Medium-Term Outlook for the Japanese Economy (Fiscal 2012 to Fiscal 2025)

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This Medium-Term Outlook for the Japanese economy is based on the previous medium-term outlook that was prepared in January 2012, and it takes account of the most-recent economic conditions as well as the effects of new data that have come to light over the past year. Compared with the previous medium-term outlook, we have extended the time horizon five years to 2025.

I. Assumptions of the Medium-Term Outlook

(1) Increases in the Consumption Tax

In preparing this outlook, we have made the following assumptions.

First, we assumed that the consumption tax rate would be increased to 8% in April 2014 and then to 10% in October 2015. Also, to maintain the social security system, we assumed that eventually additional tax increases would be implemented and, therefore, made the assumptions that the consumption tax rate would be increased to 12% in April 2018 and then to 15% in April 2020.

Next, we assumed that electric power shortages would basically have no impact on economic activity. Although there are concerns about power supplies in some areas, we believe that shortages can be fully prevented through power-saving measures, power interchange among utility companies, and increases in in-house power-generating capacity in the private sector. In addition, with certain exceptions, nuclear power plants are expected to remain out of service, and Japan's principal source of electricity will shift to thermal power generation, principally natural gas, for the time being. At the same time, since power-generating capacity relying on renewable energy sources will rise, there will be steady upward pressure on power rates for electricity from the sources that are purchased at established rates.

Regarding the Trans-Pacific Partnership (TPP) agreements, the government of Prime Minister Shinzo Abe is adopting a cautious approach to deciding whether to participate, and it will be difficult for Japan to join in the initial negotiations. However, negotiations with individual countries for free trade agreements (FTAs), the East Asian Region Comprehensive Economic Partnership (RCEP), Japan-Korea FTA, and other agreements are expected to move forward. Therefore, the liberalization of trading activities is not expected to come to a halt.

(2) Outlook for Overseas Economies

The forecast for world economic growth is for average annual growth of 3.7% from 2011 to 2015, 3.7% from 2016 to 2020, and 3.4% from 2021 through 2025 (Chart 1).

We are assuming that the trend toward deceleration in growth will continue, mainly in the emerging countries. The principal reason for this is expected to be the demographic aging of the population. Additionally, since the need to restructure government finances and exercise restraint in monetary policy will grow, mainly in the industrialized nations, even though there may be downward pressures in the industrialized nations, capital flows from the industrialized world will be restrained, and there is a possibility that growth may slow in the industrializing countries. Also, in the industrializing countries, such core countries as China may continue to show deceleration in growth as their economies undergo adjustments, and, even other countries may show weaker growth as a result of the rise in their income levels as they enter the so-called "middle income trap" and their pace of expansion slows.

Chart 1: World Economic Growth Rates Assumed in This Outlook
(Annual Average Rates of Growth)

(Unit: %)

	2011 ～ 2015	2016 ～ 2020	2021 ～ 2025
World	3.7	3.7	3.4
Industrialized countries	1.7	2.0	1.9
United States	2.3	2.4	2.0
Europe	0.6	1.2	1.3
Japan	0.7	0.5	1.2
Other countries	3.0	3.2	3.0
Emerging countries	5.7	5.2	4.4
Asia as a whole	7.2	6.2	5.0
China	8.0	6.6	5.7
Former Soviet Union (Russia, etc.)	4.3	4.0	3.7
Middle East	4.0	3.6	3.4
Central America, South America (Brazil, etc.)	3.9	3.9	3.6

Note: The classification by industrialized and emerging countries follows the International Monetary Fund (IMF) definitions.
Data through 2011 were sourced from the IMF. Data for 2012 and subsequent years are MURC forecasts.
Source: IMF

II. Summary of the Medium-Term Outlook

(1) Economic Trends through Fiscal 2015

The outlook is that slow growth in the Japanese economy will be inevitable in fiscal 2020. This will be because initiatives will have to be taken to deal with issues that have been postponed, including putting government finances on a sounder footing. This period is positioned as a preparatory interval for realizing high growth rates thereafter.

In Japan, for many years, the prolonged adverse impact of the bursting of the economic bubble restrained economic growth. However, balance sheet adjustments in the corporate sector proceeded, and earnings improved. In addition, in the financial sector, nonperforming loan issues were resolved, and this created a strong financial system. Although adjustments required time, it is believed that the negative legacies of the bubble economy were largely eliminated.

Nevertheless, in reaction, large amounts of fiscal expenditures were allocated to stimulate the economy and, since tax revenues stagnated, distortions in the form of deterioration in the government's fiscal position remained. In addition, issues related to the social security system led to concerns that the rising cost burden accompanying changes in the system might cause deterioration in the economy, and it has not been possible to make major reforms. For this reason, the period through fiscal 2020 will be a time for emphasis on restructuring the government sector and the social security system.

Amid these circumstances, we are forecasting the following economic trends in the first half of the 2010s (through fiscal 2015).

First, in fiscal 2013, the economy will begin to recover, and the growth rate will be boosted by the surge in demand in the latter half of the year prior to the next hike in the consumption tax. However, as a result of the increase in the consumption tax, the economy will slow to almost zero growth in fiscal 2014. Although the economy is expected to begin to improve in fiscal 2015, since the consumption tax is scheduled to be increased again in October, the deceleration in the economy will become more pronounced.

Over this period, the average real growth in GDP is expected to be +0.5%. Although this will exceed the +0.2% average rate of real growth in the latter half of the 2000s (fiscal 2006 to fiscal 2010), which was influenced by the collapse of Lehman Brothers, it will be below Japan's potential growth rate (Chart 2). For this reason, deflationary pressures will remain, and, if the effects of the increase in the consumption tax are excluded, the rate of change in real prices will dip into the minus zone.

Turning next to the outlook for components of demand, personal consumption is forecast to show only marginal increases because of such factors as the decline in the population, small increases in wages, and the increase in the consumption tax. Private capital investment is expected to expand, supported by a range of factors, including demand for recovery in the aftermath of the March 2011 earthquake, investments for the maintaining and renewal of capital equipment, and investments in energy-saving facilities. However, reflecting the cautious stance of corporations, investment for the expansion of capacity will be restrained to only the necessary minimum levels, and capital investment as a whole will continue to lack robustness. On the other hand, government final consumption expenditure is forecast to continue expanding steadily, as medical costs rise along with the demographic aging of the population and because of other factors. Government investment will be a factor boosting the economy because of the demand for expenditures to rebuild and recover in the aftermath of the earthquake, but this boosting effect is expected to run its course in fiscal 2013 and subsequent years. The contribution of overall domestic demand to real GDP growth is forecast to be +0.7 percentage point. This will be an improvement over the –0.1 percentage point contribution of domestic demand in the latter half of the 2000s (fiscal 2006 to fiscal 2010), but, from an overall perspective, growth will remain at a moderate level.

Chart 2: Medium-Term Outlook for the Principal Components of GDP

(Average, %)

	Fiscal 2006 to 2010 (Actual)	Fiscal 2011 to 2015 (Forecast)	Fiscal 2016 to 2020 (Forecast)	Fiscal 2021 to 2025 (Forecast)
Real GDP growth rate	0.2	0.5	0.5	1.0
Domestic (percentage point contribution)	-0.1	0.7	0.3	0.8
Personal consumption	0.5	0.5	0.0	0.4
Capital investment	-1.7	1.7	1.1	2.8
Government consumption	1.2	1.5	1.1	1.0
Public investment	-3.0	-0.1	-0.1	0.1
External (percentage point contribution)	0.3	-0.2	0.2	0.2
Exports	2.4	0.9	3.2	2.0
Imports	0.3	2.9	1.9	1.2
Nominal GDP growth rate	-1.0	0.2	0.7	1.3
GDP deflator	-1.2	-0.3	0.2	0.4
Per capita GDP (real)	0.2	0.7	0.9	1.5

Sources: Cabinet Office, *Annual Report on National Accounts of National*;
Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Population Estimates*

From 2013 onward, positive growth in exports will continue primarily because the pace of expansion in overseas economies will recover and because exports to overseas subsidiaries will increase. However, since the growth in the world economy will be moderate, substantial expansion is not expected. On the other hand, imports are forecast to rise at a faster rate than exports, reflecting the expansion in demand for energy fuel imports for electric power generation and the increased penetration of imports that has accompanied the appreciation of the yen and the increase in reverse imports. As a result, the contribution of external demand to GDP growth will average about –0.2 percentage point, substantially less than the +0.3 percentage point in the latter half of the 2000s (fiscal 2006 to fiscal 2010).

(2) Outlines of the Economy in the Latter Half of the 2010s

During the latter half of the 2010s (fiscal 2016 to fiscal 2020), further increases in the consumption tax rate are expected, and, as a result, the rate of growth in real GDP will be restrained and the basic flow of economic events will not change. Real GDP growth will be forced to remain at a low level, as surges in demand prior to increases in the consumption tax will alternate with periods of reactionary decline, against a background of increasing margins of decline in the population. Specifically, fiscal 2016, when the effects of an increase in the consumption tax will remain, fiscal 2018, when another hike in the consumption tax will be implemented, and fiscal 2020 will be years of weak growth. On the other hand, trends in fiscal 2017 and fiscal 2019 will be relatively firm. As a result, the average rate of real GDP growth during the latter half of the 2010s (fiscal 2016 to fiscal 2020) will remain around +0.5%.

In the meantime, many structural changes will be taking place beneath the surface. First, exports will recover steadily. The pace of economic expansion in the world economy will not change from the fiscal 2011 to fiscal 2015 period, but in Asia, where Japan's principal export customers are located, growth rates, principally in China, are expected to gradually become more moderate. Despite this, exports will continue to grow because it is believed likely that, along with the globalization of corporations, exports to their overseas subsidiaries will rise and that there will be a shift toward higher-value-added exports. The effects of these trends will gradually emerge in certain sectors.

However, even though exports may improve, corporate performance is expected to continue to stagnate as domestic demand remains lackluster. In addition, there will be shakeouts and corporate mergers because of the weakness in domestic demand in Japan and the declining competitiveness of Japanese companies in international markets, and, along with this, there will be a growing trend for small and medium-sized enterprises (SMEs) to go out of business.

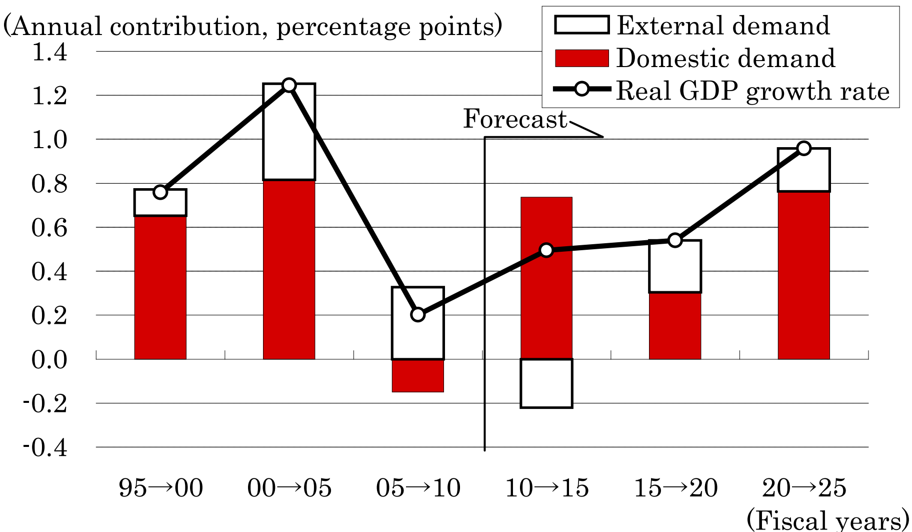
For this reason, corporations will continue to restructure, and this will not lead to improvement in employment and income conditions. In addition, although the growth in energy fuel imports will diminish to a more-relaxed pace, the penetration of imports in the domestic economy will continue to deepen, and growth in imports will hold steady. For this reason, the contribution of external demand to GDP growth is forecast to average about +0.2 percentage point, thus not increasing significantly.

On the other hand, among domestic demand components, personal consumption is expected to continue to stagnate and show an average growth rate of around plus or minus 0.0% from fiscal 2016 through fiscal 2020. On the one hand, the consumption tax rate will be increased to 15%, but since growth in wages will be restrained, growth in real disposable income will become negative, thus having a major impact. Specifically, from fiscal 2006 through fiscal 2010, real disposable income grew at +0.9% per annum, but because of the impact of the increase in the consumption tax rate, growth in disposable income is forecast to fall to +0.1% during the period from fiscal 2011 to fiscal 2015, and then descend further to –0.4% from fiscal 2016 through fiscal 2020. Also, because of the aging of the population, there is a possibility that, from fiscal 2016 onward, the household savings rate will become negative.

Moreover, during this period, corporate capital investment will continue to be weak. Demand for recovery following the earthquake will run its course, and, because of lackluster corporate performance, the drive to make capital investments among companies will show little or no improvement. Since corporations have ample cash flows, there is a possibility that companies may become active in making investments in IT and equipment to increase productivity; however, because of the trend toward shakeouts and mergers in various industries, the level of required capital investment will decline.

Government final consumption will continue to expand at about the same rate along with the demographic aging of the population, thus providing underlying support for the economy. In addition, although expenditures on public investment and demand for expenditures for reconstruction and recovery following the earthquake will run their course, investments for maintaining and replacing Japan's aging infrastructure will be necessary. In addition, there is a possibility of an increase in investments related to disaster prevention and construction work for making structures more-earthquake resistant. Accordingly, public investment is likely to remain virtually level with the previous period. The average contribution of domestic demand as a whole to real GDP growth is estimated at +0.3 percentage point, which will be lower than the +0.7 percentage point contribution from fiscal 2016 to fiscal 2020.

Chart 3: Contribution of Domestic Demand to Real GDP Growth (Five-Year Intervals)



Source: Cabinet Office, *Annual Report on National Accounts*

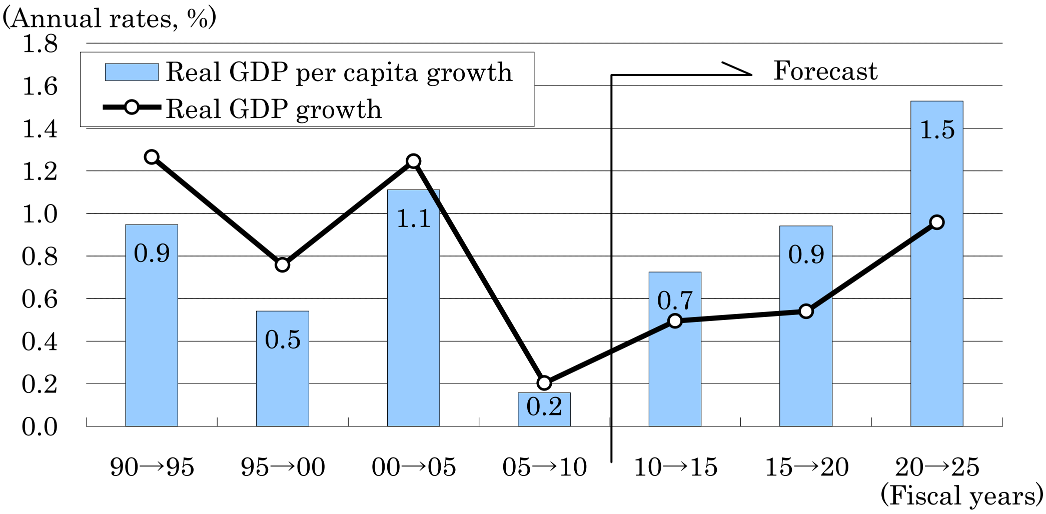
(3) The Economy in Fiscal 2021 and Beyond

Based on these various trends, our specific forecast for real GDP growth for the first half of the decade beginning in 2020 (fiscal 2021 to fiscal 2025) is average annual growth of +1.0%. At first glance, +1.0% may not seem high, but this figure should be viewed as an increase in the context of the accelerating speed of decline in the population. From this perspective, it is definitely not a low figure. Converted to real GDP per capita, this implies annual average expansion of 1.5% (Chart 4). This compares to the +0.9% annual per capita growth figure that prevailed from fiscal 1991 to fiscal 1995, when there were still lingering effects from Japan's bubble economy. It is also higher than the +1.1% per capita growth rate from fiscal 2001 to fiscal 2005, which coincided with the bubble in the world economy.

Examining expected trends in components of demand, personal consumption is forecast to show steady increases, even in the midst of population decline, as the rate of increase in wages rises. Private capital investment will continue to show relatively high rates of expansion, because of the improvement in corporate performance and the reaction to restraints on investment in previous years, and may even become an overall driving force for the economy. In the public sector, government final consumption is forecast to continue expanding steadily, reflecting the aging of the population. Government investment is expected to remain virtually level because wasteful investments have already been reduced to a bare minimum. As a consequence, the contribution of domestic demand to real GDP growth will average +0.6 percentage point on an annual basis.

Exports are forecast to show slightly slower growth as the tempo of expansion in the world economy slows, but, even so, firm growth will continue. On the other hand, imports will rise at a slower pace than exports as renewable energy sources account for a gradually increasing portion of total energy demand and growth in demand for imports of energy fuels diminishes. As a result of progress toward the international division of labor, exports and imports will expand simultaneously, and the contribution of the external sector will not rise very much. As during the latter half of the 2010s, the external sector will maintain an annual average contribution of +0.2 percentage point.

**Chart 4: Forecast of the Growth Rate of GDP Per Capita
(Five-Year Intervals)**



Note: Real GDP from fiscal 1990 to fiscal 1995 is converted to constant prices of 2000, and other figures are in constant prices of 2005.
Sources: National Institute of Population and Social Security Research, *Population Projection for Japan (estimates as of January 2012)*;
Cabinet Office, *Annual Report on National Accounts*

Please note that as real GDP growth continues above Japan's potential growth rate, the gap between supply and demand will diminish, and, as upward pressures on prices build, Japan is expected to finally escape from deflation. Also, as a result of mergers and a greater concentration of industries, companies should have a higher degree of pricing power vis-à-vis their customers, and, if this is accompanied by higher wages, price increases will not be just a temporary phenomenon, but, instead the rate increase in prices will gradually rise.

(2013.2.5)

*This is an English summary of a report originally published on January 11, 2013. 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.