

## 35. JAPAN

### Stimulus-driven growth in the near term

*Fiscal stimulus, postponed fiscal consolidation and continued monetary accommodation is set to underpin growth in 2016 and 2017, but waning stimulus effects and underlying weakness in domestic demand will weigh on economic performance in 2018.*

In 2016 real GDP is projected to grow by 0.7% underpinned by recovery in domestic demand and supportive macroeconomic policies. In 2017 postponed fiscal consolidation, additional fiscal stimulus and continued monetary accommodation are expected to maintain growth above potential at 0.8%. However, on the back of waning fiscal stimulus and underlying weakness in domestic demand growth is likely to decrease to 0.4% in 2018. Over the medium-term supply-side constraints in terms of adverse population dynamics and labour market rigidities are expected to continue weighing on growth in the absence of forceful structural reforms.

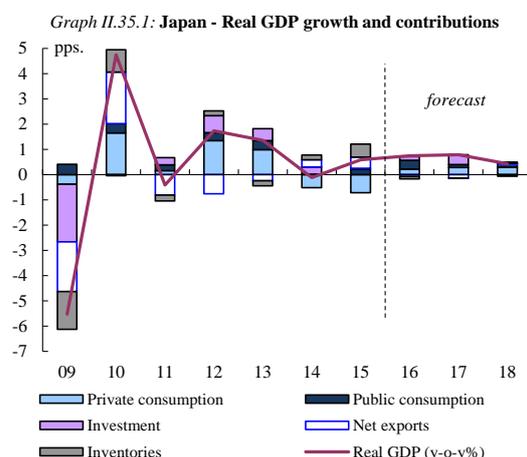
#### Near-term growth should remain resilient...

After contracting by 0.4% quarter-on-quarter in 2015-Q4, real GDP rebounded to 0.5% (q-o-q) in 2016-Q1. Growth moderated in Q2 to 0.2% (q-o-q) as net exports subtracted 0.3 pps to quarterly growth. Private consumption – which recovered only weakly in the aftermath of the April 2014 increase in the consumption tax rate – gradually firmed up over the first half of the year, and improved consumer confidence points to continued recovery. Private consumption is expected to grow gradually underpinned by fiscal stimulus supporting low-income households, moderate employment creation, and by subdued inflation dynamics. At the same time weak wage dynamics is projected to remain a drag over the medium term. Unemployment is expected to remain at the current low rate of around 3%, with employment increasing only moderately driven by the gradual recovery of domestic demand and persistent labour supply bottlenecks. However wage growth is set to remain subdued, reflecting entrenched duality in the labour market, weaker inflation dynamics feeding into lower pay rises in annual wage negotiations, and to some extent lower profits in the export sector (as a result of the stronger yen).

Gross fixed capital formation is expected to contribute to growth in 2016 and 2017, and subtract slightly in 2018 when stimulus-driven public investment expires. Housing starts are on an upward trend, pointing to a gradual recovery in

private residential investment after the collapse in the aftermath of the April 2014 increase in the consumption tax rate. Loose financing conditions and fiscal support for low-income households should underpin growth in housing investment over the forecast horizon, but weak household income growth and population decline should continue acting as drags over the medium term.

As the recently adopted fiscal stimulus is implemented, public infrastructure investment is expected to lift economic activity in the near term, whilst waning stimulus effects are expected to subtract from growth in 2018. Private sector core machinery orders – a leading indicator of business investment – suggest only moderate expansion over the second half of the year. Whereas supportive macroeconomic policies is assumed to also underpin business investment, the pace of growth is set to remain subdued as diminished external profitability and weak potential growth weigh on the business environment.



External demand has deteriorated over the first half of the year, with exports falling 1.5% (q-o-q) in 2016-Q2, and monthly export volume data suggest continued volatility stretching into the second half of the year. The outlook for exports has worsened due to weakening demand from China, and diminished profitability from the yen

appreciation. Overall net exports are expected to weigh on growth in 2016 and 2017, and remain broadly neutral in 2018.

#### ...underpinned by changes in fiscal policy...

Recent changes in fiscal policy had a substantial impact on the growth outlook. In early June the increase to 10% in the consumption tax rate previously planned for April 2017 was postponed to October 2019, which had the effect to smoothen near-term growth projections. In early August the government announced a large fiscal stimulus package including direct government spending equivalent to 1.5% of GDP, centred on supporting public infrastructure projects and improving income conditions in the nursing sector, which is set to boost economic activity in the near term. Fiscal consolidation is expected to pause over the forecast horizon, and the general government deficit should remain at around 5% of GDP.

#### ...and continued monetary accommodation.

Following a comprehensive assessment ahead of its September monetary policy meeting, the Bank

of Japan has introduced a new QQE framework with Yield Curve Control, which also includes an inflation-overshooting commitment entailing continued expansion in the monetary base until core CPI inflation exceeds the 2% target in a stable manner. CPI inflation has followed a downward trajectory over the last quarters, reflecting lower energy prices and gradual currency appreciation, and weighing on inflation expectations which have lowered adaptively. As inflationary pressures are expected to remain subdued reflecting lack of demand-driven inflation dynamics, monetary policy is set to remain accommodative in line with the inflation overshooting commitment aimed at triggering forward-looking inflation expectations.

#### Risks predominantly on the downside

Weaker profitability in the export sector may entail stronger-than-expected knock-on effects on wage growth and business investment. As potential growth remains weak, domestic risks prevail over the medium term, with underlying fragility in domestic demand and negative confidence effects due to lack of progress with fiscal consolidation possibly weighing on growth.

Table II.35.1:

#### Main features of country forecast - JAPAN

	2015			Annual percentage change						
	bn JPY	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP	499211.2		100.0	0.7	1.4	0.0	0.5	0.7	0.8	0.4
Private Consumption	292409.0		58.6	0.8	1.7	-0.9	-1.2	0.4	0.5	0.5
Public Consumption	101812.5		20.4	1.8	1.9	0.1	1.2	1.8	0.6	0.6
Gross fixed capital formation	108222.1		21.7	-1.4	2.5	1.3	0.0	0.7	1.9	-0.3
of which: equipment	-	-	-	0.2	0.3	3.5	-	-	-	-
Exports (goods and services)	89352.6		17.9	4.0	1.2	8.3	2.8	-1.0	0.8	1.0
Imports (goods and services)	94141.5		18.9	2.3	3.1	7.2	0.3	-0.7	1.8	0.9
GNI (GDP deflator)	522126.5		104.6	0.8	1.9	0.3	1.1	0.3	0.9	0.4
Contribution to GDP growth:		Domestic demand		0.5	1.9	-0.2	-0.5	0.9	0.9	0.3
		Inventories		0.0	-0.2	0.2	0.6	-0.1	0.0	0.0
		Net exports		0.2	-0.3	0.0	0.4	-0.1	-0.1	0.0
Employment				-0.3	0.6	0.6	0.4	0.8	0.3	0.2
Unemployment rate (a)				4.5	4.0	3.6	3.4	3.2	3.2	3.2
Compensation of employees / head				-0.8	0.0	1.1	0.6	-0.2	0.5	0.6
Unit labour costs whole economy				-1.8	-0.8	1.8	0.5	-0.2	0.0	0.4
Real unit labour cost				-0.6	-0.2	0.1	-1.5	-0.5	0.3	-0.1
Saving rate of households (b)				10.4	6.5	6.1	7.9	8.9	9.2	9.0
GDP deflator				-1.1	-0.6	1.7	2.0	0.3	-0.4	0.4
Consumer-price index				-0.1	0.3	2.8	0.8	-0.3	0.0	0.1
Terms of trade goods				-3.0	-2.2	-1.1	8.3	6.3	0.1	0.2
Trade balance (goods) (c)				1.7	-2.2	-2.5	-0.8	0.0	-0.1	0.0
Current-account balance (c)				3.0	0.7	0.5	3.2	3.7	3.7	3.7
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				2.9	0.5	0.5	3.2	3.7	3.6	3.7
General government balance (c)				-6.3	-7.7	-6.2	-5.3	-5.0	-5.1	-5.0
Cyclically-adjusted budget balance (d)				-	-	-	-	-	-	-
Structural budget balance (d)				-	-	-	-	-	-	-
General government gross debt (c)				176.3	244.5	249.1	248.3	250.7	254.7	257.7

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.