Medium-Term Outlook for the Japanese Economy: 2009 to 2020

- A Decade for the Japanese Economy to Emerge from Economic Crisis and Address the Issues of an Aging Population and Smaller Families -

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The world economy is beginning to show improvement following the most serious economic downturn since World War II, which was triggered by the financial crisis. The Japanese economy is also continuing to show signs of improvement. Industrial production remains on an upward trend, led by the rise in exports. In addition, as the positive effects of economic policies, including increases in public works spending projects and measures to stimulate personal consumption, are emerging, the economy is expected to avoid a second downturn. Looking ahead also, provided countries around the world implement exit strategies properly, even though output is lower than pre-crisis levels, the world economy is expected to continue to grow, led by the economic development of the emerging countries, including China.

The Economic Research Department of Mitsubishi UFJ Research and Consulting Co., Ltd., has recently prepared a medium-term outlook for the Japanese economy covering the period through FY2020. This outlook was prepared from the perspective of three key trends: the aging population and declining birthrate, the financial soundness of Japan's corporations, and the growth potential of the world economy. First, demographic trends––namely, the aging of the population, falling birthrate and the overall decline in Japan's population––are believed likely to continue going forward. Second, Japanese corporations reported strong performances from 2002 through 2007, which was the longest period of economic recovery in the postwar period, and, as a result of restructuring efforts thus far, are maintaining stronger business and financial positions than they had after the collapse of Japan's bubble economy in the 1990s. Although corporations have reported recently that they perceive they have excessive employment and production facilities, improvement in profitability and capital investment is likely if growth in exports leads steadily to expansion in industrial production. Third, we believe that favorable economic activities will continue in the emerging economies, especially in China, and that the world economy as a whole will continue to grow. Amid these developments, the leading position of the United States will remain unchanged and that the U.S. dollar is likely to continue to play the role of a key international currency.

Moreover, our view is that the potential growth rate of the Japanese economy (underlying long-term growth power) during the decade beginning in 2010 will be approximately 1%. In view of the increasing margin of decline in the labor force accompanying the shrinkage in Japan's population, growth will decelerate to somewhat less than 1% during the latter half of the forecast period.

As for demand components, exports will remain on an increasing trend since the world economy will continue to grow, led principally by the emerging economies. Driven by exports, industrial production and corporate profits will rise, and recovery in the employment environment will continue. Although increases in wages will remain generally moderate, the present government express their strong will to support households with the introduction of the new child allowances. Therefore, disposable income is expected to begin to rise as Japan enters the second decade of the 21st century and, thus, consumer spending is likely to show improvement. In addition, private capital investment is expected to finally show a rising trend. On the other hand, growth in private residential investment is likely to remain low because of the decline in the population and other factors. Government expenditures will be restrained. During the second half of the forecast period, real growth in most components of demand will be slowing.

Note that the household savings ratio will remain on a declining trend, reflecting the demographic aging of the population. Although the surplus in the current account of the international balance of payments will continue, it will diminish as a percentage of the GDP.

＜Chart1 Summary of the medium-term outlook>

Percentage change in averages for the year	FY2001 toFY2005 (Actual)	FY2006 toFY2010 (Forecast)	FY2011 toFY2015 (Forecast)	FY2016 toFY2020 (Forecast)
Real GDP growth	1.3%	-0.2%	1.0%	0.8%
Nominal GDP growth	0.0%	-1.1%	1.4%	1.6%
GDP deflator	-1.3%	-0.9%	0.4%	0.7%

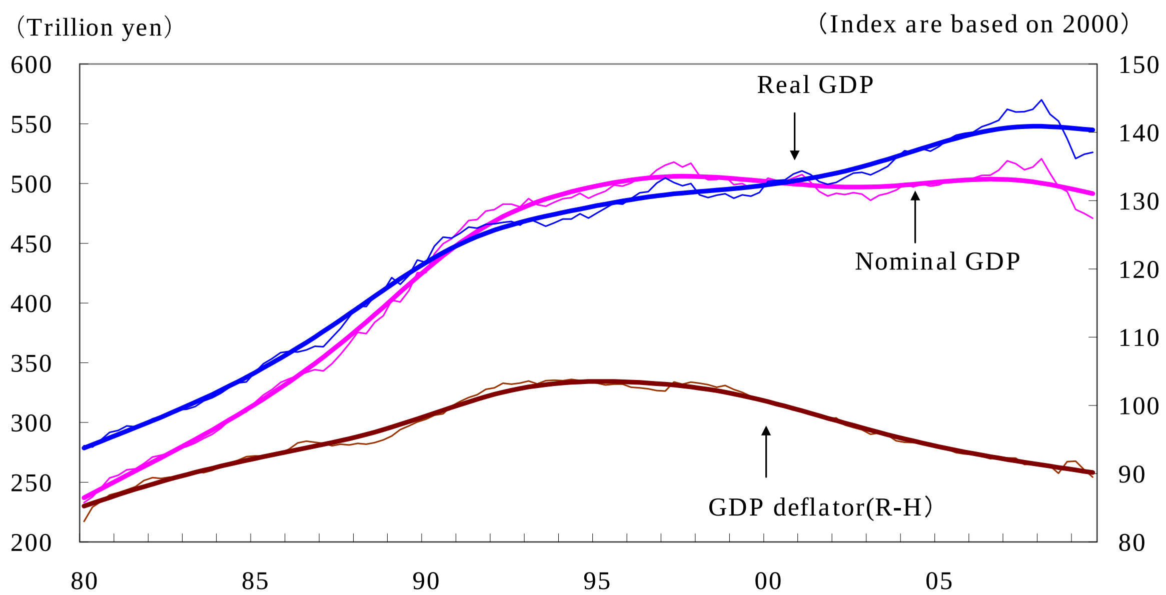
Note: Forecast figures are our own estimates.

Thus, the Japanese economy is generally expected to continue to expand in line with its underlying growth potential. The economic growth rates will be more moderate than in previous recovery periods, but, inasmuch as the economy has recovered from the sharp downturn experienced after the “Lehman Shock”, this should be recognized as a steady and solid improvement.

In the other hand, since the emerging economies are expected to show smooth economic development over this period, the share of the Japanese economy in the world economy will diminish. Japan’s positioning in the international economy will shift from being the second-largest economy in the world to being just one of the leading economies. The share of Japan’s economy in the world economy (on a purchasing-power parity basis) is expected to diminish from about 6% in 2008 to about 4% in 2020. (Over this same period, the share of the U.S. economy will decrease from approximately 21% to approximately 17%, and the Chinese economy will rise from about 10% to about 17%.)

For Japan to realize steady growth in the medium term, the most-important issue for the time being will be to extricate itself from deflation. In retrospect, Japan’s nominal GDP has been virtually flat since the mid-1990’s after showing upward trend until then. However, as a result of the steady decline in the GDP deflator, real GDP has been on a rising trend.

<Chart2　Trends in Japan’s GDP＞



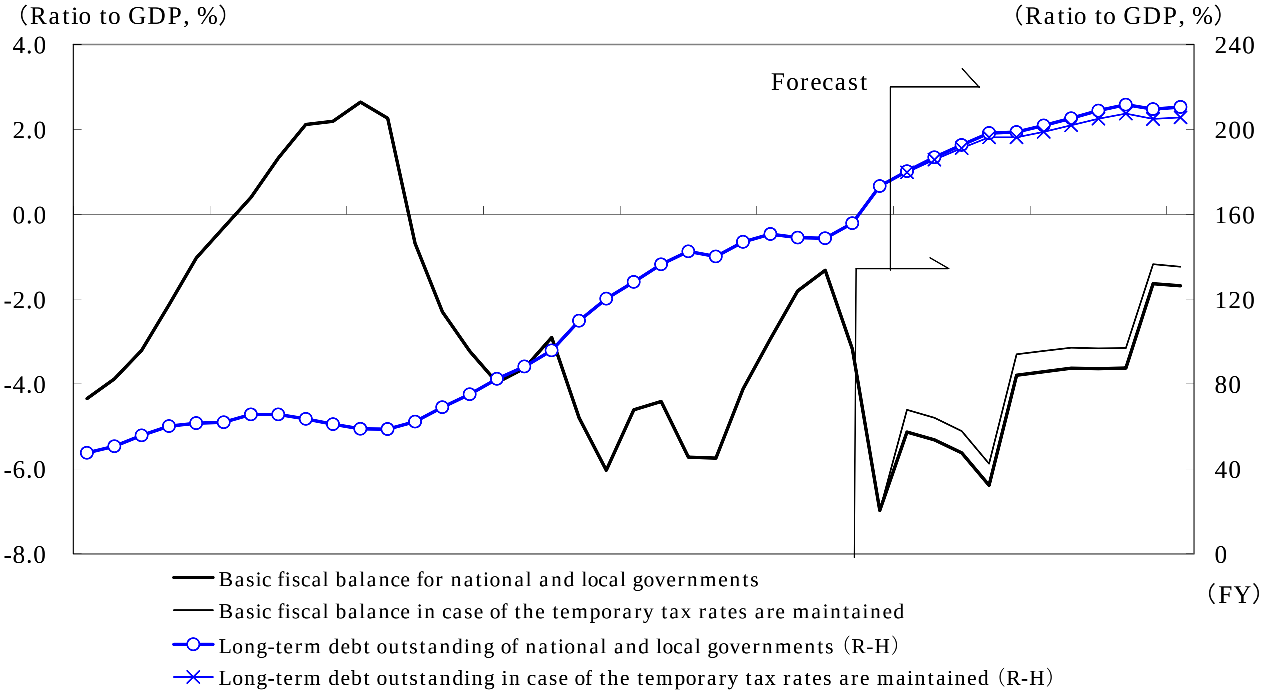
Note:The seasonally adjusted GDP deflator (the fine line) and
the three trend lines (bold lines) are estimated by MURC
Source: Caninet Office

This flattening in the nominal GDP comes from the influence of the decline in the working-age population accompanying the trends toward the demographic aging of the population and the falling birthrate. On the other hand, reasons for the decline in price levels include the effects of (1) the stagnation in demand following the bursting of Japan’s economic bubble in the 1990s, (2) downward pressure on prices of goods and wages thanks to economic globalization, and (3) declines in prices of electronic equipment and appliances owing to technological progress. In addition to these circumstances, the GDP gap has increased as a result of the sharp drops in exports and capital investment due to the impact of the “Lehman Shock” in fall 2008. For these reasons, aggressive policy efforts will be required for the Japanese economy to escape from deflation.

From an even longer-term perspective, we believe that attention must also be directed to three areas in particular: (1) The need for initiatives to restore fiscal soundness as the population continues to decline, (2) the importance of expanding trade and investment with the newly emerging countries as we confront the diminution of the Japan’s share in the international economy, and (3) the need to place emphasis on education and R&D to promote innovation in order to create new technologies and products persistently as well as thereby maintain sustained economic expansion.

Regarding the issue of fiscal soundness in particular, the balance of outstanding long-term public-sector debt, as a sum of the obligations of national and local governments, was approximately ¥825 trillion at the end of fiscal 2009. This amounted to about 170% of GDP, much higher than in any other industrialized country. We have assumed that, during the forecast period, Japan’s consumption tax will be increased twice, to 15%, but, even following these increases, the fiscal primary balance will still be in deficit, and Japan’s long-term public-sector debt is forecast to rise to more than 200% of GDP. For the time being, further increases in government bond issues will be unavoidable in view of the necessity to compensate for the drop in government revenues and the need for government fiscal spending to deal with the lingering adverse impact of the “Lehman shock” and deal with deflation. However, as the recovery trends in the private sector strengthen clearly, it will be absolutely essential to take strong initiatives, at the earliest possible time, aimed at restoring fiscal soundness (Chart 3*).

＜Chart3: Outlook for the Fiscal Balance＞



Note: The basic fiscal balance excludes temporary factors, such as transfers from the special accounts for the Treasury Investment and Loan Account to the Sperical Account for Government Bond Consolidation.
Source: Cabinet Office, Ministry of Finance

*This medium-term forecast has been prepared with the assumption that the temporarily top-up tax rates tax for gasoline would be abolished. However, according to the general outline of tax reforms for fiscal 2010, this temporary tax rate will, in actuality, be maintained. Therefore, Chart 3 also shows the future outlook in the case where the temporary tax is not eliminated.

*This is an English summary of a report originally published on December 24, 2009. The full report is available only in Japanese, but the author will answer questions regarding the topic by e-mail.
*The information and the views contained herein are subject to change without notice.