35. JAPAN

Historical growth revised upwards, outlook largely unchanged

Following methodological changes, the historical real GDP growth series was revised up significantly, but the outlook remains substantially unchanged. Economic growth is expected to pick up marginally to 1.0% in 2017 underpinned by supportive macroeconomic policies, and to slow to 0.5% in 2018 on the back of waning stimulus effects.

In 2017 economic growth is expected to pick up marginally to 1.0% as continued recovery in domestic demand is underpinned by sustained monetary accommodation, postponed fiscal consolidation, and additional fiscal stimulus. In 2018 the pace of expansion is projected to decelerate to 0.5% as waning fiscal stimulus should weigh on economic performance. Over the medium term, in the absence of more forceful structural reform, potential growth will remain weak reflecting supply-side constraints in terms of adverse population dynamics and labour market rigidities.

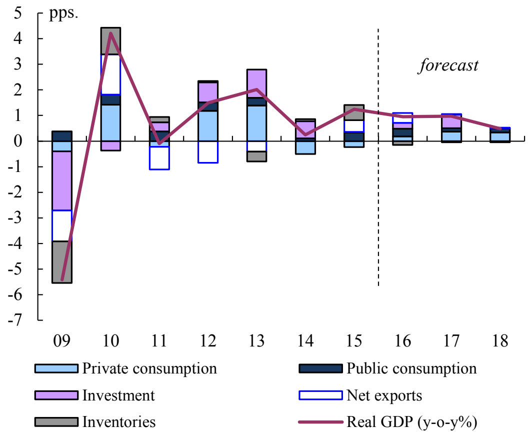
Historical growth has been stronger than previously estimated…

A comprehensive data revision mainly due to the transition from SNA 1993 to SNA 2008 entailed stronger historical growth than previously estimated. This is mostly the result of stronger growth in private non-residential investment stemming from changes in the accounting treatment of research and development (R&D) expenditure. According to the new data, between 2013 and 2015 the economy expanded at an average pace of 1.2% per year, compared to 0.6% according to SNA 1993 data. The economy performed better than previously estimated also in 2016. Real GDP rebounded to 0.7% (q-o-q) in 2016-Q1, before easing to 0.5% and 0.3% in 2016-Q2 and 2016-Q3 respectively. Overall growth for the year is estimated to come in at 0.9% reflecting the ongoing, moderate recovery in private consumption and investment and a positive contribution from net exports mainly stemming from a decline in import volumes.

…but the near-term outlook has not changed fundamentally.

Recovery in private consumption is set to carry on throughout the forecast horizon underpinned by fiscal support for low-income households, tight employment conditions and weak inflation. But subdued wage dynamics are expected to continue and weigh on growth over the medium term. Employment creation is likely to continue at a slower pace reflecting increasingly stringent labour supply bottlenecks, whilst unemployment should remain at around 3%. Wage growth will continue to be hampered by entrenched labour market duality and weak inflation passing through to limited pay rises in annual wage negotiations.

Graph II.35.1: **Japan - Real GDP growth and contributions**



Gross fixed capital formation is expected to contribute to growth in 2017 and remain broadly neutral in 2018 as stimulus-driven public investment expires, whilst private investment is projected to grow at a moderate pace. Housing starts point to a resilient recovery in private residential investment, which is expected to continue reflecting loose financing conditions, favourable employment dynamics, and fiscal support for low-income households. Business sentiment has deteriorated as heightened uncertainty surrounding external demand and profitability weighs on the outlook for private non-residential investment, which is projected to grow only modestly over the forecast horizon. Public investment is expected to lift economic activity in the near term, whilst waning stimulus effects should weigh on growth in 2018.

Export volumes are expected to increase at a moderate pace over the forecast horizon, reflecting the ongoing recovery in global trade and improvement in external competitiveness led by exchange rate dynamics driven by the US tightening cycle. As the recovery in domestic and external demand firms up, import volumes should gradually rebound from the slump in 2016. As a result, net exports are likely to remain broadly neutral in 2017 and 2018.

Data revisions point to a slightly better fiscal situation

Recent data revisions have lifted the 2015 nominal GDP level by 6.3%, which is having a positive effect on historical deficit- and debt-to-GDP ratios. According to the new data, the general government deficit declined from 7.6% of GDP in 2013 to 3.5% of GDP in 2015, which implies an additional 0.3 pps. consolidation compared to SNA 1993 data. The primary deficit reached 3.1% of GDP in 2015, which is below the intermediate target of 3.3% set by Japan to achieve a primary balance by fiscal year 2020. As additional fiscal measures were postponed beyond the forecast horizon, fiscal consolidation is expected to stall in the near term, and the general government deficit should hover at around 4% of GDP.

Monetary policy to remain accommodative

CPI inflation is expected to have bottomed out at -0.1% (y-o-y) in 2016. However inflationary pressures are likely to remain subdued in the near term, and to be mainly driven by exchange rate dynamics in response to monetary policy divergence among advanced economies, and global commodity price developments. Following the comprehensive assessment of Quantitative and Qualitative monetary Easing (QQE) in September 2016 and the introduction of the Yield Curve Control framework, monetary policy is set to remain accommodative in line with the Bank of Japan's commitment to a protracted easing cycle until CPI inflation exceeds the 2% target in a stable manner. CPI inflation is expected to pick up only gradually over the forecast horizon to around 0.5% (y-o-y).

Risks

Heightened uncertainty surrounding the external environment may be reflected domestically into weaker wage and investment dynamics than currently projected. Over the medium term domestic downside risks should prevail, reflecting weak and declining potential growth and incomplete structural reform.

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		530545.2	100.0	0.6	2.0	0.3	1.2	**0.9**	**1.0**	**0.5**
Private Consumption		300081.6	56.6	0.8	2.4	-0.9	-0.4	**0.3**	**0.6**	**0.6**
Public Consumption		105335.3	19.9	1.8	1.5	0.5	1.6	**1.5**	**0.7**	**0.7**
Gross fixed capital formation		124305.7	23.4	-1.4	4.9	2.9	0.1	**1.0**	**2.3**	**0.0**
of which: equipment		40361.2	7.6	0.4	-1.0	4.5	-2.8	**-**	**-**	**-**
Exports (goods and services)		93566.3	17.6	4.3	0.8	9.3	3.0	**0.2**	**1.0**	**1.0**
Imports (goods and services)		95280.0	18.0	2.3	3.3	8.3	0.1	**-2.0**	**0.9**	**0.7**
GNI (GDP deflator)		550623.6	103.8	0.7	2.7	0.6	1.4	**0.4**	**1.0**	**0.5**
Contribution to GDP growth:		Domestic demand		0.4	2.8	0.3	0.1	**0.7**	**1.0**	**0.5**
		Inventories		0.0	-0.4	0.1	0.6	**-0.2**	**-0.1**	**-0.1**
		Net exports		0.3	-0.4	0.0	0.5	**0.4**	**0.0**	**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	**3.1**	**3.1**	**3.0**
Compensation of employees / head				-0.6	-0.1	1.1	0.7	**0.1**	**0.7**	**0.8**
Unit labour costs whole economy				-1.5	-1.5	1.4	-0.1	**0.0**	**0.0**	**0.5**
Real unit labour cost				-0.5	-1.2	-0.4	-2.1	**-0.2**	**0.1**	**0.0**
Saving rate of households (b)				12.4	7.1	6.6	7.5	**8.7**	**9.4**	**9.5**
GDP deflator				-1.0	-0.3	1.7	2.0	**0.2**	**-0.1**	**0.5**
Consumer-price index				-0.1	0.3	2.8	0.8	**-0.1**	**0.4**	**0.6**
Terms of trade goods				-3.1	-1.4	-0.7	11.2	**4.6**	**0.5**	**0.3**
Trade balance (goods) (c)				1.9	-1.7	-2.0	-0.1	**0.7**	**0.9**	**1.0**
Current-account balance (c)				2.9	0.9	0.8	3.2	**3.9**	**4.1**	**4.2**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				2.8	0.7	0.7	3.1	**3.8**	**4.0**	**4.1**
General government balance (c)				-6.6	-7.6	-5.4	-3.5	**-3.7**	**-4.0**	**-3.8**
Cyclically-adjusted budget balance (d)				-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)				-	-	-	-	**-**	**-**	**-**
General government gross debt (c)				170.2	232.8	236.1	248.0	**248.8**	**250.6**	**252.0**

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