end the phase of high-growth led by the investment, and just as Japan 40 years ago and South Korea 20 years ago, 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, about the same 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 account deficit will be only small in 2025.

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 and Current Account



Sources: Ministry of Finance and BOJ"Balance of Payments", Cabinet Office"System of 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	1.0	0.9	0.7
Private final consumption expenditure	growth rate, %	0.5	1.2	-0.0	-0.3
Private Non-Resi. Investment	growth rate, %	-1.7	2.8	2.8	2.6
Exports of Goods & Services	growth rate, %	2.4	2.1	3.8	2.7
Imports of Goods & Services	growth rate, %	0.2	4.5	2.3	1.7
Nominal GDP	growth rate, %	-1.0	0.7	1.4	1.2
Capital-output ratio (Public capital)[1]	ratio to GDP	1.5	1.5	1.5	1.4
Capital-output ratio (Private capital)[2]	ratio to GDP	2.4	2.4	2.5	2.6
Consumer Price Index	growth rate, %	-0.1	1.0	1.5	1.7
Compensation of employee per capita	growth rate, %	-1.1	0.8	1.1	1.3
Household savings rate ※	%	2.5	-2.0	-3.3	-5.0
Primary balance[3] ※	ratio to GDP	-6.6	-3.6	-1.1	0.8
Outstanding debt[4] ※	ratio to GDP	172.3	199.6	202.0	199.9
Current accounts ※	ratio to GDP	3.5	0.4	0.1	-0.7
Unemployment rate	%	4.4	4.0	3.4	3.2
Crude oil price (WTI) ※	dollars/barrel	79.6	90.5	121.2	157.7
World real GDP[5]	growth rate, %	4.5	4.1	3.7	3.1
CO2 emissions ※	Vs. 1990, %	6.1	10.0	6.5	4.5

Notes: 1. Capital-output ratio (Public capital) = Real public capital stock (Gross)/Real GDP.
2. Capital-output ratio (Private capital) = Real private capital stock (Gross)/Real GDP.
3. Primary balance of central and local governments.
4. Outstanding debt of central and local governments.
5. World real GDP is an average weighted by exports from Japan.
6. All figures with ※ are those of the end year, the others are period average (growth rates are annualized).

Sources: Cabinet Office, "System of National Accounts", Ministry of Internal Affairs and Communications, "Consumer Price Index"; "Labour Force Survey"; "White Paper on Local Public Finance", Ministry of Finance, "Debt Management Report", Ministry of Finance and BOJ, "Balance of Payments", IEA, "World Energy Outlook 2013 (Current Policies Scenario)", IMF, "World Economic Outlook", The Institute of Energy Economics, Japan, "EDMC Energy Data Bank"

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