

J A P A N

TOWARDS A NEW DYNAMIC GROWTH
Highlights from the 2013 OECD Economic Survey of Japan

APRIL 2013



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Japan - Towards a New Dynamic Growth

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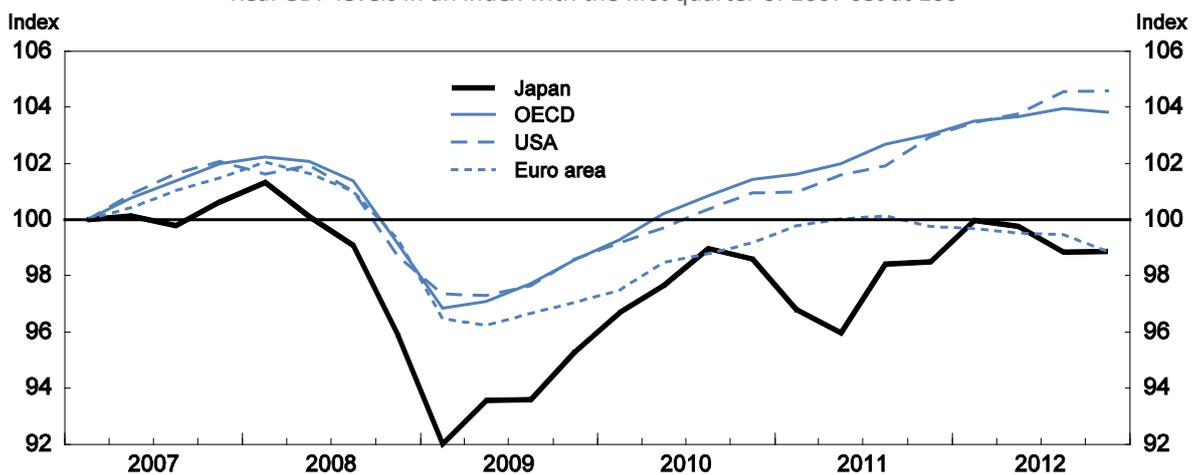
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INTRODUCTION

After two severe shocks – the 2008 global financial crisis and the 2011 Great East Japan Earthquake – Japan fell into recession for the third time in five years. The public debt ratio has risen steadily for two decades, to over 200% of GDP. Strong and protracted consolidation is therefore necessary to restore fiscal sustainability, which is Japan's paramount policy challenge. However, this will slow nominal GDP growth, making fiscal adjustment still more difficult. Hence, exiting deflation and boosting Japan's growth potential are key to addressing the fiscal predicament. In this light, the new government's resolve to revitalise the economy through a three-pronged strategy combining bold monetary policy, flexible fiscal policy and a growth strategy, is most encouraging.

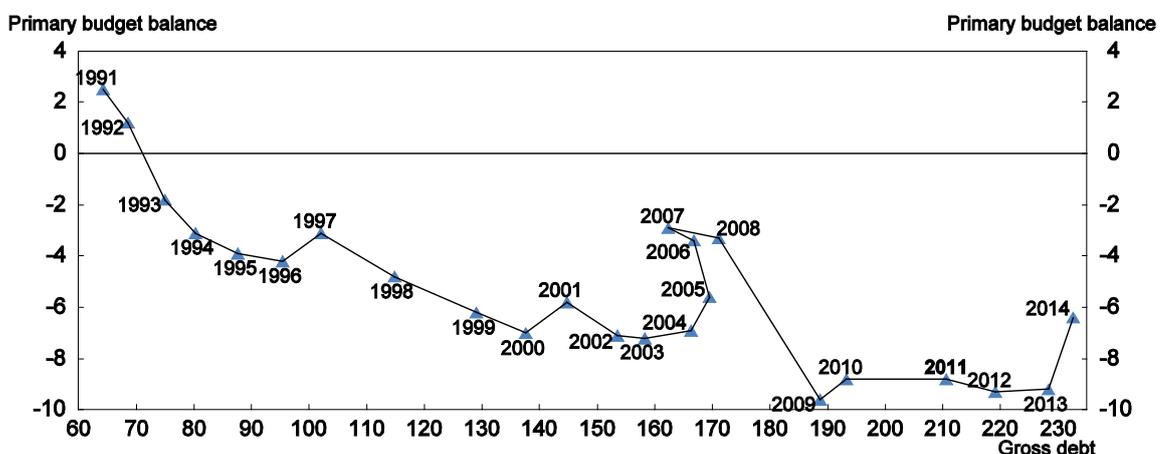
The full implementation of the three-pronged strategy, which is aimed at exiting deflation and revitalising the Japanese economy, is of the utmost importance, particularly to restore fiscal sustainability, but also because of the ramifications for the world economy.

Japan has faced two major shocks since 2008
Real GDP levels in an index with the first quarter of 2007 set at 100



Source: OECD Economic Outlook Database.

Japan's fiscal situation has deteriorated sharply over the past 20 years¹
Primary budget balance² and gross government debt as a per cent of GDP

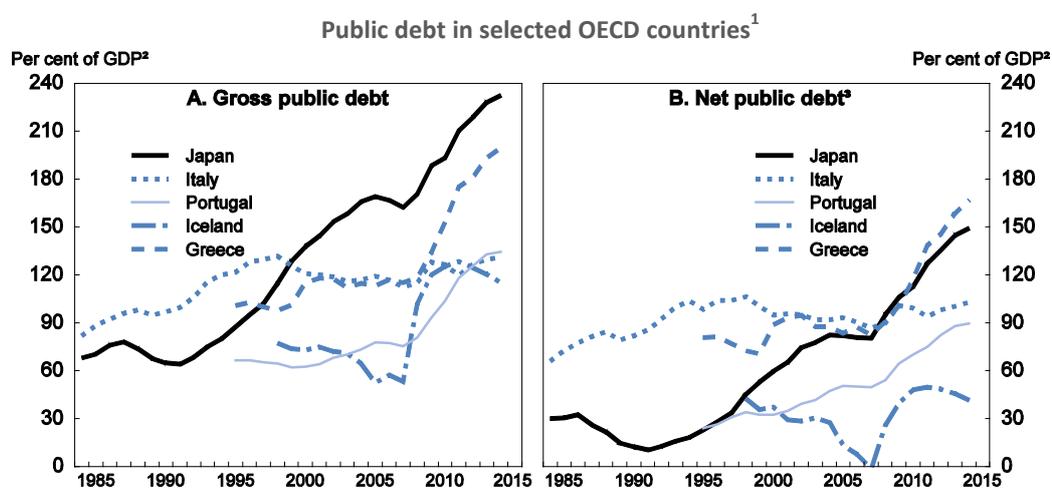


1. General government basis.
2. Excluding one-off factors.

Source: OECD Economic Outlook Database.

RESTORING FISCAL SUSTAINABILITY

Stopping and reversing the rise in the debt-to-GDP ratio is crucial. Stabilising the public debt ratio by 2020 may require, depending on the evolution of GDP and interest rates, an improvement of the primary fiscal balance from a deficit of 9% of GDP in 2012 to a surplus as high as 4% by 2020. Controlling expenditures, particularly for social security in the face of rapid population ageing, is key. Substantial tax increases will be needed as well, although this will also have a negative impact on growth. Given the size and duration of fiscal consolidation, Japan faces the risk of a marked rise in interest rates, threatening a banking system that is highly exposed to Japanese government debt.



1. The five countries with the highest gross debt ratios (gross liabilities divided by GDP) in the OECD area in 2010.
2. OECD estimates for 2012 and projections for 2013-14.
3. Net debt is gross debt less financial assets held by the government.

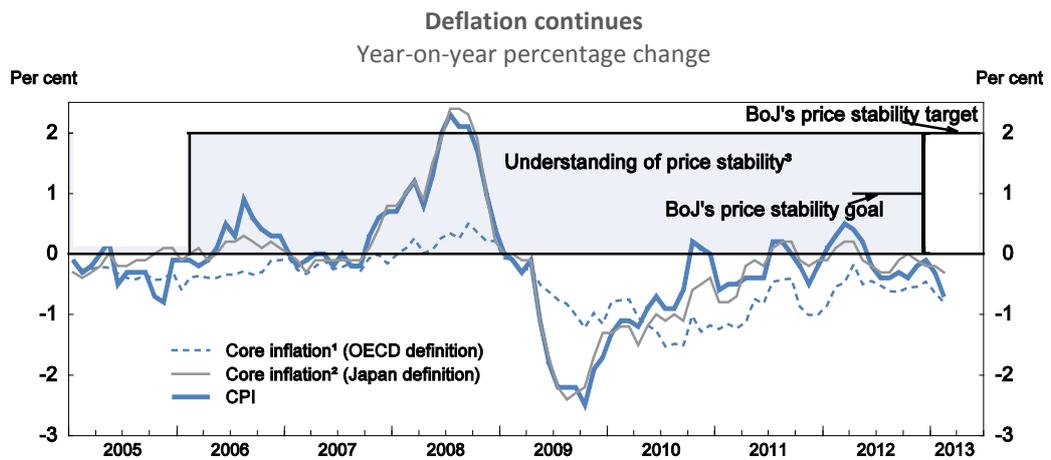
Source: *OECD Economic Outlook, No 92, and revised OECD estimates and projections for Japan for 2012-14.*

KEY OECD RECOMMENDATIONS

- Target a primary budget surplus large enough to stabilise the debt ratio by 2020 and set out a detailed and credible plan, including spending goals by category and a timetable for tax hikes, to reach the target.
- Implement the planned hike in the consumption tax rate in two stages to 10% by 2015, while maintaining a single rate to avoid the distortions associated with multiple rates.
- Reform social security programmes, including hiking the pension eligibility age, to contain spending growth.
- Rely primarily on the consumption tax but also on other indirect taxes, such as environment-related levies, as well as the broadening of personal and corporate income tax bases, to boost government revenue.
- Use the Council on Economic and Fiscal Policy as an expert body to guide and monitor fiscal consolidation.

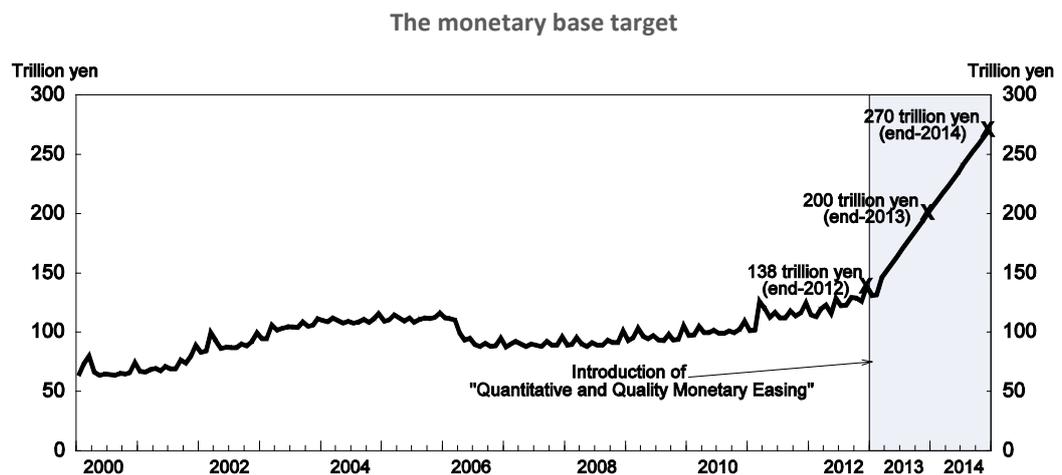
ENDING DEFLATION

Ending 15 years of deflation is a priority. The Bank of Japan's new commitment to a 2% inflation target and "quantitative and qualitative monetary easing" is welcome. The planned doubling of the monetary base, through expanded purchases of government bonds with longer maturities and private assets, is aimed at achieving the inflation target in about two years. Aggressive monetary easing will boost growth and inflation, in part through a weaker yen, although Japan is not targeting the exchange rate.



1. Excludes food and energy.
2. Excludes only fresh food.
3. Of the Bank of Japan's Policy Board members.

Source: Bank of Japan and OECD Economic Outlook Database.



Source: Bank of Japan.

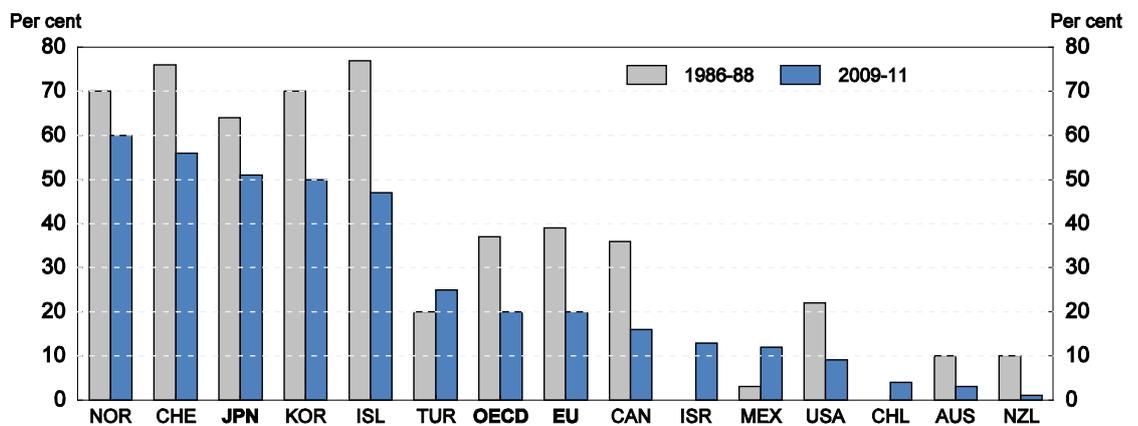
KEY OECD RECOMMENDATIONS

- Implement the "quantitative and qualitative monetary easing" to achieve the new 2% inflation target as early as possible.
- Maintain an expansionary policy stance until inflation has durably reached the 2% target level.

REFORMING AGRICULTURE AND PROMOTING JAPAN'S INTEGRATION IN THE WORLD ECONOMY

Reconstruction from the tragic 2011 disaster highlights some of the structural reform challenges facing by Japan. Reform of agriculture, an important sector in the Tohoku region, is a priority. The high level and distortionary nature of agriculture support imposes heavy burdens on consumers and taxpayers, undermines the dynamism of the farming sector, complicates Japan's participation in comprehensive bilateral and regional trade agreements, and entails environmental costs.

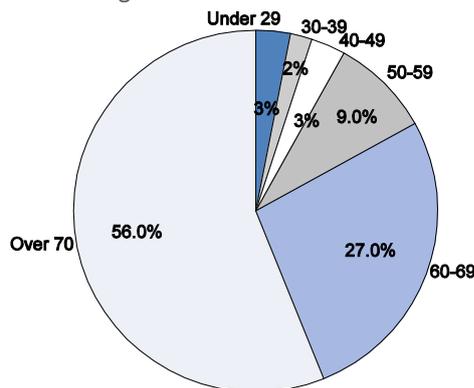
The Producer Support Estimate for Japan is one of the highest in the OECD¹



1. Producer support is the annual monetary value of gross transfers from consumers and taxpayers arising from policies that support agriculture as a per cent of the value of gross farm receipts.

Source: OECD PSE/CSE Database 2012.

Japan's farm work force is elderly
The age distribution of rice farmers in 2010



Source: Ministry of Agriculture, Forestry and Fisheries.

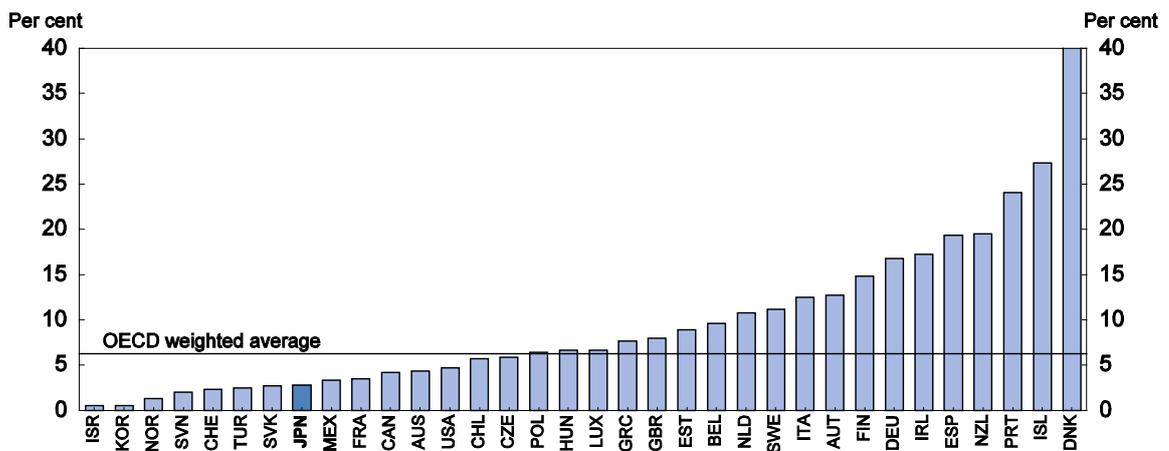
KEY OECD RECOMMENDATIONS

- Shift from market price supports to decoupled payments, while phasing out supply control measures.
- Promote the consolidation of farmland to lower production costs.
- Liberalise border measures on agricultural goods as domestic reforms advance, thereby facilitating participation by Japan in comprehensive regional and bilateral trade agreements, including the Trans-Pacific Partnership.

PROMOTING GREEN GROWTH AND RESTRUCTURING THE ELECTRICITY SECTOR

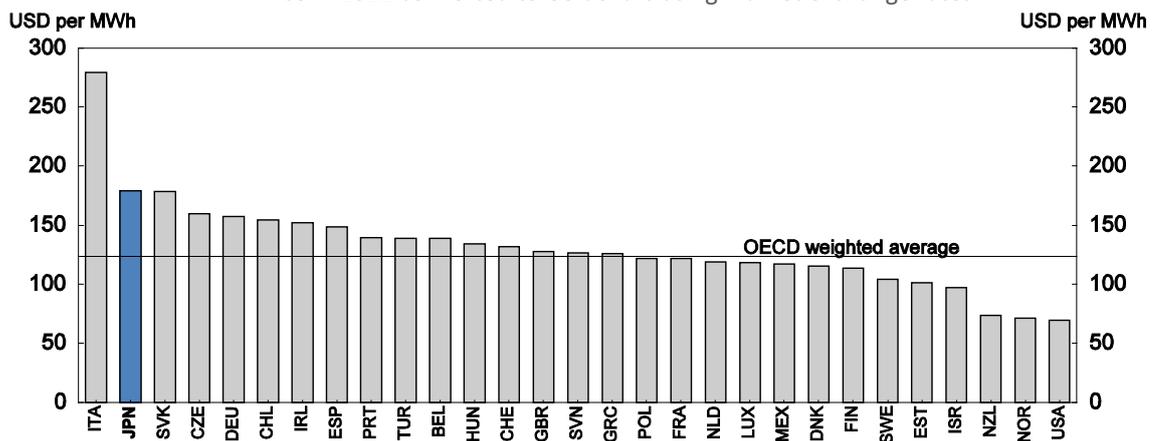
The reduced role of nuclear power following the Fukushima accident calls for accelerating the development of renewable energy over the long run. This would be facilitated by fundamental reform of the electricity sector to reduce the negative impact of integrated, regional monopolies and the lack of an effective price mechanism.

Share of non-hydro renewable energy in power generation in Japan is low
In 2011



Source: OECD/IEA Renewables Information Database.

Japan's electricity price in the industrial sector was one of the highest in the OECD in 2011
Price in 2011 converted to US dollars using market exchange rates



Source: OECD/IEA, Energy Prices and Taxes 2012.

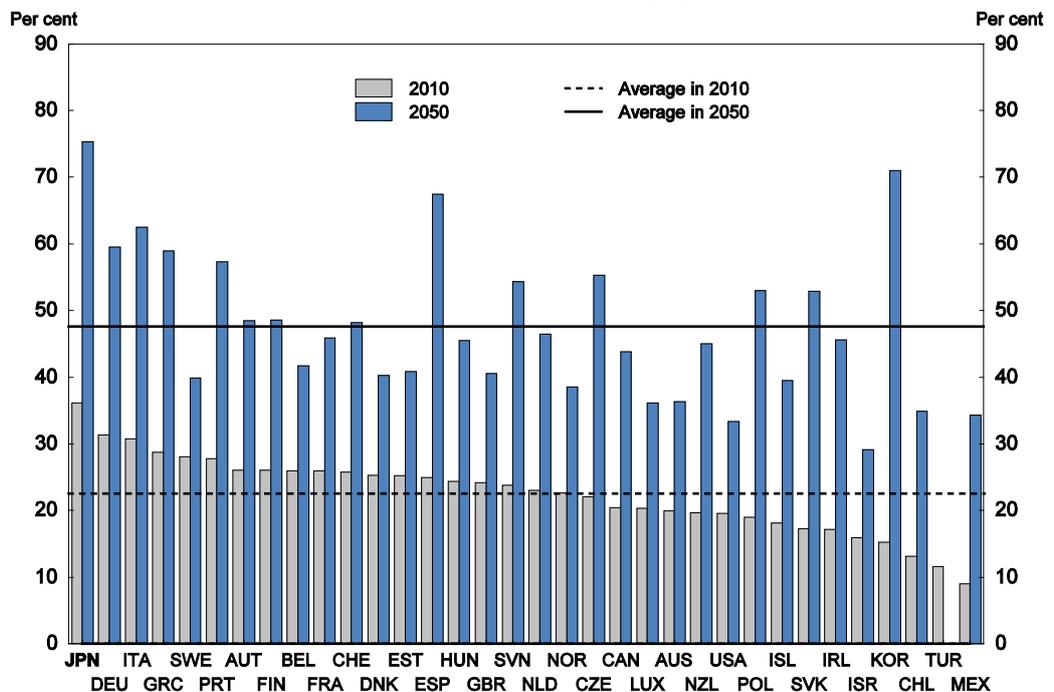
KEY OECD RECOMMENDATIONS

- Offset the decline in nuclear power by expanding the role of renewable energy through green growth policies, including a strong and consistent price on carbon through a carbon tax in combination with an emissions trading system.
- Create a more competitive electricity sector by reducing the dominance of the ten regional monopolies through ownership unbundling of generation and transmission and expanding the wholesale market.
- Ensure the independence of the new Nuclear Regulatory Agency and create an independent regulator for the electricity sector to promote competition.

INCREASING LABOUR FORCE PARTICIPATION AND RAISING PRODUCTIVITY THROUGH EDUCATION

Boosting labour force participation and productivity are essential. With the working-age population projected to fall by 40% by 2050, measures are needed to make the most of Japan's human resources, including women, older persons and youth. The tax and social security systems and inadequate childcare facilities create work disincentives for secondary earners, primarily women. For older workers, mandatory retirement at age 60 ends careers prematurely, especially as Japan has the highest life expectancy in the world. Educational reforms are needed to help boost productivity, beginning with more investment in pre-primary education. Japanese universities do not rank high in international comparison in many respects, including in their contribution to innovation.

Japan's population, already the oldest in the OECD, is ageing rapidly
The over-65 population as a share of the working-age (15 to 64) population



Source: OECD Demography and Population Database.

KEY OECD RECOMMENDATIONS

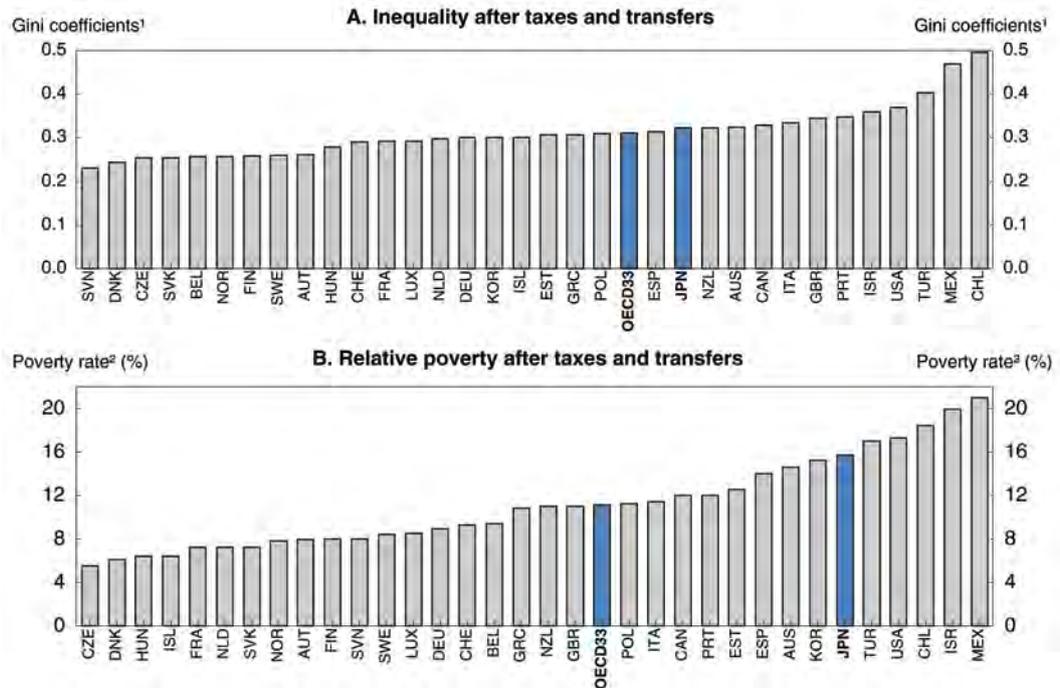
- Increase female participation by reforming the tax and social security systems, encouraging better work-life balance, increasing the availability of affordable childcare and breaking down labour market dualism.
- Encourage greater use of flexible employment and wage systems, in part by abolishing mandatory retirement at age 60, to lengthen the careers of older workers.
- Improve tertiary education by strengthening competition through increased transparency about performance and internationalisation of universities, while expanding their role in innovation.

PROMOTING SOCIAL COHESION

Fiscal consolidation may adversely affect inequality and poverty. Both have risen in recent years, with Japan's relative poverty rate now the sixth highest in the OECD. The redistributive powers of the tax and benefit systems are weak in Japan, while the high share of low-paid, non-regular workers contributes to inequality. Labour market dualism is driven in part by higher employment protection for regular workers, encouraging firms to hire non-regular workers to enhance employment flexibility, and by the lower labour cost of non-regular workers. The reliance on private, after-school lessons, particularly in juku, perpetuates inequalities, as their high costs makes participation dependent on family income.

The level of income inequality and relative poverty in Japan are relatively high

Working-age population in the late 2000s



1. The Gini coefficient ranges from 0 (perfect equality) to 1 (perfect inequality). Market incomes are all gross incomes from earnings, savings and capital. Disposable income adds transfers and subtracts taxes.
2. The relative poverty rate is defined as the share of population that lives on less than half of the median income

Source: OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*.

KEY OECD RECOMMENDATIONS

- Break down labour market dualism by upgrading training programmes and increasing the social insurance coverage of non-regular workers and reducing effective employment protection for regular workers.
- Enhance the redistributive power of tax and benefit systems by increasing the share of net benefits received by low-income persons, while providing training and incentives to leave assistance for those able to work.
- Introduce an earned income tax credit, while enhancing transparency about income.
- Reduce reliance on private, after-school lessons, particularly in juku, and ensure access to high-quality early childhood education and care for children from low-income families.

More information about Japan at www.oecd.org/japan.

For the 2013 OECD Economic Survey of Japan, visit: www.oecd.org/eco/surveys/japan-2013.htm



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