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THE ECONOMIC RESEARCH ORGANIZATION
AT THE UNIVERSITY OF HAWAI'I

Forecast Project

Saving, Investment, and Japan's Current Account Balance

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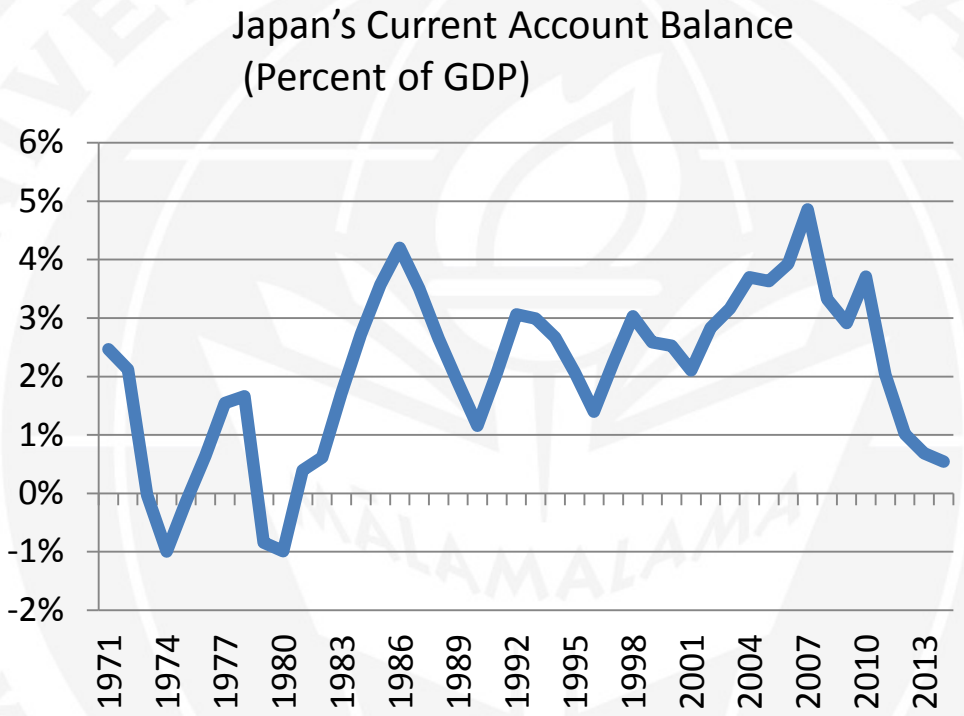
11th Global Meeting of the National Transfer Accounts Network

Dakar and Saly, Senegal, June 20-24, 2016

Japan's persistent surplus

- **Japan's current account in surplus for three decades**
  - Support for export-led growth, capital flows to other countries, but exporting unemployment?
- **Gap has closed recently**
  - Special circumstances
  - Changes in macro fundamentals that have supported high saving
- **Might current account deficits be the new norm?**
  - How will saving change compared with investment?



Our objective

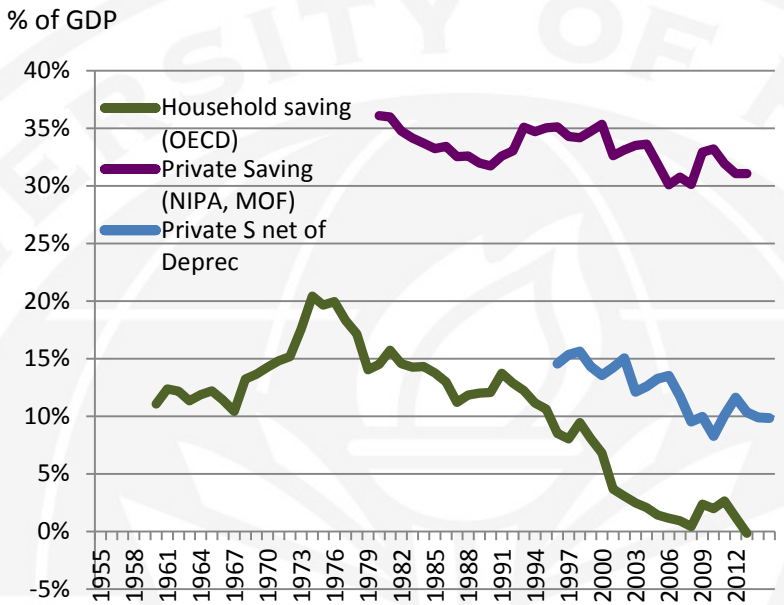
- **Evaluate Japan's current account from a macroeconomic perspective**
  - Recent adjustment
  - Prospects
    - What are the implications for saving and investment of coming demographic change?
    - Of requirement that public finance be sustainable?
    - Simulations in National Transfer Accounts context
  - Unfinished business: Why we really need a global perspective

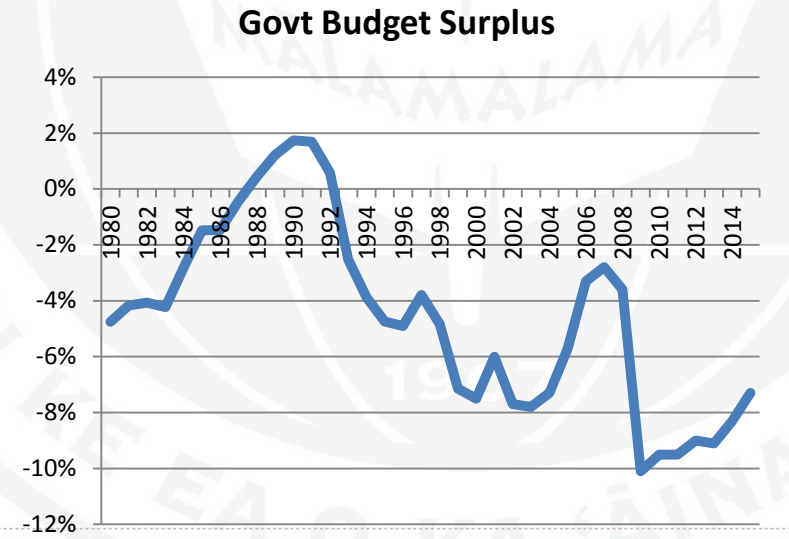
The macro perspective on the current account

- **Trade perspective**
  - CA = X - M + NFI + NTR
- **A macro perspective: Saving and investment**
  - CA = CF = S – I
  - National saving includes private saving and the government budget surplus

Japan's changing saving and investment

- **Personal saving has trended lower**
  - *Life-cycle* saving supported high rates in the past
- **Government budget has deteriorated**
  - From surpluses in 1980s to deficits of 9–10% of GDP





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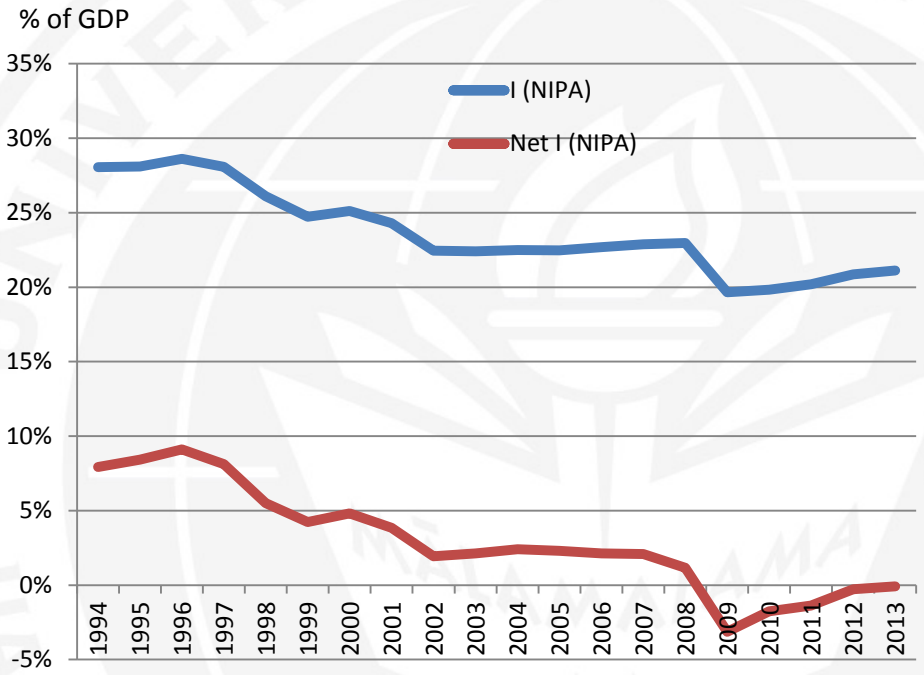
Japan's changing saving and investment

- **Investment has also fallen**
  - Lower productivity growth, flattening labor force, and slowing growth



Japan's changing saving and investment

- **Note**
  - There are important demographic stories
  - Cyclical factors can explain a portion of both
  - And there have been special factors
    - Post-Fukushima energy imports
    - Competitiveness and outsourcing?

Current account prospects

- **Aging population will reduce life-cycle saving needs**
  - But people could retire later; female labor force participation could rise, fertility could recover
  - Government transfer cuts could affect behavior
  - Not all saving is life-cycle related
- **Shrinking labor force will reduce investment**
  - But incentives for labor-saving investments
- **Government budget will have to improve**
  - Otherwise debt will balloon to 400% of GDP by 2040
  - Growing fiscal burden of population aging will make this very difficult
- **No consensus in the literature on the net effect on the current account**

Projecting drivers of the current account

An NTA structure for projecting S, I and the CA

- **Private saving**
  - Individuals at each age receive labor income, private asset income, public and private transfer inflows, and net transfers from abroad
  - They pay taxes and allocate disposable income across consumption, saving, and outward transfers
  - Ratios of consumption and saving by age are fixed; transfers vary with age structure
  - Aggregate private saving evolves along with age structure
- **Public saving**
  - Given policy, taxes and public transfers change with demography, with implications for government's budget balance and debt position
  - We assume changes in tax and spending profiles needed to create a sustainable fiscal path
- **Investment**
  - Output changes with effective labor force and exogenous productivity growth (no feedback from investment and capital formation)
  - Net investment as needed to maintain fixed capital/output ratio

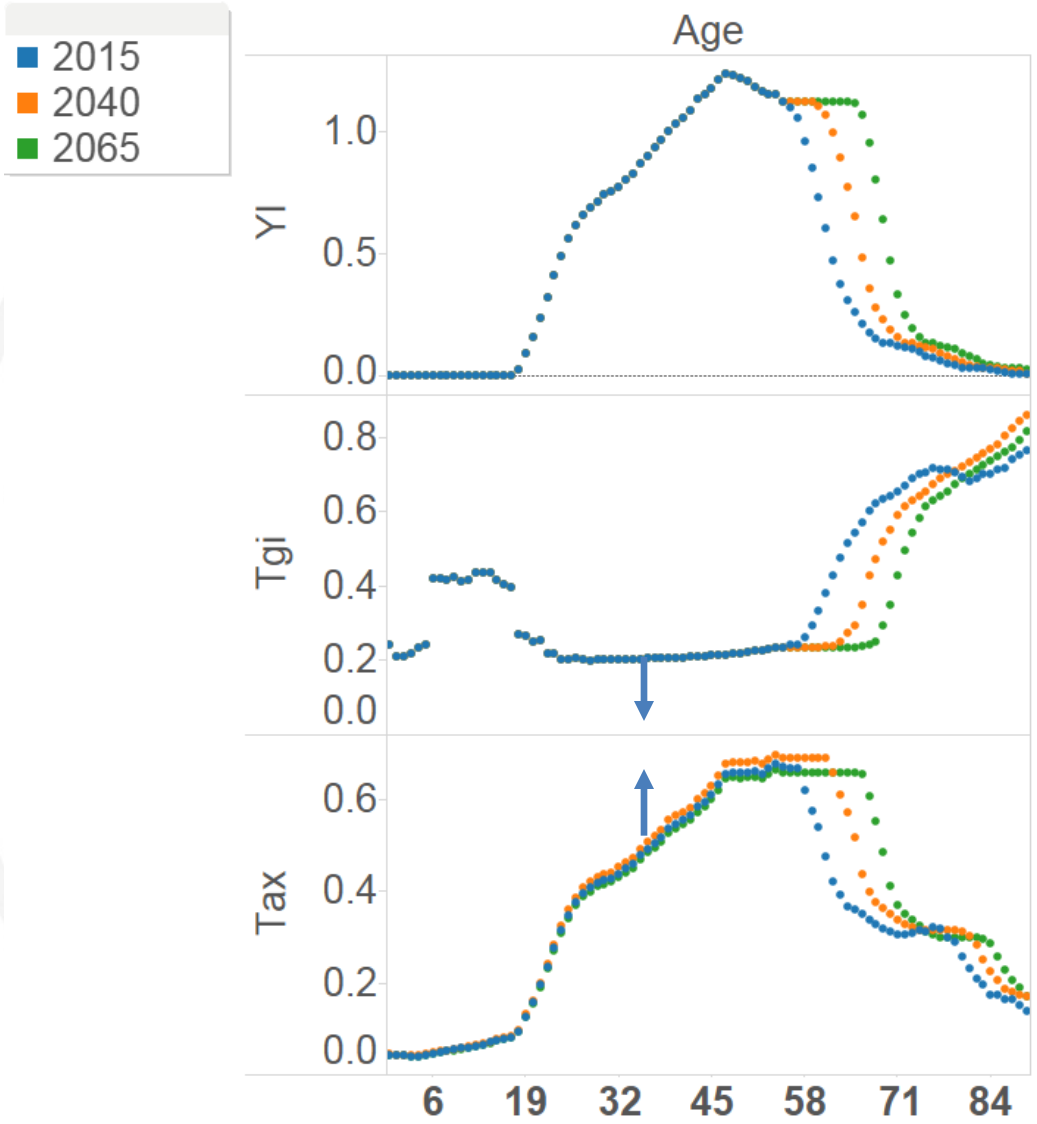
Alternative scenarios

- **Japan's harsh fiscal reality will require big policy changes**
- **We simulate two paths**
  - ***Status quo scenario.*** Normalized age profiles of public transfer inflows and taxes are held fixed at their initial year values
  - ***Survival-linked scenario (life-cycle reform).*** Normalized age profiles of labor income, public transfer inflows, and taxes are indexed on age-specific survival rates as a proxy for life expectancy and health

- **In both cases, we restrict net debt/GDP ratio to 125% and size of government to 45% of GDP**
  - Public transfers are reduced at each age and taxes are raised to meet these constraints

Survival-linked reform

- Survival-linked scenario pushes “retirement age” out by about ten years over the century
- Raises labor income and taxes for older residents
- And reduces their transfer inflows
- In each case transfers get pushed down and taxes up as fiscal constraints bind

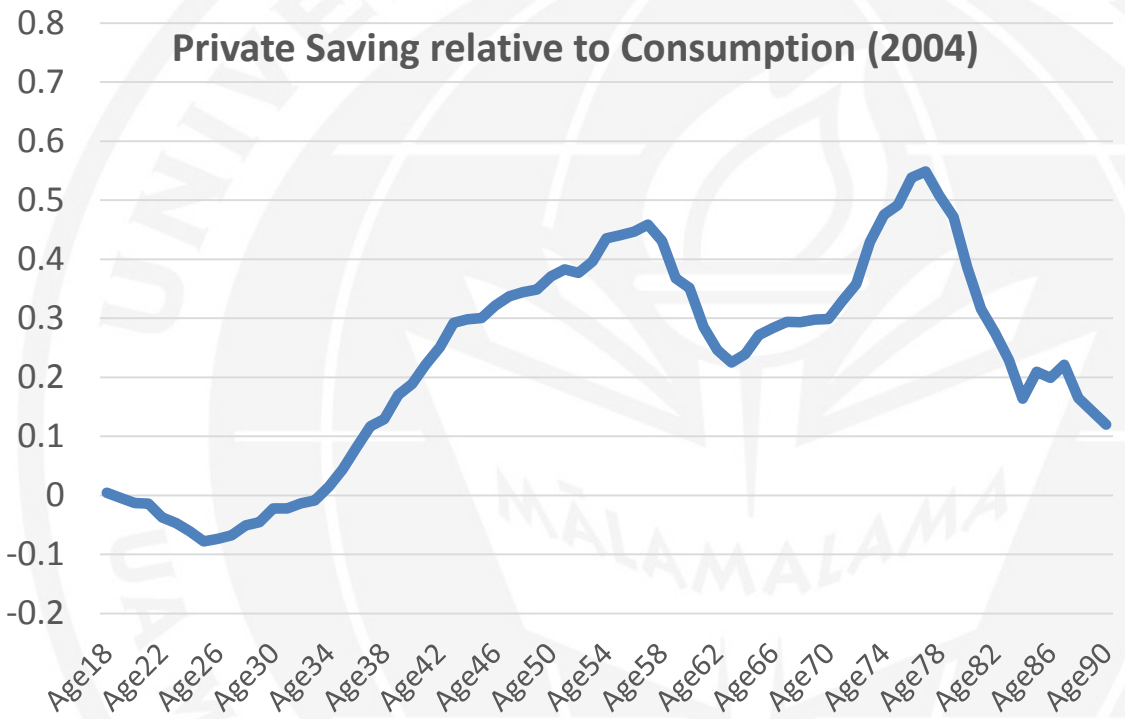


The saving rate remains high

- **Public dissaving is reduced rapidly under fiscal constraint**
  - Required adjustments are smaller in survival-linked case
- **Private saving rate remains in the 10% range**
- **There is no marked downward trend in national saving**

Saving does not decline monotonically with age

- Econometric studies often predict savings will turn sharply negative as old-age dependency rises
- But Japanese saving remains high in retirement
- A life-cycle based alternative NTA projection has some savings decline, although not a turn to negative



Current account surpluses widen and persist

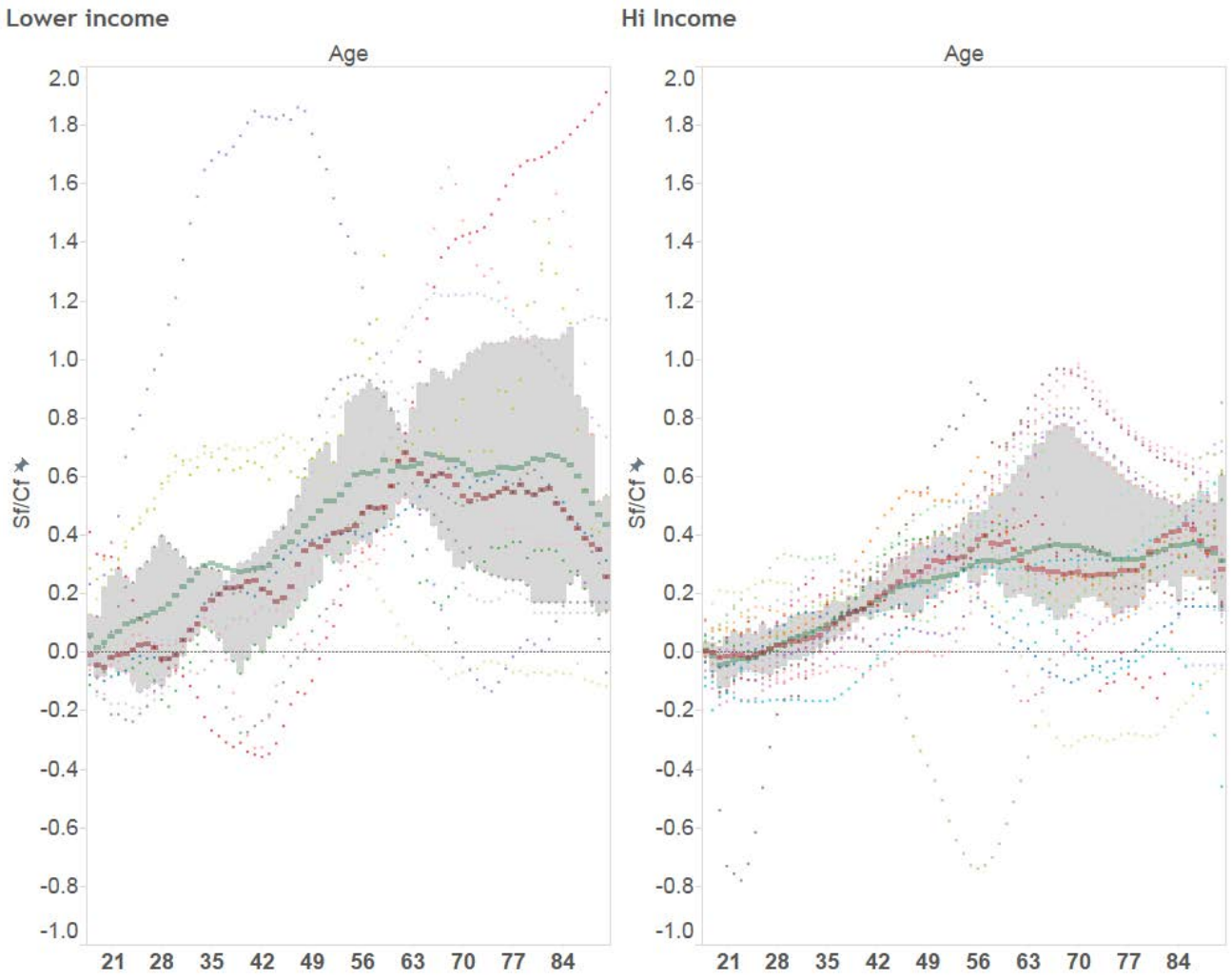
- **So national saving jumps and remains high**
- **Investment declines**
  - Less in the survival-linked case because effective LF decline is smaller
- **Current account surpluses actually widen in the near term and remain positive**

The global context

- **CA surpluses of this size will probably not be sustained**
  - Feldstein-Horioka result
  - Adjustments inside Japan?
  - Adjustments in Japan's external relationships?
- **The need for a global context**
  - Current accounts balance globally
  - Where will the saving and investment be?
- **There is some literature on expected patterns of capital flows**
  - Some predict capital will flow from aging countries to younger ones
  - But others find a move to deficits to meet aging needs
- **NTA data should be able to shed light on this**

A global saving glut?

- The pattern of persistently high elderly saving is shared by many countries
- How will this compare with investment demand?
- Implications for rates of return and S, I levels



Conclusion

- **Prospects for Japan's current account are more complex than commonly thought**
  - Change will depend on relative changes in saving and investment
  - Demographic change will play a major role
  - Government budget adjustment will be key
    - Has direct and indirect effects
  - Existing literature overestimates the decline in old-age saving
- **There is a great deal of uncertainty about all of these factors**
  - What will be relative magnitude and timing of SF, SG, and I?
  - Depends on behaviors that are hard to predict, reactions to policy
  - Global patterns of saving and investment will matter