››› Japan – a trailblazer in economic policy change?

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One Pager

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After a relatively solid performance in the first quarter of this year, Japan's overall economic expansion slowed down noticeably in the second quarter. Price-adjusted GDP gained a mere 0.2 % on the previous quarter. The rather moderate momentum of domestic demand that has been observed for quite some time was recently compounded by a pronounced export weakness. During the first phase of "Abenomics" the Japanese economy had still benefited from the currency devaluation induced by monetary policy. The recent surge of the yen has ruined that advantage. Japan needs additional growth stimuli. As the already very expansionary monetary policy is gradually nearing its limits, fiscal policy is increasingly coming back into play again.

The fiscal policy trend reversal ...

The consumption tax increase planned for 2017 has been postponed again – to 2019. Furthermore, a package of fiscal policy measures worth JPY 28 trillion (around EUR 245 billion) has been put together. Only around one fourth of it will have a direct impact on expenditure. The planned credit subsidies and infrastructure measures, for example, will have an effect only in the medium term.

... will impact on growth

The change in fiscal policy – particularly the postponement of the consumption tax increase – is good news for Japanese growth. Japan had temporarily slipped into recession after the first stage of consumption tax increase in 2014. A repeat is now being avoided. The extra government spending that will take effect in the short term is not generous, but it will at least bolster growth to a limited extent. We therefore expect growth to pick up slightly to ¾ % in 2017 after around ½ % in 2016.

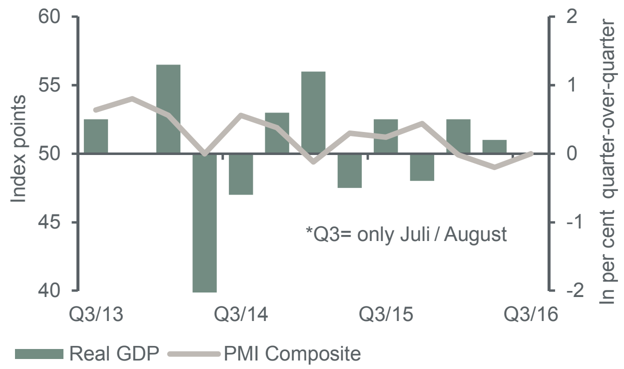
... will impact on public debt

The policy change does mean a setback for the medium-term consolidation of public finances, a course that had been pursued only half-heartedly to begin with. A continuing high current budget deficit (which is likely to be around 5 % of nominal GDP in 2016) and a rising public debt ratio are inevitable. On the financing side, this does not pose a problem, at least not for now. The debt service ratio in the central budget has remained relatively stable in the past years at around 25 % thanks to ultra-low interest rates. Public debt is increasingly being passed on to the Bank of Japan. As a result of its high-volume bond purchases it currently holds around one third of outstanding government bonds and will quickly reach the 50 % mark in the next two years. Considerations have already been made on how Japan can deal with this trend in the medium term. One option that has been brought into play is to convert the bonds held by the BOJ into debt instruments with unlimited maturities.

A more balanced economic policy mix

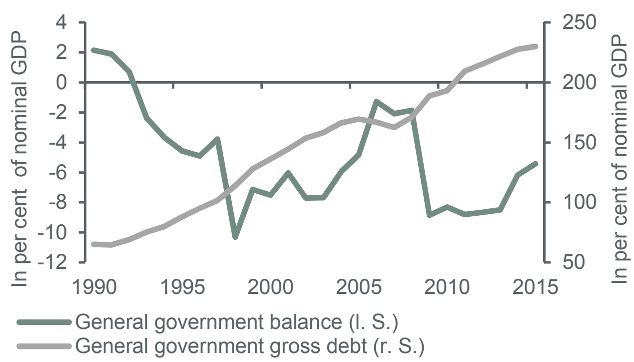
Even if the new Japanese fiscal package is significantly less ambitious than it seems at first sight, it does convey an important message: monetary policy alone will not do the trick. In order to counteract the weakness in aggregate demand, fiscal policy will have to take on a more active role. That will allow it to become a useful addition, although not a substitute for longer-term structural reforms. These must continue to be pursued. The effort to achieve a more balanced economic mix is to be applauded. It has the potential to make Japan a trailblazer for other countries. ■

Figure 1: Growth and sentiment



Source: Bloomberg

Figure 2: National budget situation



Source: Feri