Japan

The year starts off slowly

- **The year 2015 ended on a weak tone as Q4 GDP contracted (-0.3% q/q).**
- **This year is hardly looking any better. The first indications for the first quarter do not point to an immediate rebound in growth, much to the contrary.**
- **Industrial output plunged in February and acquired growth is negative in Q1. It now seems probable that GDP will contract again in Q1.**

The year 2015 ended on a weak tone as GDP contracted in Q4, erasing the previous quarter's rebound (-0.3% q/q *vs.* +0.3% in Q3). Full-year growth accelerated slightly (+0.5% year-on-year) after virtually stagnating in 2014 (-0.1%). As to 2016, the first available indicators for February do not point to a significant improvement in activity in the first part of the year.

The slowdown in the emerging economies, and China in particular, continues to handicap Japan's manufacturing sector and exports, especially for capital goods. In 2015, nearly 25% of Japanese exports were shipped to China (including Hong Kong), which is Japan's biggest trading partner. After virtually stagnating in January (+0.3% m/m), total exports contracted by more than 2% in February. Machinery orders, a leading indicator of manufacturing output and exports, declined in January (-8.8% m/m, after +1.4% in December), pulled down by the drop-off in foreign orders (-29.4%, vs -2.2% the previous month).

Industrial output fell sharply in February (-6.2%) as the sector continues to scale back inventories to face up to the slowdown in foreign demand in general and Asian demand in particular. The decline was sharpest in the durable goods sector (-9.2% m/m). For industrial output, acquired Q1 growth declined 2% q/q in February. To find a comparable decline, we have to look back to Q2 2012 (-2.2% q/q), when GDP contracted 0.4%.

Despite full employment, household consumption has barely contributed to growth in the first part of the year, after contracting 0.9% q/q in Q4. In February, the unemployment rate picked up slightly to 3.3%, from 3.2% in January, the lowest level in twenty years. The ratio of job offers to demand was also unchanged at 1.28 in February, the highest level since the early 1990s, signalling a shortage of labour force despite the increase in the active population in keeping with higher participations rate for women and seniors. Reacting slowly to changes in labour market conditions, wages have not accelerated, shaking household confidence. In February, confidence dropped to the lowest level in more than a year, and the jobs component reported the biggest decline since October 2013. In February, retail sales contracted by more than 2% m/m. The Bank of Japan attributed this poor showing, which mainly hit clothing sales, to unseasonably warm temperatures.

Industrial output and GDP

GDP (%, q/q, LHS);
Industrial output (%, q/q)
*: Acquired Q1 growth in February

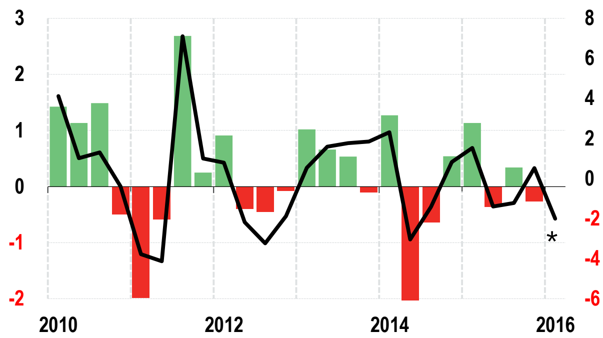

Chart 1 Sources: Cabinet Office, METI

Under these conditions, the monetary authorities continue to be alarmed by February's consumer price statistics. Headline inflation was +0.3%, while core inflation, excluding fresh produce and energy prices, rose slightly to +0.8% (from 0.7% in January).

The Bank of Japan's efforts to lift inflation to its 2% target have been very slow in bearing fruit. With spring wage talks (*Shunto*) resulting in smaller wage increases than those negotiated in 2015 (+2.2%), deflation is proving hard to beat. Under these conditions, the Bank of Japan has little choice but to continue easing monetary policy and to opt for new actions.

In January, the monetary policy committee decided to lower the rate of interest on excess reserves (IOER) below zero. After this 0.10 bp cut, the IOER rate could be cut by another 0.20 points by June unless there is a significant improvement in the list of factors the Bank of Japan used in January to justify its decision (*volatility of global financial markets, ongoing decline in oil prices, and uncertainty in China particularly and in the emerging and commodity-exporting countries*).