

# Japan

## Pale horizons

*Economic activity in Japan remains in a slump, and the slowdown observed in 2018 seems set to last. Manufacturing activity deteriorated in the first quarter. In the short and medium term, Japan will continue to be hard hit by the slowdown in China, its main trading partner. Demographics are still a major problem in a country where the over-65 age group continues to swell and now accounts for more than a quarter of Japan's total population. It serves as a constant incentive to boost productivity gains through large-scale structural reforms in the goods and services markets as well as in the labour market.*

Japan is one of the OECD economies with the highest exposure to the emerging markets of Asia. Already confronted with numerous structural challenges, Japan is also on the front line when it comes to the risk of a Chinese slowdown.

### ■ A sluggish economic situation

Economic activity slowed sharply in Japan in 2018 as GDP rose only 0.8%, compared to 1.9% in 2017. The growth profile was jagged. The country was hard hit by a typhoon in Q3 2018 that hit domestic demand particularly hard, especially investment. The fourth-quarter rebound was not as strong as expected as foreign trade once again curbed growth.

In Q1 2019, cyclical indicators are still mixed. According to the Bank of Japan's Tankan survey, a good indicator of business confidence, the index levelled off in the non-manufacturing sector but deteriorated in the manufacturing sector, possibly suggesting a decline in Asian orders, essentially from China. The purchasing managers index (PMI) for the manufacturing sector dropped from 52.6 in December 2018, to 49.2 in March 2019, which seems to corroborate this observation. Although the Japanese economy is not very open (exports in value account for less than 20% of the country's total value added), the weighting of the manufacturing sector is relatively high compared to the OECD average. It has even followed a slightly upward trend since 2013<sup>1</sup>. Given the structure of Japan's productive fabric and external trade (more than half of Japanese exports are shipped to Asia, and about 20% to China alone), the economy could be vulnerable to the current global cyclical downturn and the sluggish momentum of international trade.

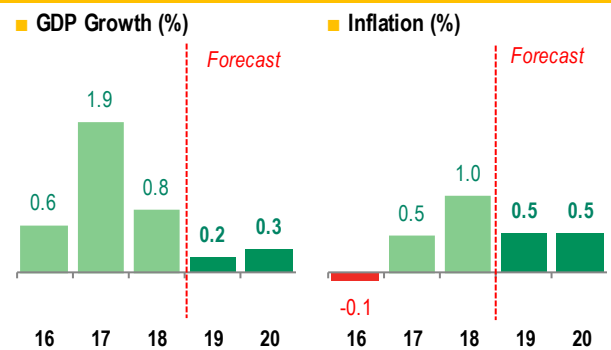
All in all, Japanese growth is falling sharply and is likely to near zero in 2019 and 2020, at +0.2% and +0.3%, respectively. The downturn in the investment cycle is likely to erode activity, as industrial companies take a wait-and-see approach to the slowdown in external demand.

There are numerous risks associated with this growth scenario. In case of a more abrupt slowdown in Chinese demand, for example, Japan would be one of the hardest hit economies, notably in the short term<sup>2</sup>.

<sup>1</sup> Source: OECD

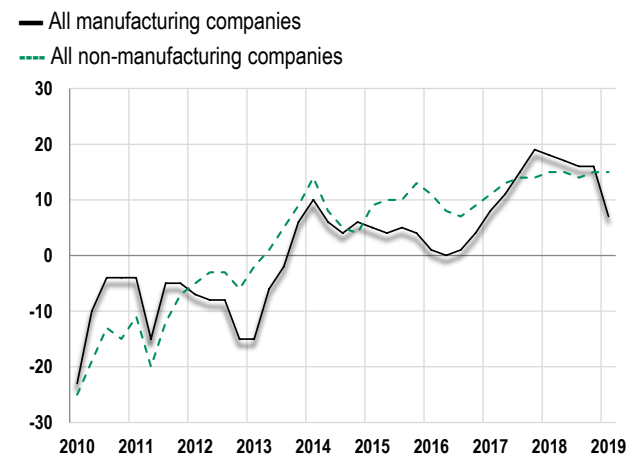
<sup>2</sup> *Global growth weakening as some risks materialize*, OECD Interim Economic Outlook, March 2019

### 1- Growth and inflation



Source: National accounts, BNP Paribas

### 2- Tankan indicator



Source: Bank of Japan

### ■ Questions about the effectiveness of monetary policy

The Bank of Japan's balance sheet has swelled rapidly since 2013 and now accounts for 100% of the country's GDP. At a time when the Fed's balance sheet is shrinking and the ECB's has stagnated, the Bank of Japan's balance sheet continues to swell, albeit at a slower pace since 2017. Meanwhile, a negative interest rate policy and yield curve controls have maintained the long end at roughly zero. This very expansionist monetary policy may have had a beneficial impact on growth, financing costs and inflation. However, price momentum is still very mild, with annual year-on-year inflation



of 0.2% in February 2019, the same as in January 2019. For the full year, inflation is expected to remain low at an average annual rate of 0.5%, due notably to the slowdown in activity. Inflation is expected to level off in 2020.

In general, Japan's extended period of low interest rates and its demographic trends (an aging population and a decline in the working age population), which reduce credit demand, pose major challenges for the local financial system. Net interest margins for the regional banks have been trending downwards since the mid-2000s. This environment encourages regional banks to take more risks, particularly in terms of their loan policy with regard to small and medium-sized enterprises (SME) (IMF, 2018)<sup>3</sup>.

### ■ Limiting the economic impact of aging population

The third arrow of Abenomics, launched in 2012, focused on so-called structural reforms. This segmented programme covers several aspects of the Japanese economy. In addition to boosting innovation and openness to trade, as illustrated by the recent trade agreement signed with the European Union, the reforms aim to limit the negative impact on the economy of 1) declining demographics and 2) labour market duality between regular and irregular workers.

Today Japan is the country with the world's oldest population, with the over-65 age group accounting for more than a quarter of the total population (see chart 4). An aging population accompanied by a decline in the share of the working age population poses a major economic challenge. It can have a negative impact on the potential growth rate by reducing the volume of work available. In terms of public finances, the decline in labour reduces fiscal revenues and leads to an automatic increase in public spending, driven up by the needs of the elderly. One solution is to integrate more women into the work force. The labour participation rate of women has increased rapidly in recent years, to 70% in 2018 from about 60% in 2012. Even so, it is still significantly lower than for men, by about 15 percentage points.

There is also the question of the labour market's structure, given its highly ingrained duality. The share of irregular workers has increased rapidly, reducing labour productivity<sup>4</sup>. Irregular contracts are relatively less expensive since they pay less than regular contracts and offer fewer job protections, training and career opportunities. In the early 2000s, regular workers accounted for 70% of total employment, but this figure has now fallen to just above 60%.

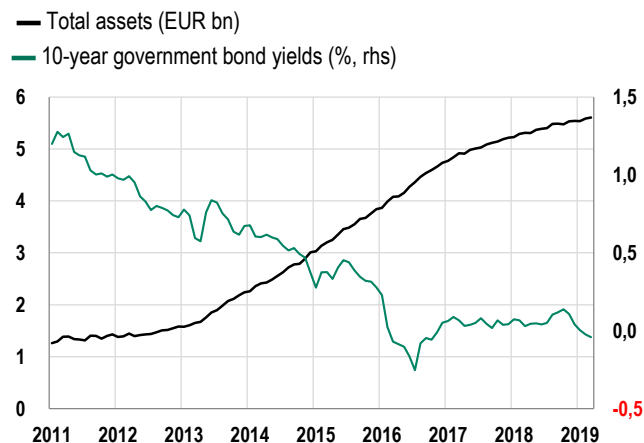
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<sup>3</sup> Article IV Consultation with Japan, IMF, November 2018

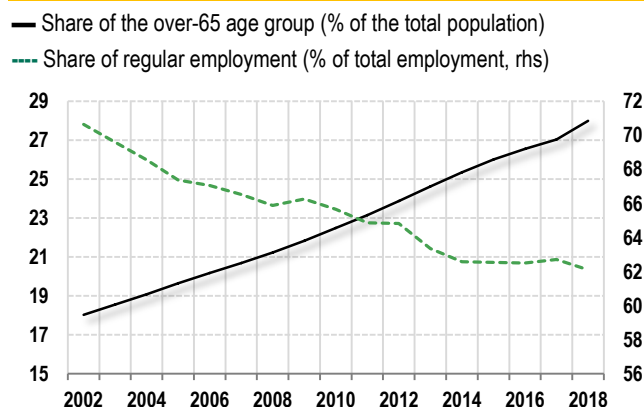
<sup>4</sup> M. Colacelli, "Macroeconomic effects of Japan's demographics: Can structural reforms reverse them?", IMF Working Papers, November 2018

### 3- Asset prices rise, while rates fall to the zero lower bound



Source: Bank of Japan

### 4- Major demographic challenges



Source: Statistics Bureau of Japan, World Bank, INED, BNP Paribas

