35. JAPAN

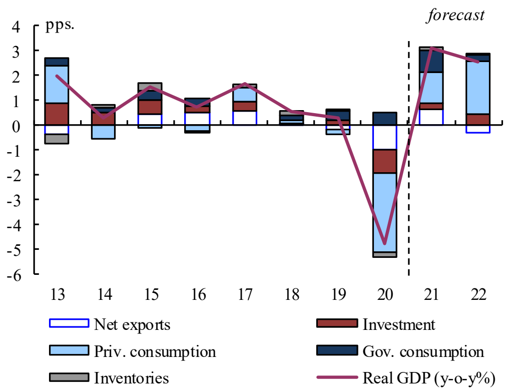
After a strong cyclical rebound in the second half of 2020 economic activity is set to moderate in the first half of 2021 amid the re-imposition of containment measures. Going forward, real GDP growth is likely to accelerate again following continued fiscal policy stimulus and recovering external demand, though structural bottlenecks and limited policy space weigh on medium term prospects.

Economic activity moderating amid new round of containment measures

After plunging by 8% q-o-q in the second quarter of 2020, real GDP in Japan rebounded by 5.3% q-o-q and 3% q-o-q in the third and fourth quarter of 2020, respectively, limiting annual real GDP contraction to 4.8% in 2020. The recovery was enabled by the relaxation of containment measures and supported by sizable fiscal stimulus packages and recovering global demand, especially from China.

Monthly business and consumer surveys showed some signs of weakening economic activity in the first quarter of 2021 amid the imposition of a new round of containment measures. Similarly, after some lull in the number of COVID-19 cases in March, a recent rise in infection numbers increases the risk of yet another round of containment measures in the second quarter of the year. This might slow down the recovery of private consumption and services. Still, the negative economic impact is likely to be much more limited than in spring 2020 as the scope of restrictions is limited to the hospitality sector and the Japanese society seems to have learnt to live with the virus and the containment measures. At the same time, exports are set to grow strongly amid healthy external demand, while fiscal measures are set to prop domestic demand.

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



Growth to pick up in the second half of 2021 as the economy slowly reverts to normal

On the domestic side, private consumption is likely to bounce back in the second half of 2021, as containment measures are set to be lifted, supporting the services rebound. At the same time, households are likely to increase spending also on the back of accumulated savings, given the brightening economic prospects. Private investment is set to continue recovering driven by accommodative funding conditions, rising demand and increasing investment into IT and automation. Continued sizable fiscal stimulus is set to support public consumption and investment. On the external side, robust demand from China and recovering demand from the US and the EU are set to support strong export expansion, though very weak foreign tourism receipts will remain a major drag. All in all, real GDP is projected to grow by 3.1% in 2021.

Cyclical recovery recedes gradually towards the end of the forecast horizon

The pace of growth is expected to decelerate to 2.5% in 2022 as structural challenges (weak productivity, ageing population, low digitalisation of the economy) and limited fiscal and monetary policy space limit growth prospects.

Private consumption growth is set to remain robust as labour market situation improves. Private investment growth is likely to remain strong as well reflecting the ongoing green and digital transformation of the economy. At the same time, public spending growth is set to be gradually curbed absent additional fiscal stimuli. On the external side, growth in goods exports is set to moderate reflecting a gradual stabilisation of external demand growth, while a possible relaxation of travel restrictions might support a moderate 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 positively to growth in 2021 and remain slightly negative in 2022.

Strong fiscal support, but monetary policy constrained

Sizable direct fiscal support, that amounts to ca. 16% of GDP in 2020-2021, includes cash handouts to firms and households, employment subsidies and additional pay-outs to healthcare workers, directly supporting the recovery in private consumption. Additional measures (e.g. investment into digitalisation and green initiatives, healthcare support) feed directly into public investment and consumption. However, supply side bottlenecks and implementation inefficiencies limit the size of fiscal multipliers. These measures are combined with financial support to corporations in the form of concessional corporate loans and expanded guarantees. Overall, the fiscal deficit is projected to increase from almost 3% of GDP in 2019 to around 13¼ % of GDP in 2020 and 9½% of GDP in 2021, pushing public debt to a record 259% of GDP in 2021. The deficit is projected to shrink thereafter, in the absence of additional stimuli, to 4% of GDP in 2022.

Measures introduced by the Bank of Japan to provide liquidity and support credit flows to the economy kept corporate financing conditions lose and supported the recovery. However, going forward, space for monetary policy support is constrained given negative interest rates and sizable direct involvement of Bank of Japan in the domestic asset markets.

Risks are elevated

Risks remain tilted to the downside, including the risk of yet another wave of the pandemic leading to a further tightening of containment measures, a slower-than-expected vaccination campaign and stronger currency undermining exports and investment recovery. On the upside, additional round of domestic fiscal stimulus and stronger-than-expected impact of US stimulus on external demand and exports 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	561266.9	100.0	0.7	1.7	0.6	0.3	**-4.8**	**3.1**	**2.5**
Private Consumption	305618.8	54.5	0.7	1.1	0.3	-0.3	**-5.9**	**2.2**	**3.5**
Public Consumption	111268.1	19.8	1.5	0.1	1.0	1.9	**2.7**	**4.1**	**1.3**
Gross fixed capital formation	134666.5	24.0	-0.4	1.6	0.2	0.9	**-4.1**	**1.2**	**1.8**
of which: equipment	45718.1	8.1	0.9	4.6	3.1	0.5	**0.0**	**0.0**	**0.0**
Exports (goods and services)	97463.5	17.4	3.8	6.6	3.8	-1.4	**-12.3**	**10.7**	**4.1**
Imports (goods and services)	97638.3	17.4	2.6	3.3	3.8	-0.4	**-6.8**	**6.2**	**4.4**
GNI (GDP deflator)	581106.4	103.5	0.8	1.9	0.6	0.2	**-4.5**	**3.2**	**2.4**
Contribution to GDP growth: Domestic demand			0.6	1.0	0.4	0.4	**-3.6**	**2.3**	**2.6**
Inventories			0.0	0.1	0.1	0.0	**-0.1**	**0.1**	**0.0**
Net exports			0.2	0.6	0.0	-0.2	**-1.0**	**0.6**	**-0.1**
Employment			0.1	1.0	1.8	0.9	**-2.0**	**0.6**	**0.6**
Unemployment rate (a)			4.4	2.8	2.4	2.3	**3.0**	**2.9**	**2.6**
Compensation of employees / head			-0.6	0.5	1.4	0.8	**1.1**	**1.4**	**1.4**
Unit labour costs whole economy			-1.2	-0.1	2.6	1.5	**4.0**	**-1.0**	**-0.5**
Real unit labour cost			-0.6	0.0	2.6	0.8	**3.1**	**-0.2**	**-1.1**
Saving rate of households (b)			10.2	9.0	10.5	10.2	**17.2**	**13.7**	**7.0**
GDP deflator			-0.6	-0.1	0.0	0.6	**0.9**	**-0.9**	**0.6**
Harmonised index of consumer prices			0.0	0.5	1.0	0.5	**0.0**	**0.3**	**0.9**
Terms of trade goods			-1.8	-4.8	-5.0	0.9	**0.0**	**-1.0**	**0.5**
Trade balance (goods) (c)			1.0	0.9	0.2	0.1	**-0.6**	**-0.3**	**-0.3**
Current-account balance (c)			2.8	4.1	3.5	3.7	**2.6**	**3.3**	**3.2**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			2.7	4.1	3.5	3.6	**2.6**	**3.2**	**3.2**
General government balance (c)			-6.0	-2.9	-2.2	-2.9	**-13.2**	**-9.5**	**-4.1**
Cyclically-adjusted budget balance (d)			:	:	:	:	**:**	**:**	**:**
Structural budget balance (d)			:	:	:	:	**:**	**:**	**:**
General government gross debt (c)			194.1	231.6	232.6	234.9	**256.3**	**259.1**	**255.3**

(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.