35. JAPAN

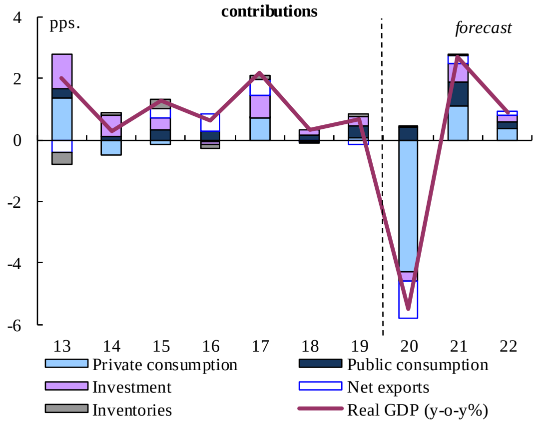
After three quarters of negative growth starting at the end of 2019, economic activity is set to rebound in the second half of 2020, amid a sizeable fiscal policy stimulus, rather successful containment policy and recovering external demand. Medium term prospects are, however, rather gloomy due to structural bottlenecks and limited policy space.

Recovering external demand and successful containment polices support near term growth

Real GDP in Japan declined by 8% quarter-on-quarter in the second quarter of 2020, the steepest post-war contraction on record, deepening the slump that started at the end of 2019. Still, Japan outperformed most other advanced economies in Q2-2020, highlighting the effectiveness of the coronavirus response, which limited the fall in private demand. At the same time, exports plummeted reflecting falling global demand and a complete standstill in foreign tourist inflows.

Monthly indicators point at a cyclical rebound taking hold in the second half of the year. Domestically, strong retail sales indicate a sustained recovery in private consumption, buoyed by a limited rise in unemployment and sizeable fiscal measures. At the same time, rebounding industrial production and exports point at brightening external trade prospects.

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



Overall, real GDP is set to decline in 2020 by 5½% reflecting deep contraction in the first half of 2020. On the domestic side, private consumption is likely to bounce back in the second half of the year, as households are likely to increase spending from accumulated savings, given the brightening economic prospects. However, the rebound will not compensate fully the significant slump in the beginning of the year, and private consumption will be the main driver of the decline in output. Private investment is likely to recover as well in the second half of the year, driven by rising investment into IT and automation, reflecting the recent increased use of modern technologies at the workplace to boost productivity. The drop in investment over the whole 2020 will thereby be only modest. Both public consumption and investment are set to remain robust on the back of sizable fiscal stimulus. On the external side, healthy demand from China and recovering demand in advanced economies will boost exports in the second half of the year, though very weak foreign tourism receipts will remain a major drag going forward.

Moderate recovery in the medium term

The pace of growth is expected to accelerate to 2¾% in 2021 as a cyclical recovery in private demand takes hold, the negative impacts of the coronavirus outbreak and the tax reform dissipate and fiscal stimulus measures feed through the economy. Private consumption is set to recover as pent-up demand picks up and the delayed Tokyo Olympics are expected to take place in 2021. Public spending is set to increase driven by a continuation of stimulus measures while private investment growth is likely to pick up temporarily in 2021, reflecting rebounding demand and ample liquidity. On the external side, goods exports are set to continue their recovery, though remaining travel restrictions are likely to hamper a strong rebound in tourism. At the same time, imports are likely to increase in line with rising domestic demand. Overall, net exports are expected to contribute negatively to growth in 2020 and recover afterwards.

Real GDP growth is projected to decelerate to 1% in 2022. This reflects shrinking fiscal and monetary policy space and mounting challenges related to sectoral reallocation away from face-to-face into digitally provided services, reshuffle of global value chains and lower tourism revenues that are expected to add to already existing bottlenecks (weak productivity, ageing population, low digitalisation of the economy) which have pushed potential GDP growth well below 1%.

Sizable fiscal stimulus, but limited scope for further monetary policy support

Generous fiscal stimulus, in the form of two supplementary budgets adopted in April and May, amounting to direct fiscal support of about 11% of GDP is set to feed the rebound. The majority of the budgetary support is intended for expanding the safety net, including cash handouts to firms and households, employment subsidies, rent provisions for companies and pay-outs for healthcare workers. These direct measures are combined with concessional corporate loans and expanded guarantees. However, given supply side bottlenecks, implementation inefficiencies and high uncertainty among the population, the economic impact is likely to be more muted than the headline numbers suggest. The fiscal deficit is projected to increase from 3¼% of GDP in 2019 to around 14% of GDP in 2020, pushing public debt to a record 265½% of GDP in 2020. The deficit is projected to shrink thereafter, in the absence of additional stimuli, to 3½% of GDP in 2022.

Absent space for further interest rate cuts, the Bank of Japan introduced a set of measures to provide liquidity and support credit flows to the economy. These included expansion of purchases of government and corporate bonds and exchange traded funds. The measures kept corporate financing conditions lose, but the risks for some sectors have increased significantly with the virus outbreak. At the same time, the space for further monetary policy easing appears limited given negative interest rates, which undermine the profitability and business model of domestic banks and an already sizeable involvement of the central bank in the domestic bond and stock markets.

Risks are elevated

Risks remain tilted to the downside, including the risk of a second wave of the pandemic, a stronger currency undermining exports and investment recovery and the negative spillovers from the trade ructions between China and the US. On the upside, sharper than expected rebound in China and the rest of Asia and higher-than-assumed fiscal multipliers might result in a swifter recovery of economic activity in the near term.

Table II.35.1:

Main features of country forecast - JAPAN

		2019			Annual percentage change					
	bn JPY	Curr. prices	% GDP	01-16	2017	2018	2019	2020	2021	2022
GDP		553962.2	100.0	0.7	2.2	0.3	0.7	**-5.5**	**2.7**	**0.9**
Private Consumption		305823.4	55.2	0.7	1.3	0.0	0.2	**-7.7**	**2.0**	**0.7**
Public Consumption		110804.7	20.0	1.5	0.2	0.9	1.9	**2.0**	**3.6**	**1.0**
Gross fixed capital formation		134666.5	24.3	-0.5	3.0	0.6	1.3	**-1.3**	**2.4**	**0.8**
of which: equipment		-	-	0.7	5.3	2.8	-	**-**	**-**	**-**
Exports (goods and services)		96988.4	17.5	3.8	6.8	3.4	-1.8	**-12.8**	**5.8**	**2.3**
Imports (goods and services)		95865.1	17.3	2.6	3.4	3.4	-0.8	**-5.4**	**3.6**	**1.4**
GNI (GDP deflator)		573801.7	103.6	0.9	2.4	0.4	0.6	**-5.3**	**2.9**	**0.9**
Contribution to GDP growth:	Domestic demand			0.6	1.5	0.3	0.8	**-4.1**	**2.5**	**0.8**
	Inventories			0.0	0.1	0.0	0.1	**0.0**	**0.0**	**0.0**
	Net exports			0.2	0.6	0.0	-0.2	**-1.3**	**0.3**	**0.1**
Employment				0.1	1.0	1.7	0.5	**-5.0**	**2.0**	**2.0**
Unemployment rate (a)				4.4	2.8	2.4	2.3	**3.1**	**2.9**	**2.7**
Compensation of employees / head				-0.5	0.5	1.5	0.9	**3.2**	**-1.0**	**-1.0**
Unit labour costs whole economy				-1.2	-0.7	2.9	0.8	**3.7**	**-1.7**	**0.1**
Real unit labour cost				-0.5	-0.5	3.0	0.2	**3.6**	**-1.9**	**-0.3**
Saving rate of households (b)				10.2	9.0	10.5	11.4	**21.1**	**13.6**	**11.0**
GDP deflator				-0.6	-0.2	-0.1	0.6	**0.1**	**0.2**	**0.4**
Consumer-price index				0.0	0.5	1.0	0.5	**0.1**	**0.1**	**0.3**
Terms of trade goods				-1.7	-4.9	-4.8	1.1	**0.0**	**0.0**	**0.0**
Trade balance (goods) (c)				1.0	0.9	0.2	0.3	**-0.6**	**-0.3**	**-0.2**
Current-account balance (c)				2.8	4.1	3.5	3.4	**2.3**	**2.8**	**2.9**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				2.7	4.1	3.5	3.3	**2.2**	**2.7**	**2.8**
General government balance (c)				-6.1	-2.9	-2.3	-3.3	**-13.9**	**-5.6**	**-3.5**
Cyclically-adjusted budget balance (d)				-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)				-	-	-	-	**-**	**-**	**-**
General government gross debt (c)				196.7	234.6	236.5	238.0	**265.5**	**263.4**	**263.5**

(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.