Japan's Economic Outlook

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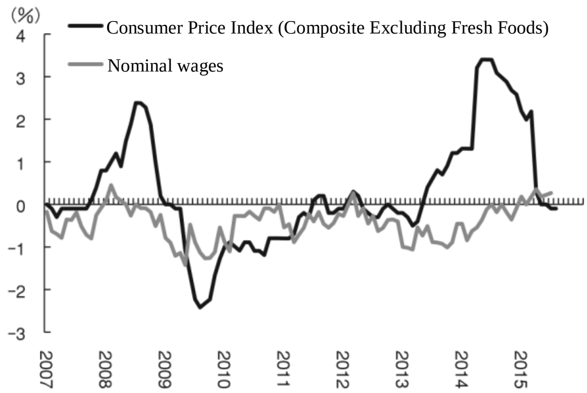
1. Near-term Economic Trends

A full three years have passed since the Abe administration came to power, yet the outlook for economic policy is becoming increasingly difficult to understand. In April of 2013, when Governor Haruhiko Kuroda began the bold monetary easing policy known as "quantitative and qualitative monetary easing," he set the goal of "achieving 2% inflation in about two years." If things had gone according to that target, there would have been 2% inflation in the spring-summer period of 2015, but recently the rate of inflation became negative, and 2% inflation seems a long way off. Mr. Kuroda has approved the stance that the latter half of 2016 will be the deadline to achieve this, yet many market participants are skeptical of achieving 2% inflation anytime within 2016. The government has set an economic growth rate target of 2.3%, but during the past three years of the Abe administration, there has been an average of 1% growth and most recently this has even become negative growth. The economic recovery that Abenomics envisioned is currently not proceeding as planned. Moreover, according to the reference date of the business cycle determined by the Cabinet Office, the business cycle was in a trough one month before the Abe administration took office (November 2012), meaning that business recovery has continued since that point in time. However, three years have already passed. Since the period spanning from the economic trough to the economic peak has mostly been about three years during the past business cycles, it wouldn't be unusual to start moving away from the economic peak this year if we consider the situation at the point in time of January 2016. If that is the case, that would mean there is an increasing possibility from this year to next year of the economy entering into a recessionary phase, and under such an environment, one can say that exiting from deflation and achieving economic growth is not going to be simple.

One reason why the economy remains weak is that workers' wages have substantially declined under the Abe administration. Figure 1 is a graph that compares the rate of inflation to the rate of wage growth.

For the past three years, the country was unable to achieve the target of 2% inflation, but the consumer price index (including the increase in consumption tax) has largely achieved around 1% of positive inflation. Additionally, due to the increase in consumption tax in April 2014, the commodity price including consumption tax from the perspective of consumers has seen inflation of more than 2% (the Bank of Japan's target of 2% inflation is for the commodity price without consumption tax). In particular, the increase in prices on foods and daily necessities has been remarkable, and this is putting pressure on the living standard of workers. However, the rate of increase in nominal wages until the middle of 2014 went from a negative 1% to hovering around approximately 0%. The rate of wage growth has finally recently started to move towards positive growth. In other words, even though the commodity price has slowly been increasing, the state of wages not rising is continuing. Substantially, this is the same as if wages were decreasing by a rate of 1% - 2%. With this we can say that far from improving, the living standard of workers has been worsening. If wages start to rise at a rate that is the same as the rate of inflation or greater, personal consumption can truly recover. For Japan to steadily recover and have strong economic growth as well, growth in wages is an extremely important issue.

(Figure 1) Rate of Inflation and Rate of Wage Growth



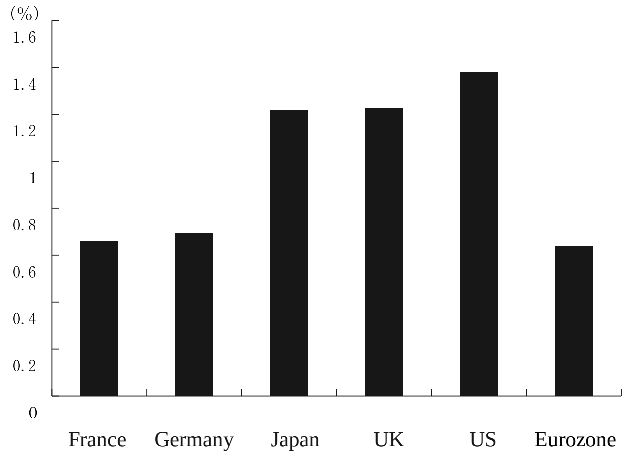
(Note) Year-on-year

(Source) Ministry of Internal Affairs and Communications "Consumer Price Index," Ministry of Health, Labour and Welfare "Monthly Labour Survey"

2. How Capable is Japan's Economy?

When considering Japan's economic growth rate going forward, what sort of level should one aim for? Looking at the first 10 years in the 2000s before Abenomics began, the economic growth rate of the Japanese economy was by no means low compared to foreign countries. A logical way to measure economic capability is to compare the productivity per individual employee. Figure 2 shows a comparison on a dollar base of the GDP growth rate per individual employee between Japan, the UK, the US, Germany, France, and the average of the EU15 nations. Looking at this figure, the economic growth rate per individual Japanese is quite high. It is higher than Germany and France, and it is comparable to the US and the UK. If that is the case, the current administration's target for the future of "achieving high economic growth" might be slightly unreasonable.

(Figure 2) International Comparison of the Economic Growth Rate per Employee (Stated in Dollars with 1990 Prices)



(Note) Average Real Growth Rates from 2001-2010

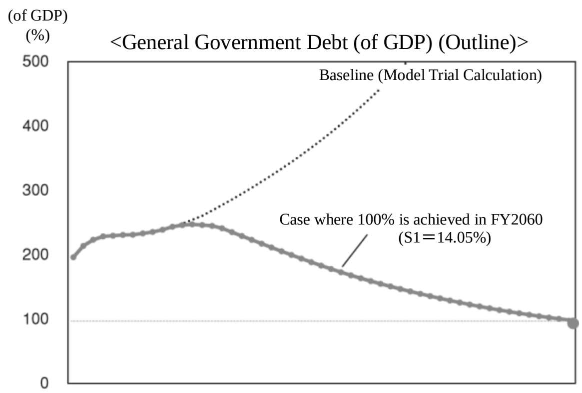
(Source) World Bank "World Development Indicators"

Currently, Japan's potential growth rate (supply capacity's growth rate) is about 0.5%, but even if Japan exits from deflation, the supply capacity will not necessarily increase (since exiting from deflation only means having the real GDP approach the supply capacity). The government's target economic growth rate as shown in the Cabinet Office's "Preliminary Calculation Concerning Mid to Long-Term Economic and Fiscal Policy" is 2.3%. How feasible is this figure? The economic growth rate per worker is determined by technological progress, and as a rule of thumb, that will be an average of

2% over the long-term. Since the economic growth rate is a combination of the economic growth rate per worker and the increase in the work force added together, the economic growth rate going forward in Japan, where the work force population is gradually decreasing by 0.5%, is predicted to be 1.5% in the long term (= 2%－0.5%). To achieve a 2.3% growth rate target, the growth rate per worker would need to be 2.8%. That would entail a continued high economic growth rate per person of the sort that was witnessed in Japan's bubble period in the late 1980s.

This is indeed a target that is too high. We will not have "perpetual growth like during the bubble period." If we consider technological progress and the numbers involved with population reduction, those with the viewpoint that the economic growth rate over the past three years reflects Japan's true ability are persuasive. When the GDP gap was reduced around the end of fiscal year 2013, the growth rate (1.3%) might have been just suitable to Japan's capabilities as the long-term economic growth rate. However, on the other hand, there are many who feel that mere continuation of the current levels of economic growth is not enough to give them hope for the future. Many consumers and business managers are feeling strong anxiety and dissatisfaction about the Japanese economy in their daily lives.

However, is that anxiety and dissatisfaction really stemming from "the fact that the economic growth rate is low?" Isn't the real reason for people's anxiety and dissatisfaction due to other factors? For that reason especially, despite the fact that it cannot necessarily be said that economic growth is too low, will anxiety and dissatisfaction ever not disappear from the hearts of the Japanese?



(Figure 3) Government's Long Term Estimate Concerning its Debt

3. The Long Term Issues Japan is Facing — Scale of Financial Risk

The Japanese economy is facing some difficult long-term problems. Those are namely the cumulative increase of government debt and the problem of its low birthrate/aging population. It is common knowledge that Japan's public debt has reached 240% of GDP, and even now, it is increasing at an accelerating pace. This level exceeds Japan's public debt after the end of World War II. Japan's debt ratio is rising, but since interest increases as the balance grows larger, the debt ratio's speed of increase is greatly accelerating, and eventually this will result in a divergence that is heading toward an infinitely large amount.

In the "Long Term Estimate Concerning Japan's Finances" reported by the Fiscal System Council's Public Finance System Subcommittee on April 28, 2014, the government showed an estimation of the actual divergence of debt. This was not the government's official estimate, but was announced as only reference material calculated by the secretariat at the Council. The contents were calculated based on data such as government statistics by researchers at the Ministry of Finance.

The baseline's dotted line illustrates how the government's public debt ratio (the base of the rough government debt balance) would be in the case that things proceed as they are without any fiscal reform, and in the case that the structures of annual expenditure and annual revenue continues as they are. Up until around 2020, the increments are not particularly large, but after that we enter into the process of divergence where interest begets interest, and in 2050, this results in a level that significantly exceeds 500% (as the current GDP is approximately 500 trillion yen, taking that as the standard this would be about 2,500 trillion yen). It is obvious that the baseline public debt ratio is heading towards infinite divergence.

In regards to this forecast, how far must Japan improve its financial income and expenditures in order to achieve fiscal reconstruction? To answer this question, a calculation has been attempted in Figure 3. Keeping the target of public debt ratio in 2060 at 100%, Figure 3's solid line represents the change in the ratio when the necessary amount of reform in financial income and expenditures has been achieved. In this case, S1 in the figure equals 14.05%, and represents the ratio of the scope of improvement in financial income and expenditures to GDP. In other words, the solid line is the change in government debt in the case of a 14.05% improvement in financial income and expenditures every year.

14.05% of GDP is approximately 70 trillion yen, and is equivalent to a consumption tax rate of approximately 30%. In other words, in order to achieve the reduction in debt that the solid line represents, Japan would have to achieve reform in financial income and expenditures of approximately 70 trillion yen (converting the consumption tax rate to the equivalent of an increase by approximately 30%).

To summarize the result of this trial calculation, if things continue as they are and nothing is done for fiscal reform, the public debt ratio will attain extreme levels of 500% and 600% after approximately 30 years from now, and will continue on until the divergence is infinite. Having a debt ratio of 500% is actually inconceivable. The reason for this is that when it exceeds 300%, the amount of the balance of government bonds will exceed the total amount of financial assets owned by the Japanese people. If that happens, even if Japanese change all of their financial assets into government bonds, government bonds would be left over in the market and Japan would have to have overseas investors purchase them. However, if the Japanese government doesn't decide to proceed with fiscal reconstruction, we cannot expect that overseas investors will continue purchasing Japan's government bonds. Accordingly, it is inconceivable that government bonds will continue to be sold until the debt ratio becomes 500%. This trial calculation is telling us that before the situation reaches that point, financial bankruptcy will occur in one way or another. Therefore, in order to have Japan's finances become sustainable after 50 years, it will be necessary to improve financial income and expenditures by about 14% of GDP (about 70 trillion yen). This is equivalent to reducing the general accounting budget by 70%, and in order to achieve this improvement in financial income and expenditures with a consumption tax increase, the consumption tax rate would have to be permanently raised by 30%.

4. Abenomics' New Issues

Similar results are backed by several academic studies conducted by economists in the United States and Japan. Even if Japan raises the consumption tax to 10%, it cannot possibly be enough to have sustainable financial recovery. To the extent that policy responses are discussed now by Nagatacho and the mass media, it is clear that the fiscal problems will not be resolved at all. Moreover, many Japanese have realized this. In particular for that reason, near-term economic growth is not sufficient, and anxiety and dissatisfaction are increasing in regards to the outlook of the economy.

The declining birthrate is also serious. If the birthrate continues as it is, Japan's population after 50 years will be 80 million. Or to put it another way, 50 years from now the population will decrease by 50 million. If the same birthrate continues even further, Japan's population after 100 years will be in the range of 30 million. We cannot possibly say that Japan's economic and social structures are sustainable in any way.

The effect of Abenomics up until now has been to leave the long-term issues of fiscal sustainability and the declining birthrate vague while trying to make the Japanese people happy with short-term optimism. The administration has taken the approach that in order to undergo initiatives for long-term problems, the first priority is to try to make people optimistic.

However, was it necessary to look a little deeper to gain insight as to why people are not optimistic? No matter how much the near-term economy grows normally, people's anxiety and dissatisfaction are simply becoming greater and greater because long-term issues such as finances and the declining birthrate cannot be addressed immediately. Ultimately, people will not be as optimistic as the administration would wish them to be, and economic growth will stall as well in a short period of time.

The same can be said with regard to entrepreneurs. No matter how much the government might play the music of optimism, entrepreneurs will not be dancing. Tatsuhiko Yoshizaki, chief economist of the Sojitz Research Institute, pointed out as follows. Looking at the government's stance of spreading optimism, companies are pessimistic that "someday the government fiscal policy will fail, and company management will also bear fallout from the ensuing disaster." "Under this condition it's definitely not the time to be impulsive." Companies think that, "Even if there must be an increase in wages, let's just increase to an extent that would not hurt the government's mood." ("Tameike Tsuushin" Vol. 575)

It's understandable that this will not stimulate the economy. The stance of the government itself emphasizes short-term optimism, which is becoming a factor as to why consumers and companies are trapped in long-term pessimism.

Here is where the original contradiction of Abenomics lies. The government was confronted with the prediction that "Japan will go bankrupt in the future" and tried to prevent it by spreading short-term optimism, and thus it implemented Abenomics. However, the more we emphasizes "exit from deflation" with Abenomics, the more we become caught in our own trap, where we cannot do anything about public debt and the declining birthrate. During that time, public debt problems and the declining birthrate will worsen more and more as well. In other words, Abenomics itself is unintentionally going in a direction that will fulfill the prediction that "Japan will become bankrupt in the future." It might be appropriate to compare this structure to a Greek tragedy, in which the hero takes a course of action in order to escape from a prediction that unintentionally ends up fulfilling the prediction.

In September of 2015, as the 2nd stage of Abenomics, Prime Minister Abe announced the new “three arrows” (a robust economy that gives rise to hope, dream-weaving childcare support, and social security that provides reassurance). Critical viewpoints arose here and there that pointed out how the government did not make any clear specific path to achieve them.

However, the new three arrows are very meaningful in addressing the original cause of the people’s anxiety, or to put it another way, showing that the government is addressing the problems of the long-term declining birthrate and social security. The first arrow (a robust economy that gives rise to hope) took over Abenomics up until now, and has been continuing to aim for GDP 600 trillion yen in 2020 through exit from deflation and high economic growth. The second arrow (dream-weaving childcare support) aims to raise the quality of domestic life by improving the childcare environment, achieve a birth rate of 1.8, and put the brakes on the declining birthrate. The third arrow (social security that provides reassurance) aims for zero turnover in nursing, increasing employment opportunities for the elderly, and aims for “a society in which all one hundred million-plus citizens are each dynamically engaged.”

The contents of specific measures are to be decided going forward, but if the new three arrows could properly resolve long-term issues such as the declining birthrate and social security, the Japanese economy would truly be able to regain its vitality, since the people’s future anxiety would be resolved. The 2nd stage of Abenomics does offer some hope that there is a course of action to squarely approach long-term issues.

However, this doesn’t make the specific path clear whatsoever. It is clear that the problem of fiscal reconstruction, which has little coverage in the “new three arrows,” has a direct connection to the success or failure of childcare support and social security. However, trying to achieve the target of a GDP of 600 trillion yen would surely also lead to increased public works. If that were to happen, public debt would noticeably worsen, the people’s future anxiety would increase more and more, and the economy might contract.

Public works to protect against natural disasters such as forestry and flood control are needed, but overdoing that can lead to the “market disaster” of government bankruptcy that will also destroy the people’s livelihood. Surely sound fiscal conditions are also important infrastructure for people's livelihood. In order to reduce the Japanese people’s future anxiety and enable Abenomics to succeed, it is necessary to have the wisdom to make sure there is balance.

5. The Challenges Financial Problems Bring to the Political System

In order to resolve the long-term issue of fiscal reconstruction, there are only three options: raise taxes, cut annual expenditure (payment of social security in particular), or drastically reduce the price of debt with a high rate of inflation. A high rate of inflation means that there will be what we could call "taxation due to mayhem in the market" (inflation is virtually asset taxation on financial assets) occurring without going through political decision-making. As mentioned earlier, if the government resolves this by increasing consumption tax, the tax rate would need to be raised to more than 30% on a permanent basis. If the government resolves to cut annual expenditure, it would need to reduce the annual government budget by 70 trillion yen (70% of the general account budget). The fact that the scale of the fiscal problem is this great means that, either way, this can be referred to as "inconvenient truths" that cannot be solved with the government's decision-making and the administration's usual process during peace time.

Japan's financial problem is a challenge to its political system (governing structure that takes a broad meaning including the political administration) in two respects.

The first point is that just as with earthquake countermeasures, Japan is at the point where it should be considering emergency countermeasures in regards to public debt as well. Emergency countermeasures would be a Plan B, or something known as a contingency plan – a plan that can deal with such situations as the price of government bonds sharply dropping, or an excessive, sudden jump in the rate of inflation that results in loss of control. Countermeasures for a Greek-style financial bankruptcy, so to speak. These sorts of discussions have occurred frequently in informal venues since some time ago. However, from the government's official standpoint along the lines of "Don't cause a situation like financial bankruptcy," it hesitates to engage in its official task of considering a Plan B, and we can surmise that staff inside the government haven't worked out sufficient countermeasures. This same lack of thinking is why countermeasures for a severe accident at a nuclear power plant were not sufficiently elaborated before 3.11. In other words, the government's logic takes the following sort of path:

(1) Not causing a debt crisis is the objective of the government's fiscal administration,

(2) Despite that, the establishment of an emergency plan that assumes the outbreak of a debt crisis arising is nothing but self-denial of the government's objective,

(3) Since the government is undertaking fiscal administration that will do away with the need to consider an emergency plan, it's ok not to consider an emergency plan.

In short, bureaucrats and politicians alike are bound to the official stance of "don't cause a debt crisis," and are trapped in a state of paralysis that prevents them from thinking flexibly about "what should we do if one does arise?" At the very least, as far as I am aware, that was the case just two years earlier, and I am sure that even now the situation isn't changing.

However, for an issue that doesn't seem to be resolved unless the consumption tax is raised to 30%, it cannot be said that under the process of the current government and administration, it will necessarily be resolved. Indeed, an emergency plan is in fact necessary after all. Normally, this is something that the fiscal authorities ought to devise measures for. However, as this is very important to the national economy overall, it is a good time currently for economists, financial scholars, private-sector financial institutions, think tanks, mass media, and political parties, etc. to concentrate their respective abilities and create a Plan B, and compete on various proposals.

The second point concerns political ideology. Fiscal reconstruction and reform of social security could be considered an "intergenerational partnership" that connects the current generation with the (not yet born) future generation. This is because distribution of benefits and burden regarding the government's services is a decision that transcends generations. However, decision-making in regards to public debt and social security will need to occur among the current generation and the future generation, who naturally are not able to participate in the decision-making process. This is the situation that violates "no taxation without representation," the very principles of modern democracy. It wouldn't be strange to say that the present-day government that issues long-term government bonds and maintains the public finance system and social security system that transcend generations is deviating from the principles of democracy, since it ignores the wishes of future generations. In order to restore democracy's fundamental decision-making, we would need to create a "representative of the future generation's interests" within the political arena at this current point in time. This is the 2nd challenge.

As a solution to this problem, movements to establish long-term fiscal forecasting agencies that maintain political neutrality and independence are becoming active among the various OECD countries. Primarily in countries such as the US, UK, and Australia, experiments are underway to strengthen organizations such as the Congressional Budget Office, and create a system that can enhance neutrality and independence and perform the function of checking long-term fiscal discipline. In Japan as well, there are movements involving legislation proposed by lawmakers to establish a budget office in the Diet. Since there haven't been "representatives of the future generation" in the political arena up until now, this has helped postpone financial problems. This sort of reform to the political system is a significant challenge to democracy in the 21st Century.

6. Outlook for New Growth Industries

Dealing with long-term issues such as public debt is also related to short-term economic recovery. However, not only are several difficult issues standing before our eyes, but the possibility of new innovation is also expanding. The situation in which Japanese society is progressing while balancing a declining birthrate and aging population might become the basis for new technological progress. Currently, there is a structure where two people in the working generation are supporting one elderly person. However, according to some calculations, one person in the working generation will be supporting one elderly person by the middle of this century. Labor-saving needs are undoubtedly increasing in the service industry, such as with medical care and nursing for the elderly. It is said that the direction of technical progress is directed by the condition of the market (MIT professor Daron Acemoglu's "Directed Technical Change" theory). For example, needs are increasing in robots and machines used in nursing/caregiving and the technical progress in this field is expected to be significantly enhanced in the future. On the other hand, Japanese companies excel in mechanical technologies such as machine movement, and Japanese companies also specialize in technology that is bridging the boundary between machines to humans (human interface). As Japan continues to experience a declining birthrate and an aging population, if the country can develop the equipment to support a variety of services for the elderly, there is high potential for this industry to take over the role automobile manufacturers had in the 20th century, and become Japan's leading export industry. Depending on the type of regulations, the phases of entrance by companies into this field will change. If we proceed with adequate regulation reform, and promising companies that possess high technical ability can enter the market, it is thought that Japan's industrial structure will change significantly.

One more field in which technological progress is capable of completely changing the landscape of the market is the broad application of FinTech (financial technology), with a representative example being virtual currency such as Bitcoin. Due to the bankruptcy in 2014 of Mt. Gox, many came away with the impression that Bitcoin is unreliable, but the mechanism "block chain" technology that created and maintained Bitcoin (known more generally as a "distributed ledger") has potential for a wide range of applications and is considered to be a significant invention. A financial network that uses a virtual currency in cyberspace is showing signs of spreading among Africa's farming regions. In developing countries, mobile phone networks are spreading before landline phone networks grids, and just as landline phones are already becoming outdated, in developing countries where the conventional world's financial network (a fixed network of bank branches) has not yet been setup, a financial network based on a virtual currency might spread first. The phenomenon in which cutting-edge technologies spread in developing countries first, and then in developed countries is called "leapfrogging." There might be leapfrogging in the world's financial industry in the decades to come.

There is tremendous potential for the Japanese economy to make a leap in progress as well if such changes become reality. Depending on the movement of technology, a second period with a high degree of economic growth might not be just a dream. To clear the way for a better outlook, Japan must continue to undertake efforts on long-term issues like its fiscal problems, maintain hopes for technological development with future prospects, and must not be negligent in investing for the future.