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Japanese Economy Resilient amid Slowdown of Global Peers

2 September 2022

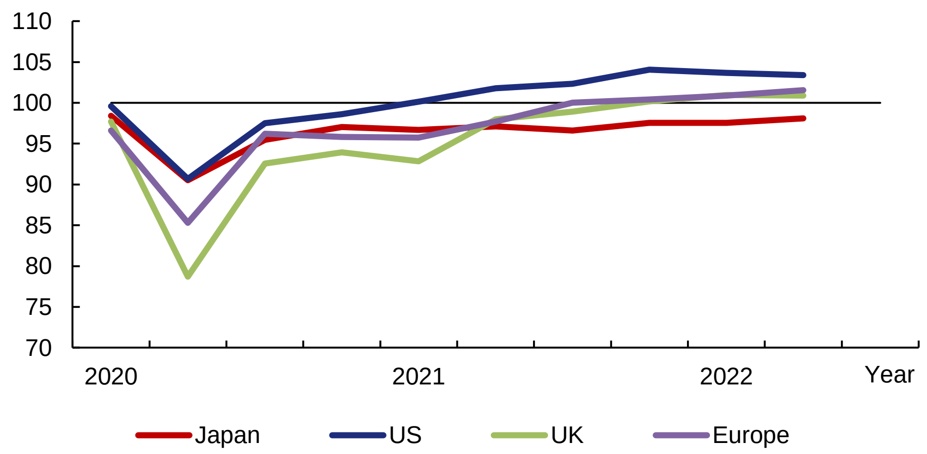
- The Japanese economy is highly likely to remain resilient despite slower normalisation of economic activity in contrast to Europe and the U.S., where fears of entering recession has become a major concern, amidst market focus shifting to corporate earnings and economic trends in the second half of the year.
- Four factors underpinning the recovery trend; (i) capital investment demand, (ii) fiscal response to inflation, (iii) easing terms of trade, and (iv) ongoing normalisation of economic activity.
- Capital investment boosts economic growth rate and easing of terms of trade benefits corporate earnings amidst ongoing normalisation of economic activity whilst caution against the spread of Covid and overseas economic slowdown remains.

Yuko Iizuka, Economist

"Delayed normalisation of the Japanese economy"

Preliminary data indicated that Japan's April-June real GDP rose at an annualised rate of 2.2 percent from the previous quarter, driven by a pick-up in economic activity following the lifting of pandemic prevention measures in March. However, unlike the U.S. and Europe, Japanese GDP has not yet recovered to pre-Covid 2019 levels (Figure 1). This is because the Japanese government imposed social restrictions until the end of the sixth wave in the January-March quarter of 2022, whereas the U.S. and Europe eased social restrictions earlier and pivoted to pursuing living with Covid policies.

Figure 1: Real GDP of Major Developed Economies



Source: Refinitiv
Period: Quarterly data from 1Q2020 to 2Q2022
Note: 2019 = 100

In the stock market, April-June earnings announcements are over and market focus is shifting to earnings and economic trends in the second half of the year.

Moving forward, the resilience of the Japanese economy may attract investors' attention relative to other major economies. Recession is feared in the U.S., where the Fed is rapidly raising interest rates in a fight to curve inflation, and in Europe, which is faced with soaring natural gas prices and supply shortages, meanwhile China's sustained zero-Covid policy poses downside risks to that economy.

There are four factors that are expected to keep the Japanese economy on a recovery track; (i) strong demand for capital investment, (ii) implementation of fiscal policy rather than monetary tightening in response to inflation, (iii) the prospect of easing terms of trade as resource prices fall back, and (iv) the fact that demand and savings remain healthy in the process of normalisation of economic activity, and the decline in the number of people going out affected by the spread of infections has been fairly limited.

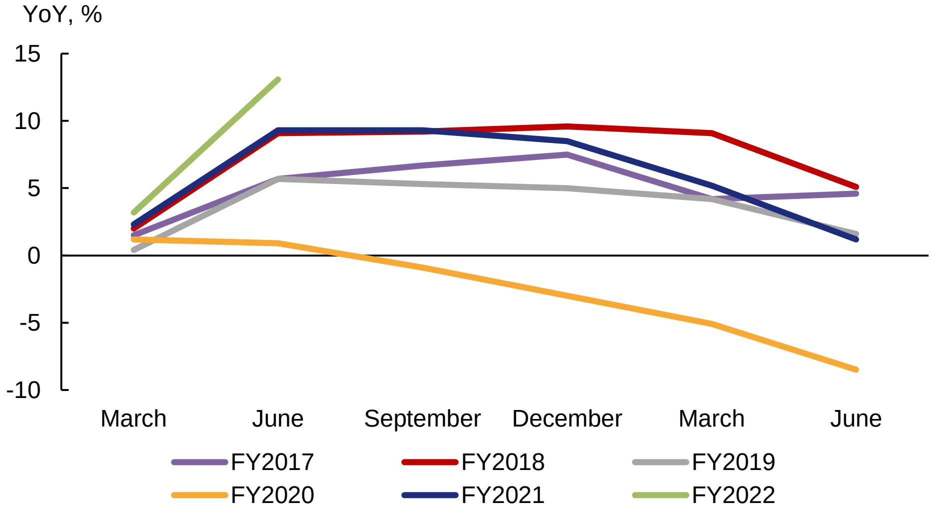
"Four factors support the Japanese economy"

(i) Capital investment demand

The biggest driver of economic recovery this fiscal year is strong demand for capital investment, which has been stagnant for the last few years due to the consumption tax hike in 2019 and subsequent pandemic.

The Bank of Japan's June Tankan outlook survey showed a year-on-year increase of 13.1 percent, the highest growth in years, in capital investment plans, which include software and R&D spending, indicating a strong appetite for investment among companies (Figure 2).

Figure 2: Capital Investment Plans (BOJ's Tankan Survey)



Source: BOJ
Period: Quarterly data from March 2017 Survey to June 2022 Survey
Note: -The horizontal axis represents the results of surveys from the initial survey (March) to the June survey of the following year (when the actual results are finalized), and the graph shows the year-on-year change (revision pattern) in the capital investment plan for each survey period.
-All industries and all enterprises are included in the survey.
-The graph shows the amount of capital investment including software and research and development (excluding land investment).

In addition, a survey by the Development Bank of Japan (DBJ) indicated that capital investment during the current financial year would recover to the pre-Covid FY2019 levels driven by the resumption of postponed investments.

Decarbonisation efforts such as investments in renewable energy, energy saving technology and electric vehicles, investments in automation to supplement the labour shortage and to promote work style reform, and investment in digital transformation are the major reasons for the recovery in capital investment.

Furthermore, from the economic security perspective highlighted by the Covid pandemic and a rise in geopolitical risks, there are moves within the government and at companies to reassess and build up domestic production capacity to avoid supply disruptions.

(ii) Monetary and fiscal policy

The Bank of Japan has reiterated that "Japan's economy is still in the process of recovering from the outbreak and is also under downward pressure from rising resource prices. It is necessary to firmly support the economy by persevering with monetary easing" and has maintained its monetary easing stance.

The difference in the direction of monetary policy in Japan from Europe and the U.S. was one of the factors behind the ongoing depreciation of the yen since March. While the weakening of the yen has had a positive effect on earnings of exporters, it has also led to higher import costs.

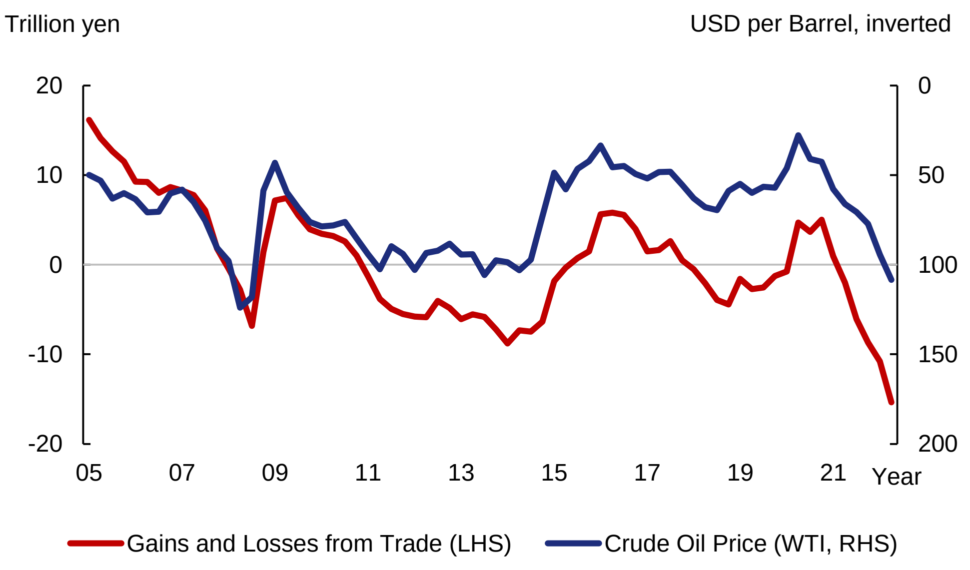
In response to soaring prices, the Government of Japan has put forward measures to reduce the burden of petrol and other fuel oil, which have been in place since January this year, and are to be extended from October onwards, as well as measures to control the prices of imported wheat and feedstuffs. The national average price of regular petrol, which is estimated to have exceeded 200 yen/litre in real terms, has been kept at around 170 yen. Japan relies on imports for most of its wheat, which is purchased by the government and then sold to domestic flour mills and companies. The government is expected to keep the price unchanged at the next regular price revision in October. The effect of the government’s price control measures on petrol and wheat, which is widely used in the production of many foodstuff such as bread and noodles, is considerable. Nevertheless, even with these price control measures put in place, overall consumer prices are expected to rise to around 3% this autumn, resulting in an annual increase in expenditure of around 100 thousand yen per household of two or more people.

(iii) Gains and losses from trade

Losses from trade has deteriorated to the worst level since 1980, the year from when current statistics are available, recording a loss of 15.4 trillion yen in the April-June 2022 quarter as a result of changes in import and export price differentials. This exhibits how much Japan's purchasing power has declined. In addition to losses from trade, net exports and net income received from abroad (value added from overseas activities) should also be taken into account for gains and losses from overseas transactions. Net exports were -0.9 trillion yen, while net income received from abroad was a record surplus of 24.3 trillion yen. Net impact amounts to approximately 8.1 trillion yen in surplus, with negatives from losses from trade and net exports erased by net income received from abroad. However, it is also true that the gap is widening between companies that receive income from overseas operations and those that have not expanded overseas or are heavily impacted by increased costs.

Due to concerns about slower global growth, the prices of oil and other resources have fallen from recent highs. If we assume a WTI crude oil price of USD 90 per barrel and make an estimate based on the past relationship between terms of trade and crude oil prices, the negative trade impact may be reduced to around -3 trillion yen (Figure 3). We think investors should continue to monitor trends in terms of trade which work to improve corporate profits.

Figure 3: Gains and Losses from Trade

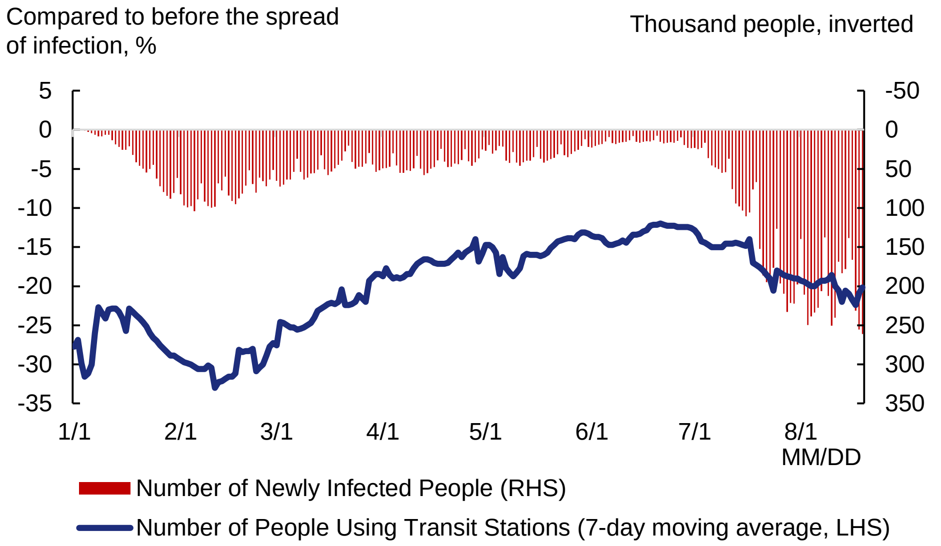


Source: The Cabinet Office and NEEDS-Financial Quest
Period: Quarterly data from 1Q2005 to 2Q2022
Note: WTI (West Texas Intermediate) Crude Oil Futures

(iv) Prospect of demand and savings

The number of newly infected people has increased to a record high, but the government has not issued any restrictions on economic activity or behaviour, and the decline in the number of people going out has been smaller than before (Figure 4).

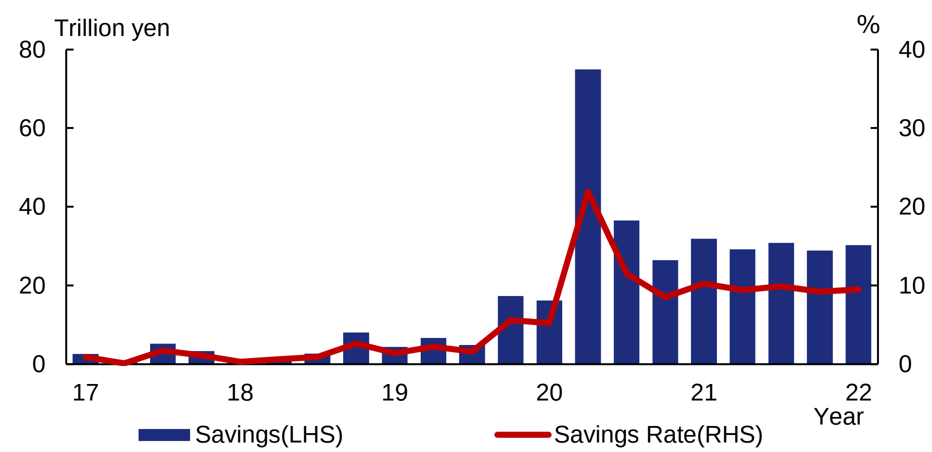
Figure 4: The Number of Newly Infected People and Mobility Data



Source: Google Community Mobility Reports and NHK
Period: Daily data from 1 Jan. 2022 to 19 Aug. 2022
Note: Percentages compared to before the spread of infection are percentages compared to median for each day of the week for the 5-week period from 3 Jan. 2020 to 6 Feb. 2020

Against this backdrop, the normalisation of economic activity is expected to continue, as unmet demand and high level of savings remain due to the delays in normalisation of consumption activity to date (Figure 5).

Figure 5: Household Savings



Source: The Cabinet Office
Period: Quarterly data from 1Q2017 to 1Q2022

However, there are also risk factors surrounding the country. Trends in the spread of infection and its impact on consumption activities are highly uncertain. The biggest risk is the deterioration of the global economy, particularly in the U.S., Europe and China. The lockdown in Shanghai, China, which had caused disruption to supply chain networks, was lifted in June and Japanese automobile production and exports have just started to pick up, but there are signs of infection spreading again in China and plants being shut down due to power shortages. There is a sense that orders from overseas for some general machinery have peaked out, and caution is required on the impact of the overseas economic downturn.

"The biggest risk factors come from outside Japan"

Japan has lagged behind Europe and the U.S. in normalising its economic activity, but the trend towards normalisation is expected to continue, as border restrictions are expected to be eased and domestic travel promotion measures are expanded. Resilience of the Japanese economy is likely to attract more attention in the future relative to other major economies, where economic slowdowns are being observed.

"Japan's economy in the spotlight"

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