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Japan lifted by improving global economy

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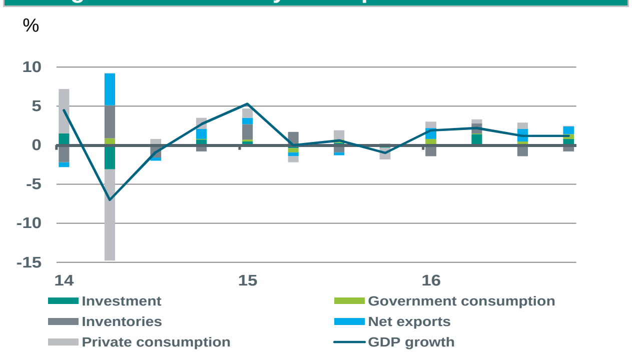
- **External demand pulling Japan's economy**
- **Inflation to remain below target for a while**
- **No change in monetary policy seen in the near-term**
- **Fiscal policy set to support growth potential**
- **Our GDP forecast is 1% in 2017 and 0.8% in 2018 (without additional easing)**
- **Our inflation forecast is 0.8% in 2017 and 1% in 2018**
- **2017 and 2018 USD/JPY forecast: 110 and 105 respectively**
- **Downside risks to growth are related to the yen's appreciation**

External demand pulling Japan's economy

Japan's economy has seen some signs of improvement as a result of the more positive momentum of the global economy. Export growth is stronger and more sustained, mainly supported by IT-related goods and by a stronger demand coming from Asia. Meanwhile, growth in domestic demand has failed to pick up and has left the economy more vulnerable to external developments. In 2016, consumption growth was weak, partly as a result of severe weather conditions, as well as declining wealth effects, brought about by a decline in equity prices. As for business investment, it remains subdued despite the rise in profit growth. Cash holdings are at historically high levels, signalling the still cautious approach of companies. Our current forecasts see that GDP growth will remain at around 1% in 2017 and slightly lower in 2018 as external demand, from major trading partners, loses some momentum.

GDP growth boosted by net exports

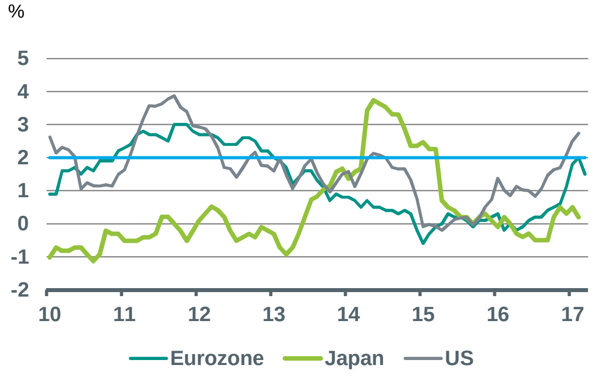


Source: Thomson Reuters Datastream, ABN AMRO

Inflation still below target

Inflation picked up in Japan as it did in other economies, as a result of higher energy prices. However, headline inflation is still far below the 2% target. Meanwhile core inflation has been stagnant for several months. There are several factors holding down core inflation. To begin with, firms have refrained from revising prices upwards given weak consumption growth. Moreover, wage growth remains subdued. There has been a rise in the labour participation rate of seniors and females. This could be delaying the expected rise of wage growth. The “shunto” spring wage negotiations, which are important to the outlook for wages, will be critical. However, the first signs suggest that wage growth will remain modest. We think it is only a matter of time before wage growth rises. The BoJ has estimated that the NAIRU is around 3%, while it is currently at 2.8%. This suggests that in the near-term wage growth could accelerate. We expect that by 2018 higher wage growth will exert more upward pressure on inflation.

Inflation moving up but at a still slow pace



Source: Thomson Reuters Datastream, ABN AMRO

No change in monetary policy the near-term

The BoJ continues to run an accommodative monetary policy. After expanding the asset purchase programme and introducing negative interest rates, on 21 September 2016 it introduced QQE with yield curve control as a means of enhancing the previous policy frameworks. One of the problems that central banks face with asset purchase programmes is that the assets become scarce and therefore it is not unusual that central banks explore other tools. Under yield curve control, the BoJ specifies a short-term policy interest rate and a target level of a long-term interest rate, instead of the amount of increase of the monetary base and the amount of JGB purchases as in the previous framework. It wil still purchase KGBs but with the objective of reaching the yield curve target. The BoJ has clarified that it does not intend to change monetary policy in the near-term arguing that with inflation so low officials need to be patient and let policy do its job. According to BoJ data, the lending channel is getting some support. The amount of outstanding bank lending has been increasing at an annual rate of around 2.5% to 3%. We expect the BoJ to maintain its current policy throughout the year. However, given that negative rates could affect the functioning of the financial system, we expect that as the economy takes advantage of the global developments and reaches more stable growth, that the BoJ will move away from the negative rate policy in 2018, while maintaining the yield curve control.

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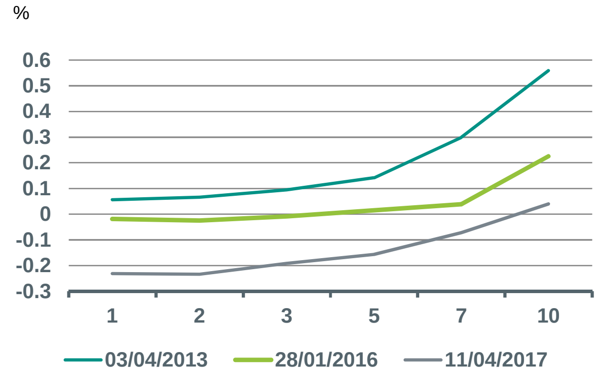
JGB rates since QQE and negative rates



Source: Thomson Reuters Datastream, ABN AMRO

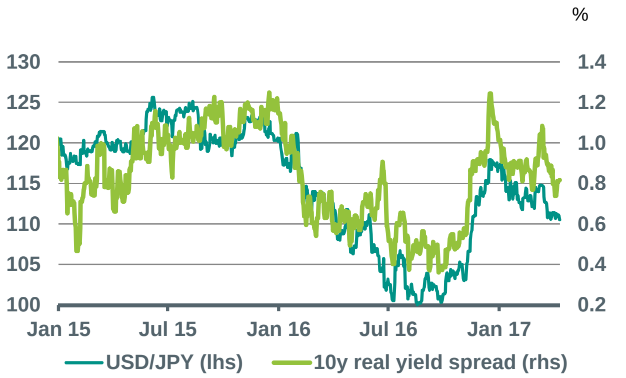
Fiscal policy set to support growth potential

The government has been implementing tax reform with the aim of adding momentum to the economy. In the FY2017 tax reform that was approved by the Cabinet at the end of last year, a number of initiatives have been included to increase the potential growth of the economy. One of the reforms is the spousal exemption for personal income tax. This is intended to support the entry of women in the labour market. In the present system, a deduction is received when the main earner of a married couple has a spouse whose annual income is zero. There are also measures to give preferential treatment to companies engaging in R&D. Beyond these initiatives, the government maintains its goal of achieving a primary surplus in fiscal 2020. This is under the assumption that economic growth would reduce the primary deficit. Japan's government debt is well above 200% GDP.

Risks of a stronger yen remain

In the period 1 January to 11 April 2017, USD/JPY moved within a 110-115 range. USD/JPY is highly sensitive to developments in the spread between US real yields and Japanese real yields. Since the start of 2015, USD/JPY and the spread have moved in tandem (graph below). Investor sentiment has always been a crucial driver as well as the yen is considered to be a global safe haven currency. Recently a deterioration in investor sentiment (geo-political concerns) has resulted in yen strength across the board. The French presidential elections are now the focus of investors. Developments in the options market suggest that investors have started to hedge the possibility of an unfavourable outcome at the second round of this presidential elections. This has resulted in higher demand for the yen versus the euro. If the outcome of the French presidential elections or geo-political developments were to result in a sharp deterioration of investor sentiment, USD/JPY could drop to100 in the near term. If investor sentiment recovers then the yen will likely fall again. The BoJ will likely try to avoid a sharp strengthening of the yen.

Japanese yen and US real yields



Source: Thomson Reuters Datastream, ABN AMRO

In the coming months we expect US real yields to rise at a modest pace as well as the real yield spread. This should provide support in USD/JPY. The pair could move towards 115 again or even slightly above it. We expect such a move to run out of steam quickly though. Our year end forecast for USD/JPY is 110. Next year, we expect USD/JPY to move lower mainly because of a general US dollar weakness. Our year-end 2018 forecast for USD/JPY is 105.

Risks to the outlook

We see risks broadly balanced in the near term. The upside risks to our GDP growth outlook are:

- Fiscal stimulus has been important for growth in the second half of 2016. We do not expect much larger extra stimulus in 2017. If there should be more stimulus, this could give a boost to the economy. We expect monetary easing to continue throughout 2017 and 2018. This means that the BoJ will continue with monetary easing and the yield curve control.
- We are optimistic about the global growth in 2017, particularly for the US and China. These are Japan's two major trading partners. This could lead to stronger external demand for Japan. Both the US and China's importance to Japan's exports amounts to a bit more than 18%.

The downside risks are related to the potential external shocks, including:

- These are related to geopolitical risks in the region, as well as any signs that President Donald Trump will favour isolationist policies This could lead to a stronger yen, which will likely be a drag for Japan's external position.