

Annual Report on the Japanese Economy
and Public Finance

2014

—Reviving the Japanese Economy,
Expanding Possibilities—

Summary

July 2014

Cabinet Office
Government of Japan

Contents

Chapter 1 Continuing Recovery of the Japanese Economy

This chapter identifies the effects of the consumption tax hike and the bold monetary policy and analyzes challenges on the road to simultaneous achievement of economic growth and fiscal consolidation.

Section 1 Underlying Trends in the Economy and Impact of the Consumption Tax Hike	2
Section 2 Monetary Policy and Monetary Developments	6
Section 3 Economic Growth and Fiscal Consolidation	10

Chapter 2 Move toward Overcoming Deflation and Points of Debate concerning Wages

This chapter reviews the underlying price trend, examines the sustainability of the price growth and analyzes the trends in income and wages and challenges related to hourly wages.

Section 1 Sustainability of Price Growth	13
Section 2 Income and Wage Trends that Support the Virtuous Circle	16
Section 3 Challenges on the Road to Higher Real Wages and Labor Participation Ratio	19

Chapter 3 Structural Changes in the Japanese Economy and Challenges for Industries

This chapter sorts out points of debate indicated by the current account deficit and examines challenges for industries that must be tackled for the Japanese economy to enhance the earning power in and outside Japan.

Section 1 Questions Posed by the Current Account Surplus	22
Section 2 Global Market and Challenges for Japanese Industries	25
Section 3 Population Decline, Aging of Society and Challenges for Japanese Industries	28

Conclusion	31
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This material has been tentatively prepared to explain the “Annual Report on the Japanese Economy and Public Finance.” For quotations and other purposes, please refer to the text of the “Annual Report on the Japanese Economy and Public Finance.”

Chapter 1 Continuing Recovery of the Japanese Economy

Section 1 Underlying Trends in the Economy and Impact of the Consumption Tax Hike

- Personal consumption increased steeply due to a last-minute demand upsurge before the consumption tax hike, boosting the growth rate in January–March 2014.
- Since April, personal consumption has declined steeply due to a demand pullback following the tax hike. Although the impact of the pullback is lingering with regard to durable goods, demand for other items is gradually recovering. Housing investment continues to decline.

Figure 1-1-1 (2) Real GDP growth rate
(Quarter-to-quarter change in contribution, %)

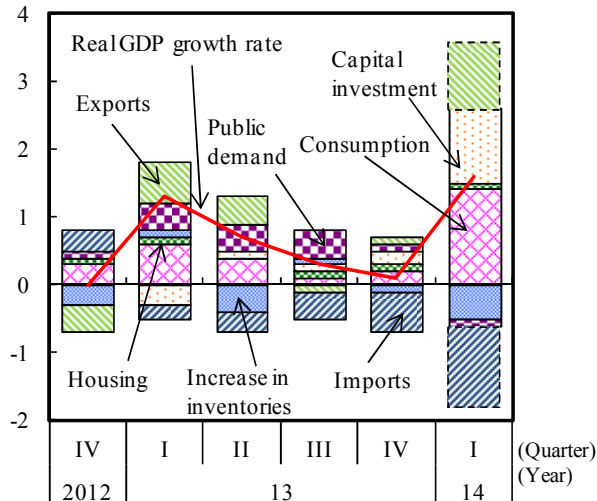
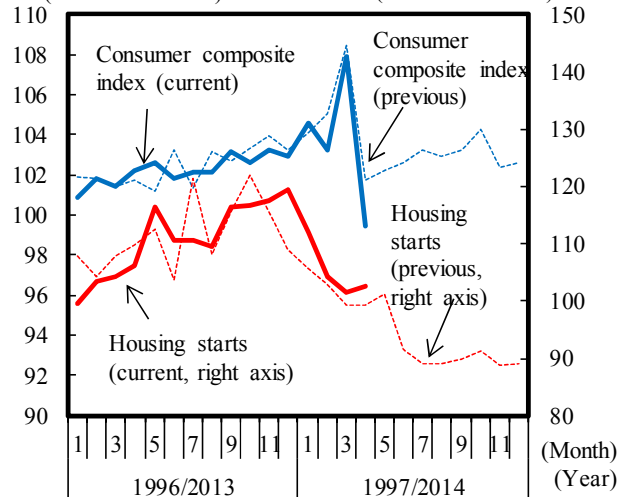


Figure 1-1-2 Impact of the consumption tax hike
(1995/2012 = 100)



- (Notes) 1. (Left) Compiled based on the System of National Accounts, the Cabinet Office.
2. (Right) Compiled based on the "Statistics on Building Construction Started," the Ministry of Land, Infrastructure, Transport and Tourism.

- On the other hand, capital investment has been increasing and public investment has also stayed steady, offsetting the demand pullback to a certain degree.
- Regarding real compensation of employees, the margin of decline in scheduled earnings narrowed in April, reflecting wage increases. However, further improvement is necessary in order to offset the impact of price growth.

Figure 1-1-2 Impact of the consumption tax hike

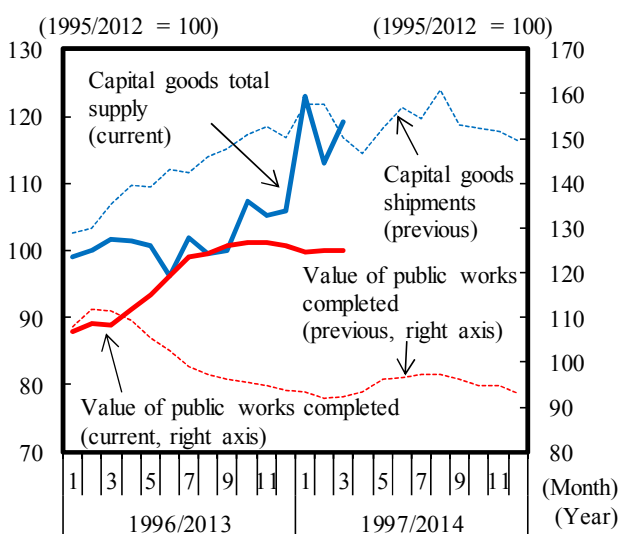
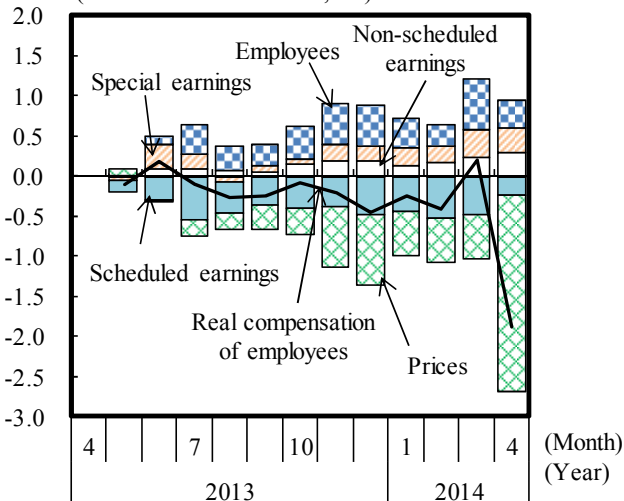


Figure 1-1-3 (3) Changes in compensation of employees before and after the consumption tax hike
(Cumulative contribution, %)



- (Notes) 1. (Left) Compiled based on the Indices of Industrial Production, the Ministry of Economy, Trade and Industry; and the Integrated Statistics on Construction Work, the Ministry of Land, Infrastructure, Transport and Tourism.
2. (Right) Compiled based on the System of National Accounts, the Cabinet Office; the Labour Force Survey, the Ministry of Internal Affairs and Communications; and the Monthly Labour Survey, the Ministry of Health, Labour and Welfare.

- Since the middle of 2013, exports to Asia (excluding China) have been stagnant.
- While major Southeast Asian countries generally continue to grow steadily, the growth rate of their gross fixed capital formation has declined. That has put downward pressure on exports of capital goods, in which Japan is strong compared with other countries. Looking forward, there are expectations for economic recovery to spread throughout advanced countries, including the United States.

Figure 1-1-4 (2) Exports from Japan by destination

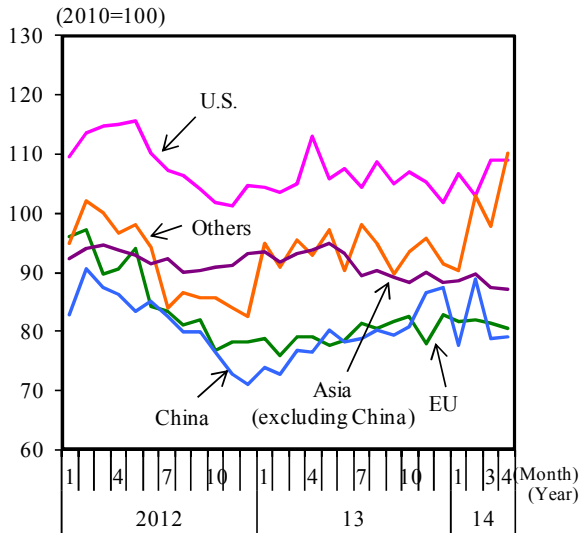
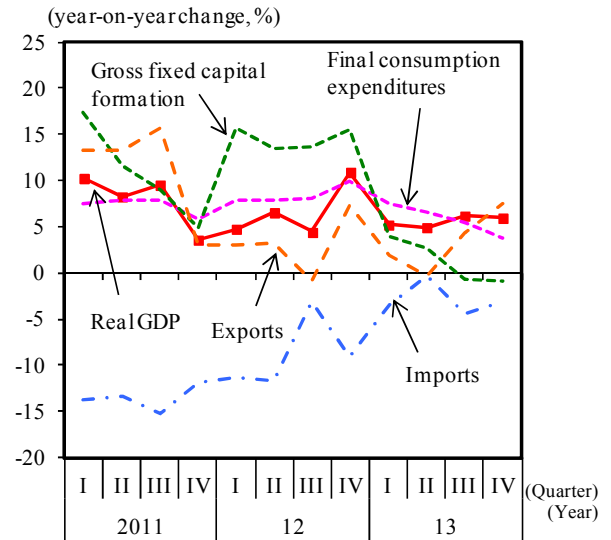


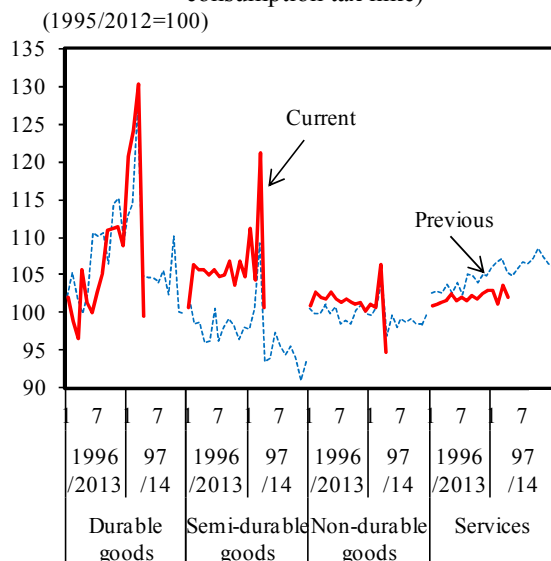
Figure 1-1-4(3) Growth rates of demand items in major Southeast Asian countries



- (Notes) 1. (Left) Compiled based on the Trade Statistics of Japan, the Ministry of Finance.
 2. (Right) Compiled based on CEIC. The data cover figures for Thailand, Indonesia, Malaysia and Singapore (weighted average weighted by exports).

- Consumption of durable goods grew steeply toward March due to a last-minute demand upsurge before the consumption tax hike but declined in April as a result of a demand pullback.
- The deviation of consumption from its underlying trend in the period leading to March was worth around 2.5 trillion yen to 3 trillion yen, which was accounted for mainly by durable goods. The deviation at this time was relatively large compared with the one at the time of the previous consumption tax hike in 1997. A demand pullback may continue to weigh on consumption somewhat for a while.

Figure 1-1-6 (1) Consumer composite index by type (comparison with the figures at the time of the previous consumption tax hike)



(Note) Estimates by the Cabinet Office.

Table 1-1-7 Deviations of consumption from the underlying trend

		Positive contribution (Percentage points)			In terms of value (Trillion yen)
		Oct.–Dec. 2013	Jan.–Mar. 2014	Full fiscal year (annualized)	
(i) Estimate based on the consumption function		0.8	3.1	1.0	3.0
(ii) Estimates by type	Durable goods	0.6	1.8	0.6	-
	Semi-durable goods	-	0.4	0.1	-
	Non-durable goods	-	0.5	0.1	-
	Services	-	-0.2	0.0	-
Total		0.6	2.6	0.8	2.5

- The increase in the financial burden of households due to the consumption tax hike is smaller this time than at the time of the previous hike, because increased social security benefits have had some moderating effects. For future recovery in consumption, steady growth in compensation of employees will be important.
- As for housing construction, order receipts have decreased due to a demand pullback, and housing starts also continue to decline. However, regarding houses for rent, the backlog of orders is piling up, supporting housing starts.

Figure 1-1-9(1) Impact on real disposable income

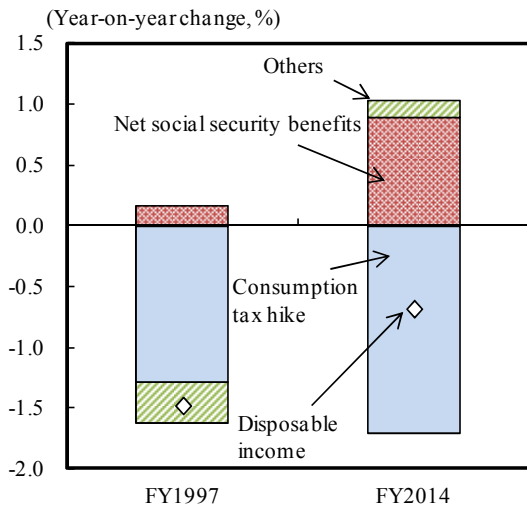
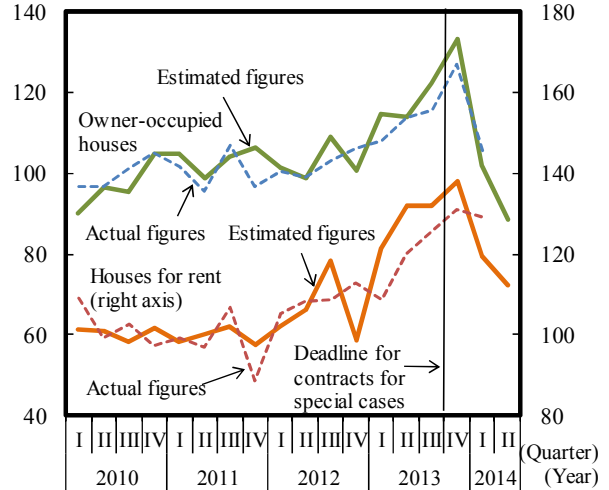


Figure 1-1-10 (3) Number of housing starts estimated from order receipts (2010–2011 average = 100)



- (Notes) 1. (Left) Compiled based on the System of National Accounts, the Cabinet Office; materials prepared by the Ministry of Health, Labour and Welfare, etc. "The impact" includes the effects of the consumption tax hike and institutional reform factors, such as the reform of public benefits and burdens. It does not include the effects of changes in compensation of employees.
2. (Right) Compiled based on "Statistics on Building Construction Started," the Ministry of Land, Infrastructure, Transport and Tourism; and data prepared by the Japan Federation of Housing Organizations. The estimated figures are calculated based on order receipts.

- Regarding production activities in the corporate sector to respond to the last-minute demand upsurge, there are moves in manufacturing industries to absorb fluctuations in demand through inventories under cautious production plans.
- In non-manufacturing industries, production activities declined sharply in April, mainly in the retail sector. But service consumption (lodging) and public investment (construction) stayed at a relatively high level, supporting overall activities.

Figure 1-1-11 (1) Production, shipments, inventories and inventory ratio in manufacturing industries

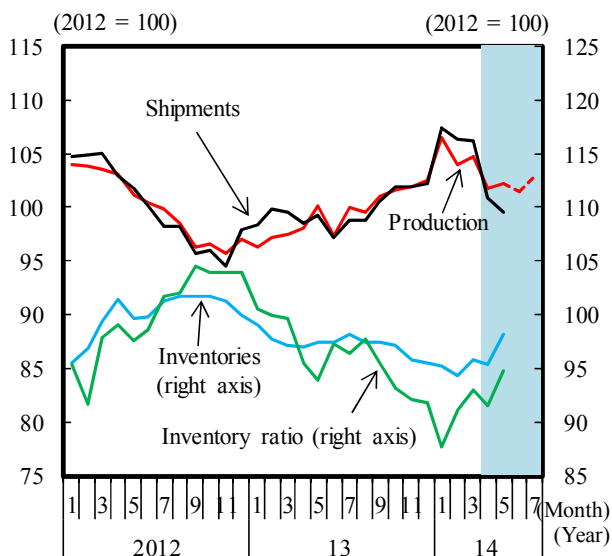
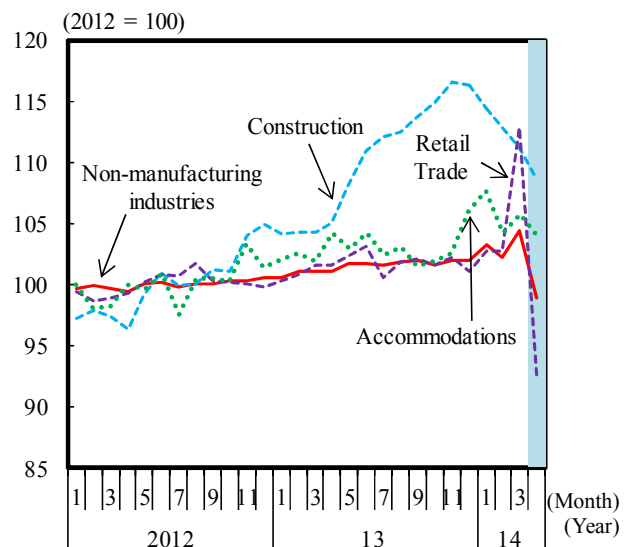


Figure 1-1-11 (3) Production activity in non-manufacturing industries



- (Notes) 1. (Left) Compiled based on the Indices of Industrial Production, the Ministry of Economy, Trade and Industry.
2. (Right) Compiled based on the Indices of Tertiary Industry Activity and the Indices of All Industry Activity, the Ministry of Economy, Trade and Industry.

- Corporate earnings have been affected by a slowdown in overseas economies. However, until now, both sales and profits have been on an uptrend due to strong domestic demand, including the last-minute demand upsurge and the yen's weakness.
- As for the future outlook, export sales are expected to grow. As for domestic sales, while small enterprises in non-manufacturing industries are bearish about future sales, most companies expect growth.

Figure 1-1-14 (2) Breakdown of sales
(Large companies in manufacturing industries)

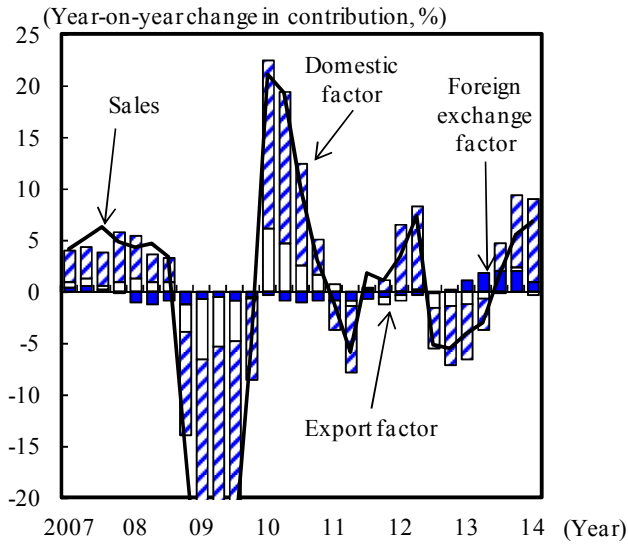
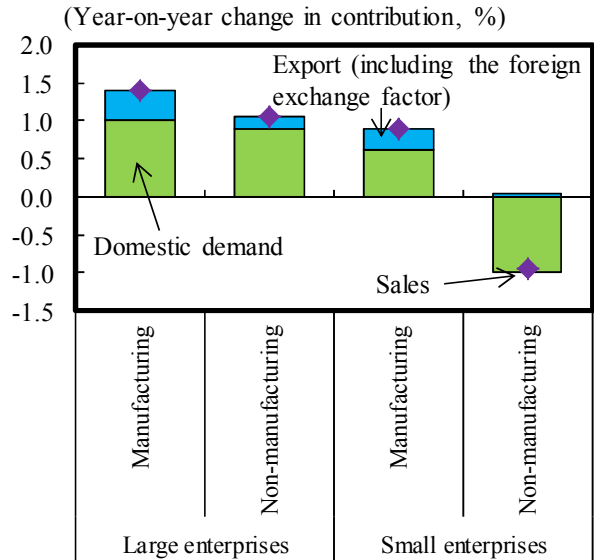


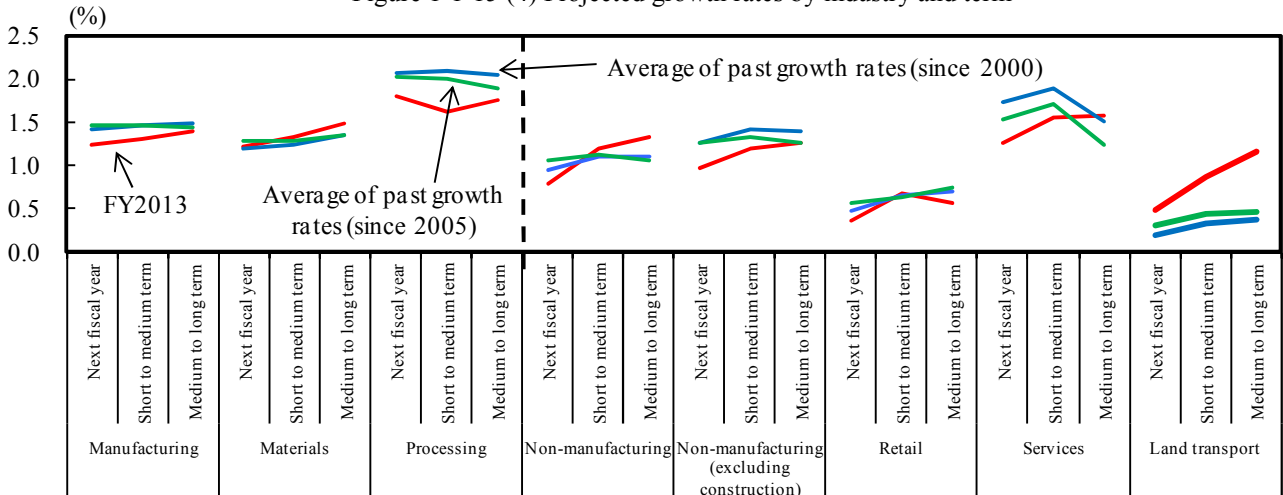
Figure 1-1-14(3) Projection of sales in FY2014
(Year-on-year change in contribution, %)



- (Notes) 1. (Left) Compiled based on the Financial Statements Statistics of Corporations by Industry and the Trade Statistics of Japan, the Ministry of Finance; the Indices of Industrial Production, the Ministry of Economy, Trade and Industry; and the Corporate Goods Price Index, the Bank of Japan.
2. (Right) Compiled based on the Tankan Survey. Bank of Japan. In principle, the above figures exclude the consumption tax.

- According to the medium-and long-term projected growth rate, which affects capital investment, the growth rate is expected to decline after the consumption tax hike (FY2014) but to recover later. This indicates companies' view that although growth will temporarily slow down due to a demand pullback, the growth rate will rise later.

Figure 1-1-15 (4) Projected growth rates by industry and term

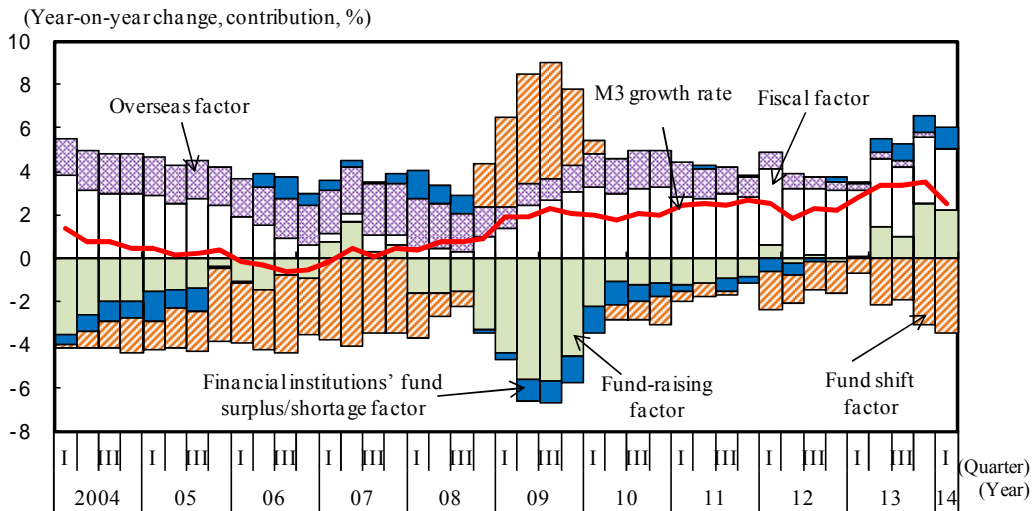


- (Notes) 1. Compiled based on the Annual Survey of Corporate Behavior, the Cabinet Office.
2. Real growth rates of industry-wide demand. The "short to medium term" refers to projected growth rates 2 to 3 years in the future and the "medium to long term" refers to projected growth rates 4 to 5 years in the future (annualized rates).

Section 2 Monetary Policy and Monetary Developments

- Although the money multiplier has further declined due to a continuing sharp increase in the monetary base, the money stock has continued to grow at a relatively high rate.
- As for background factors for changes in the money stock, fund raising by households and companies became active. Moves to increase financial assets other than cash and deposits (fund shift) also grew.

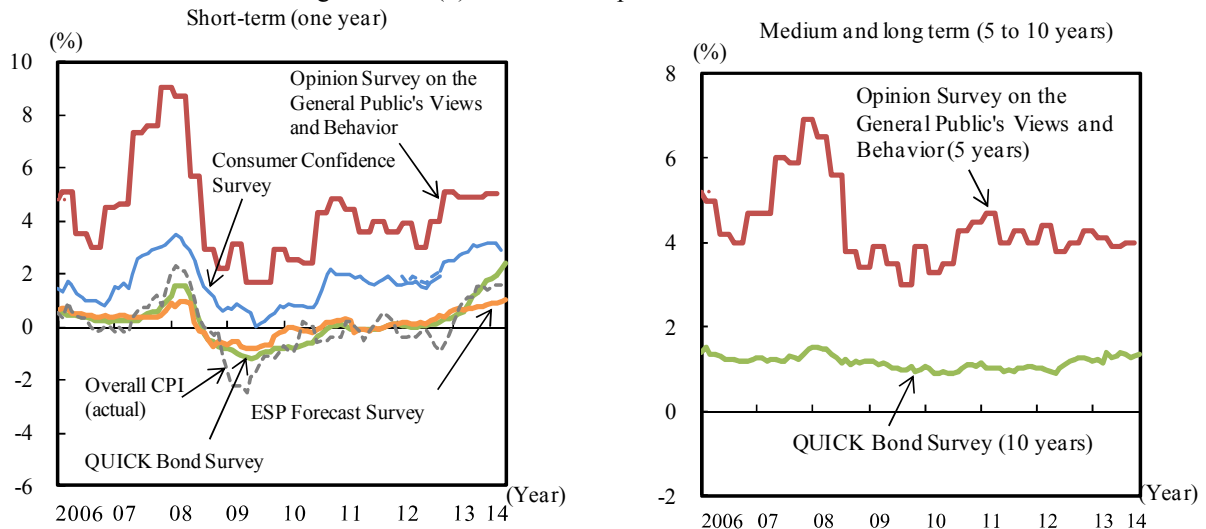
Figure 1-2-1 (3) Breakdown of variable factors of the money stock



(Note) Compiled based on the Flow of Funds Accounts, the Bank of Japan.

- As for changes in expected rates of inflation, short-term expected rates have risen steeply, reflecting the price growth that has been so far observed.
- Medium- and long-term expected rates of inflation have been gradually rising among market participants. Although the rates have remained flat among households, expectations of price growth have grown since the beginning of 2013 according to qualitative assessment. There are hopes that a rise in medium- and long-term expected rates of inflation among both households and market participants will further consolidate the move toward an exit from deflation.

Figure 1-2-2 (1) Indexes of expected rates of inflation



(Notes) Compiled based on the Consumer Price Index, the Ministry of Internal Affairs and Communications; the Consumer Confidence Survey, the Cabinet Office; the Opinion Survey on the General Public's Views and Behavior, the Bank of Japan; the ESP Forecast Survey, the Japan Center for Economic Research; and the QUICK Monthly Bond Survey, QUICK Corp.

- Long-term interest rates in Japan have remained relatively low compared with interest rates abroad, domestic stock prices and expected rates of inflation.
- Bond market players are paying attention to the bond supply and demand condition as a factor for an interest rate decline, so the Bank of Japan's massive purchases of Japanese government bonds (JGBs) are presumed to be helping to keep interest rates low.

Figure 1-2-3 (1) Trends of long-term interest rate by country

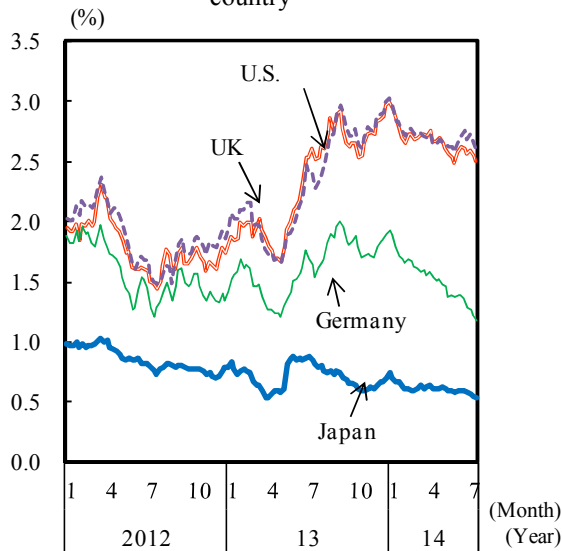
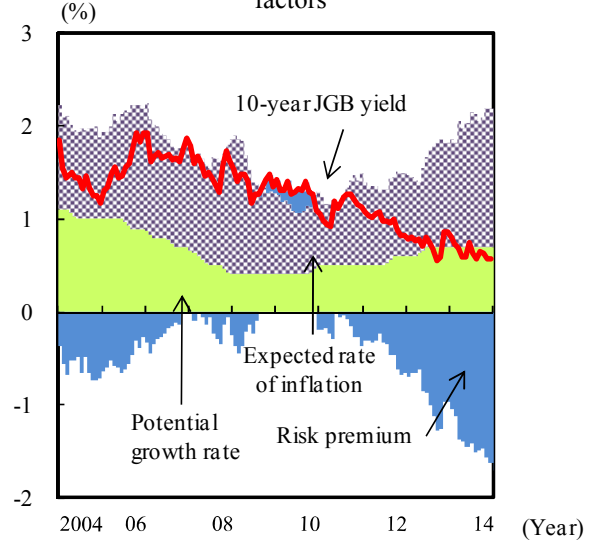


Figure 1-2-3 (3) Breakdown of long-term interest rate factors



(Notes) 1. (Left) Compiled based on data from Bloomberg.

2. (Right) Compiled based on data from Bloomberg; QUICK Monthly Bond Survey, Quick Corp; and data prepared by the Cabinet Office.

- Banks have significantly increased the ratio of funds deposited into the Bank of Japan's current account since the introduction of "quantitative and qualitative monetary easing," while reducing the ratio of JGBs considerably.
- Whereas risk assets such as loans decreased during the period of the previous quantitative easing policy, such assets have increased this time. Portfolio rebalancing is proceeding.

Figure 1-2-4 (1) Japanese banks' asset mix

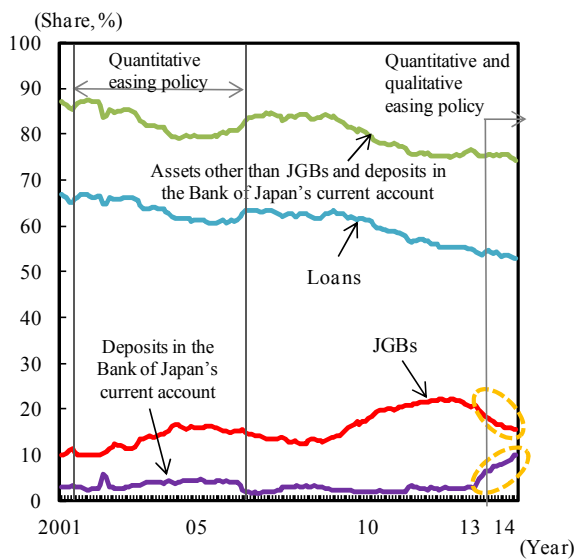
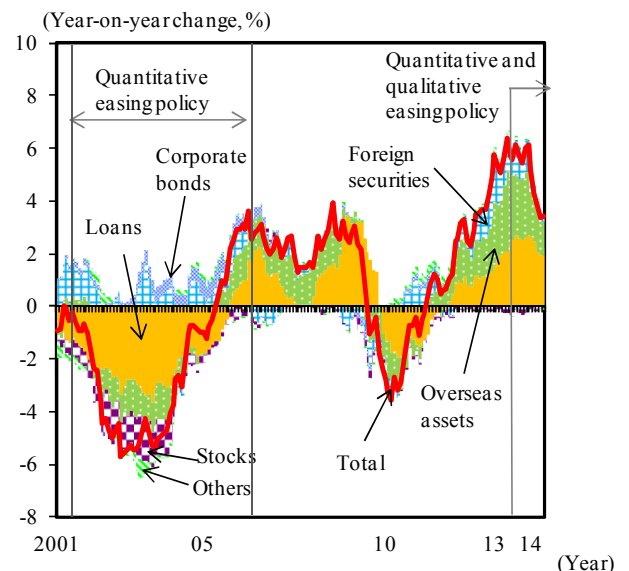


Figure 1-2-4 (2) Outstanding balance of Japanese banks' assets other than JGBs and deposits in the Bank of Japan's current account



(Note) Compiled based on the Financial Institutions Accounts, the Bank of Japan.

- Recently, loans to a broader range of borrowers have increased. Brisk corporate activities are contributing to an increase in demand for external funds.
- While the ratio of debts continues to decline, the ratio of liquid assets has hit the ceiling. Amid an increase in the cost of holding cash and deposits due to the price growth, there are signs of a change in companies' stance on holding cash and deposits.

Figure 1-2-5 (3) Contribution by industry to loans to corporations

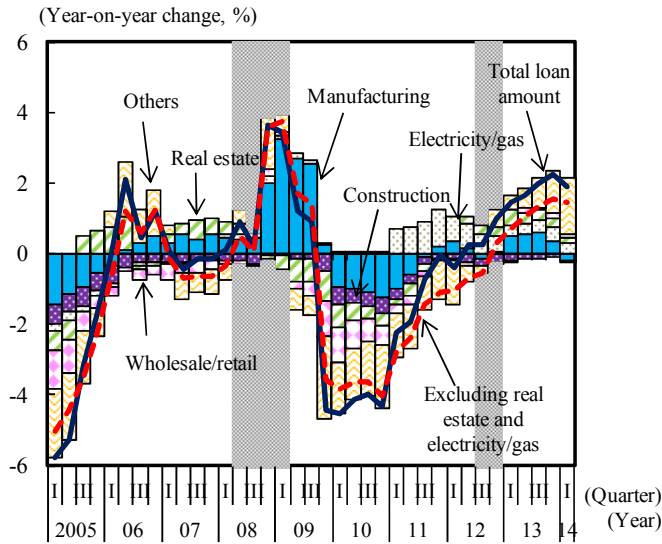
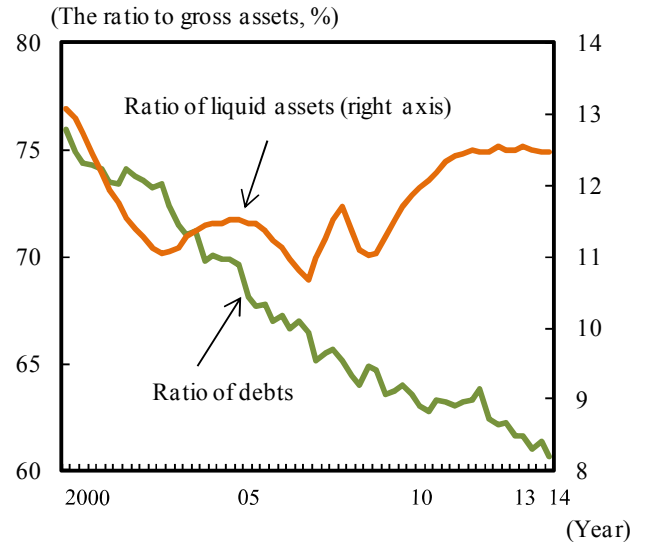


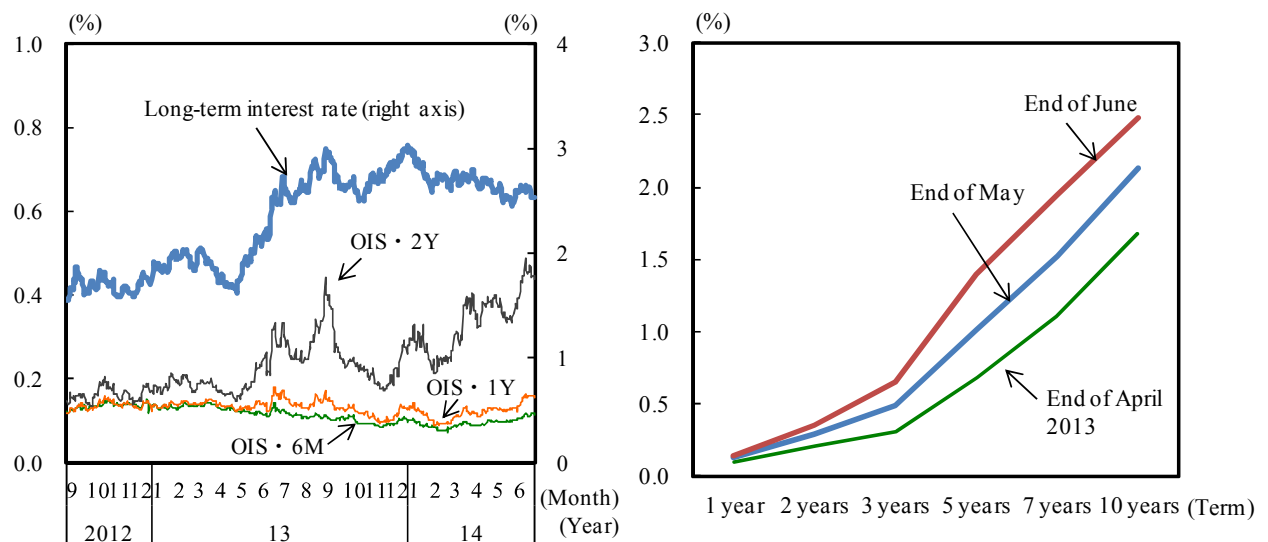
Figure 1-2-6 (2) Companies' ratio of liquid assets and ratio of debts



(Notes) 1. (Left) Compiled based on the Loans and Bills Discounted by Sector, the Bank of Japan. The shaded areas indicate the periods of recession.
2. (Right) Compiled based on the Statistics of Corporations by Industry, the Ministry of Finance.

- In the United States, there has been an attempt to lower longer-term interest rates by announcing an intention to maintain policy interest rates for longer than usual.
- However, as awareness about an "exit" from the quantitative easing grew, the market showed significant reactions, such as a sharp rise in U.S. long-term interest rates. That indicated the importance of communication with the market.

Figure 1-2-8 (1) Expectations of a change in the U.S. policy interest rate and the U.S. long-term interest rate



(Note) Compiled based on data from Bloomberg.

- On the whole, the amount of banks' JGB holdings (the ratio to net assets) is similar to the amount at the time of the previous quantitative easing policy. But it should be kept in mind that the status of JGB holdings differs in duration and other terms according to the type of financial institution and from bank to bank.
- On the other hand, there is the risk of asset bubbles arising if low interest rates continue for long. Among tasks to be performed are implementing micro- and macro-prudential policies and strengthening banks' fundamental profitability.

Figure 1-2-9 (1) Outstanding balance of JGBs held by domestic banks

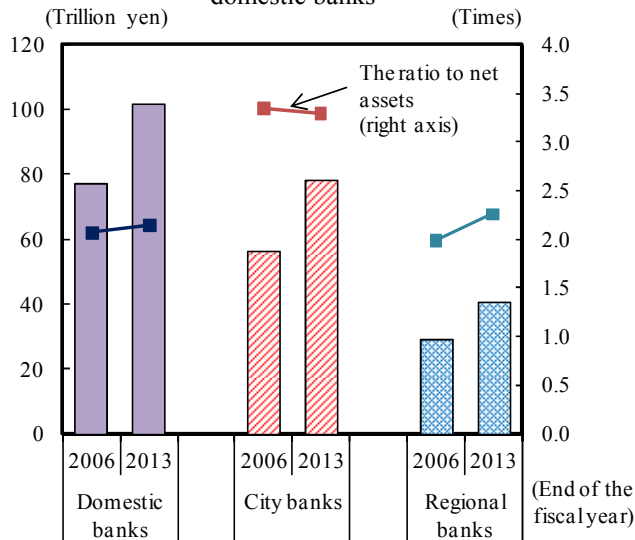
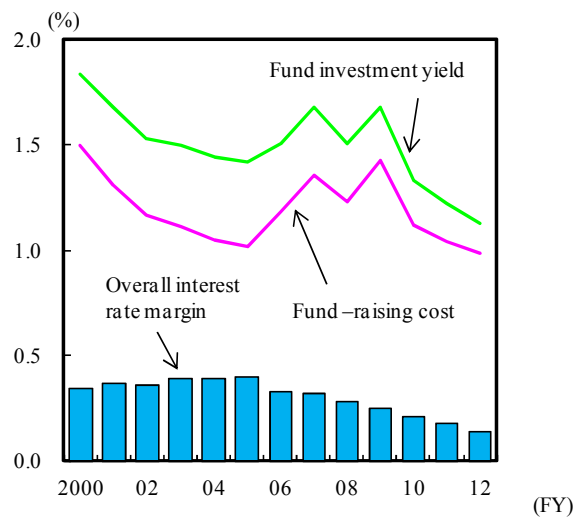


Figure 1-2-9(2) Banks' overall interest rate margin



- (Notes) 1. (Left) Compiled based on the Flow of Funds Accounts and the Financial Institutions Accounts, the Bank of Japan; and materials prepared by the Japanese Bankers Association.
 2. (Right) Compiled based on materials prepared by the Japanese Bankers Association.

- As the ratio of public debt-servicing expenditures to overall expenditures is high, a rapid interest rate rise may aggravate the fiscal position.
- Meanwhile, if the purchase of JGBs is continued even after the achievement of the price stability target, there is the risk of considerable price growth and an interest rate upsurge due to concerns over fiscal finance. It is necessary to take measures to achieve steady fiscal consolidation while there is market confidence.

Figure 1-2-10 (1) Changes in public debt servicing expenditures

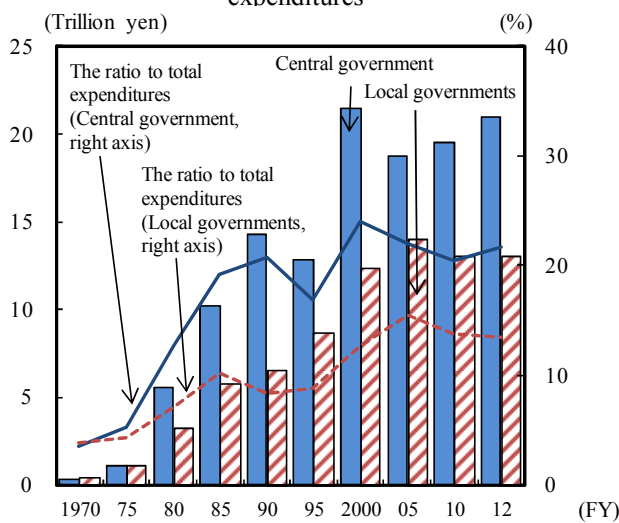
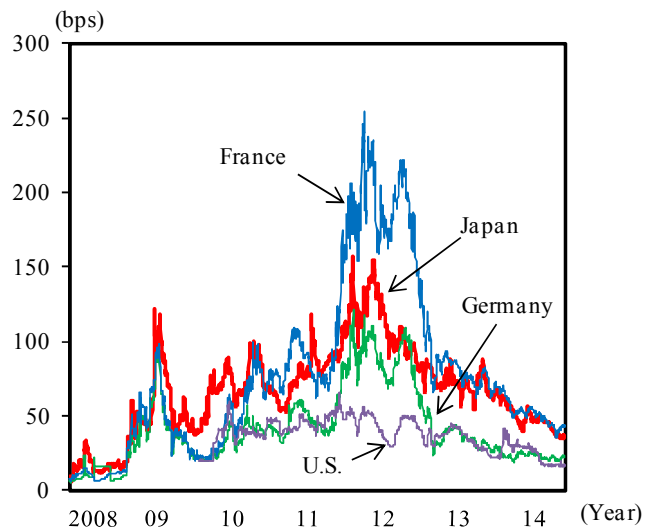


Figure 1-2-10 (3) Sovereign CDS spread (5 years)

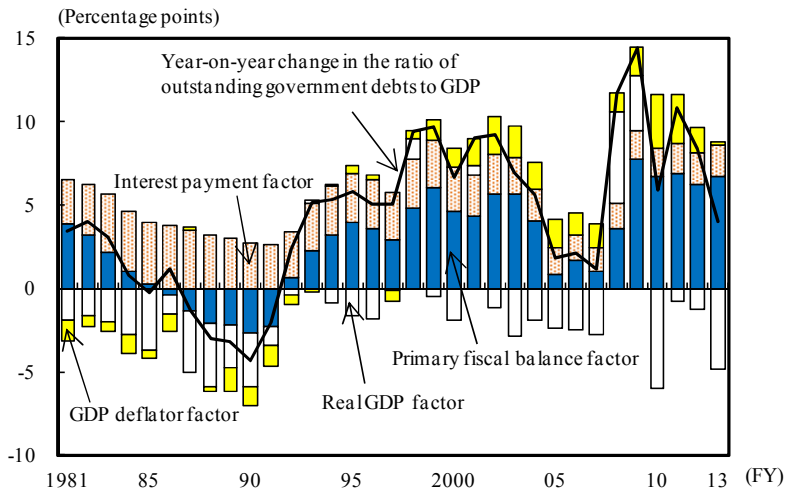


- (Notes) 1. (Left) Compiled based on materials prepared by the Ministry of Finance and the Ministry of Internal Affairs and Communications.
 2. (Right) Compiled based on data from Bloomberg.

Section 3 Economic Growth and Fiscal Consolidation

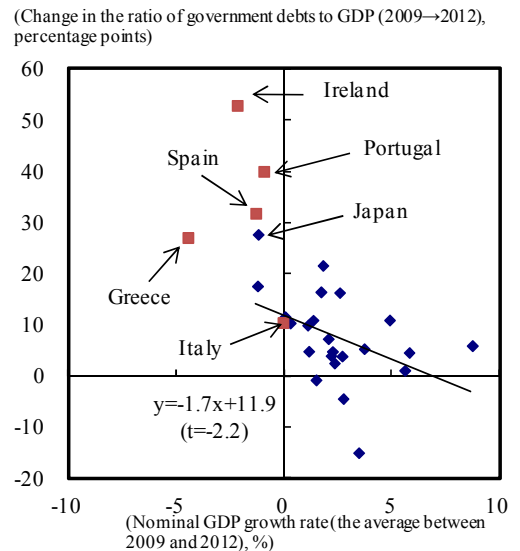
- The ratio of outstanding central and local government debts to GDP in Japan has been rising. The continued primary fiscal deficit and the stagnant nominal economic growth rate have contributed to the cumulative increase in outstanding debts.
- The higher the economic growth rate is, the lower the ratio of outstanding debts to GDP becomes. To achieve fiscal consolidation, it is important to raise the nominal economic growth rate by overcoming of deflation and steadily executing the growth strategy.

Figure 1-3-1 Factors that raise the ratio of outstanding government debts to GDP in Japan



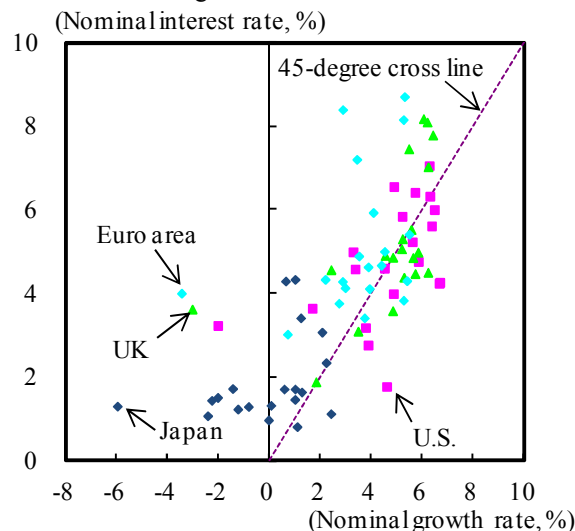
- (Notes) 1. (Left) Compiled based on the System of National Accounts and the Economic and Fiscal Projections for Medium to Long Term Analysis (announced in January 2014), the Cabinet Office; and materials prepared by the Ministry of Finance.
2. Compiled based on OECD, Stat; and the World Economic Outlook, the IMF.

Figure 1-3-2 (1) Nominal GDP growth rates and changes in the ratio of outstanding government debts to GDP



- In the most recent 20 years, the long-term interest rate has tended to be higher than the nominal economic growth rate. It is necessary to steadily rectify the primary fiscal deficit.
- Reducing tax distortions and implementing expenditure reduction measures that increase labor supply will be effective as fiscal consolidation measures that support economic growth.

Figure 1-3-3 (1) Nominal growth rates and nominal long-term interest rates



- (Notes) 1. (Left) Compiled based on OECD, Stat.
2. (Right) Compiled based on OECD Economic Department Working Papers No. 937 (2012). Regarding the “impact on per-capita GDP”, the mark “++” indicates a larger impact than the mark “+”. The measures with no mark are included in the above table as examples of policy measures whose direct impact is presumed to be negative but which are expected to improve economic welfare (environmental tax) or to keep the standard tax rate low by keeping the tax base low (value-added tax).

Table 1-3-4 Fiscal consolidation measures compatible with economic growth

Fiscal consolidation measures			Impact on per-capita GDP
Expenditures	Pension	Raising the starting age of pension benefits	++
	Medical care	Improving medical care efficiency	+
	Social transfer	Reducing unemployment benefits	+
	Education	Raising university tuitions	+
Revenues	Income tax (personal and corporate)	Expanding the tax base	++
	Value added tax	Expanding the tax base	
	Real estate tax	Expanding real estate tax	
	Environmental tax	Introducing environmental tax	

- The consumption tax hike as part of the integrated reform of social security and tax systems contributes to fiscal consolidation as well. However, further efforts to improve the fiscal balance are essential.
- Revenue from the consumption tax and personal income tax is low in Japan compared with in countries where abundant social security benefits are provided.

Figure 1-3-6 (2) Relationship between the Cabinet Office's Projections for Medium to Long Term Analysis and fiscal consolidation targets

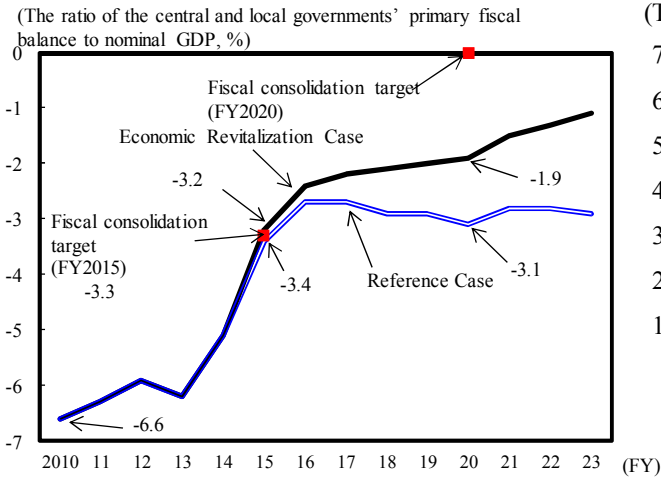
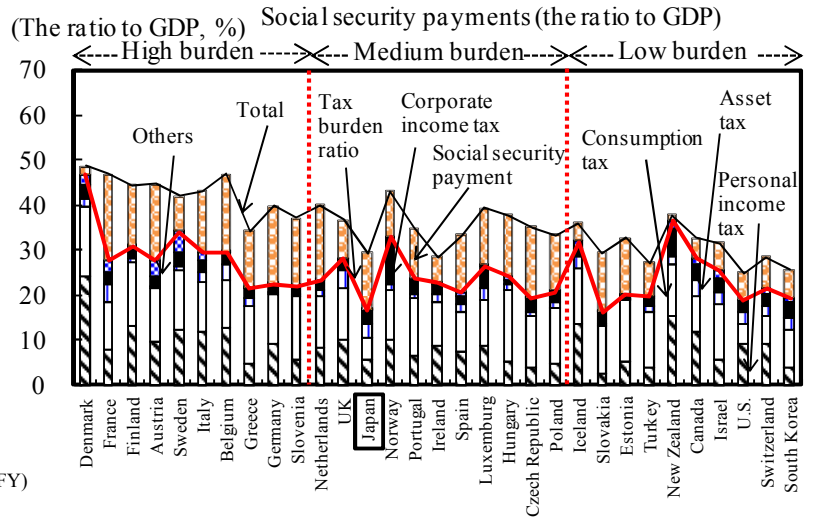


Figure 1-3-7 (2) The breakdown of the ratio of the burden of tax and social security payments (ratio to GDP) in OECD countries



- (Notes) 1. (Left) Compiled based on the Economic and Fiscal Projections for Medium to Long Term Analysis (announced in January 2014), the Cabinet Office
 2. (Right) Compiled based on "Revenue Statistics," "National Accounts," "Consumption Tax Trend 2012," OECD; and the System of National Accounts, the Cabinet Office.

- In Japan, the corporate tax rate is high, and the corporate tax burden ratio (corporate tax revenue divided by nominal GDP) and the dependence on corporate tax (corporate tax revenue divided by total tax revenue) are also high.
- Amid the prolonged deflation, corporate tax revenue has been eroded. The growth strategy intended to overcome deflation and raise the potential growth rate is important from the perspective of restoring tax revenue as well.

Figure 1-3-8 (1) Tax rates and the ratio of corporate tax payments (the ratio to GDP) (2012)

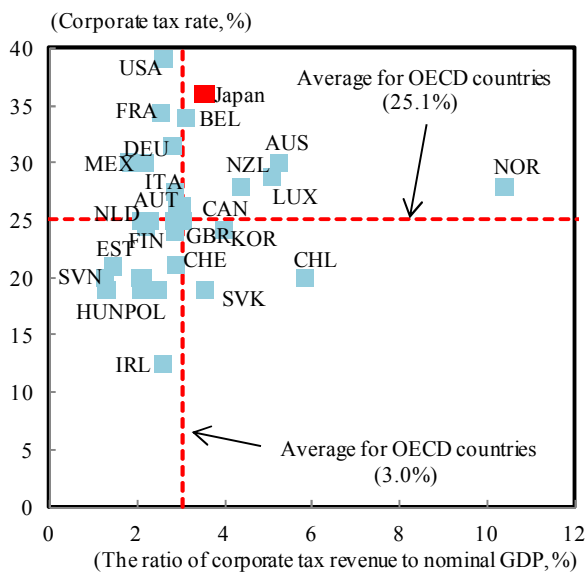
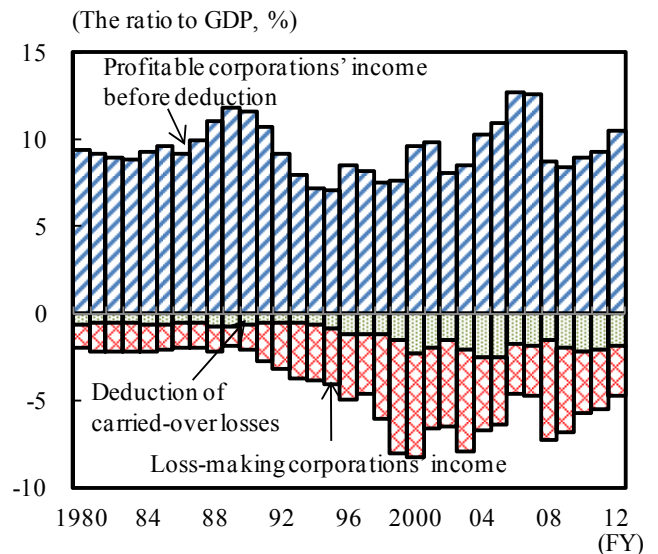


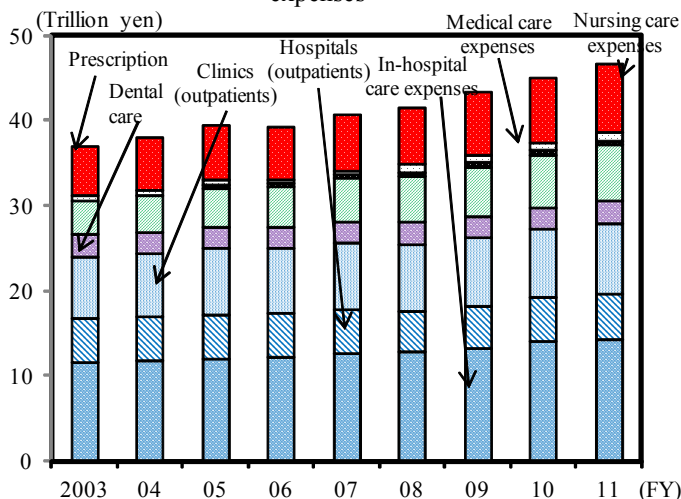
Figure 1-3-9 (1) Income of loss-making and profitable corporations and deduction of carried-over losses for profitable corporations (the ratio to GDP)



- (Notes) 1. (Left) Compiled based on "Tax Database," "Revenue Statistics," OECD; OECD. Stat; the System of National Accounts, the Cabinet Office; and materials prepared by the Ministry of Finance and the Ministry of Internal Affairs and Communications.
 2. (Right) Compiled based on the Actual Status of Corporations as Seen from Tax Statistics, the National Tax Agency; and the System of National Accounts, the Cabinet Office.

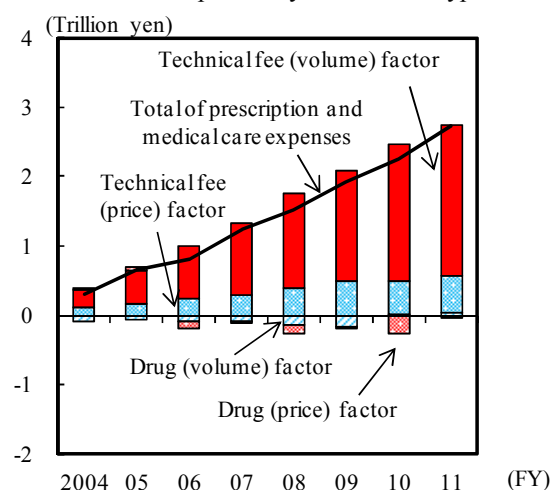
- Social security expenses have grown at a much faster pace than the economic growth rate. Growth in medical and nursing care expenses, which account for a large portion of social security expenses, are attributable mainly to increases in prescription, in-hospital care and nursing care expenses.
- Growth in the amount of prescribed drugs is contributing to the increase in prescription expenses. It is necessary to review the method of calculating drug prices and consider introducing the viewpoint of the cost-benefit balance when evaluating the application of insurance.

Figure 1-3-11 (1) Changes in medical and nursing care expenses



- (Notes) 1. (Left) Compiled based on the Estimates of National Medical Care Expenditure, the Report on the Status of Nursing Insurance Care and the Survey of Long-term Care Benefit Expenditures, Ministry of Health, Labour and Welfare.
 2. (Right) Compiled based on the Trend of Prescription and Medical Care Expenses (electronically-processed expenses), Ministry of Health, Labour and Welfare.

Figure 1-3-13 (1) Factors that increase prescription and medical care expenses by medical fee type



- In order to keep in-hospital care expenses at an appropriate level, it is necessary to keep the number of hospital beds (total number of hospital beds and the number of hospital beds by category, such as emergency care beds) at an appropriate level.
- It is important to establish medical and nursing care service provision systems that suit the local needs for medical and nursing care. To that end, it is necessary to formulate local medical care plans that take into consideration local medical care needs and establish local comprehensive care systems for promoting in-home medical care and nursing assistance.

Figure 1-3-16 (1) Changes in hospital beds by basic hospitalization fee

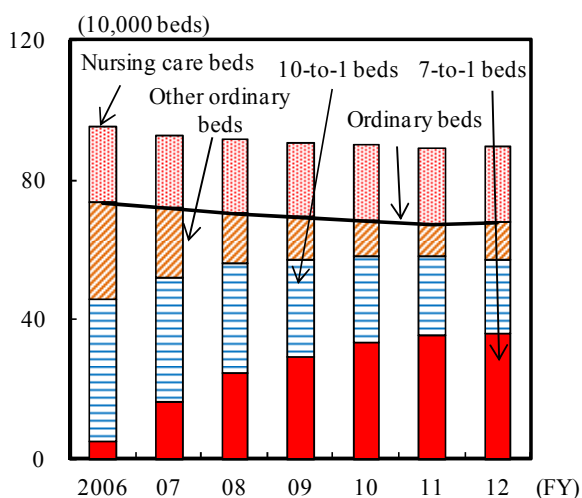
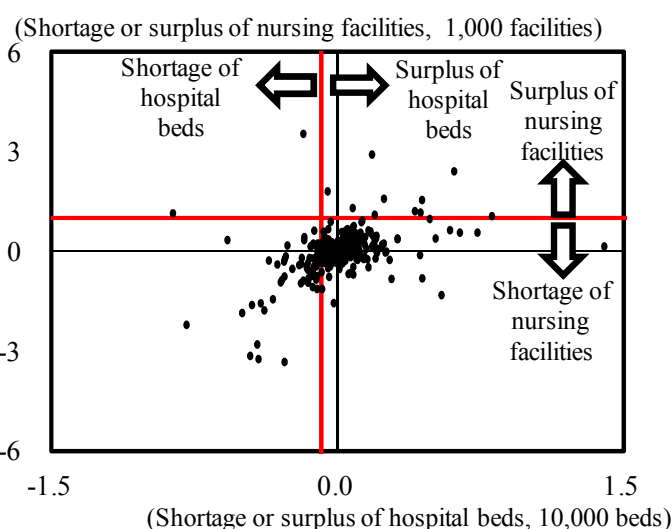


Figure 1-3-17 (2) Distribution of nursing facilities and hospital beds by secondary medical care area



- (Notes) 1. (Left) Compiled based on "Status of Notification concerning Major Facility Standards, etc.," the Central Social Insurance Medical Council.
 2. (Right) Secondary Medical Care Area Database, Wellness; Status of Applications for Admission to Special Nursing Care Homes for Elderly People and the Report on Hospitals, and Hospital Report, the Ministry of Health, Labour and Welfare.