

## 35. JAPAN

### Continued moderate expansion

*Supportive macroeconomic policies and firming external demand are set to underpin the growth momentum in 2017, and entail a modest acceleration in the pace of growth. Economic performance is expected to weaken in 2018 as the effects from past fiscal stimuli wane.*

#### Pick-up in growth followed by deceleration

Continued implementation of Abenomics aiming at reflation the economy and achieving stronger growth has generated a positive impact, but real GDP and inflation targets remain ambitious. Real GDP growth is projected to pick up to 1.2% in 2017 on the back of the ongoing recovery in global demand, continued support from monetary policy, and expansionary fiscal policy. In 2018 the pace of expansion is expected to slow to 0.6% as waning fiscal stimulus is expected to dampen domestic demand. In the absence of more forceful structural reform supply-side constraints in terms of labour market rigidities and adverse population dynamics will continue weighing on potential growth over the medium term.

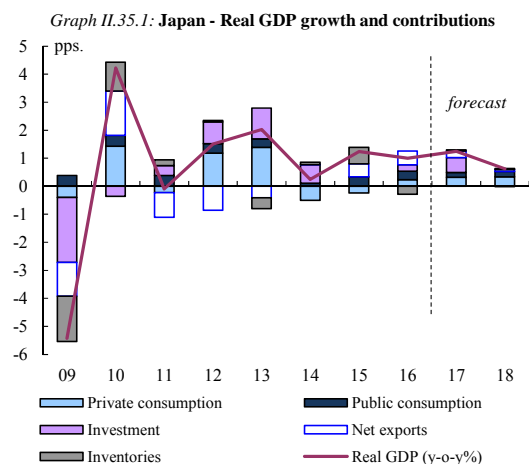
#### The near-term growth momentum has firmed

The economy grew for four consecutive quarters in 2016, supported by continued recovery in domestic demand and a pick-up in external demand in 2016-H2. Overall growth for the year came in at 1.0%, with domestic demand and net exports contributing 0.5 pps each. Leading indicators point to a stable growth momentum. Industrial production has been on a steady upward trend since 2016-Q1. Production plans, upward trending manufacturing PMI and rising business sentiment suggest a positive outlook, and continued expansion in the manufacturing sector. The tertiary activity index has been on a modest recovery trend, and rising PMI and sentiment indicators point to continued expansion ahead also in the services sector.

#### Continued recovery in consumption and investment

Private consumption growth turned positive in 2016 after two years of negative growth. Further moderate expansion is expected going forward, but no major acceleration. Consumer sentiment has picked up steadily, reflecting favourable labour market dynamics. The unemployment rate fell to below 3% in early 2017, and the new job openings-to-applicants ratio has been rising

steadily since 2009 to above 2. These very tight labour market conditions are bound to remain, reflecting rising labour supply bottlenecks and moderate employment creation. However wage dynamics are likely to be restrained on the back of entrenched duality between regular and non-regular workers, and modest gains expected in annual wage setting negotiations, as confirmed by preliminary shuntō data for 2017. Subdued wage growth and unfavourable demographic dynamics should entail only a mild expansion in private consumption over the forecast horizon.



Gross fixed capital formation is set to underpin growth in 2017, and come to a halt in 2018 as fiscal stimulus expires and the decline in public investment weighs on growth. Recovery in business sentiment and a steady upward trend in machinery orders point to a stable expansion in private non-residential investment in 2017, whilst the pace of growth should decline in 2018 reflecting weak growth prospects from negative population dynamics. Favourable labour market and financing conditions will support private residential investment, but the pace of growth should gradually decelerate on the back of demographic decline.

#### Supportive macroeconomic policies

Headline CPI inflation has been rising gradually (reaching 0.3% y-o-y in February 2017), but

survey- and market-based inflation expectations remain subdued. Rising commodity prices and currency depreciation stemming from monetary policy divergence among advanced economies imply further moderate inflationary pressures which should however remain moderate. Headline CPI inflation is expected to remain well below the Bank of Japan's 2% target, which should warrant continued accommodative monetary policy over the near term 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.

Fiscal consolidation has progressed at a stronger pace since 2013, spurred by stronger nominal GDP growth and higher revenues from the 2014 increase in the consumption tax rate. As a result the general government deficit has narrowed from 7.6% of GDP in 2013 to 3.7% in 2015, and is estimated to have remained at the same level in 2016. Looking ahead, fiscal policy should underpin near-term growth and turn expansionary in 2017 as the deficit is expected to widen to above 4% of GDP, before declining to around 3.5% in 2018 as fiscal stimulus expires.

### External demand is strengthening

After very subdued growth in the first half of 2016, export volumes recovered steadily over the second half of the year driven by broad-based demand from the US, Asia and the EU. Looking ahead, the ongoing recovery in global trade and output and the real exchange rate depreciation are expected to support export demand. After declining by 1.7% in 2016, import volumes should also recover moderately as domestic and external demand firm up, resulting in a modest growth contribution from net exports over the forecast horizon.

### Risks

External downside risks have become more prominent. Heightened geopolitical tensions in the East Asian region may weigh on business sentiment, and on regional trade and investment activity. At the same time there is lingering uncertainty about trans-pacific trade relations, and possible repercussions for regional trade dynamics. These heightened external risks may entail negative domestic spillovers in terms of weaker wage and investment dynamics.

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	530465.7		100.0	0.6	2.0	0.3	1.2	1.0	1.2	0.6
Private Consumption	300081.6		56.6	0.8	2.4	-0.9	-0.4	0.4	0.6	0.6
Public Consumption	105335.3		19.9	1.8	1.5	0.5	1.6	1.5	0.9	0.9
Gross fixed capital formation	124226.2		23.4	-1.4	4.9	2.9	0.0	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	1.2	2.8	1.1
Imports (goods and services)	95280.0		18.0	2.3	3.3	8.3	0.1	-1.7	1.3	0.7
GNI (GDP deflator)	550883.8		103.8	0.7	2.7	0.6	1.4	0.4	1.3	0.6
Contribution to GDP growth:										
		Domestic demand		0.4	2.8	0.3	0.1	0.8	1.0	0.5
		Inventories		0.0	-0.4	0.1	0.6	-0.3	0.0	0.0
		Net exports		0.3	-0.4	0.0	0.5	0.5	0.3	0.1
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	0.5
Unit labour costs whole economy				-1.5	-1.5	1.4	-0.1	-0.1	-0.2	0.1
Real unit labour cost				-0.5	-1.2	-0.4	-2.1	-0.4	-0.4	-0.4
Saving rate of households (b)				12.4	7.1	6.6	7.5	8.6	8.8	8.6
GDP deflator				-1.0	-0.3	1.7	2.0	0.3	0.2	0.4
Consumer-price index				-0.1	0.3	2.8	0.8	-0.1	0.4	1.0
Terms of trade goods				-3.1	-1.4	-0.7	11.2	5.9	-0.9	0.0
Trade balance (goods) (c)				1.9	-1.7	-2.0	-0.1	0.9	0.9	0.9
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	3.9	4.1	4.2
General government balance (c)				-6.6	-7.6	-5.4	-3.5	-3.7	-4.2	-3.6
Cyclically-adjusted budget balance (d)				-	-	-	-	-	-	-
Structural budget balance (d)				-	-	-	-	-	-	-
General government gross debt (c)				170.2	232.8	236.1	238.0	238.6	239.4	240.5

(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.