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Mizuho Economic Outlook & Analysis

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The "corona shock" and the Japanese economy

Substantial contraction of the economy expected in FY2020
Future recovery will be slow

< Summary >

◆ We forecast that Japan's economic growth rate in FY2020 will be -6.0%. A state of emergency declared in Japan and the lockdown of major cities overseas led to a significant decrease in personal consumption and exports during the April to June quarter in 2020. We expect the Japanese economy in the July to September quarter to show rebound growth driven mainly by a recovery in exports and personal spending.

◆ Going forward, the pace of economic recovery will most likely remain slow since (1) there will be adjustments in employment, wages, and capital investment; (2) consumption activities will be partially restrained to prevent the spread of infection; and (3) uncertainty over a resurgence of the pandemic will shrink the activities of households and companies.

◆ Japan's economic growth rate in FY2021 is projected to remain at the +3.4% level, which is not strong enough to win back the decline in the previous year. A widening supply and demand gap will raise concerns about deflation, and the impairment of capital stock will lower the potential growth rate.

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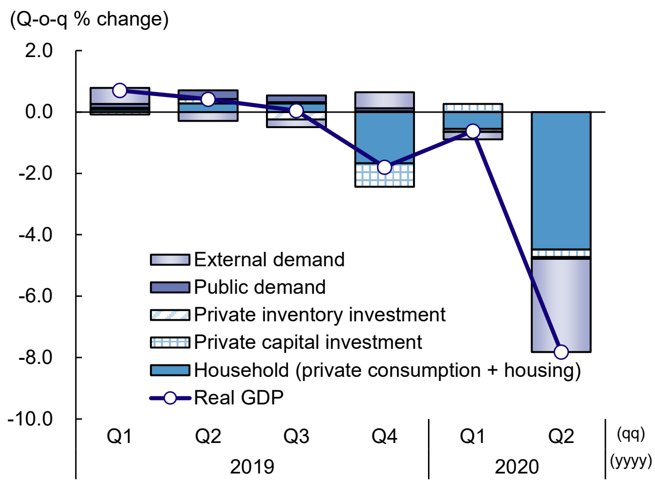
1. Introduction

The coronavirus (COVID-19) pandemic (hereinafter "the corona shock") has severely damaged the Japanese economy. After the Japanese government declared a state of emergency in April, it asked the general public to stay home and various entertainment facilities to close temporarily, and this situation caused an acute drop in private consumption centering on service spending. Many cities worldwide were forced into lockdowns, leading to a decline in the export of automobile-related items and capital goods, and furthermore, the sharp drop in inbound tourists led to a substantial decline in service exports. Not only corporate earnings and capacity utilization ratios deteriorated significantly on the back of the sudden loss of external and internal demand, capital investment was also slashed due to the rise in uncertainty over the future outlook and worsening of the business sentiment. Real GDP in the April to June quarter plunged -7.8% (-27.8% on an annualized basis) from the previous quarter, a significantly greater negative range compared with the rate recorded in the January to March quarter of 2009 after the Global Financial Crisis (-17.8% from the previous quarter on an annualized basis) (**Chart 1**).

As the Japanese government canceled the state of emergency order, and many countries eased or lifted the lockdowns of major cities, the economic indicators have started to improve for now. On the other hand, with the resumption of economic activities, confirmed cases are on the rise once again in many countries and regions around the globe, including Japan.

With uncertainty looming large over a resurgence of the coronavirus, it is difficult to compile an accurate outlook of the economy in the future, but this murky situation makes the importance of economic forecasting even greater. In this report, we will offer our present outlook of the Japanese economy up until FY2021 by considering developments in the international economy.

Chart 1: Real GDP



Source: Made by MHRI based upon the Cabinet Office, *Quarterly Estimate of GDP*.

2. Current status and outlook of the global economy

(1) Global economy in 2020 – A greater decline than in 2009, one year after Lehman's collapse

At the end of last year, the novel coronavirus discovered in Wuhan, China, quickly spread throughout the world, inflicting a serious blow to the global economy. China, the country where the virus originated, put the city of Wuhan under lockdown at the end of January, imposed strict restrictions on human mobility, and ordered the closure of businesses in other cities as well. As a result, China's real GDP tumbled by -6.8% year on year in the January to March quarter, falling into negative territory for the first time since 1992 when quarterly statistics first became available.

Nations other than China followed suit and imposed lockdowns after March, causing a sudden shrinkage of economic activities. The real GDP growth rate in the US, after turning a negative figure at -5.0% in the January to March quarter (from the previous quarter, annualized basis), recorded a historical decline of -32.9% in the following April to June quarter. Real GDP in the eurozone also registered a -3.6% drop in the January to March quarter from the preceding quarter and a significant fall of -12.1% in the April to June quarter. Most emerging countries and regions also experienced an economic downturn of an unprecedented scale as a result of restrictions imposed on economic activities, albeit to varying degrees.

To a greater or lesser extent depending on the countries and regions, restrictions on human mobility during the lockdown period led to a substantial decline in personal spending. Not only were restaurants and cultural and entertainment facilities subject to temporary closure in most cases, restrictions on travel and human mobility inside and outside of countries caused service consumption to fall dramatically. Furthermore, since many countries and regions began to limit the purchase of nonessential and nonurgent items (excluding essential goods such as food and medical products), the purchase of automobiles, apparel items, and other such goods also plummeted. While the drastic decline in personal consumption was a main factor behind the global economic downturn, this sudden contraction in personal consumption and mounting concerns over an uncertain future led many firms to prioritize securing cash at hand, which in turn put a damper on capital investment.

China, after lifting the lockdown ahead of other countries, returned to a positive growth track by posting a +3.2% year-on-year GDP growth rate in the April to June quarter. Also, most major countries such as the United States and some European nations eased their nationwide lockdowns in May toward June, stimulating a recovery in economic activities. In addition to the bounce-back effect of the lockdowns, with many countries implementing large-scale fiscal packages to support households and companies, these countries are expected to generate relatively high economic growth rates in the July to September quarter. Hence it is highly possible that the global economy has already started to pick up from the worst period.

Nonetheless, due to the lack of vaccines or medicines to prevent or cure COVID-19 as well as lingering concerns over the resurgence of infections, some economic activities will continue to be restricted to a certain extent. There have been many reported cases of fresh spikes of the coronavirus after the resumption of economic activities, and some activities have had to be restricted a second time. For service consumption, especially on eating out, it is difficult to imagine a full-fledged recovery for the time being. Also, as most nations are being prudent about lifting restrictions on the cross-border movement of people, recovery of international tourism is expected to be slow, and the economies of various regions that are tourist destinations will likely remain sluggish going forward. With uncertainty over the future remaining high, we expect firms to continue holding back on capital investment. In light of these circumstances, the pace of economic recovery in the October to December quarter is expected to slow down in most nations and regions.

As a result, the global economic growth rate in 2020 is projected to be -4.1%, a significant deterioration compared with the growth rate of -0.1% recorded in 2009 right after the Global Financial Crisis (**Chart 2**). As mentioned earlier, the main factor behind the significant contraction of the economy is the decline in economic activities due to the lockdown of major cities through the April to June quarter, and hence the economy in the latter half of the year is expected to move toward recovery. However, with a sense of caution remaining strong over a possible resurgence of COVID-19, it is difficult to imagine that private sector demand (households and enterprises) will be normalized within this year.

(2) Global economy in 2021 – A full-fledged recovery is far off

We hear media coverage that many pharmaceutical companies and research institutions all around the world are working to develop a vaccine to prevent coronavirus diseases, and that they will start supplying some of these vaccines this fall. But to eliminate the threat of the novel coronavirus completely, it is necessary that effective vaccines and medicines be made available throughout the world. MHRI forecasts this situation to be realized in early 2022 and calculates its economic forecast based on the assumption that concerns over the return of COVID-19 will remain in 2021. We also assume there will be no major lockdowns in the future, as was seen in March through May.

Under these assumptions, while the world economy will experience a gradual recovery in 2021, the level of economic activities will not return to the pre-coronavirus period, with the exception of some countries such as China. Just like in the latter half of 2020, service consumption such as eating out and traveling is expected to remain sluggish. In addition, there is concern over a backlash caused by a series of gigantic fiscal stimulus packages introduced in 2020 in many countries and regions, hence impeding the economic recovery in these respective countries. It is difficult for the US, eurozone countries, and Japan to continue piling on fiscal support measures of the scale seen this year, and some emerging nations may even face the risk of financial collapse.

While we forecast the global economic growth rate in 2021 to be +4.3%, it lacks in strength considering that it comes right after a year of substantial economic contraction with a -4.1% growth rate.

We believe the biggest risk factor in the above forecast is the trend of the novel coronavirus pandemic. As most countries were severely impacted during the lockdown period in the first half of the year, we believe that most will not reintroduce nationwide lockdowns. However, if major nations or regions, including the United States, eurozone countries or China, fail to control the pandemic and are compelled to impose large-scale lockdowns a second time, a significant decline in the global economic growth rate will be impossible to avoid. And the realization of this scenario will make it difficult for their governments to offer economic packages of the scale seen this year, since most countries will have less room for further public spending. The outlook of the global economy up until next year remains highly opaque, and we must say that the downside risk is substantial.

The following pages provide our outlook of the Japanese economy based on our recognition of the current situation of the global economy as described above.

Chart 2: Overview of the global economic forecast

	2017 CY	2018	2019	2020 (Outlook)	2021
Global real GDP growth	3.9	3.6	2.9	-4.1	4.3
Japan, US, Eurozone	2.3	2.2	1.6	-6.9	3.7
US	2.3	3.0	2.2	-5.0	2.7
Eurozone	2.5	1.9	1.3	-9.1	5.1
UK	1.9	1.4	1.5	-10.8	6.8
Japan	2.2	0.3	0.7	-5.7	2.1
Asia	6.3	6.1	5.2	-0.8	5.7
China	6.9	6.7	6.1	1.3	7.0
NIEs	3.4	2.9	1.7	-2.3	2.9
ASEAN5	5.4	5.3	4.8	-3.7	5.4
India	6.6	6.8	4.9	-3.4	3.9
Australia	2.5	2.8	1.8	-4.2	2.9
Brazil	1.3	1.3	1.1	-7.5	2.7
Mexico	2.1	2.2	-0.3	-11.1	2.5
Russia	1.8	2.5	1.3	-4.6	2.9
Japan (FY)	1.9	0.3	0.0	-6.0	3.4

Note: The shaded areas are forecasts. The global real GDP growth rate is calculated based on the GDP ratio (PPP) by the IMF.

Source: Made by MHRI based upon releases by the International Monetary Fund (IMF) and statistics of the relevant countries and regions.

3. Outlook of the Japanese Economy

(1) An economic contraction of -6.0% is expected in FY2020. The corona shock reduces GDP by 5% to 6%

We forecast that the Japanese economy in FY2020 will shrink by -6.0% (**Chart 3**). A substantial decline in major demand items such as personal consumption, capital investment, and exports seems unavoidable in view of the corona shock. The degree of economic contraction is expected to exceed the negative rates recorded at the time of the Global Financial Crisis in FY2008 (-3.4%) and FY2009 (-2.2%).

Chart 3: Overview of the Japanese economic forecast

		2019 FY	2020	2021	2020 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2021 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2022 Jan-Mar
GDP (real)	Q-o-q % ch	0.0	-6.0	3.4	-0.6	-7.8	3.5	0.9	0.9	0.5	0.6	0.5	0.4
	Q-o-q % ch p.a.	—	—	—	-2.5	-27.8	14.9	3.8	3.7	2.2	2.5	2.0	1.5
Domestic demand	Q-o-q % ch	0.2	-3.9	2.6	-0.4	-4.8	2.2	0.7	0.8	0.5	0.5	0.4	0.3
Private sector demand	Q-o-q % ch	-0.5	-5.7	3.3	-0.5	-6.5	2.7	1.0	1.0	0.5	0.5	0.5	0.4
Personal consumption	Q-o-q % ch	-0.6	-5.4	3.2	-0.8	-8.2	5.4	1.3	0.7	0.4	0.2	0.2	0.2
Housing investment	Q-o-q % ch	0.5	-8.6	-0.3	-4.2	-0.2	-4.8	-1.9	0.1	0.6	0.7	0.9	0.6
Capital investment	Q-o-q % ch	-0.3	-6.4	4.5	1.7	-1.5	-6.2	0.5	2.0	1.5	1.8	1.7	1.5
Inventory investment	Q-o-q contribution, % pt	-0.1	0.0	-0.1	-0.1	0.0	0.2	0.0	0.1	-0.1	0.0	0.0	-0.1
Public sector demand	Q-o-q % ch	2.5	1.2	1.0	0.0	0.0	1.1	-0.1	0.0	0.2	0.7	0.0	0.0
Government consumption	Q-o-q % ch	2.3	0.8	1.3	0.0	-0.3	0.4	0.3	0.4	0.3	0.2	0.2	0.3
Public investment	Q-o-q % ch	3.3	3.0	-0.2	-0.5	1.2	3.6	-1.5	-1.6	-0.2	2.3	-0.8	-1.0
External demand	Q-o-q contribution, % pt	-0.2	-2.0	0.7	-0.2	-3.0	1.2	0.2	0.1	0.1	0.1	0.1	0.1
Exports	Q-o-q % ch	-2.6	-15.2	9.0	-5.4	-18.5	8.5	2.8	2.0	1.5	1.5	1.6	1.7
Imports	Q-o-q % ch	-1.5	-3.7	3.8	-4.2	-0.5	0.2	1.2	1.0	0.9	0.9	0.9	0.9
GDP (nominal)	Q-o-q % ch	0.8	-5.9	2.0	-0.5	-7.4	3.0	0.3	0.5	0.0	0.9	0.1	0.0
GDP deflator	Y-o-y % ch	0.8	0.0	-1.4	0.9	1.5	0.3	-0.5	-1.1	-2.2	-1.3	-1.0	-1.1
Domestic demand deflator	Y-o-y % ch	0.5	-0.2	0.1	0.7	0.1	0.2	-0.5	-0.4	0.2	-0.1	0.0	0.0

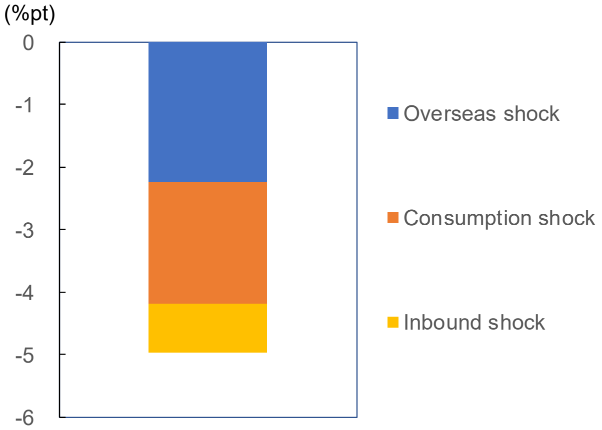
Note: The figures in the shaded areas are forecasts.
Source: Made by MHRI based upon the Cabinet Office, *Preliminary Quarterly Estimates of GDP*.

Chart 4 depicts the estimate results of the impact of the corona shock using MHRI's macro model and input-output analysis. Here, we estimated the impact of the following three shocks on real GDP: (1) downward shock on personal consumption in the domestic market as a result of people staying home, (2) downward shock on the global economy due to overseas lockdowns, and (3) shock of inbound travelers disappearing. Our results show that (1) personal consumption shock had an impact of -1.7%, (2) global economy shock -2.2%, and (3) inbound tourist shock -0.8%, and the total negative impact on real GDP reached around -5%. If we factor in the impact of declining capital investment driven by mounting uncertainty, which is not reflected in our macro model, we believe the corona shock has pushed down real GDP in FY2020 by around -5% to -6%.

We described the economic downturn in the April to June quarter at the beginning of this report, and for our future outlook, although we expect that the resumption of economic activities will put the economy back on a growth track, the pace of recovery is expected to be sluggish. The reasons for this slow recovery are (1) adjustments in employment (wages) and capital investment will make progress from now on, (2) spending on eating out, traveling, and entertainment will be partially subdued during the "with corona" period, and (3) uncertainty over a coronavirus resurgence will weigh down the activities of households and firms.

In the following section, we examine the outlook of each demand item (for the July to September quarter and onwards).

Chart 4: Estimate of various shocks on GDP



Note: The figures above represent a yearly deviation rate from the baseline (scenario where there is no shock).
Source: Made by MHRI based upon the Cabinet Office, among others.

Reference: Overview of the Japanese economic forecast (major economic indicators)

		2019	2020	2021	2020				2021				2022
		FY	(Forecast)		Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
Industrial production	Q-o-q % ch	-3.8	-11.0	9.3	0.4	-16.7	8.8	2.4	2.2	1.8	1.6	1.7	1.5
Ordinary profits	Y-o-y % ch	-13.1	-41.6	18.9	-28.4	-59.1	-49.7	-29.4	-21.4	32.9	18.3	14.1	13.8
Nominal compensation of employees	Y-o-y % ch	1.8	-3.8	1.2	1.7	-2.7	-3.3	-5.8	-2.9	0.6	0.5	2.4	1.2
Unemployment rate	%	2.4	3.1	2.9	2.4	2.8	3.3	3.2	3.1	3.0	2.9	2.8	2.8
New housing starts	P.a., 10,000 units	88.4	76.1	76.4	86.3	79.8	75.6	75.4	75.0	76.0	76.5	77.3	77.5
Current account balance	P.a., JPY tril	19.7	10.5	7.9	19.4	8.5	12.4	12.3	10.0	8.4	8.9	8.9	6.9
Domestic corporate goods prices	Y-o-y % ch	0.1	-1.6	0.4	0.6	-2.2	-0.5	-2.5	-1.2	2.2	-0.2	-0.3	-0.1
Domestic corporate goods prices (ex consumption tax)	Y-o-y % ch	-0.6	-2.5	-	-1.0	-3.7	-2.1	-	-	-	-	-	-
Consumer prices, ex fresh food	Y-o-y % ch	0.7	-0.1	0.1	0.6	-0.1	0.4	-0.1	-0.3	0.4	0.1	0.0	0.1
Consumer prices, ex fresh food (ex consumption tax, free education)	Y-o-y % ch	0.5	-0.2	-	0.2	-0.5	0.1	-0.1	-0.2	-	-	-	-
Consumer prices, ex fresh food and energy	Y-o-y % ch	0.6	0.0	-0.2	0.7	0.3	0.4	-0.1	-0.4	-0.3	-0.2	-0.2	-0.2
Consumer prices, ex fresh food and energy (ex consumption tax, free education)	Y-o-y % ch	0.5	-0.1	-	0.5	0.2	0.1	0.0	-0.4	-	-	-	-

Note: 1. The figures in the shaded areas are forecasts. The readings above may differ from the public releases because the rates of change are calculated on the basis of real data.
2. Ordinary profits are based on the *Financial Statements Statistics of Corporations by Industry* (all industries basis) (excluding finance & insurance).
Source: Made by MHRI based on relevant statistics.

(2) Strong economic growth is expected for the July to September quarter driven by personal consumption and exports as a rebound from the previous quarter is seen; but capital investment will remain negative

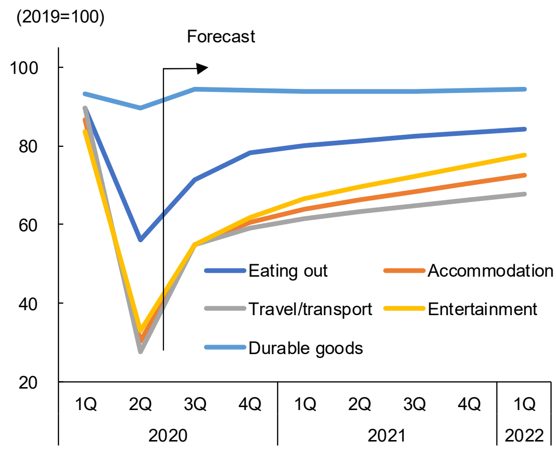
In the July to September quarter, the economic growth rate is projected to return to a positive track, thanks to the lifting of the state of emergency order in Japan and the relaxation of lockdowns in major countries. We expect that the growth rate will be a two-digit number on an annualized basis driven mainly by personal consumption and exports, and also as a result of a rebound from the significant downturn experienced in the preceding quarter.

Personal consumption in June showed signs of recovery because of the positive effects of restaurants reopening following the lifting of the state of emergency, provision of special cash payments, and last-minute demand before the end of the reward program for cashless payments. The GDP growth rate in the July to September quarter is anticipated to be stronger than the previous quarter on the back of the carry-over effects of the recovery in June (**Chart 5**). However, as concerns over a return of the coronavirus still exist, the pace of recovery in service consumption is expected to be slow. As for the consumption of goods, the termination of the special cash payments effect will likely curtail home appliance sales growth after July.

Exports are projected to show positive growth mainly led by automobile-related items on the back of a recovery in demand following the lifting of lockdowns in overseas markets. Information-related goods are also expected to pick up thanks to a recovery in automobile production and the rising demand for remote work. Nevertheless, due to weakened capital investment demand in the United States and Europe, we assert that capital goods exports will continue to be weak (**Chart 6**).

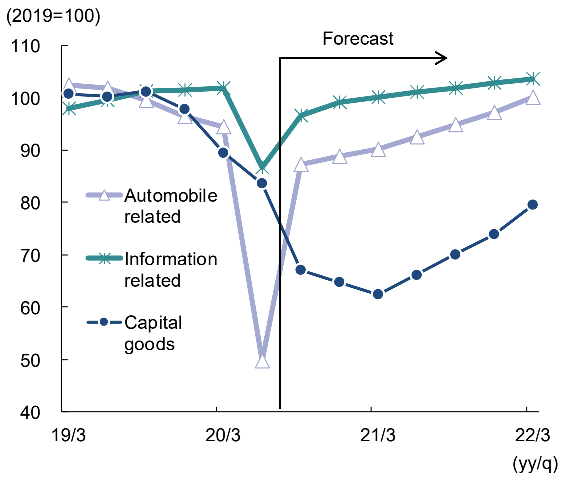
Concerning capital investment, we expect the adjustment to make headway in the July to September quarter. Due to the weakening of exports and production following the stagnation of economic activities inside and outside Japan, the sense of overcapacity is growing considerably. Also, corporate profits (based on the Financial Statements Statistics of Corporations by Industry) in the April to June quarter are projected to plunge by -59.1% on a year-on-year basis. Deterioration of the facility operation rate and corporate earnings will likely lead to an ongoing contraction of capital investment in the July to September quarter. It should be noted that compared with the time of the Global Financial Crisis when serious dislocations of the financial markets occurred, we believe the degree of capital investment decline will be milder this time, as companies have gained a degree of financial strength by securing sufficient liquidity at hand, and also because financial assistance (increase in lending) has contributed to mitigating the negative impact on cash management.

Chart 5: Path of main goods/service consumption



Note: For services, sectors greatly impacted by the novel coronavirus were selected.
Source: Made by MHRI based upon the Cabinet Office, *Preliminary Quarterly Estimates of GDP* and various other statistics.

Chart 6: Path of real exports (by goods)



Source: Made by MHRI based upon the Bank of Japan.

(3) The pace of recovery after the October to December quarter is expected to be slack

The pace of recovery of the Japanese economy after the October to December quarter, however, is expected to be slack.

Starting with personal consumption, we forecast that concerns over a second wave of the pandemic will place downward pressure especially on service consumption. In addition, worsening of the employment and income environment may also have a negative impact. The number of people placed on administrative leave rose exponentially in April, but most are expected to return to work following the resumption of corporate activities. A portion of these people, however, may become underemployed after the summer when companies start to suffer from a cash shortage. We forecast a rise in the unemployment rate to the 3% level in the July to September quarter, and only after the latter half of FY2021 will the unemployment rate return to the pre-pandemic level (about 2.7% to 2.8%). Considering that the number of employed persons will be adjusted and that a substantial cut in year-end bonuses is expected as a result of wage adjustments, it is inevitable that the job and income environment in the latter half of FY2020 will worsen. Kotera (2020) has estimated that about one-third of households cannot cover the income loss with the special cash payments, centering on relatively low income households and specific groups including self-employed, part-time workers, and workers employed in accommodation, food, and entertainment services (**Chart 7**).

In terms of exports, a slump in capital goods exports bound for the US and Europe will make the recovery of goods exports sluggish. The pick-up of service exports will also likely be delayed even assuming that immigration restrictions are relaxed for some business travelers in the latter half of the year. We expect the number of foreign visitors to Japan to remain at the 4 million level in 2020.

We also expect capital investment to remain lethargic due to uncertainty over the resurgence of infections. While investment in labor savings is anticipated to continue supporting investment activity, investment in reinforcing capacity may be postponed by many firms.

As described above, the Japanese economy in the latter half of FY2020 is projected to suffer from sluggish growth. According to the current profit forecast in the Bank of Japan's Tankan survey (Short-term Economic Survey of Enterprises in Japan) of June, almost all industries expect a decline in current profit in the first half of the year, and many expect their profit to fall again in the latter half of the year, which is a very cautious outcome. This suggests that most companies do not expect corporate activities in the latter half of FY2020 to return to the pre-pandemic level.

(4) The economic growth rate for FY2021 is forecast to be +3.4%. The ongoing risk of the pandemic resurging will limit the strength of the rebound

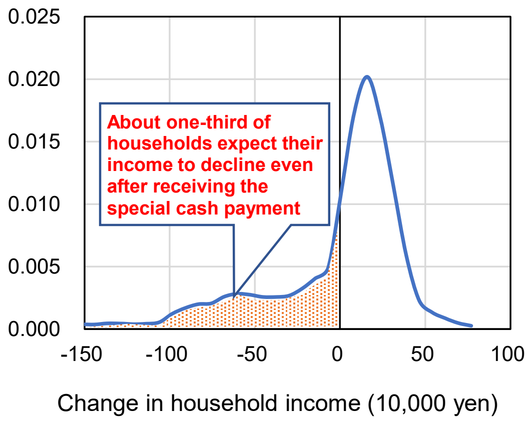
In FY2021, consumption activities in accommodation, food, and entertainment services are expected to be partially restricted again, and looming uncertainty over the resurgence of the pandemic will continue to shrink the activities of households and firms. The economic growth rate in FY2021 will stay at around +3.4%, a level not strong enough to recover from the drop recorded in FY2020.

For personal consumption we anticipate that service consumption will be sluggish, as was presented in **Chart 5**. We expect consumption in such areas as eating out, accommodation, travel, and entertainment will only recover to around 70% to 85% of the pre-pandemic level (2019 average) by the end of FY2021. In addition to concerns over a resurgence of coronavirus infections, falling off of the special cash payments effect in FY2021, and a substantial decline in disposable income (forecast to fall -3.3% year on year) will likely be factors pushing down personal consumption (**Chart 8**).

As for exports, a gradual rebound of capital goods exports may boost overall goods exports to the pre-pandemic level (2019 average) by the latter half of FY2021 (**Chart 6**). On the other hand, for service exports it is difficult to anticipate a full-fledged recovery of foreign travelers coming to Japan mainly for leisure purposes in the absence of effective vaccines or remedies to prevent and cure COVID-19. A full recovery in the number of foreign visitors to Japan will mostly likely be after 2022, and hence we forecast that service exports in FY2021 will continue to be slack (**Chart 9**).

Regarding capital investment, while corporate earnings picking up after the recovery of the global and domestic economies is expected to make a positive contribution, there is no change in the existing structure with the ongoing uncertainty over the pandemic's return continuing to exert downward pressure. The recovery expected in FY2021 will likely be a gradual one. Machinery investment is expected to pick up on the back of an improvement in the capacity utilization rate, while IT investment will be a positive contributor. On the other hand, for construction investment we expect the impact of declining orders to spread with a time lag and therefore forecast a decrease in construction investment in FY2021on a progressive basis.

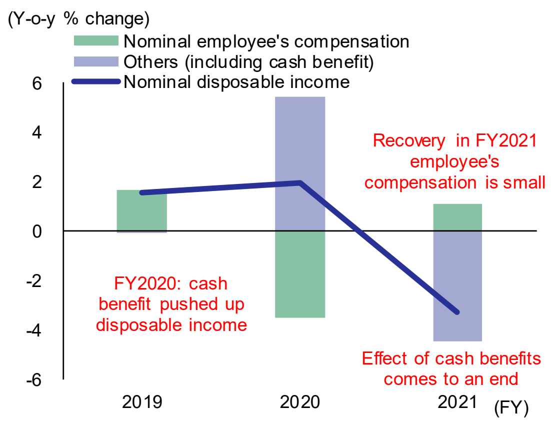
Chart 7: Household distribution of the "special cash payment received – expected decline in income" (estimate)



Note: The chart above employs the Kernel density estimation. We eliminated the abnormal values in the calculation. The survey was conducted at the end of April and the sample size was about 1,000 before eliminating the abnormal values. Refer to Kotera (2000) for details.

Source: Made by MHRI based upon data from Belot, M., Choi, S., Jamison, J.C., Pa-pa-george, N.W., Tripodi, E. and van den Broek-Altenburg, E. (2020), "Six Country Survey on COVID-19." IZA Discussion Paper.

Chart 8: Forecast of nominal disposable income



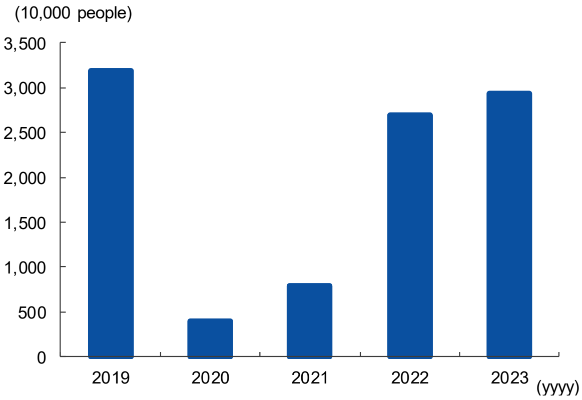
Source: Made by MHRI based upon the Cabinet Office, *Preliminary Quarterly Estimates of GDP*, the Ministry of Health, Labour and Welfare, *Monthly Labour Survey*, and the Ministry of Internal Affairs and Communications, *Labour Force Survey*.

(5) The economic package will push up GDP by +1.4%pt. A significant deterioration in the fiscal balance is expected

The government's economic package (FY2019 supplementary budget, FY2020 initial budget, and FY2020 first and second supplementary budgets) is expected to boost GDP by around +1.4% by stimulating public investment and personal consumption through the provision of cash benefits to households, among other means (**Chart 10**). Furthermore, the second supplementary budget for FY2020 saw an extensive increase in the allocation of funds to support companies' liquidity and contingency funds for the COVID-19, and we believe the budget gives the government leeway to respond flexibly to the crisis in the case where a state of emergency has to be declared due to a second wave of infections. To achieve the intended economic effect, however, the government must execute its measures smoothly. Sakai and Kotera (2020) have pointed to the government's problems in executing its economic measures, including various benefit payments, due largely to the delay in digitalizing its administrative procedures.

As for FY2021, we expect a decline as a rebound of the preceding fiscal year, particularly in the public investment area, since no additional economic measures have been indicated.

Chart 9: Forecast of foreign travelers to Japan



Source: Made by MHRI based upon JNTO.

Chart 10: Effect of economic measures

Budget	Measures	Amount (trillion yen)	Contribution to FY2020 GDP (%pt)
FY2019 Supplementary FY2020 Initial	・Increase public investment	4.6	0.6
FY2020 First Supplementary	・Special cash payments to all people ・Payments to students (from contingency funds)	13.0	0.6
FY2020 Second Supplementary	・Payments to low-income households ・Grants to medical treatment providers	2.5	0.2
Total		20.0	1.4

Source: Made by MHRI based upon the Ministry of Finance, among others.

According to media coverage, amid speculation that a snap election will be held this fall, there is a possibility that the consumption tax will be reduced temporarily as part of a new economic stimulus package. But we do not support the idea of slashing the consumption tax to stimulate the economy in response to the corona shock. The impact of the corona shock is unevenly distributed across specific areas, such as the accommodation and food industries, and it would be more effective to prioritize the employees in these specific sectors when providing support. A uniform tax cut targeting the general public would not be as efficient, given that some people have not suffered an income decline.

We would also like to provide our mid-term view on the fiscal balance. The primary balance after the FY2020 general budget (including the secondary budget) shows an expanded deficit of -66.1 trillion yen, and if we reflect the fall in tax revenue on the back of the economic slowdown, the deficit will rise even higher. The FY2021 budget is expected to see another increase in coronavirus-related spending. To realize fiscal consolidation and economic stimulus at the same time, the government needs to slash expenditures in future fiscal years while increasing tax revenues. Since a tax hike is unrealistic at present in view of the current financial condition of households and companies (and also the political situation), we believe the government will try to increase tax revenues through income taxes by employing a scheme similar to the special tax for reconstruction (it is realistic to enhance tax revenues over the long-term by limiting the yearly burden to a small range) after the economic activities will have returned to pre-corona period (MHRI expects that it will be after 2024).

(6) The BOJ core CPI will decline from the previous year

As for prices, while some goods (masks and medicines) face price hike pressure, the overall price trend is anticipated to decline driven by a widening minus range in the supply and demand gap. The BOJ core CPI (excluding fresh food and energy), an indicator of price trends, is expected to fall into negative territory in the latter half of FY2020 and to continue hovering in a slightly negative range throughout FY2021 (**Chart 11**).

The supply and demand gap in the April to June quarter 2020 is projected to be about -9%, but we hold that this significant drop is temporary, and that in FY2021, a year when economic activities will recover to a certain extent, the remaining average deflation gap (estimated to be -3.2%) will place downward pressure on prices (about a 0.8%pt contraction on a year-on-year basis expected on the BOJ core CPI). Considering that the recovery in the commodity market will mitigate the downward pressure on prices originating upstream, we believe the degree of price decline will not be as significant as was seen at the time of the Global Financial Crisis.

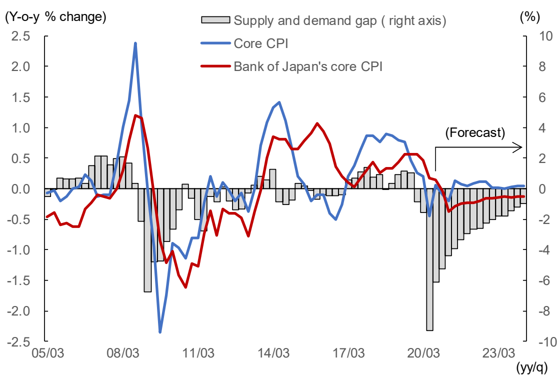
The core CPI in FY2020 is expected to remain in negative territory compared with the previous year, since the decline in crude oil prices will affect utility prices (electricity and gas) with a time lag. For FY2021, the core CPI is anticipated to be around 0%, affected by the stagnant movement of the BOJ core CPI.

(7) The negative impact on capital stock will lower the potential growth rate

The impact of the corona shock has also affected the supply side. As mentioned above, a decrease in capital investment in FY2020 is expected to negatively impact capital stock, and it seems that we cannot avoid a downward revision of the potential growth rate (**Chart 12**). We estimate a decline in the potential growth rate to +0.2% in FY2020 and +0.1% in FY2021. This implies that the mid-term potential of the Japanese economy is on the verge of decline, suggesting the risk of a decrease in companies' middle to long-term expected growth rate.

A key to enhancing the potential growth rate is improved productivity. The corona shock has awakened company managers to the necessity of digitalization and has promoted a movement to upgrade the systems to enable remote working and web meetings. The important point is not to simply cut expenses by making IT investments, but also to reform the business models to enable the generation of new added value. The development of new sources of demand by e-commerce is a typical example of this. But advancing a true "digital transformation," as in the above example, is a time-consuming process since it involves tackling many issues that would ultimately require a review of the overall operation flow. A fall in the potential growth rate may be inevitable in the short term, but it is important to make continuous efforts to improve productivity in the mid to long term.

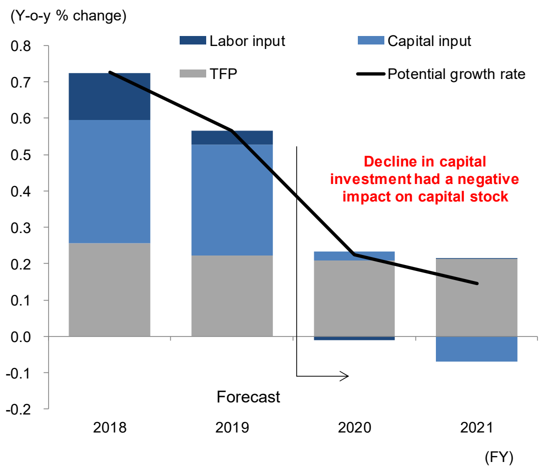
Chart 11: Outlook of CPI and supply and demand gap



Note: Year-on-year changes of core CPI and the BOJ core CPI exclude the impact of consumption tax hike and introduction of free education.

Source: Made by MHRI based upon the Ministry of Internal Affairs and Communications, *Consumer Price Index*, among other statistics.

Chart 12: Forecast of the potential growth rate



Source: Made by MHRI based upon the Cabinet Office, among others.

4. Conclusion

Thus far we have examined the current status and outlook of the global economy and offered our forecast of the Japanese economy. We believe Japan's economy in FY2020 cannot avoid a significant contraction, and its recovery is expected to be slow in FY2021.

However, if the coronavirus begins to spread again, and Japan and other countries are forced to lock down a second time, the Japanese economy will shrink even more drastically (if the pandemic resurges in the fall of 2020 and economic activities contract to the level seen in the April to June quarter, we predict that the FY2020 growth rate will decline to around -8%). With the number of confirmed cases now on the rise in various parts of Japan, uncertainty over the future is also increasing.

To prevent the spread of COVID-19 and encourage the resumption of economic activities during this "with corona" period, it is imperative to enhance testing and the medical system. It is important to establish a system that will enable people to receive PCR tested anytime, and to identify and isolate those who test positive, while allowing others who test negative to expand their economic activities flexibly.

At the same time, the government should promote digitalization of its administrative procedures and build a system to speed up the execution of economic measures. Provision of the employment adjustment subsidy and special cash payments revealed a delay in the development of e-government. The Basic Policy on Economic and Fiscal Management and Reform 2020 was approved by the Cabinet on July 17, and the implementation of digital government was positioned as a pillar of the policy.

Delays in executing various benefit payments may give rise to more bankruptcies, increasing job losses, and other concerns before the government's economic policies start to take effect. We hope the government will accelerate its digital transformation from the users' point of view based on the lessons learned from the initial execution of the latest economic package.

［**Reference**］

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Reference

Refer to the original Japanese report by clicking the URL below for the reference material

https://www.mizuho-ri.co.jp/publication/research/pdf/insight/jp200818.pdf