Japan's Economic Outlook

- **The Japanese economy is in recession as both external and domestic demand falter; we expect a gradual recovery to take hold in the latter half of 2020.**
- **Fiscal and monetary policies have become more accommodative despite limited policy space.**

ECONOMIC GROWTH OUTLOOK

The Japanese economy is in recession as it continues to fight the COVID-19 outbreak. As the virus-curve has yet to flatten in Japan (chart 1), Prime Minister Shinzo Abe has extended the state of emergency until the end of May. Real GDP has been declining since the fourth quarter of 2019, and we expect further contractions in the first half of 2020. Assuming that the virus will be brought under control by mid-year, the economy will recover in the second half of the year and into 2021. We expect Japan's real GDP to drop by 3.8% in 2020, followed by a rebound to 2.3% in 2021; nevertheless, we assess that risks to our forecasts are on the downside.

Subdued economic conditions in China and outright recession in most advanced economies around the world will hamper Japan's external sector prospects, both in terms of goods and services exports. China and the US are Japan's most important export markets, purchasing over 42% of the country's shipments abroad. Against the weak global backdrop, Japan's manufacturing sector sentiment has weakened significantly, while export volumes and industrial production are well below year-earlier levels (chart 2).

The outlook for domestic demand is equally muted. Consumer sentiment has plummeted (chart 3), with households entering the health crisis in an already-cautious environment, which reflected the consumption tax rate increase (from 8% to 10%) in the fourth quarter of 2019. Consumer spending will likely remain muted over the coming months as the labour market continues to weaken (chart 3). Meanwhile, business confidence has softened and corporate bankruptcies have risen, implying that fixed investment decisions will likely be largely kept on hold in the uncertain environment. As private spending prospects are constrained, public outlays will provide some support to the economy.

Substantial emergency stimulus measures have been announced to support the Japanese economy. On April 20, the government approved a revised supplementary budget for fiscal year 2020, taking total stimulus to JPY 117.1 trillion (USD 1.06 trillion), equivalent to 21% of GDP. Announced measures include healthcare support, cash handouts, higher childcare allowances, subsidies for small businesses, deferred taxes, and financial aid for businesses, including lending programs. Fiscal spending accounts for 42% of the package, equivalent to 8.9% of GDP. While the stimulus package will inevitably lead to a rise in public debt—from the already-high 238% of GDP in 2019, according to the IMF—we note that the government does not rely on external financing for its debt as almost 90% of it is held domestically, primarily by the Bank of Japan (BoJ) and other public institutions, banks, and pension funds. Any debt-related turmoil seems a rather distant possibility in Japan.

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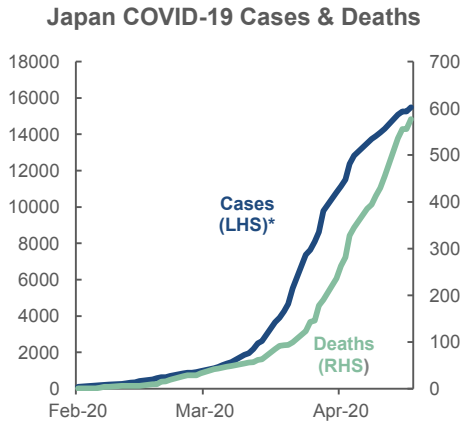
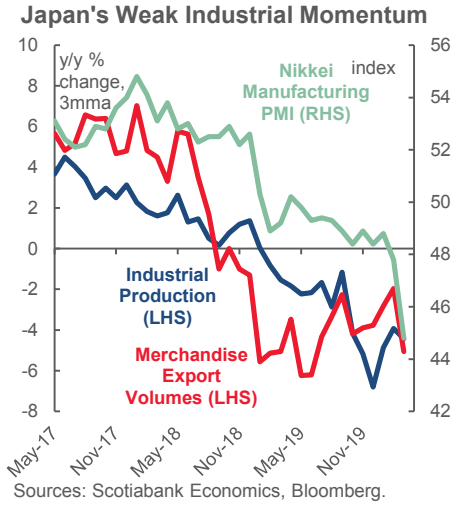
Chart 1



*Since 100th recorded case.
Sources: Scotiabank Economics, Johns Hopkins University.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

MONETARY POLICY, INFLATION AND YEN OUTLOOK

The BoJ has become more concerned about the Japanese economy's outlook. Accordingly, the central bank's monetary policy stance will stay highly growth-supportive for an extended period of time. The BoJ has enhanced its monetary easing efforts over the past two months, yet it has maintained the policy rate at -0.1% and continued its policy of "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control", which aims to keep the 10-year JGB yield at around 0%.

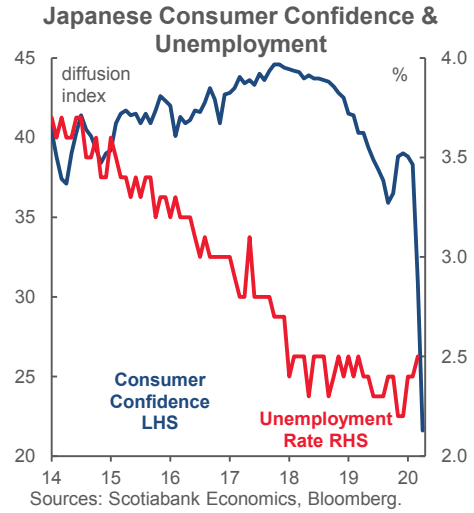
The BoJ held an emergency monetary policy meeting on March 16 and decided to increase purchases of corporate bonds, commercial paper, exchange-traded funds, and Japan real estate investment trusts. It also introduced a new financing program to assist businesses with liquidity issues. Following its scheduled policy meeting on April 27, the BoJ announced enhanced measures, recognizing that corporate financing conditions had become less accommodative. It further increased its purchases of commercial paper and corporate bonds and expanded the financing facility that was introduced in March. Moreover, it announced that it will boost purchases of JGBs and treasury discount bills. The central bank essentially shifted to unlimited quantitative easing, as an earlier reference to conducting "JGB purchases at annual pace of JPY80 trillion" was omitted. Responding to the fact that the Japanese government's bond issuance will increase on the back of announced fiscal stimulus measures, the BoJ will maintain higher purchases "for the time being" to keep bond yields low.

We expect the BoJ to keep monetary policy on hold in the near future, assessing the impact of the announced measures. Nevertheless, we point out that the monetary policy outlook is heavily influenced by the evolution of the virus outbreak and its impact on the economy. Reflecting substantial downside risks, the BoJ maintains a dovish bias. It has highlighted that it stands ready to ease monetary policy further if needed and that it expects short- and long-term policy interest rates to remain either at their present levels or lower for the time being.

Japan's decades-long struggle with low inflation—or outright deflation—will continue over the foreseeable future. The BoJ's 2% annual inflation target seems unattainable; in fact, following years of deflation, Japan's cumulative inflation over the past two decades is only 2.1% (chart 4). The CPI excl. fresh food—the BoJ's preferred inflation measure—rose by 0.4% y/y in March. Reflecting low international oil prices and the current recessionary backdrop, which will keep wage gains and demand-driven inflationary pressures at bay, we expect inflation to hover near zero for most of 2020; periods of declining prices are likely.

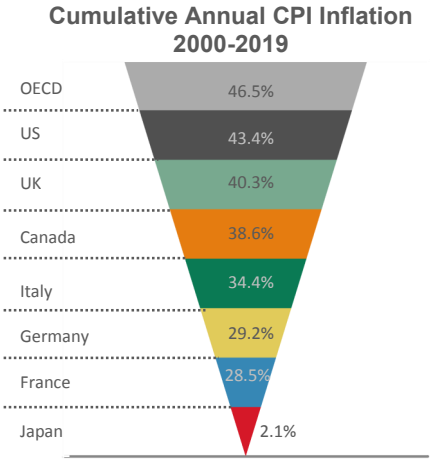
While the US dollar (USD) has been supported by safe-haven flows amid elevated risk aversion, the Japanese yen (JPY) has felt the same dynamics even to a greater extent. It is the best-performing major currency against the USD so far this year. The JPY's near-term outlook is a balancing act between two considerations: concerns regarding the reopening of the US economy and the risk of a second wave of COVID-19 infections may give further support to the JPY, yet the risk of another USD liquidity crunch may underpin the greenback more than the yen. Once the global economic recovery is well underway, the JPY will likely face a mild strengthening bias vis-à-vis the USD on the back of broader dollar weakness that will partially reflect the flood of dollar liquidity due to the US Federal Reserve's massive monetary easing. We expect USDJPY to close 2020 at 107 and 2021 at 105, with the near-term exchange rate likely to hover in the range of 106–109.

Chart 3



Sources: Scotiabank Economics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, OECD.

Chart 5

Sources: Scotiabank Economics, Bloomberg.