

35. JAPAN

Trade tensions add to domestic woes

Robust economic activity in the first half of 2019 is set to weaken in the remainder of the year in the wake of the consumption tax increase and sluggish external demand. Accommodative fiscal and monetary policies offer some respite, but a sluggish recovery is likely to take hold only towards the end of the forecast horizon as Japan remains highly vulnerable to global and regional trade tensions.

Public spending supports growth

After a weak second half of 2018, economic activity accelerated in the beginning of 2019 on rising public consumption and investment spending. Private consumption accelerated in 2019-Q2 boosted by the extraordinary long Reiwa holidays and frontloading of major purchases ahead of the October consumption tax hike. At the same time, the intensification of global trade tensions took a toll on exports and manufacturing.

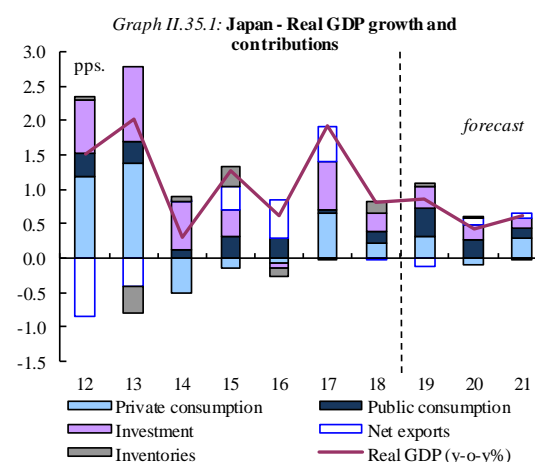
Leading indicators point to a moderate output deceleration in 2019-Q3 driven by weak global demand. Industrial production and exports deteriorated in August, after a temporary rebound in July. At the same time, private consumption activity signals strong consumption growth underpinned by continued frontloading of purchases of big-ticket items. Economic activity is likely to weaken further towards the end of the year following the rise in the consumption tax rate bringing the annual growth rate to 0.9% in 2019.

Consumption volatility and trade tensions weaken the outlook

Real GDP growth is forecast to decelerate to 0.4% in 2020 on an expected decline of domestic demand in the immediate aftermath of the planned tax hike and continued trade weakness. Private consumption spending is likely to contract in 2020. However, the impact of the tax hike is set to be much milder compared to a similar experience in 2014 due to significant government measures to smoothen demand, before and after the tax hike, including the introduction of a points redemption program for cashless payments and tax breaks on car purchases and homes. Consumer spending is likely to recover in 2021 driven by a continued robust labour market. Labour market conditions should remain very tight amid severe labour shortages and strong demand for labour, with the unemployment rate at slightly above 2% over the forecast horizon. At the same time, wage pressure is set to remain contained amid subdued inflation

expectations and a rising share of non-regular employment.

High business profits, continued monetary accommodation and rising spending on automation in view of persistent labour shortages are set to support private investment spending in the near term. Public investment spending is forecast to remain strong on Olympics-related investment and increasing public works. Government consumption spending is set to accelerate as part of the additional revenue from the consumption tax hike has been earmarked to provide free preschool education.



The external trade outlook is clouded by the intensification of global and regional trade tensions. Exports are set to decline in the near term reflecting sluggish demand from China, continued weakness in the tech cycle and ongoing trade tensions between Japan and Korea. They are expected to rebound somewhat in 2020 in line with the tepid recovery in global demand, but continued trade tensions might lead to a recalibration of regional value chains in the medium term. Imports are forecast to decline in the near term reflecting weak domestic demand before increasing gradually toward the end of the forecast horizon. Overall, net exports are expected to remain broadly neutral until 2021.

Fiscal consolidation is somewhat delayed

The recent increase in the consumption tax from 8% to 10% lies at the core of the fiscal consolidation strategy, aimed at achieving a primary balance by fiscal year 2025. However, the stimulus measures enacted in 2019 are likely to offset partly the positive fiscal impact of the tax hike, at least in the near term. Still, the general government deficit is expected to gradually narrow to around 2% of GDP in 2021 as the stimulus wanes.

Continued monetary accommodation

Inflation has decelerated since the beginning of the year with core inflation at 0.5% y-o-y in August 2019 despite continued unprecedented scale of monetary accommodation. Annual headline inflation is set to stay well below 1% this year and temporary edge up just above 1% in 2020 reflecting the effects of the tax hike. It is, however, likely to decelerate again towards the end of the

forecast horizon as the entrenched low inflation expectations, reflecting the deeply enshrined deflationary mind-set of the population, may continue limiting inflationary pressures. Monetary policy is expected to remain highly accommodative throughout the forecast horizon on weak demand and contained inflation.

Trade-related risks weigh on the external side

Risks on the external side include intensification of trade tensions between Korea and Japan and further appreciation of yen undermining business sector profitability if global-risk-off sentiment returns. Domestic risks in the near term relate to the stronger-than-expected negative effects of the consumption tax hike on private spending and prospects of introduction of additional offsetting fiscal measures that would boost domestic demand in the near and medium term. However, this may result in a weaker fiscal position than assumed in the forecast with a negative impact on business confidence and private investment.

Table II.35.1:

Main features of country forecast - JAPAN

	2018		Annual percentage change							
	bn JPY	Curr. prices	% GDP	00-15	2016	2017	2018	2019	2020	2021
GDP	548907.2		100.0	0.9	0.6	1.9	0.8	0.9	0.4	0.6
Private Consumption	305123.5		55.6	0.8	-0.1	1.1	0.3	0.6	-0.2	0.5
Public Consumption	108395.3		19.7	1.6	1.4	0.3	0.8	2.0	1.2	0.6
Gross fixed capital formation	132784.8		24.2	-0.4	-0.3	3.0	1.1	1.4	0.9	0.7
of which: equipment	-		-	1.1	-1.8	4.9	-	-	-	-
Exports (goods and services)	101060.6		18.4	4.4	1.7	6.8	3.4	-1.5	0.6	0.8
Imports (goods and services)	99785.0		18.2	3.3	-1.6	3.4	3.4	-0.8	0.3	0.5
GNI (GDP deflator)	568749.3		103.6	1.0	0.1	2.1	0.8	0.9	0.3	0.4
Contribution to GDP growth:										
Domestic demand				0.7	0.1	1.4	0.6	1.0	0.4	0.6
Inventories				0.1	-0.1	0.0	0.1	0.0	0.0	0.0
Net exports				0.2	0.6	0.6	0.0	-0.1	0.1	0.1
Employment				0.0	1.0	1.0	1.0	0.5	0.2	0.3
Unemployment rate (a)				4.5	3.1	2.8	2.4	2.3	2.2	2.2
Compensation of employees / head				-0.6	1.1	0.5	1.2	0.9	1.0	1.0
Unit labour costs whole economy				-1.5	1.5	-0.5	1.4	0.5	0.8	0.7
Real unit labour cost				-0.7	1.2	-0.2	1.5	0.2	0.2	0.4
Saving rate of households (b)				10.4	9.3	9.0	8.9	8.7	8.5	7.9
GDP deflator				-0.7	0.3	-0.2	-0.1	0.3	0.6	0.3
Consumer-price index				0.0	-0.1	0.5	1.0	0.5	1.1	0.7
Terms of trade goods				-2.5	7.4	-4.9	-4.9	0.1	0.2	0.0
Trade balance (goods) (c)				1.1	1.0	0.9	0.2	0.2	0.3	0.3
Current-account balance (c)				2.7	4.0	4.2	3.5	3.5	3.5	3.3
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				2.6	3.8	4.2	3.5	3.4	3.4	3.3
General government balance (c)				-6.3	-3.5	-3.0	-3.0	-2.8	-2.6	-2.2
Cyclically-adjusted budget balance (d)				-	-	-	-	-	-	-
Structural budget balance (d)				-	-	-	-	-	-	-
General government gross debt (c)				190.5	236.3	235.0	236.3	236.4	236.6	236.6

(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.