The 47th Medium-Term Economic Forecast (Tentative Revision)

The Japan Center for Economic Research (JCER), Japan's leading think tank, forecasts Japan's economy from 2020 to 2035.

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Economy before and after the Coronavirus Crisis

- Real GDP level will fall by 2% due to rapid expansion of debt
- Prolonged virus outbreak and intensified international friction will result in “nightmare scenario”

Summary

The Japan Center for Economic Research (JCER) has revised its medium-term economic forecast on how the trajectory of economic growth will change with the coronavirus crisis. It was compared with the previous forecast released in March (chart 1). On June 19, restrictions on domestic economic activity were completely lifted. However, can it return to the economy prior to the Covid-19 pandemic? A “nightmare scenario” was also considered in which a prolonged outbreak and intensified political and economic conflict between the United States (US) and China leads to deep global recession. In the baseline scenario, real GDP has been revised downward by about 2% compared to the previous forecast, but in the case of the nightmare scenario, it will fall by nearly 8%, and will constantly remain in negative growth from fiscal year (FY) 2029. Preventing a widespread second wave of Covid-19, developing therapeutic drugs/ vaccines, and establishing a system for international cooperation to mitigate and/or eliminate political and economic conflicts will be needed in order to avoid global depression.

Chart 1 Negative growth from FY 2029 onward in Nightmare Scenario

Growth paths lowered

Decomposition of reduction in GDP

(Note) Forecasted by JCER for FY 2020 and beyond
(Source) National Accounts

1 The period of the fiscal year (FY) is from April to next March.
1. Baseline scenario: Real GDP in FY 2035, 2.2% worse than the previous forecast

(1) Economy will not return to 2018 Pre-Covid levels until FY 2024

The baseline scenario assumes that the coronavirus crisis will end in FY 2020 in Japan, the Tokyo Olympics will be held as scheduled, and international travel to and from other countries will gradually be eased. Still, the level of real GDP in FY 2035 will fall by 2.2% from the previous forecast. The economy will not return to 2018 Pre-Covid levels until FY 2024. The lost income will be about 230 trillion yen from FY 2020 to FY 2035. The potential GDP will also drop by more than 2% in FY 2035. Various measures taken to control the outbreak will result in public and private debt to increase sharply and capital spending to weaken, so the decrease in capital stock will push down potential GDP (chart 2).

Chart 2 Real GDP, 2.2% lower than expected before the Coronavirus Crisis

(Note) Forecasted by JCER for FY 2020 and beyond
(Source) National Accounts

Behind the weak recovery in real GDP, which fell by 6.8% in FY 2020, is the weakness of overseas economies, especially in Europe and the United States (US). In particular, the US has suffered a severe virus outbreak and it will take some time before the restrictions on economic activity are completely lifted. In addition, China, which is said to have controlled the spread of Covid, is affected by the stagnation of Western economies. Moreover, China is not only in conflict with the United States in terms of trade but also with dealing with the pandemic. For this reason, it is believed that the growth of the global economy will not easily return to its original growth trajectory (chart 3). The GDP level in 2035 will be 2.2% worse in the US and 2% in China. Crude oil depreciation is a plus for Japan, but such favorable conditions will not last long. Taking world inflation into consideration, it is assumed that oil prices will reach 110 dollars / barrel in 2035.
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Chart 3 Global economy also revised downward by 2%

Chart 4 Japan's government debt will exceed 1,400 trillion yen in FY 2035

(2) Government debt outstanding will increase to 270% of nominal GDP

In response to the coronavirus crisis, the government will provide SMEs and freelancers with subsidies for sustaining businesses of up to 2 million yen, up to 6 million yen in rent subsidies, and 100,000 yen cash handouts to all residents in Japan. Therefore, in FY 2020, the government approved primary and secondary supplementary budgets exceeding 50 trillion yen. All financial resources will be covered by the issuance of government bonds. As a result, government debt will exceed 1.4 quadrillion yen in FY 2035, and the nominal GDP ratio will reach 270% (chart 4).

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(Source) IMF

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In the baseline scenario, it is assumed that from FY 2025 to 2050, an annual income tax increase of 1.6 trillion yen will be used for the redemption of government bonds, following the reconstruction funding method of the Great East Japan earthquake. However, it may also be covered it by increasing the value-added tax (VAT) rate. According to calculations based on our macroeconomic model, the impact on the macroeconomy was not significantly different between the income tax increase and the value-added tax increase. However, there is debate over whether high-
income earners should pay more for financial measures to deal with the Covid crisis, or whether it should be widely paid by the entire population.

Corporates debt will also surge sharply. To secure operating funds, it is assumed that debt would increase by 50 trillion yen and cash and deposits would decrease by 20 trillion yen (chart 5). From FY 2022 onward, capital spending will be sluggish because priority will be given to lowering the debt ratio that increased in FY 2020 and FY 2021. Nominal capital spending will not return to 2018 pre-coronavirus crisis levels until FY 2035. Sluggish capital spending will lead to the pushing down of potential GDP shown in Chart 2.

Chart 5 Sluggishness of investment caused by priority given to lowering the debt ratio

(Note) Forecasted by JCER for FY 2020 and beyond
(Source) National Accounts, Financial Statements Statistics of Corporations by Industry

(3) The rate of decline in per capita personal consumption will be larger than that of real GDP

Due to the slump in the macroeconomy, the compensation of employees per person and real consumption will also become sluggish. As companies prioritize debt repayment, the compensation of employees will be restrained, and personal consumption will weaken by 3.0% compared to the previous forecast. This is 0.8 points larger than the decline in real GDP. In addition, the decline in real GDP per worker (≡ labor productivity) in FY 2035 will be 0.6%. The real consumption per person will be affected by the annual income tax increase of 1.6 trillion yen from FY 2025 onward as a financial source for coronavirus measures. Furthermore, the business behavior of companies prioritizing debt repayment will also adversely affect personal consumption through the compensation of employees (Chart 6).
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Chart 6 Decline in consumption larger than that of real GDP

(Note) Forecasted by JCER for FY 2020 and beyond
(Source) National Accounts

The unemployment rate is expected to remain in the range of 3.0~3.5% in FY 2020 due to measures such as employment adjustment subsidies taken by the government. However, it is estimated that the unemployment rate will reach 9%, when hidden unemployment due to suspension of business operations and shortened working hours is taken into consideration. Hidden unemployment will gradually disappear as the economy recovers, but overemployment will remain for more than five years (chart 7).

Chart 7 Unemployment rate including hidden unemployment will reach 9%

(Source) Labour Force Survey, Monthly Labour Survey

(4) Even if a rapid rebound in foreign visitors occurs, pre-Covid levels will only be achieved in FY 2028

According to the announcement of Japan National Tourist Organization (JNTO), the number of foreign visitors to Japan dropped to 2,900 in April and 1,700 in May 2020, from an annualized rate of 30 million people before the coronavirus crisis. Although there are movements to lift travel restrictions with some countries, new restrictions for foreign visitors are being considered such as mandatory PCR testing and a ban on the usage of public transport. Visitor flows to Japan in FY 2020 are unlikely to recover rapidly, considering the virus outbreaks in Europe, the US and Asia, and will
be close to zero. In the baseline scenario, it is assumed that the coronavirus outbreak will be contained in FY 2020, and that inbound tourism demand will return in FY 2021, boosted by the Tokyo Olympics. It is assumed that from FY 2022 onward, tourists from East Asia such as China and South Korea will increase at the same rate as when the so-called "explosive shopping spree" phenomenon was widely observed (FY 2012 to 2018). As a result, in FY 2028, there will be more than 31 million visitors, reaching the 2018 pre-coronavirus crisis levels. Even in FY 2035, it will be difficult to achieve the government goal of 60 million annual visitors (2030) (chart 8).

Chart 8 Foreign visitors down by 16 million in FY 2035 even with rapid rebound

(Note) Nominal consumption of foreign visitors to Japan per capita increases by 2% every year
(Source) Japan Tourism Statistics, National Accounts

2. Nightmare scenario: Fear of Global Depression

In the US, South America, Southern Asia, etc., the spread of the first wave of the coronavirus, not to mention the second wave, has not been brought under control. Prevention of an outbreak a necessary condition for full-scale economic activity and recovery, and international cooperation is essential. However, the US, where the spread of the virus has yet to be contained, is blaming China for its responsibility. With the trade friction from last year, the Trump Administration’s “America First” policy intensified. The US has threatened to cut funding for international organizations such as WHO over coronavirus and WTO over trade. In December 2019, JCER published its long-term economic forecast "2060 Digital & Global Economy" and warned that Trump's policy would cause the world to split into regional blocs and the "nightmare scenario" may trigger the Great Depression. The nightmare scenario (the worst case scenario) in the 47th Medium Term Forecast has started to look increasingly likely. Japan's potential growth rate will turn negative in the 2020s. Real GDP will also fall into negative growth by the end of the 2020s (chart 9).
Japan’s economy will not recover to pre-coronavirus levels

Real GDP in 2011 prices

Potential GDP

(Note) Forecasted by JCER for FY 2020 and beyond

(Source) National Accounts

(1) Fear of second and third waves at home and abroad - Global growth rate will fall to 1% range

In the nightmare scenario, it is assumed that the second and third waves will arrive across the globe, and it will take time to develop a vaccine and make it widely available. The positive rate was about 0.1% in the antibodies test conducted in Tokyo by the Ministry of Health, Labor and Welfare. In New York, where nearly 400,000 people have been infected and the death toll has exceeded 30,000, a little over 10% tested positive for Covid antibodies. Herd immunity cannot be achieved in Japan as the large part of the population have not yet been affected by the virus. After the First World War, the Spanish Flu affected 40% of the population and ended after the third wave (chart 10), but by that time nearly 400,000 people had died. It is considered impossible for society to accept such consequences in Japan today. If vaccine development takes time, virus outbreaks will be prolonged and economic activities will be restricted and eased repeatedly.

Chart 10 Spanish flu epidemic spread in three waves

(Million Persons)

(Mortality, right axis)

Declined to 1/10 of the previous wave

(Source) Ministry of Home Affairs

Covid-19 is continuing its spread across the world (chart 11). The Trump administration claims that the US pandemic occurred because “China hid information about the infection and did not
cooperate.” This has resulted in serious conflicts with the Chinese government. The Trump administration has also threatened to withdraw the US from the WHO, because China is too influential. Some states have restarted their economic activities before the outbreak is over, raising the risk of another outbreak. It seems impossible to achieve international cooperation in an attempt to control the pandemic.

Chart 11 Global outbreak of the Covid-19 pandemic

(Source) The number of infected people was aggregated by Nikkei based on data from countries and data from WHO and Johns Hopkins University.

It is also possible that trade friction will intensify due to the coronavirus conflict. The WTO, a dispute arbitration institution, is already unable to get US cooperation to fill the Appellate Body vacancies. The WTO is supposed to be able to deal with trade disputes in a two-stage process, but the process has not been opened due to lack of a senior committee.

Considering this situation, it is assumed that the global economic growth rate would be 1% worse than the baseline scenario (chart 12). From 2028 onward, the world growth rate will fall short of 2% (in which case a global recession will occur) and reach 1%. Intensified friction may cause the world to split into regional blocs. The global economy will shrink by almost 30%, and in the 2030s, the US will be overtaken by China in terms of economic size.

Chart 12 Global economy will shrink by almost 30% due to intensified international friction

(Source) IMF, Global growth rate is calculated by weighted average by PPP-converted GDP of each country
(2) Government debt to nominal GDP ratio to reach 320%, over 1.5 quadrillion yen

Due to the prolonged outbreak (second and third waves expected) in Japan and overseas, in the nightmare scenario, it is assumed that in addition to the coronavirus relief "financial expenditure of 40 trillion yen" in FY 2020, a supplementary budget of 30 trillion yen will be prepared in FY 2021. Government debt will expand from the current 1 quadrillion yen to 1.5 quadrillion yen in FY 2035. The government debt to nominal GDP ratio will also be 320%. In the nightmare scenario, it will implement a tax increase (1.6 trillion yen as baseline) of 2.8 trillion yen from FY 2025 on the redemption of JGBs issued for coronavirus measures totaling 70 trillion yen in FYs 2020 and 2021. Even so, the expansion of debt will not stop. If government debt grows at this pace, there is a risk of financial failure by FY 2035 (chart 13).

Chart 13 Concerns about financial failure

(Note) Forecasted by JCER for FY 2020 and beyond

Private-sector debt will increase by 50 trillion yen in FY 2021 compared to the baseline scenario due to securing working capital, etc. It is easy to imagine that debt repayment will be given higher priority, and capital spending will be reduced by 13 trillion yen (about 15%) from the baseline scenario in FY 2035. The decrease in capital stock will cause growth to fall to a negative level. Even if efforts are made to reduce debt at the expense of investment, the debt ratio for FY 2035 will only return to the level of FY 2020 (i.e. it cannot be suppressed to the level before coronavirus crisis.) Chart 14)
Chart 14 The debt ratio cannot be suppressed to pre-Covid levels

(Note) Forecasted by JCER for FY 2020 and beyond
(Source) National Accounts, Financial Statements Statistics of Corporations by Industry

(3) Foreign visitors to Japan will fall to 10 million, back to levels before the “explosive shopping spree” phenomenon

A prolonged outbreak will have a grave effect on foreign visitors to Japan. If second and third waves of the outbreak occur, it will not be possible for Tokyo to hold the Olympics in summer 2021, crushing hopes to bring back tourists. If vaccine development cannot be carried out for the time being, Japan will require mandatory PCR testing on arrival, which will be a big hurdle for foreigners travelling to Japan. Also, in China and other countries, Covid contact tracing applications are widely used, but without such applications, Japan will be avoided as a tourist destination. A prolonged coronavirus outbreak will shy away tourists from Japan, especially from Asia. Japan is facing challenges in digitization and improvement of the medical system. With the global economy in a serious recession, inbound foreign visitors will only return to 2010 levels before the start of the "explosive shopping spree" phenomenon, and the unit consumption of visitors to Japan will remain flat (2% increase every year in the baseline scenario). The consumption of foreign visitors in Japan in FY 2035 will shrink to 1/10 compared to the previous forecast (chart 15).
(Note) Nominal Consumption of Foreign visitors to Japan per capita will be flat by FY 2035
(Source) Japan Tourism Statistics, National Accounts

(4) Complete deflationary economy, and hidden unemployment rate of 7%

In the nightmare scenario, the economy is expected to revert to full deflation. The decline in corporate profits is reflected in wages, which will be reduced by 17% in FY 2035 compared to the baseline scenario. Wages will continue to decline, far from what they were before the coronavirus crisis. Consumer prices (CPI) will continue to decline as wages fall. The CPI will decrease by more than 10% from before the coronavirus crisis (FY 2019) to FY 2035. This will result in a deflationary spiral (Chart 16).

Chart 16 Consumer prices and wages continue to decline

(Source) Labour Force Survey, Monthly Labour Survey, CPI

The effects of the deflationary economy will also affect unemployment. As the second and third waves of the pandemic hit the country, the unemployment rate including hidden unemployment (e.g. suspension of business operations) for FY 2020 and 2021 will exceed 10% before gradually declining, but overemployment will not be resolved. The unemployment rate including hidden unemployment will reach 7.6% in FY 2035 (chart 17). The forecast assumes that companies will
maintain Japanese-style employment (life-time employment) and that the government will continue to adopt a policy that allows "Unemployment within companies" to prevent actual unemployment. In reality, it will be difficult to maintain Japanese-style employment under the deflationary spiral for 15 years and to continue the employment maintenance policy, and there is a high possibility that mass unemployment will surface.

Chart 17 Unemployment rate including hidden unemployment due to suspension of business operations and shortened working hours will exceed 7% in FY 2035

(Source) Labour Force Survey, Monthly Labour Survey

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