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The 41st Medium-Term Economic Forecast (FY2014— FY2025)

The Japanese Economy's Challenge in Achieving Fiscal Reconstruction and the Transition of Demographic Trends

— Consideration of Future Generation-Supporting Social Security Reforms

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Several years have passed since Japan's population entered a declining phase, and the downward trend is expected to accelerate in the years ahead. The population is aging, and a decline in the labor force is unavoidable in the immediate future. Given the situation, fiscal reconstruction has become urgently necessary. As the worldwide trend is an aging population with a declining birth rate, it is a challenge never easy to address. However, some developed countries including those in northern Europe have pulled out of this trend, suggesting that there is a way to solve this problem. Japan has taken the first step toward reducing its fiscal deficit, by finally raising the consumption tax in spring last year. However, the circumstances of putting off the tax rate increase to 10% until April 2017 suggest that future steps will not be easy.

The main baseline forcast projects the most likely scenario, taking into account the postponement of the consumption tax hike and the proposed reduction of corporate taxes. Next, we introduce simulations based on the reform scenario that seeks fiscal reconstruction and the transition of the declining population trend.

I. Baseline Scenario

Growth rate

Tax and social security reforms are essential for real growth of around 1% and fiscal reconstruction.

- ✓ During the forecast period (2014 to 2025), the Japanese economy will be able to grow at a rate a little higher than its potential growth rate, given that investment will expand supported by low real interest rates, corporate tax cuts and world economic growth, and that consumption will also increase moderately. Government consumption will also increase due to the expansion of demand for health and nursing care services, which will boost aggregate demand.
- ✓ However, as the ratio of government debt outstanding to nominal GDP will continue to rise moderately, fiscal sustainability remains questionable. It is necessary to reform the social security system, which is the main cause for the huge fiscal deficit, and to make a structural shift in the tax system toward a more growth-oriented one.

Prices

Inflation will be limited as domestic demand will remain fragile.

- ✓ In the baseline scenario, the expansion of consumption will be moderate because of the progression of the aging population with a declining birth rate. As domestic demand is fragile, upward pressure on prices will be limited. Inflation will not reach the price target of 2% set by the Bank of Japan.
- ✓ The recent yen depreciation, dragged by falling oil prices, will not give enough lift to inflation. Although oil prices are expected to turn up after hitting bottom in FY2015, they will not be strong enough to drive overall prices up.

Current account/trade

The current account will maintain a surplus as oil prices will settle.

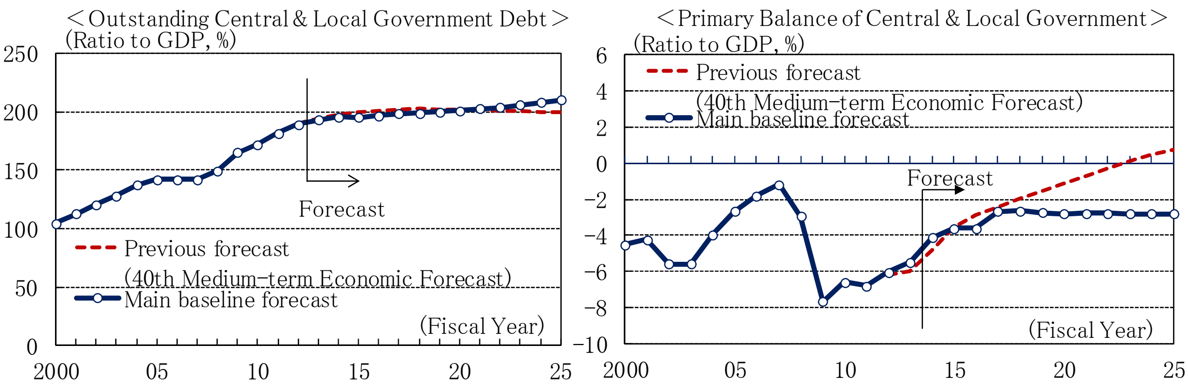
- ✓ Exports will increase due to the weak yen and the expansion of the world economy. The rise in oil prices will be more restrained than previously projected, and the expansion of the goods and services deficit will be limited. Combined with the large primary income account surplus, the current account will maintain a surplus.

World economy/ energy

Oil prices are expected to rise in the long term but have recently fallen sharply. Even if oil prices settle in the future, the negative effect will be greater if stagnation of the world economy is the cause.

- ✓ The world economy is likely to maintain relatively high growth due to urbanization, population increase and a rise in the average age. Therefore, energy prices are also expected to rise in the long term.
- ✓ Meanwhile, oil prices have been falling sharply since the middle of last year due to the oversupply of oil producers and declining demand due to the stagnation of the world economy. Although the fall in oil prices is preferable for Japan, the negative effect of losing export destinations will be much greater than the positive effect of low oil prices if the settling of oil prices is brought by the prolonged stagnation of the world economy.

Figure 1　Achieving fiscal consolidation will prove to be a challenge



(Note) Our previous forecast (40th Medium-term economic forecast) included the assumption of a consumption tax hike – raised to 10% in October 2015, and then in annual increments of 1% from FY2017 onward, reaching 19% in 2025.
(Source) Cabinet Office "System of National Accounts"

Figure 2 Forecast of the Japanese Economy (FY2014-FY2025, baseline scenario)

(Fiscal Year)

Indicator	Unit	2006 ～10	2011 ～15	2016 ～20	2021 ～25
Real GDP	annualized growth rate, %	0.2	0.8	1.1	1.0
Nominal GDP	annualized growth rate, %	-1.0	1.0	1.2	1.1
Consumer Price Index	annualized growth rate, %	-0.1	0.8	1.0	0.7
Primary balance (ratio to GDP)	period average, %	-4.0	-5.2	-2.9	-2.8
Outstanding debt (ratio to GDP)	end year, %	172.3	195.1	201.2	210.3
Current accounts (ratio to GDP)	period average, %	3.7	1.7	2.1	0.9
Compensation of employee per capita	annualized growth rate, %	-1.1	0.6	0.9	1.0
Ratio of ordinary profits to sales	period average, %	3.2	4.1	4.5	4.3
Household savings rate	period average, %	1.7	0.4	-1.7	-2.8
Unemployment rate	period average, %	4.4	3.9	3.4	3.3
Yen to US dollar exchange rate	period average, yen/USD	102.1	98.4	123.8	116.2
Crude oil price (WTI)	end year, USD/barrel	79.6	53.4	78.1	97.2
Real world GDP (weighted by exports from Japan)	annualized growth rate, %	4.5	3.9	3.9	3.2

(Note) 1. Crude oil price and world GDP figures are shown in calendar year format.
2. Ratio of ordinary profits to sales figures are of corporations with capital of over 10 million yen.
3. This forecast is based on all data that was available up to and including 16th February 2015, when "Quarterly Estimates of GDP Oct. - Dec. 2014 (The First Preliminary)" was released.

II. Reform Scenario

Secular stagnation theory

Stagnation in Japan is caused by the low degree of market openness and insufficient progress in gender equality.

- ✓ As stagnation in developed countries is the result of an aging and shrinking population, a relative surplus of capital equipment and the long-term downward trend of technology advancement is unavoidable to some extent.
- ✓ However, stagnation in Japan stands out. The main causes are the low degree of market openness and a lack in the promotion of gender equality (supporting the active participation of women in society). It is desirable to seek to raise the degree of market openness and improve productivity by lowering corporate taxes in line with the global standard.

Childcare support

An aging population combined with a low birth rate is the worldwide trend. The issue in Japan is not the seriousness of the problem itself, but the lack of its countermeasures. Childcare support with a total budget of 13 trillion yen is essential.

- ✓ Japan should promote the activities of women through childcare support aiming to completely eliminate the nursery school waitlist of 2.1 million children, including those potentially listed.
- ✓ From a global perspective, the lack of childcare support is obvious in Japan. Japan should seek to maintain a population of 100 million people as of 2060 by raising the total fertility rate to 2.1 with childcare support of 13 trillion yen.

- ✓ As a countermeasure against rising non-marriage rates, providing opportunities for people to socialize "naturally" (as opposed to marriage-seeking activities) is effective, in addition to childcare and double-earner support.

Tax / social security reforms

The reshuffling of tax and social security systems to promote growth and reconstruct the government budget is essential. Fundamentally enhanced support for families with small children can be made possible by increasing the burden on the elderly.

- ✓ Pension finance, which has already spent down the fund, will become unsustainable under the current system, given a further aging population combined with a low birth rate. We propose that basic pension be financed entirely by tax revenue, and privatization of the second tier and above be considered.
- ✓ The input of public funds into medical and nursing care insurance has reached nearly 20 trillion yen. The premium rate and patients' self-pay rates at the counter should be raised to make the insurance system self-sustaining. Public funds left over by this measure could instead be used as a source for the 13 trillion yen childcare support.

Rationalization of the health and nursing care sector

Regional comparisons show that there is considerable room for rationalization of medical expenses. It is possible to reduce medical and nursing care expenses by using information and communications technology (ICT) and promoting the employment of the elderly.

- ✓ There is considerable room for the rationalization of medical expenses, which largely differ among prefectures. Japan should promote significant rationalization by using digitalized medical data and big data technology.
- ✓ Preventive care and increasing the employment rate of the elderly will help reduce medical and nursing care expenses.

Policy proposals

- ✓ We propose the realization of growth-oriented tax and social security reforms and improvements in health and nursing care services efficiency, to secure the budget for countermeasures against the low birth rate. If achieved, the Japanese economy will be able to attain growth at an annual average rate 0.6% points higher than the baseline scenario by 2025, reconstruct the government budget and reverse the declining population trend.
- ✓ If the increase in the burden on the elderly proves too heavy, financing medical and nursing care expenses with the consumption tax hike would be an option. In that case, an increase of about 10% in the consumption tax rate would be necessary, as indicated in the projection last fiscal year. However, the intergenerational inequality will remain to some extent, while if the expenses were paid by users based on the beneficiaries-pay principle, the inequality would be corrected. The national burden rate will also be heavier. Further discussion regarding all possible options is awaited.

Figure 3 Forecast of the Japanese Economy (FY2014-FY2025, reform scenario)

(Fiscal Year)

Indicator	Unit	2006 ～10	2011 ～15	2016 ～20	2021 ～25
Real GDP	annualized growth rate, %	0.2	1.0	1.8	1.4
Nominal GDP	annualized growth rate, %	−1.0	1.2	1.9	1.4
Consumer Price Index	annualized growth rate, %	−0.1	0.8	0.9	0.5
Primary balance (ratio to GDP)	period average, %	−4.0	−5.2	−2.0	−1.6
Outstanding debt (ratio to GDP)	end year, %	172.3	193.4	188.9	189.2

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