Japan's Economic Outlook

- Japan's economic activity is gathering pace after the COVID-19 slump.
- Fiscal and monetary policies will remain growth-supportive over the foreseeable future with policymakers ready to do more if needed.
- Japan's decades-long struggle with low inflation will continue.

ECONOMIC GROWTH OUTLOOK

The Japanese economy is showing signs of recovery after the slump caused by the COVID-19 pandemic. The government lifted the state of emergency at the end of May, yet at no point—for the time being, at least—did it have to resort to broadly based restrictions on movement, business closures, or full lockdowns. Accordingly, the drop in Japan’s real GDP in the second quarter was smaller than in its advanced economy peers; output declined by 7.8% q/q (non-annualized). In year-over-year terms, the economy shrank by 9.9% in the second quarter. Nevertheless, Japan’s economic malaise has persisted longer; output has been contracting since the fourth quarter of 2019 when the government raised the consumption tax rate, causing households to tighten their purse strings.

We expect economic recovery to take hold through the second half of 2020, but Japan’s annual real GDP growth is set to remain negative for the year as a whole. We foresee the economy shrinking by almost 5% in 2020, followed by a rebound of 2½% in 2021 on the back of base effects, pent-up demand, and the lagged impact of implemented monetary and fiscal stimulus measures. Nevertheless, we highlight that the outlook entails significant uncertainties; a potential large resurgence of COVID-19 infections at home and abroad together with the likely escalation of the US-China dispute ahead of the US presidential election in November are notable downside risks to both sentiment and real activity.

Japan’s external sector continues to face challenges on the back of still-weak demand conditions globally. Indeed, export volumes and industrial production remain well below year-earlier levels although some signs of revival have started to emerge (charts 1 and 2). Sentiment indicators, such as the manufacturing sector purchasing managers’ index, point to improving conditions over the coming months (chart 1). Regardless, the continuously evolving virus-situation, particularly in the US, may make external demand recovery bumpy; the US is Japan’s most important export market, purchasing 20% of Japan’s total exports.

Domestic demand will be an important factor supporting the economy’s recovery. At the height of the virus outbreak, consumer confidence collapsed along with deteriorating employment conditions (chart 3), causing households to put spending decisions on hold. While unemployment seems to have peaked and confidence has started to strengthen, voluntary self-restraint to prevent infections will continue to weigh on consumer spending over the near-term. Meanwhile, corporate profits have deteriorated, weakening prospects for business outlays. Nevertheless, Japanese authorities’ efforts to support corporations during the pandemic seem to have worked as fixed capital investment declined by only 0.7% q/q (non-annualized) in the second quarter. We expect both household spending and business investment to recover gradually over the coming quarters.
Public spending will provide support to the Japanese economy as it tries to get back on its feet. Two supplementary budgets for the current fiscal year (April–March) were unveiled in April and May, taking direct fiscal spending (i.e. measures such as lending programs are excluded) related to the COVID-19 shock to over 11% of GDP. Announced measures include additional healthcare funding, employment support, cash handouts, higher childcare allowances, and subsidies for small businesses. In our view, a third supplementary budget is possible over the coming months if Japanese policymakers assess that the economy needs an additional boost.

**MONETARY POLICY, INFLATION AND YEN OUTLOOK**

The Bank of Japan (BoJ) is set to maintain its ultra-accommodative monetary policy for an extended period of time. The BoJ’s COVID-19 response contains three key aspects. The first is the Special Program, created in March and enhanced later, which supports corporate financing. Its total size is around 120 trillion yen, entailing commercial paper and corporate bond purchases as well as the Special Funds-Supplying Operations, which are used to provide funds on favourable terms to financial institutions for giving loans to businesses struggling with COVID-19 implications. The second is the BoJ’s ample provision of yen and foreign currency funds through unlimited JGB purchases and enhanced US dollar operations. The third measure consists of purchases of ETFs and J-REITs to prevent sentiment from weakening due to market volatility.

Following the most recent monetary policy meeting on July 15, the BoJ left its monetary policy parameters unchanged. It 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% via government bond purchases. The central bank has pointed out that it expects short- and long-term policy interest rates to remain at their present or lower level for the time being. BoJ Governor Kuroda assesses that the three policy dimensions used for dealing with the economic and financial fallout of the virus outbreak have been effective; nevertheless, he has highlighted that the BoJ will closely monitor the situation and will not hesitate to “do whatever it takes as a central bank if necessary”.

Low inflation and a persisting threat of deflation will remain key characteristics of the Japanese economy in the foreseeable future. In our view, the BoJ’s 2% annual inflation target seems unachievable. The CPI excl. fresh food—the BoJ’s preferred inflation measure—remained at zero in y/y terms in July. The muted economic backdrop will keep wage gains and demand-driven inflationary pressures at bay; accordingly, we expect headline inflation—at 0.3% y/y in July—to dip slightly into negative territory by the end of the year.

The Japanese yen (JPY) has reacted little to the market’s risk-on mood (chart 5), remaining range-bound against the US dollar (USD). The yen is underpinned by broad USD-negative flows and a narrowing of the US’s yield advantage that partially reflects the flood of dollar liquidity due to the US Federal Reserve’s massive monetary easing. Risks ahead of the US presidential election on November 3 and potentially escalating US-China tensions may provide further support to the JPY. We expect USDJPY to close 2020 at 105. Should the yen appreciate further against the US dollar below the USDJPY 105 mark, the BoJ’s policymakers would likely start feeling increasingly uncomfortable about the currency’s strength and its disinflationary consequences.
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