Prospects & Challenges for the Japanese Economy Ahead of a Decision on a Consumption Tax Hike in April 2017


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In looking at the immediate prospects for the Japanese economy, including this year, and with the House of Councilors election coming up in the summer, one of the biggest challenges it faces is the "decision on a tax hike" — in other words, the political decision on whether to raise the current 8% consumption tax rate to 10% in April 2017. Why is the decision on a tax hike so important?

To begin with, the Cabinet approved the "Basic Policy on Economic and Fiscal Management and Reform 2015" (the so-called Basic Policy 2015) at the end of last June, embodying new financial reconstruction plans. The Basic Policy 2015 sets the traditional target of turning the Primary Balance (PB), which combines the national and regional balance sheets, to a surplus by fiscal 2020, and it also embodies a guideline for the PB deficit ratio for fiscal 2018 to be set at around 1% of GDP. The Cabinet Office then published a revised version of the "Mid- to Long-term Estimates on the Economy and Finance" (so-called mid- to long-term estimates) at the Council on Economic and Fiscal Policy meeting which convened in January 2016. According to the estimates, it has become clear that even under the optimistic high-growth (real GDP growth rate moving around 2%) "economic revitalization scenario", a PB surplus, which the government targets for fiscal 2020, cannot be achieved, and rather it will be a deficit of 6.5 trillion yen.

Moreover, this "economic revitalization scenario" assumes a raise in the consumption tax rate to 10% in April 2017. This means that if the tax hike is postponed beyond April 2017, the PB surplus for fiscal 2020 will increase, and this raises the bar even higher in achieving a PB surplus in 2020.

In addition, if one were to look at the sustainability of Japanese public finances from a long-term perspective, not just the short or mid-term perspective like 2017 or 2020, it is clear that there is no time to waste in postponing the tax hike beyond April 2017. One source that is useful to this extent is the "Long-term Estimates of Japan's Public Finance" which the Sub Working Group on the Fiscal System of the Fiscal System Council of the Ministry of Finance published in the form of a submission by a Draft Review Committee member on Oct. 9, 2015. The estimates were revisions of the long-term estimate figures published in April 2014, and project an outlook for the impact of increasing social security costs on the long-term financial landscape, as a result of an aging population, under several scenarios up to fiscal 2060. They also estimate the PB improvement range required for financial stabilization (=stabilization of the debt balance as a percentage of GDP after 2060).

The key message of these estimates is that under each scenario a fundamental reform of the social security system is necessary to control the emanation of debt balance (as a percentage of GDP). The estimates highlight that a 2.46% to 11.12% improvement in the PB balance as a percentage of GDP is necessary. Below is a brief description of the scenarios and projections.

A consumption tax hike in April 2017 is assumed to be implemented under each scenario, but the estimates are weak in spending reform around social security costs, and touch on several scenarios based on the current system, including one where the PB balance is not achieved in fiscal 2020, both on a national and local level (scenario 1), and one where the PB balance is achieved (scenario 2).

Under each scenario, if the real GDP growth rate drops to 0.4% after 2024, the PB improvement ratio (against GDP) for the government that is required for financial stability under scenario 2 is 9.78% (equivalent to a 19.5% supplementary tax increase under consumption tax rate conversion). But the same ratio is 11.12% (equivalent to a 22.2% supplementary tax increase under consumption tax rate conversion) under scenario 1. This indicates that if a PB surplus is not achieved in fiscal 2020, the account balance improvement range required for financial stabilization rises by 3% under consumption tax rate conversion. It also indicates that if sharply increasing social security expenditures are not controlled, and financial reconstruction takes the form of an increase in the consumption tax rate, then the final consumption tax rate will be 32% under scenario 1, and around 29% under scenario 2.

This means that the decision to raise the tax rate in April of fiscal 2017 should become a major political issue for the Japanese economy in 2016. But the national and local debt to GDP ratios both exceed 200%, and from a mid- to long-term perspective it is important we stand straight and face the reality that "even if Japan were able to achieve a PB surplus in fiscal 2020, the financial situation still remains grim."

With such a situation in mind, Prime Minister Shinzo Abe spoke about raising the consumption tax rate to 10% in April 2017, saying "Unless there is an event like the Lehman Shock, the plan (to raise the tax rate) remains on schedule." I believe this view is correct for the following three reasons.

Sustainability of Japanese Public Finances

The first is that the time remaining for sustainable Japanese public finances is most likely around 15 years. Dr. Anton Brown and his team at the Federal Reserve Bank in Atlanta conducted research using a different approach from the aforementioned long-term estimates to analyze the sustainability of public finances. To be more concrete, under the assumption of an "implementation scenario" (a scenario that maintains the consumption tax rate of 10% while the expansion of social security expenditures is not controlled) and a "postponement scenario" (similarly, a scenario that maintains the 5% consumption tax rate), they conducted an analysis of how many more years it can be postponed before it reaches the limit where the consumption tax rate has to be raised to 100%. Under this analysis, public finances are deduced to be sustainable in the "implementation scenario" until 2032, and in the "postponement scenario" until 2028.

One needs to be careful and understand that it is obviously politically impossible to raise the consumption tax rate to 100% so that public finances can achieve stabilization. Similarly, it is also impossible to raise the consumption tax rate to, for example, 30% and cut expenditures by 70% to match the remaining 70% of the presumed 100% consumption tax rate.

The current consumption tax rate is 8%. Thus, on the basis of Dr. Brown's research, unless additional reforms are carried out, Japanese public finances will likely become unsustainable "around 2030", which is halfway between 2028 and 2032. In other words, if the analysis is appropriate, the time remaining for sustainable Japanese public finances is around 15 years.

Limit of Quantitative & Qualitative Monetary Easing

The second reason is the limitation of quantitative and qualitative monetary easing (the so-called "different dimension easing") by the Bank of Japan (BOJ). The reason why the debt interest payments are stable at around 10 trillion yen is because even when the government debt balance (against GDP) is increasing, the different dimension easing means the BOJ is buying large volumes of Japanese government bonds and controlling the interest rate below the 1% level. This is so-called "financial repression", but continuing this policy has its limitations. The reason is simple. With the additional easing of Oct. 31, 2014, if the BOJ continues to buy in government bonds at a pace that leaves an annual 80 trillion yen outstanding balance in long-term bonds, there will be no government bonds left to trade in the market.

Very roughly, if the budget deficit (value of newly issued government bonds) is around 30 trillion yen, and if the BOJ purchases around 80 trillion yen net worth of government bonds from the market through different dimension easing, 50 trillion yen (80 trillion yen — 30 trillion yen) worth of government bonds that financial institutions own will be absorbed by the BOJ.

As of 2015, outstanding government bonds amount to around 800 trillion yen, and the BOJ already holds around 300 trillion yen worth of government bonds. Simple calculations show that in roughly 10 years [(800 — 300) trillion yen divided by 50 trillion yen], the BOJ would have bought all the government bonds and the bond market will have dried up. To be more precise, banks, insurance companies, pension funds etc. are required to hold a certain amount of government bonds for asset management purposes, and I therefore estimate that the different dimension easing is likely to hit its limit around 2017.

On Jan. 29, 2016, the BOJ decided at its Policy Board and Monetary Policy Meeting (by a vote of five to four) to implement a negative interest rate for the first time in Japanese history. Can we then expect results from this negative interest rate policy? The conclusion is, unfortunately, we cannot. The mechanism of the negative interest rate that the BOJ introduced is the same layer method that Europe (Switzerland, Germany, and others) has already adopted, and under this method private banking institutions' accounts with the BOJ ("BOJ Current Account", balance at around 250 trillion yen as of the end of December 2015) are divided into three layers, and each account is applied a positive interest rate (0.1%), zero interest rate, and a negative interest rate (-0.1%).

The negative interest rate policy poses two serious problems, aside from other challenges such as crushing of the interest rate term spread (the difference between the long-term and short-term interest rates) and the possibility of a weakening profit base for banks as the profit margins on loans shrink. The first major problem is the transfer of costs that arise with the introduction of negative interest rates. Just as the three Japanese mega-banks have already lowered their interest rates on some of their savings accounts, other banks can transfer the cost on to depositors by lowering interest rates or by increasing the account maintenance commissions and ATM transaction fees. But it is difficult to transfer the costs on to depositors by lowering the deposit interest rate to a negative figure.

What about transferring the costs to debtors? There has been media coverage talking about expectations of a negative interest rate on housing loans, but that is an outlook that is too optimistic. For example, Swiss banks have begun transferring the rise in negative interest rate costs to mortgage interest rates, although some instances may be attributed to the fact that the Swiss housing loans market is oligopolistic. In Japan, loans have not increased as expected despite the monetary base having increased by two times with the quantitative and qualitative monetary easing. This is primarily due to the declining population and lack of domestic demand. Thus, it is quite difficult to transfer the costs of negative interest rates simply by increasing loans or the lending rate. Rather, the costs need to be absorbed by the banking sector, primarily those regional banks whose profit base is limited.

Another problem is the debate that has long been ongoing about the way monetary policy is structured based on "rule" versus "discretion". If the discretion for a negative interest rate policy is bigger, then it poses the risk of losing the trust that market participants have placed in the BOJ. This is because it is unclear which range of the BOJ current accounts the negative interest rates apply to. This has prompted the BOJ to release a "Q&A on the Quantitative and Qualitative Monetary Easing with Negative Interest Rates", which explains that of the BOJ current accounts, the initial volume that negative interest rates apply to is 10 trillion yen. Then it goes on to explain that the 10 trillion yen may be controlled to 30 trillion yen. But just as the BOJ governor went ahead with the introduction of a negative interest rate this year after having denied the policy would be introduced at the Diet, the volume or range of the negative interest rate may suddenly change course. If the trust placed in the BOJ begins to rock, the buying operation of government bonds will cause an underbidding and "the quantitative and qualitative monetary easing with negative interest rates" policy will have the inherent risk of hitting a wall very soon.

Assessing Growth Rate Under Declining Population

The third reason is the assessment of Japan's potential growth rate (real GDP growth rate), which shows the real abilities of the Japanese economy. The Cabinet Office released the first preliminary quarterly estimates of GDP on Nov. 16, 2015. According to the release, the real growth rate for the period July to September 2015 was a negative 0.2% quarter on quarter, confirming two consecutive quarters of negative growth. It is important to note that the growth rate was negative for two consecutive terms, but with the effect of a fast-declining population in place, and because the potential growth rate is almost zero, "negative growth = recession" does not necessarily hold true.

According to the estimates by the Cabinet Office, the potential growth rate during the 1980s was 4.4% and for the 1990s 1.6%, and it is still declining today with the potential growth rate since 2013 at 0.5% to 0.8%. The estimate for the period January to March 2015 was at 0.6%, but the estimate was revised downward to 0.5% for the period March to June 2015.

On the potential growth rate, if productivity does not rise, from a mid- to long-term perspective, the real GDP growth rate may turn out to be constantly negative. In fact, in forecasting the Japanese economy in 50 years from now, the final report by the government's "Choice for the Future" Commission (released in November 2014) discloses its estimations of a low growth rate at a negative 0.1% annually after 2040 if the declining population issue is left untouched, and if productivity also remains low.

In other words, under the current circumstance where the potential growth rate is almost zero, it is too early to say that we are in a recession just because the real GDP growth rate is negative, and there is a need to look at the various economic indicators comprehensively, and soundly, in order to make judgements.

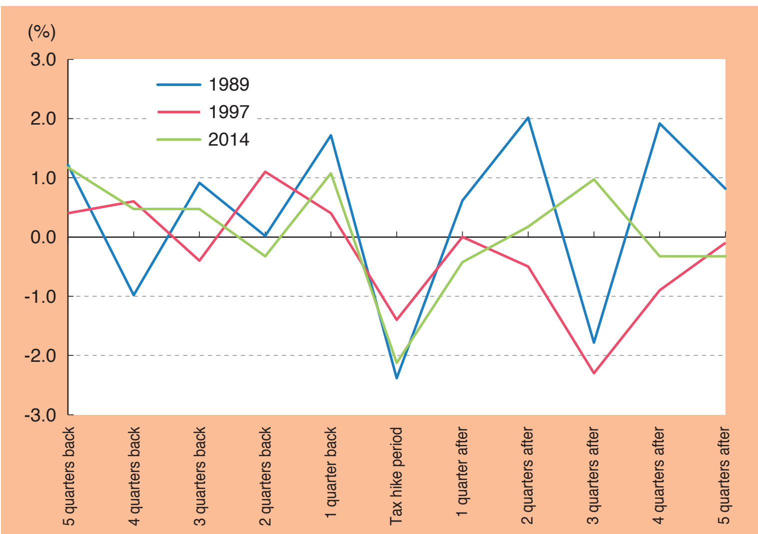
Assessing Past Impacts of Tax Hikes

On this note, I would like to briefly touch on the tax hike in April 2014, when the consumption tax was raised from 5% to 8%. Looking at the aforementioned first preliminary quarterly estimates of GDP, it may seem like an increase in the consumption tax to 10% in April 2017 is highly ambitious, but that may not necessarily be the case. Consumption tax hikes have occurred three times: when it was first introduced in 1989 (0% to 3%), in 1997 (3% to 5%), and most recently in 2014 (5% to 8%). But when making assessments of the impact of a tax hike in relation to growth rates, the analysis has to be made by comparing it to the trend growth rate (= potential growth rate). In other words, it is correct to define the magnitude of the impact of a consumption tax rate hike as being "real growth rate — trend growth rate".

Therefore, the *Chart* shows estimated calculations of "real growth rate — trend growth rate", using such data as the aforementioned potential growth rate (4.4% during the 1980s, 1.6% during the 1990s, and 0.5% for the most recent period), the preliminary quarterly estimates of GDP released by the Cabinet Office, and other data. It shows that during the tax hike period (April to June), the refraction range of the real growth rate was "1989 (2.4% decrease) >2014 (2% decrease)> 1997 (1.4% decrease)", and the effect of the tax hike was greater than the 1997 period, but slightly smaller than 1989.

But it also shows that the "real growth rate — trend growth rate" for the fifth period after the tax increase (July to September 2015)

CHART
Trends in "Real Growth Rate – Trend Growth Rate" before & after tax increase



Source: System of National Accounts, Cabinet Office, Japan was negative, and it is apparent that a sound decision is needed to determine whether it is feasible to raise the consumption tax rate to 10% in April 2017 as planned, by paying close attention to the future trends of the Japanese economy.

Cyclical trends also need to be closely monitored. The Cabinet Office made a judgement on the cyclical trends of the economy based on discussions by the "Diffusion Index Research Committee", chaired by Prof. Hiroshi Yoshikawa of the University of Tokyo. According to the judgement, which was released on July 24, 2015, the peak of the 15th economic cycle which began in March 2009 was confirmed to be in March 2012, and the trough in November 2012. This means that the current economic cycle began in November 2012, immediately before Abe came to power, and the released documents also showed that the past economic expansion period lasted, on average, three years (36.2 months).

If that is the case, then currently three years have already past, and the economic expansion period can end at any moment. But as mentioned in the previous sections, considering the limitations of public finances or the different dimension easing, just as Abe said, raising the consumption tax rate needs to happen in April 2017, unless something like the Lehman Shock occurs. In other words, Abe's statement is correct.

Double Election Scenario

The real issue is the political dynamics of Japan, with the House of Councilors election coming up in the summer of 2016. On this point, it is worth noting that the convocation date of the ordinary Diet session was Jan. 4, 2016, the earliest since 1992. In this case, the end date of the ordinary Diet session is June 1, 2016, but in considering the Public Offices Election Act and the possible date for the House of Councilors election whose members end their terms on July 25, there is a possibility of a double election for both the House of Representatives and the House of Councilors. Even if it does not turn out to be a double election, there is a possibility of a sudden decision to hold an election for the House of Representatives, before or after the election of the House of Councilors.

One such indicator of this double election possibility is Abe's sudden decision to dissolve the House of Representatives on Nov. 18, 2014 and call a general election. He determined that there were increasing concerns of a downward trend in economic growth, and in order for the Japanese people to vote on a year-and-a-half postponement of the consumption tax hike, which was planned for October 2015, he officially announced the dissolution of the House of Representatives. Immediately afterwards, I decided to publish my book *Depths of the Financial Crisis: Tax Hike, Pensions, and Government Debt* (in Japanese, NHK Shuppan Shinsho, 2014). Below is a quote from it that illustrates my impression of the current financial situation.

> There is a movie called The *Titanic*. The bottom of the magnificent luxury cruise ship hits an iceberg and is damaged. The ship slowly submerges and sinks. But on deck, the band keeps on playing music as if nothing is happening, perhaps knowing that the ship is capsizing and sinking, but clinging naively to the perception that "the damage is small, this cruise ship cannot possibly sink". I cannot help but be reminded of this scene from the movie when I look at the current financial situation in Japan.

A consumption tax hike postponement has already taken place, but a further extension will clearly induce huge skepticism about the outlook for the Japanese financial situation. Unless an unusual incident such as the Lehman Shock or the Great East Japan Earthquake occurs, it is not a wise choice to postpone a hike in the consumption tax any longer.

Turning Point for the Japanese Economy

Ultimately, there are only three methods of financial reconstruction — a tax hike, spending cuts and economic growth. Of these, the only method that is not painful is economic growth with financial restructuring. But while economic growth is important in expanding national income, a financial restructuring that relies on it is a gamble. As stated in my third point, in the scenario where the declining population is left untouched and productivity remains low, the real GDP growth rate for the mid to long term may be negative. That means that to restructure Japanese public finances, a tax hike and spending cuts need to be implemented. Therefore, the true nature of the confrontation over another tax hike is not one of implementation or postponement, but rather of taking in the pain now or facing even greater pain in the near future, and choices should be made accordingly.

Needless to say, a fundamental reform of the social security system should be at the core of spending cuts, and every Japanese citizen should exercise their vote to determine the future direction of this country in the election scheduled this year. The time remaining for us is now very limited, and 2016 will most likely be an important turning point in determining the future direction of the Japanese economy, including whether to raise the consumption tax rate or not.

On June 19, 2016, the Amended Public Offices Election Act that lowers the voting age to 18 will be enacted. Together with the young generation who will now have voting rights, we need to acknowledge the importance of each and every vote that we exercise, and think about the welfare of the future generations. This year will be one in which the responsibilities and commitments of all voters will be tested. JS

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