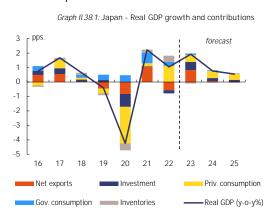
# 38. JAPAN

After a very strong first half of 2023, economic activity in Japan is expected to moderate in the remainder of the year amid persistently elevated inflation and soft global demand. Growth is set to decline in 2024 and edge further down towards potential in 2025, reflecting both a cyclical downturn and structural bottlenecks. Headline average annual consumer inflation is set to remain above the central bank target of 2% over the forecast horizon, reflecting rising wage pressure.

# Robust growth in the first half of 2023 peters out

Real GDP growth in Japan surprised on the upside, rising by 0.8% quarter-on-quarter and 1.2% quarter-on-quarter in the first and second quarter of 2023, respectively. However, while domestic demand drove growth in the first quarter supported by booming services, growth in the second quarter reflected mainly a strong positive contribution from net exports while both private consumption and investment turned negative on rising costs of living and uncertainty. Lower domestic demand led to declining imports while automotive exports increased.

Economic activity is expected to soften for the remainder of 2023, amid a moderating growth in domestic demand and recovering imports. On the domestic side, a tight labour market and fiscal measures support private consumption growth despite still elevated inflation. Private investment is forecast to rise, backed by investments in new technologies and still accommodative financing conditions, tough elevated uncertainty is projected to limit the scale of the expansion. On the external side, imports are set to increase gradually in the second half of the year, after three quarters of negative growth, while exports are expected to remain subdued as global



demand falters. Still, contribution of external trade to growth is forecast to be highly positive reflecting the deep fall in imports in the beginning of the year. Overall, real GDP growth is projected to reach 1.9% in 2023.

## Growth prospects are subdued going forward

Going forward, private consumption growth is expected to remain modest as the saving rate remains elevated and the scale of fiscal support gradually declines. A tight labour market and rising inflation expectations are likely to result in a higher nominal wage growth, though its effect on consumption is likely to be tempered by persistently elevated inflation. Private investment growth is likely to be constrained by weak external demand prospects and high uncertainty, despite continued accommodative monetary policy. At the same time, public spending growth is set to remain muted reflecting the limited size of new fiscal measures. Overall, real GDP growth is forecast to moderate to 0.8% in 2024 and to 0.6% in 2025 as the cyclical downturn adds to structural challenges (e.g. a rapidly aging society, declining labour supply, low innovative capacity of the economy) that limit potential growth in Japan.

On the external side, export growth is set to gradually pick up reflecting a positive effect of a weaker currency, the turnaround in the global tech cycle and some increase in global demand. After a robust growth in 2022-2023, on the back of the re-opening of Japan to foreign tourists, services trade, in particular tourism, is likely to moderate within the forecast horizon. Import growth is projected to pick up reflecting a delayed demand from export-oriented manufacturing companies for foreign components. Overall, net exports are set to be broadly neutral to growth over the forecast horizon, while the current account surplus is expected to gradually decline from ca. 3.4% of GDP in 2023 and 2.4% of GDP in 2025, driven by recovering imports.

Risks to the outlook are broadly balanced. On the downside, major risks to growth are related to a more pronounced impact of the slowdown in China on exports and higher and more persistent inflation that would force the Bank of Japan to increase interest rates, clouding the outlook for domestic demand. On the upside, risks include higher fiscal spending that would support consumption and a more robust rise in the number of tourists that would boost exports.

### Inflationary pressures persist

After peaking at 4.3% in January 2023, headline inflation subsided to 3% in September 2023 on lower energy prices and special, policy-related factors (e.g. subsidies for gas and electricity). However, core inflation (excluding energy and fresh food) stabilised at around 4.2% in September 2023 reflecting higher pass-through of input costs to goods' prices as the behaviour of Japanese firms (e.g. retailers) seems to have been gradually changing. Going forward, annual headline inflation is expected to increase from 2.5% in 2022 to 3.3% in 2023 reflecting higher utility prices, rising food prices and a depreciating yen pushing up price of imported goods. Annual average inflation is projected to subside very gradually to 2.7% in 2024 and to 2.2% in 2025 as softening domestic demand is partly counterbalanced by rising wage pressures and discontinuation of energy subsidies. Monetary policy is likely to remain accommodative over the forecast horizon. However, the growing divergence between the level of headline interest rates in Japan and globally might result in further yen depreciation and an upward pressure on government bond yields.

### Scale of fiscal support is likely to decline

Fiscal deficit is set to amount to around 6.6% of GDP in 2023 reflecting a large package of measures (e.g. electricity, gas and oil subsidies, cash support to families with children) introduced to counterbalance rising costs of living. A new round of fiscal stimulus, which extends the energy subsidies until the end of 2023 and provides support to SMEs, was announced in October 2023, while the government intends to boost military spending over the next 5 years to reach the 2% of GDP target in 2027. Still, the scale of fiscal support is likely to decline within the forecast horizon and the fiscal deficit is expected to fall gradually to 4.1% of GDP in 2025. Public debt is projected to decline from around 258.0% of GDP in 2022 to around 250.4% of GDP in 2025.

Table II.38.1:

Main features of country forecast - JAPAN

	2022				Annual percentage change					
	bn JPY	Curr. prices	% GDP	04-19	2020	2021	2022	2023	2024	2025
GDP		557227.0	100.0	0.7	-4.2	2.2	1.0	1.9	0.8	0.6
Private Consumption		308634.6	55.4	0.5	-4.7	0.4	2.1	0.9	0.9	0.7
Public Consumption		120825.7	21.7	1.3	2.4	3.5	1.2	0.5	0.2	0.1
Gross fixed capital formation		146383.4	26.3	0.2	-3.5	0.2	-0.9	2.1	0.8	0.6
Exports (goods and services)		120233.2	21.6	3.7	-11.6	11.9	5.1	1.4	2.7	2.2
Imports (goods and services)		141481.9	25.4	2.8	-6.8	5.1	8.0	-2.1	2.2	2.2
GNI (GDP deflator)		592279.6	106.3	0.9	-4.5	3.4	2.5	1.3	0.7	0.5
Contribution to GDP growth:	[	Domestic demand	i	0.6	-2.9	1.0	1.2	1.1	0.7	0.6
	I	nventories		0.0	-0.5	0.2	0.4	-0.1	0.0	0.0
	1	Vet exports		0.2	-0.8	1.0	-0.6	0.8	0.1	0.0
Employment				0.4	-0.5	-0.1	0.2	-0.1	-0.1	-0.1
Unemployment rate (a)				3.9	2.8	2.8	2.6	2.5	2.4	2.4
Compensation of employees / head				0.0	-0.8	2.0	2.3	3.7	3.2	2.9
Unit labour costs whole economy				-0.4	3.0	-0.3	1.4	1.6	2.3	2.2
Saving rate of households (b)				10.3	18.0	15.0	13.9	14.6	14.4	13.7
GDP deflator				-0.3	0.9	-0.2	0.3	3.6	1.9	1.6
Consumer price index				0.3	0.0	-0.2	2.5	3.3	2.7	2.2
Terms of trade goods				-2.2	6.8	-9.1	-13.2	5.7	-2.2	-2.0
Trade balance (goods) (c)				0.7	0.5	0.3	-2.8	-1.2	-1.6	-2.0
Current-account balance (c)				3.0	2.9	3.9	2.1	3.4	2.9	2.4
General government balance (c)				-5.3	-9.1	-6.2	-7.1	-6.6	-5.3	-4.1
Structural budget balance (d)				:	:	:	:	:	:	:
General government gross debt (c)				209.1	258.7	255.4	258.0	252.1	251.2	250.4

(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.