JAPAN

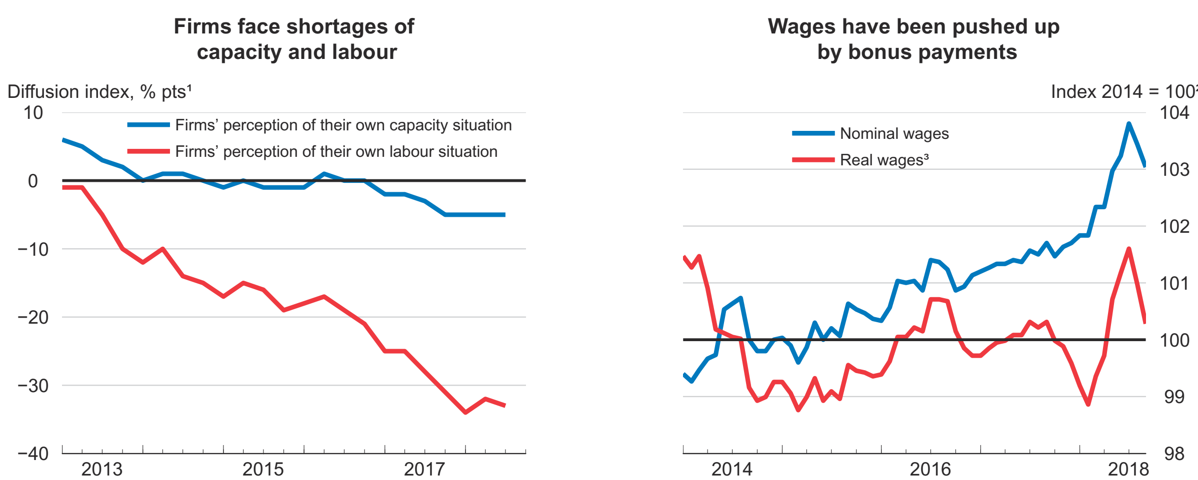
Economic growth is projected to remain around 1% in 2018-19, as record-high corporate profits and labour shortages drive business investment. In addition, stronger wage gains will support a pick-up in private consumption in 2019. Although the October 2019 consumption tax hike will temporarily reduce demand, growth is projected to resume in early 2020, buoyed by additional government spending and the 2020 Olympic Games in Tokyo. Sustained growth, combined with higher oil prices, is expected to boost inflation to 1½ per cent (excluding the impact of the consumption tax hike) in 2020.

Government debt relative to GDP, which is the highest ever recorded in the OECD area, poses serious risks. Achieving fiscal sustainability requires a detailed consolidation programme that includes gradual hikes in the consumption tax, beginning with the planned increase in 2019, and measures to control spending in the face of rapid population ageing. With the working-age population declining, additional policies to sustain employment and structural reforms to boost productivity are a priority. Monetary policy needs to remain expansionary until the 2% inflation target is achieved.

Private consumption and business investment have been driving growth

The current expansion, which began in December 2012, is on track to become Japan's longest post-war upturn in early 2019. However, the benefits for households have been limited by weak wage growth. Private consumption during this expansion has risen at an annual rate of only 0.6% in per capita terms, well below the 1.5% pace of per capita output. Headline consumer price inflation is around 1% in 2018.

Japan



1. 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.
2. Seasonally-adjusted data (three-month moving average) based on establishments with 30 or more workers.
3. Deflated by the consumer price index, excluding rent.

Source: Bank of Japan; and Ministry of Health, Labour and Welfare.

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Japan: **Demand, output and prices**

	2015	2016	2017	2018	2019	2020
	Current prices YEN trillion	Percentage changes, volume (2011 prices)				
GDP at market prices	532.0	1.0	1.7	0.9	1.0	0.7
Private consumption	301.2	0.1	1.0	0.4	0.9	-0.1
Government consumption	105.3	1.3	0.4	0.5	0.6	1.0
Gross fixed capital formation	126.5	1.1	2.5	1.7	1.5	0.8
Final domestic demand	533.0	0.6	1.2	0.7	1.0	0.4
Stockbuilding[1]	1.2	-0.2	-0.1	0.1	0.0	0.0
Total domestic demand	534.2	0.4	1.2	0.8	1.0	0.4
Exports of goods and services	93.6	1.7	6.7	2.8	1.4	3.8
Imports of goods and services	95.8	-1.6	3.5	2.6	1.4	2.0
Net exports[1]	- 2.2	0.6	0.6	0.1	0.0	0.3
Memorandum items						
GDP deflator	_	0.3	-0.2	-0.1	0.3	1.6
Consumer price index[2]	_	-0.1	0.5	1.0	1.4	1.9
Core consumer price index[3]	_	0.4	-0.1	0.2	1.2	1.9
Unemployment rate (% of labour force)	_	3.1	2.8	2.4	2.4	2.4
Household saving ratio, net (% of disposable income)	_	2.6	3.0	4.2	4.1	4.4
General government financial balance (% of GDP)	_	-3.4	-3.7	-3.2	-3.0	-2.6
General government gross debt (% of GDP)	_	222.3	224.2	226.4	227.9	227.6
Current account balance (% of GDP)	_	3.8	4.0	3.3	2.6	3.0

1. Contributions to changes in real GDP, actual amount in the first column.
2. Calculated as the sum of the seasonally adjusted quarterly indices for each year.
3. Consumer price index excluding food and energy.

Source: OECD Economic Outlook 104 database.

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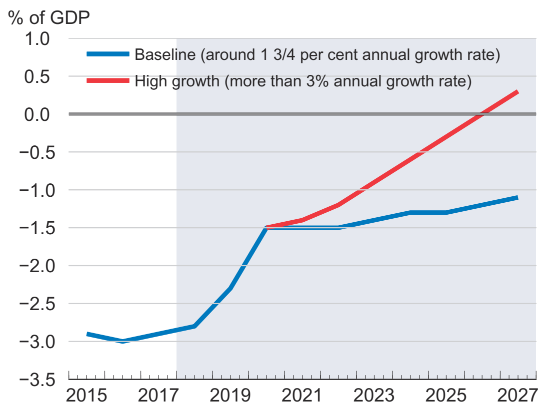
Growth has been led by private consumption and business investment. The accelerating decline in the working-age population is exacerbating labour shortages, particularly in services. The unemployment rate is around 2½ per cent, while the ratio of job openings to applicants has risen to its highest level since 1974. Wage growth has been sustained by an 8.6% rise in summer bonuses in 2018 in large firms and by tax incentives, thereby supporting private consumption. Labour shortages, combined with capacity shortages and the record high level of corporate profits in 2018, is stimulating business investment. However, exports declined in the third quarter of 2018 in the context of weaker world trade growth.

Ensuring fiscal sustainability also depends on monetary policy and structural reforms

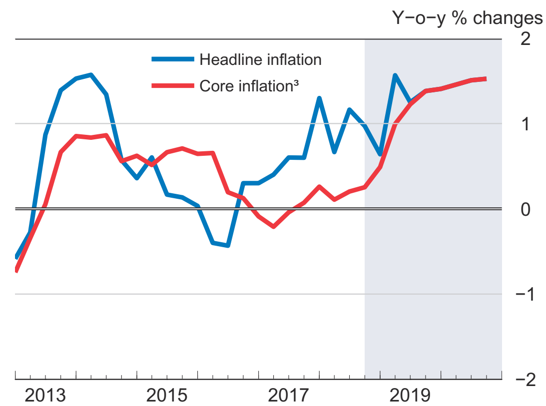
Japan's gross general government debt has risen to 226% of GDP. With a primary deficit of around 3% of GDP in 2018, the target of a primary surplus has been pushed back from FY 2020 to FY 2025. To offset the impact of the October 2019 hike in the consumption tax from 8% to 10%, the government is planning exceptional measures, such as a temporary increase in spending and a cut in taxes on cars and housing, in FY 2019-20. The impact of the tax hike on the budget deficit will be limited by the decision to use half of the additional revenue for new spending programmes. Japan needs a detailed and concrete

Japan

The primary budget deficit is likely to continue under current policies[1]



Consumer price inflation remains below the 2% target[2]



1. Government projections in July 2018. It assumes that the hike in the consumption tax rate from 8% to 10% is implemented as planned in 2019. The primary balance is central and local governments, as a percentage of GDP on a fiscal year basis.
2. Excluding the effects of the April 2014 consumption tax hike, which added 2 percentage points to inflation in FY 2014 according to a government estimate. It also excludes the scheduled October 2019 consumption tax hike, which would add 1 percentage point to inflation in the fourth quarter of 2019, and the impact of free childcare for children aged three to five, which would reduce it by 0.5 percentage point, according to an OECD estimate.
3. OECD measure, which excludes food and energy.

Source: Cabinet Office; OECD Economic Outlook 104 database; and Bank of Japan.

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consolidation plan to ensure confidence in its fiscal sustainability by achieving a primary surplus and putting the government debt ratio on a downward path. Measures to raise revenues should rely primarily on less-distortive taxes, notably the consumption tax and environmentally-related taxes. The 2019 consumption tax hike should be followed by gradual further increases that raise it towards the 19% OECD average. On the spending side, the key is to contain social spending, notably health and long-term care.

Large-scale government bond purchases by the Bank of Japan, which now owns 45% of the outstanding stock of government bonds, has mitigated the impact of high government debt. Under its "yield curve control" policy, the central bank is keeping the yield on 10-year government bonds close to zero. The Bank of Japan is committed to continue expanding the monetary base until CPI inflation (excluding fresh food) exceeds the 2% target and stays above it in a stable manner. The projection assumes that the supportive monetary stance continues through 2020.

Japan's shrinking and ageing population makes it important to remove obstacles to employment for older persons through labour market reform, including abolishing the mandatory retirement age, which is currently set at 60 by most firms. Breaking down labour market dualism would promote female employment and reduce Japan's large gender wage gap. The government has proposed allowing foreign nationals who have completed training programmes in Japan to remain for up to five additional years to work in sectors facing severe labour shortages, such as construction and long-term care. The New Economic Policy Package set an ambitious target of doubling labour productivity growth to 2% by 2020 through a range of measures, including corporate governance reforms, financial support for investment in ICT by SMEs and tax incentives for wage and investment increases. Japan is promoting trade liberalisation through its leadership in the

Comprehensive and Progressive Agreement for Trans-Pacific Partnership (TPP-11), which should go into effect in 2019.

The tax hike will have only a temporary impact on output

Output growth is projected to remain around 1%, in line with Japan's potential rate, in 2018-19 before slowing to 0.7% in 2020 following the 2019 tax hike. However, the impact of the consumption tax rise will be temporary and partially offset by planned fiscal measures. Growth depends significantly on wage developments. While the jump in bonus payments in 2018 is a positive sign, larger increases in basic wages are important to sustain private consumption. Protectionism remains a risk, though under the new initiative for a Trade Agreement on Goods with the United States, no new trade restrictions are to be introduced while negotiations continue. Japan's unprecedentedly high level of public debt is a key risk. A loss of confidence in Japan's fiscal sustainability could destabilise the financial sector and the real economy, with large negative spillovers to the world economy.