

## Japan's Economic Outlook 2021–2023

- The Japanese economy is set to enjoy solid real GDP expansion in 2021 and 2022 before it returns to a more normal growth trajectory in 2023.
- Rising vaccination levels and easing movement restrictions are underpinning consumer and business confidence, helping domestic demand to complement the export sector's growth momentum.
- Japan's fiscal policy is expected to remain supportive of economic growth over the foreseeable future.
- With significant inflationary pressures likely to remain absent, the Bank of Japan will maintain ultra-accommodative monetary policy well past other major central banks' monetary normalization timelines.

### ECONOMIC GROWTH OUTLOOK

The Japanese economy is emerging from a prolonged period of uncertainty arising from repeated waves of COVID-19. The nation is well-positioned to record two years of solid real GDP growth (by Japanese standards), after the pandemic triggered contraction of 4.7% in 2020 (chart 1). We forecast Japan's output gains to average 2.5% y/y this year, followed by a 2% expansion in 2022, propelled by a low base—a factor particularly in 2021—as well as robust export sector activity and recuperating domestic demand. The economy's momentum is likely to normalize by 2023, with real GDP growth slowing to 1.2% y/y, which is in line with the country's pre-pandemic average growth between 2010 and 2019.

Japan's external sector has played an important role in the country's economic recovery, supported by strong overseas demand for Japanese electronics and automotive exports. Nevertheless, the global shortage of semiconductors, transportation bottlenecks, and high input costs have recently started to adversely impact Japanese manufacturing activity and shipments (chart 2). China and the US are Japan's two most important export destinations, together purchasing 44% of the country's shipments abroad; while demand dynamics are set to remain solid in the US over the coming quarters, China's weaker growth trajectory will likely be felt among Japanese exporters. Once the Regional Comprehensive Economic Partnership (RCEP), the world's largest trade agreement, becomes effective after its ratification is completed, Japanese exporters to China and South Korea (Japan's third largest export market) in particular are expected to benefit from lower tariffs.

Easing movement restrictions and a rising COVID-19 vaccination coverage are brightening the outlook for domestic demand; currently slightly over 70% of the Japanese population is fully vaccinated. While uncertainties remain elevated, prospects for private consumption are improving as consumer confidence continues its climb toward pre-pandemic levels (chart 3) and as pandemic-related state of emergency measures are lifted. Pent-up demand will likely be reflected in household spending growth, supported by a rebounding labour market and elevated household savings. Meanwhile, in a supportive policy environment, fixed investment is expected to recover gradually over the coming quarters, along with strengthening business confidence and robust global demand.

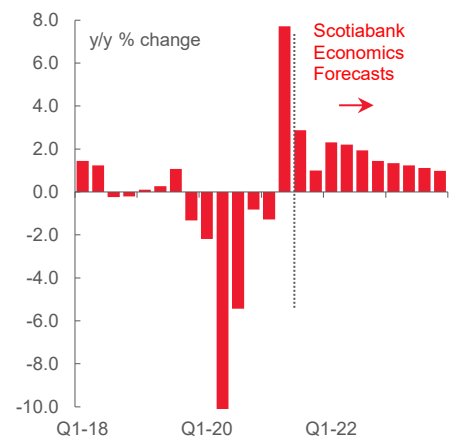
Japan's fiscal policy continues to underpin the economy's recovery; the country's pandemic-related fiscal response has been one of the highest among the G-20

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Chart 1

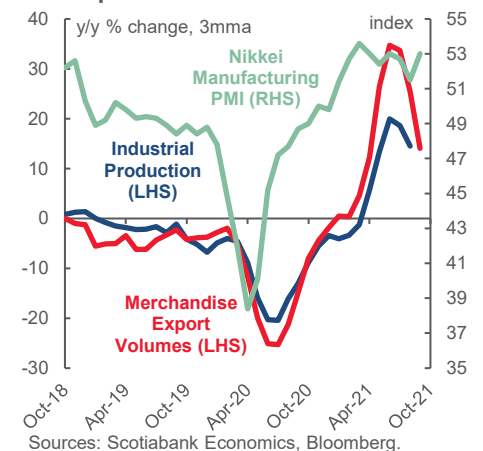
#### Japan's Real GDP Growth



Sources: Scotiabank Economics, Bloomberg.

Chart 2

#### Japan's Industrial Momentum



Sources: Scotiabank Economics, Bloomberg.

group and another sizable stimulus bill is expected to be unveiled before the end of the year, once the nation's new domestic political configuration is established. Japan will hold general elections on October 31. Polls suggest that the ruling Liberal Democratic Party (LDP) and its coalition partner Komeito will be able to maintain a majority. The LDP has a new leader, former finance minister Kishida Fumio, who became Japan's Prime Minister on October 4, 2021 after his predecessor Suga Yoshihide resigned in September. We expect broad policy continuity over the foreseeable future to help with the economy's recovery.

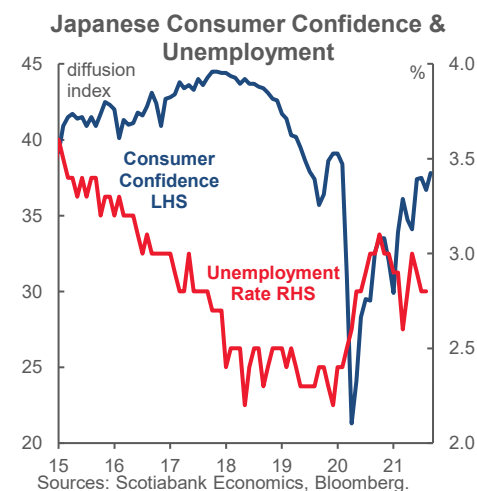
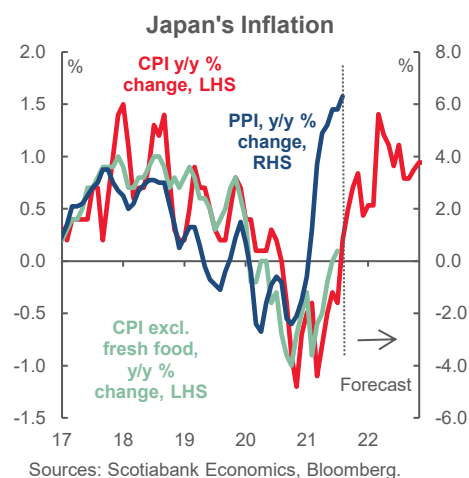
### INFLATION, MONETARY POLICY AND JAPANESE YEN OUTLOOK

Japan may have finally defeated deflation, which took hold in October 2020, with headline consumer prices increasing by 0.2% y/y in September 2021 (chart 4). Prices excluding fresh food—the Bank of Japan's (BoJ) preferred inflation measure—advanced by 0.1% y/y. While inflation remains very low, we foresee it climbing somewhat over the coming months. The depressed figures are partially a reflection of a government-initiated cut to mobile phone charges; once the impact fades away, headline inflation will likely temporarily approach 1½% y/y in the spring of 2022. Nevertheless, while higher input prices globally will have some spillover impact on consumer prices, demand-driven inflationary pressures are expected to remain absent in Japan. Accordingly, we see inflation remaining around 1% y/y for most of our forecast horizon, below the BoJ's 2% inflation target.

The BoJ assesses that Japan's inflation dynamics differ from the pressures experienced in other advanced economies on the back of three key factors: 1) a delayed domestic demand recovery; 2) Japanese companies' unwillingness to pass higher costs to consumers; and 3) low wage pressures. Partially due to Japan's employment practices, Japan is not facing significant labour shortages and wage inflation, which are becoming increasingly evident in many of its peer economies. In Japan, the preference for long-term employment kept the unemployment rate relatively steady during the height of the pandemic (the jobless rate rose from 2.1% at end-2019 to the peak of 3.1% in October 2020) as firms primarily adjusted hours worked. Now, with the economy rebounding and production ramping up, Japanese employers have largely avoided the struggle to attract people back to work, which has limited pressure on wages. In August, real cash earnings were up by only 0.2% y/y.

We expect the BoJ to maintain its ultra-loose monetary policy stance for an extended period, well past other major central banks' monetary normalization timelines. At the BoJ's most recent monetary policy meeting on October 28, the central bank kept the policy rate at -0.1% and continued the "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control", which maintains the 10-year JGB yield at around 0% via the BoJ's government bond purchases. The BoJ restated its earlier position that the central bank is prepared to take additional monetary easing measures if needed, and that it expects policy interest rates to remain "at their present or lower levels". We do not foresee any changes to the BoJ's policy parameters before the end of 2023.

The Japanese yen (JPY) has faced notable weakening pressure against the US dollar (USD) in recent weeks (chart 5), crossing the 110-threshold at end-September. The shift largely reflects rising interest rate differentials between the US and Japan as the US Federal Reserve prepares for tapering of its bond purchase program. Moreover, higher energy prices are eroding Japan's positive trade balance that is providing support to the JPY. We forecast USDJPY to close the year at 113. Divergent monetary policies are set to weaken the yen further over the course of 2022, taking USDJPY to 116 by the end of 2022.

**Chart 3**

**Chart 4**

**Chart 5**


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