JAPAN

Economic growth is projected to reach 1.0% in 2017 before slowing to 0.8% in 2018, boosting headline inflation to 1¼ per cent by the end of 2018. With three supplementary budgets in 2016, fiscal consolidation is pausing, helping Japan to cope with the impact of the yen appreciation. Private consumption is projected to continue rising in the context of labour shortages and the historically high level of corporate profits.

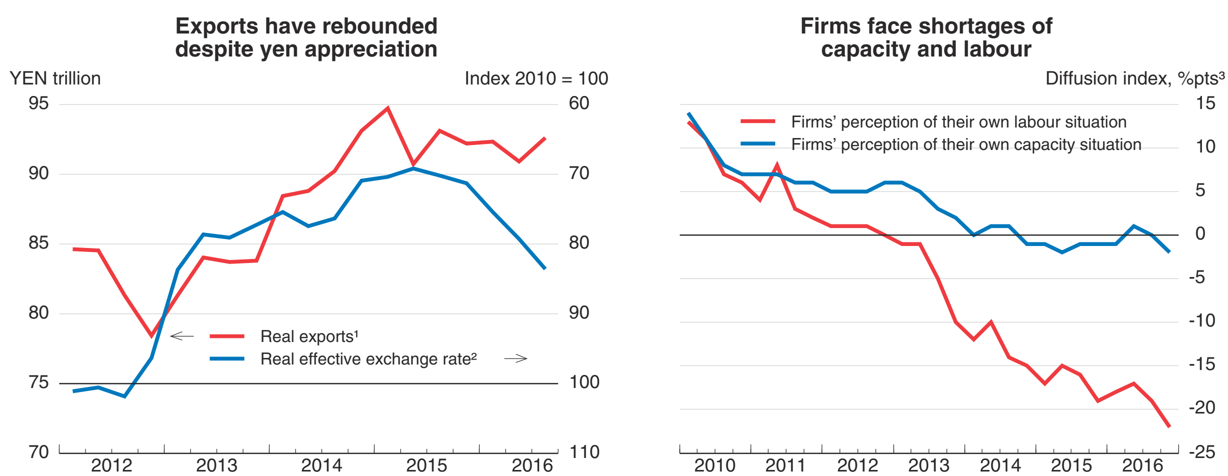
The Bank of Japan should maintain monetary easing, as intended, until inflation is stable above the 2% target, while taking account of costs and risks in terms of possible financial distortions. Structural reforms are essential to boost productivity and bring more people, especially women, into employment. This would enhance social cohesion, and reduce Japan's high relative poverty rate. Faster growth is critical to stopping and reversing the run-up in public debt, which is projected to reach 240% of GDP by 2018.

To sustain confidence in Japan's public finances, the implementation of a more detailed and credible consolidation plan, including a path of gradual increases in the consumption tax rate, is essential. Such a plan should also slow the rise in public social spending, which accounts for more than half of government expenditures. Investment in areas such as education and training is needed to boost Japan's growth potential. Limiting the negative impact of higher taxes on growth requires relying primarily on the consumption tax for increased revenue, accompanied by an earned income tax credit to promote employment and social cohesion.

Private consumption is driving growth

Real GDP increased at a 1.6% annualised rate in the first three quarters of 2016 despite yen appreciation and a decline in business investment. Growth was led by consumer

Japan



1. National accounts basis.
2. Trade-weighted, vis-à-vis 48 trading partners, calculated using consumer prices. A decrease indicates an appreciation of the yen.
3. The diffusion indices show the number of firms responding they had an excess number of workers minus those reporting a shortage and the number responding that they had excess capacity minus those with a capacity shortage. A negative number thus indicates an overall shortage of labour and capacity. Numbers for the fourth quarter in 2016 are companies' projections made in September 2016.

Source: OECD Economic Outlook 100 database; and Bank of Japan.

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Japan: **Employment, income and inflation**

Percentage changes

	2014	2015	2016	2017	2018
Employment	0.6	0.4	1.0	0.2	-0.2
Unemployment rate[1]	3.6	3.4	3.1	3.0	2.9
Compensation per employee[2]	0.8	0.7	0.5	1.2	1.6
Unit labour cost	1.6	1.0	1.2	0.3	0.7
Household disposable income	0.5	1.1	1.0	0.4	0.7
GDP deflator	1.7	2.0	0.4	0.0	0.7
Consumer price index[3]	2.7	0.8	-0.3	0.3	1.0
Core consumer price index[4]	2.0	1.0	0.4	0.4	1.0
Private consumption deflator	1.9	0.2	-0.7	0.2	0.9

1. As a percentage of labour force.
2. In the total economy.
3. Calculated as the sum of the seasonally adjusted quarterly indices for each year.
4. Consumer price index excluding food and energy.

Source: OECD Economic Outlook 100 database.

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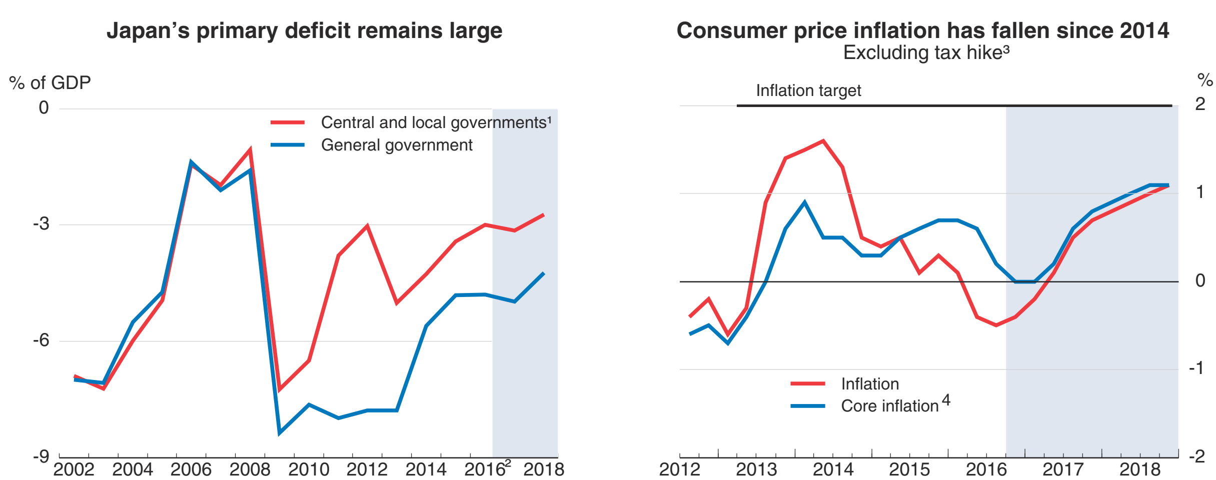
spending, supported by wage growth, which was nonetheless surprisingly muted given the tightest labour market conditions in 25 years. Consumer purchasing power was also boosted by the fall in headline inflation back into negative territory, in part due to declining oil prices. Even excluding energy and food prices, inflation is close to zero. After declining in the first half of 2016, exports rebounded sharply in the third quarter of 2016.

Japan



1. This measure excludes the balance of social security funds and reconstruction spending.
2. OECD estimate for 2015-16.
3. In April 2014, the consumption tax was raised from 5% to 8%. The tax hike added 2 percentage points to inflation in FY 2014 according to estimates by the Bank of Japan and the Cabinet Office.
4. OECD measure, which excludes food and energy.

Source: OECD Economic Outlook 100 database; OECD calculations; and Bank of Japan.

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Japan: **Financial indicators**

	2014	2015	2016	2017	2018
Household saving ratio, net[1]	-0.8	1.4	2.7	2.4	1.8
General government financial balance[2]	-6.2	-5.4	-5.2	-5.2	-4.3
General government gross debt[2]	227.7	229.9	233.7	237.5	239.7
General government net debt[2]	126.2	128.5	132.2	136.1	138.3
Current account balance[2]	0.8	3.3	3.8	3.8	4.1
Short-term interest rate[3]	0.1	0.1	0.0	-0.1	-0.1
Long-term interest rate[4]	0.6	0.4	-0.1	0.0	0.0

1. As a percentage of disposable income.
2. As a percentage of GDP.
3. 3-month interbank rate.
4. 10-year government bonds.

Source: OECD Economic Outlook 100 database.

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Fiscal consolidation has paused

The expansion was also supported by two fiscal packages in the first half of 2016. In August, the government announced a Yen 7.5 trillion (1.5% of GDP) fiscal package for FY 2016-17, offsetting the earlier planned tightening. With three fiscal packages in 2016 and the decision to delay the consumption tax hike that had been planned for April 2017, the primary deficit is projected to remain close to 5% of GDP during 2015-17.

The government has an objective of achieving a primary surplus (central and local governments) in FY 2020. It has also set a benchmark of a primary deficit of around 1% of

Japan: **Demand and output**

	2015	2016	2017	2018	Fourth quarter 2016	Fourth quarter 2017	Fourth quarter 2018
	Current prices YEN trillion	Percentage changes from previous year, volume (2005 prices)					
GDP at market prices	499.3	0.8	1.0	0.8	1.5	0.8	0.9
Private consumption	292.5	0.4	0.5	0.5	1.1	0.5	0.4
Government consumption	101.8	1.5	0.0	0.1	0.9	0.1	-0.2
Gross fixed investment	108.2	0.6	1.6	0.1	1.2	0.7	0.4
Public[1]	23.4	-1.6	0.0	-7.6	2.3	-4.8	-5.7
Residential	14.7	5.5	3.3	1.2	7.3	1.3	1.1
Non-residential	70.1	0.3	1.7	2.1	-0.4	2.2	1.9
Final domestic demand	502.5	0.7	0.7	0.3	1.1	0.5	0.3
Stockbuilding[2]	1.7	-0.1	0.0	0.0			
Total domestic demand	504.1	0.5	0.6	0.3	1.0	0.5	0.3
Exports of goods and services	89.3	-0.4	3.0	3.1	1.3	2.8	3.3
Imports of goods and services	94.2	-1.6	1.6	1.0	-0.9	1.8	1.0
Net exports[2]	- 4.9	0.2	0.2	0.3			

Note: Detailed quarterly projections are reported for the major seven countries, the euro area and the total OECD in the Statistical Annex.

1. Including public corporations.
2. Contributions to changes in real GDP, actual amount in the first column.

Source: OECD Economic Outlook 100 database.

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Japan: **External indicators**

	2014	2015	2016	2017	2018
			USD billion		
Goods and services exports	816.6	738.5	755.5	778	811
Goods and services imports	961.6	778.7	736.5	748	765
Foreign balance	- 145.0	- 40.3	19.0	29	45
Invisibles, net	181.6	175.1	160.5	155	156
Current account balance	36.6	134.9	179.5	184	201
			Percentage changes		
Goods and services export volumes	8.3	2.8	- 0.4	3.0	3.1
Goods and services import volumes	7.2	0.4	- 1.6	1.6	1.0
Export performance[1]	3.9	0.6	- 2.5	0.3	- 0.1
Terms of trade	- 1.0	8.9	6.9	0.0	- 0.1

1. Ratio between export volume and export market of total goods and services.
Source: OECD Economic Outlook 100 database.

StatLink http://dx.doi.org/10.1787/888933438750

GDP in FY 2018 to help achieve this target. However, the primary deficit by this measure is projected at over 2¾ per cent of GDP in 2018, even with some improvement in the fiscal position as reconstruction spending wanes.

Keeping Japan's promises to provide health and long-term care and pension benefits to its rapidly-ageing population requires a comprehensive plan to achieve fiscal sustainability. Such a plan should include detailed and concrete measures to boost revenues through gradual increases in the consumption tax, broadening the personal and corporate income tax bases and raising environmental taxes. The plan should also include reforms to contain the growth of social spending. In healthcare, savings could be achieved by shortening hospital stays and increasing elderly co-payments for health and long-term care spending. As for public pensions, it is important to raise the pension eligibility age and to fully apply macroeconomic indexation to pension benefits.

Controlling the growth of social spending would also create space for public "soft" investment that would boost Japan's growth potential. In particular, expanding childcare and long-term care – two priorities of Abenomics – would reduce the number of workers who leave their jobs to care for children or elderly relatives. In addition, eliminating the provisions of the tax code that discourage full-time work by second earners in households would boost labour inputs.

Achieving the inflation target remains a priority

Faster nominal output growth – by increasing real growth and inflation – is also essential to achieve fiscal sustainability. In September 2016, with inflation negative, the Bank of Japan (BoJ) announced a new policy framework based on "yield curve control" to keep the yield on 10-year government bonds near its current level of around zero. The new framework enhances flexibility in the amount of bond purchases. The short-term interest rate is to remain at -0.1% for a portion (about 4%) of bank deposits at the central bank. The BoJ also made an "inflation-overshooting commitment" to continue expanding the monetary base until consumer price inflation (excluding fresh food) exceeds the 2% target in a stable manner. Such policies should continue until the commitment has been achieved, while taking account of costs and benefits. Thus far, there is no sign of price bubbles in the stock market and real estate.

Growth momentum will continue through 2018

Annual output growth is projected to remain between ¾ per cent and 1% over 2016-18. Although real wage gains are expected to ease as the increase in inflation outstrips wage growth, a fall in the saving rate to its pre-2013 level, supported by the improvement in consumer confidence, is projected to sustain private consumption. Export growth is expected to pick up with the rebound in international trade and this will support investment in the business sector, where profitability and cash holdings are historically high. As fiscal stimulus and reconstruction fade, the downward trend in public investment will resume, although it will be partly offset by construction related to the 2020 Olympics. Inflation is projected to rise to 1¼ per cent by the end of 2018, while the current account surplus remains close to 4% of GDP.

Sustained output growth requires a virtuous circle of rising prices, wages and corporate earnings. The major uncertainty is wage growth, which has remained sluggish despite high corporate profitability and labour shortages. If firms raise wages more rapidly than projected to reduce labour shortages, private consumption and output growth would be stronger. The major downside risk is that the improvement in consumer confidence will not be sustained, leaving the household saving rate high. A second risk is Japan's unprecedentedly high level of public debt. Unless it implements a more detailed and concrete strategy to stabilise the debt ratio, Japan could face a loss of confidence in its fiscal sustainability, which in turn could destabilise the financial sector and the real economy, with large spillovers to the world economy. External risks are largely on the downside, given uncertainty about China, which accounts for a quarter of Japanese exports.