Japan
A slow recovery despite a strong stimulus

Michael Wolf
Japan entered the pandemic already mired in recession.¹ Real GDP contracted in Q4 2019 after a consumption tax was implemented in October, and another contraction was recorded in Q1 this year. We expect a far steeper decline in Q2 as the country has implemented a state of emergency to stem the contagion of COVID-19. A low rate of new infections, an effective contact-tracing program, and substantial fiscal and monetary stimulus should have put Japan in a relatively favorable position to rebound from the current crisis. However, the recovery is expected to be fairly slow as cautious consumers restrain domestic demand and weak global growth hits exports and industrial production.

Policymakers step up to the challenge

A strong health policy response has ensured that Japan’s pandemic is relatively muted compared to many other large countries. Japan uses a decidedly low-tech and labor-intensive method of contact tracing to prevent the spread of the virus that had proved to be surprisingly effective.² Public health officials also encourage residents to avoid the three Cs: crowds, close contact, and closed spaces.³ Experience with the SARS and MERS outbreaks and a greater willingness to wear masks have also helped curb the spread of the virus in the country.⁴ Although the rate of new per capita infections in Japan was less than 15% of the global average on July 22,⁵ a rise in localized outbreaks remains a challenge.

The economic policy response has been huge. According to the International Monetary Fund (IMF), fiscal stimulus in response to COVID-19 in Japan has amounted to about 40% of the GDP—this includes cash transfers to individuals and companies, deferred tax payments, work subsidies, rent subsidies, and concessional loans. Other analysts estimate the fiscal response is somewhat lower than what the IMF has reported, but the estimates all point to an incredibly large amount of stimulus being pumped into the economy.⁷ For example, according to the IMF measures, the US stimulus was closer to 15% of GDP.⁸ To be fair, not all the Japanese funds will be disbursed at once and some will only be spent if the pandemic worsens. Besides, there have been complaints about delays⁹ and potential misallocations of funds. Still, the sheer size of the fiscal stimulus response in Japan is impressive.

The Bank of Japan (BoJ) has continued to ease monetary policy through unlimited purchases of Japanese government bonds (JGBs); increased purchases of exchange-traded funds (ETFs), Japanese real estate investment trusts (J-REITs), corporate bonds, and commercial paper; enhanced dollar liquidity; and indirect lending programs.¹⁰ The additional monetary stimulus, which amounts to more than 100 trillion yen or US$1 trillion,¹¹ has helped keep shorter-term JGB yields in negative territory despite the rapid rise in the supply of government debt. For now, we expect the BoJ to hold off on any major changes to monetary policy until it can better assess how the current programs are affecting the broader economy. With inflation

Even with trillions of dollars in fiscal stimulus, consumers will remain cautious. Weak external demand, particularly from the United States, will weigh on Japan’s exporters and manufacturers.
just 0.1% higher than a year ago in May, monetary tightening seems unlikely anytime soon.

Consumers are capable of spending more, but they’re being cautious

Given the incredible fiscal and monetary policy responses to the current crisis, Japanese consumers are capable of spending more. Disposable incomes for workers’ households jumped 13.4% from a year earlier in May; furlough schemes kept the unemployment rate below 3%; and central bank purchases have propped up the stock market. At the same time, interest rates and inflation remain low.

Despite the ability to spend more, many consumers appear far more cautious than usual. For example, consumer expenditure for workers’ households fell 15.5% from a year earlier in May despite the surge in disposable incomes in the same month. Some of the decline in spending seems directly related to the state of emergency, which restricted travel and encouraged the closure of bars and restaurants. Spending on services, particularly those related to culture and recreation, was particularly weak in May.

With the state of emergency now lifted, there remain concerns that spending will continue to struggle. For one, the low unemployment rate masks much of the pain felt in the labor market as workers on furlough are not counted as unemployed. Perhaps a more accurate view of the state of the
labor market is aggregate hours worked, which dropped 10.8% from a year earlier in May. The loss of hours worked have translated into a decline in average monthly wages, which suggests the dramatic rise in disposable incomes was almost entirely due to government transfers. Although such transfers help, consumers likely see them as temporary sources of income, which restrains their willingness to spend a larger share of those earnings.

Consumer confidence improved in June, which suggests that spending also picked up. This is likely true, given the low base seen in May. However, confidence remains more than 10 points below what it was a year ago, and there are signs that consumers are losing some steam. For example, mobility near retail and recreation establishments improved significantly from the end of May through most of June but has stagnated at a depressed level since. Mobility near these establishments in the week to July 3 was still 10.9% below the reference period in January and February. Consumer caution continues to be an issue even in countries such as China that were able to beat back the health risks of the virus sooner.

**Interlinked manufacturing and trade face a harsh global reality**

Japan’s service sector has borne the maximum brunt of the pandemic. The services purchasing managers’ index (PMI) fell to a paltry 21.5 in March as a state of emergency was announced and consumers stayed home, avoiding services such as retail, restaurants, and travel. By contrast, the manufacturing PMI troughed at just 38.4. However, by June, the services PMI jumped to 45.0 while the manufacturing PMI increased to just 40.1.

**FIGURE 2**

Japan’s manufacturing sector is struggling to recover

Jibun Bank/IHS Markit PMI (diffusion index)

Source: IHS Markit and Jibun Bank via Haver Analytics.
Manufacturers are falling behind because they rely on foreign demand for their goods while service providers are still able to benefit from the ongoing improvements in the domestic economy. Goods exports and manufacturing production are highly correlated in Japan. In May, manufactured goods exports fell 23.8% from a year earlier, while manufacturing production was down 25.9% over the same period. Unfortunately, the pickup in global demand that Japanese manufacturers so desperately need seems unlikely any time soon.

On the positive side, Japan’s biggest export market is China, which is easily the strongest-performing large economy in the world right now. Also, well over half of Japan’s goods exports are destined for Asia, which is generally outperforming the rest of the world amid the pandemic. Unfortunately, Japan’s second-largest export market is the United States, which is grappling with a rising wave of COVID-19 infections and is potentially headed toward a double-dip recession. In addition, many of Japan’s exports to Asia are reexported elsewhere, which diminishes some of the benefits of exporting to markets that are further along in their renormalization process.

Japanese exports are also looking less competitive due to the lofty value of the yen. During times of global panic, investors typically flock toward safe havens such as yen-denominated financial assets. The yen is not only slightly stronger against the US dollar, it has also appreciated more substantially against the currencies of some of its largest export markets in Asia. There is also a risk that global investors will dump dollar-denominated assets in favor of yen- and euro-denominated assets should economic conditions worsen in the United States. Such a scenario would put more upward pressure on the yen and further constrain Japanese manufacturers.

Weak global demand and a strong yen will weigh on Japan’s trade balance during the second half of the year. Higher commodity prices will likely push imports higher while exports struggle amid weak global demand and international tourism restrictions. The outlook for Japanese international trade has several downside risks, including a wave of protectionism that risks lowering global trade volumes. In addition, heightened geopolitical tensions could threaten Japanese exports and foreign direct investment positions. Conflict between Japan and China over disputed islands in the East China Sea is also flaring up again. Previous conflict over the islands resulted in anti-Japanese protests and boycotts.

Japan’s policymakers have provided ample fiscal and monetary stimulus to cushion the fall in demand amid the worst times of the pandemic and to support growth as the country attempts to renormalize. However, consumers remain cautious as health risks linger and uncertainty over the future clouds the outlook. Manufacturers are expected to continue to struggle with weak global demand, a strong currency, and geopolitical risks. Japan’s economy should improve from here, but growth will likely remain subdued.
Endnotes

8. IMF, “Policy responses to COVID-19.”
14. Ibid.
21. Trading Economics, “Japan services PMI.”
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Michael Wolf is a global economist at Deloitte Touche Tohmatsu Ltd. He provides written commentary and analysis on global economic issues that affect the firm and its clients. He has been quoted by various media outlets, including the Wall Street Journal and NPR. Wolf began his career as an economist at the US Labor Department and has since held economist positions at Moody's Analytics, Wells Fargo Securities, and PwC. He has two graduate degrees, one in economic policy from Columbia University, and the other in statistics from Baruch College. He also has a bachelor’s degree in economics from the University of Maryland.

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