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Japan's COVID-19 response: Crisis met with strong economic package, but is it enough?

Hugo Le Damany,
Economist (Japan),
Macro Research – Core Investments

Key points

- Japan's government has approved a second package of economic measures, totalling some ¥117.1tn (21.5% of GDP), roughly the same as the previous boost adopted in April. This brings the total package to 43% of GDP
- The headline includes significant contributions from private sector projects and financial assistance via government-affiliated financial institutions. It is not obvious how much these facilities will be used, and they do not constitute direct fiscal spending. Excluding these items, additional spending is a smaller ¥57.6tn, or 10.6% of GDP, boosting the deficit by 11 percentage points (ppt) to 14% in 2020
- Overall, net direct stimulus would be ¥30.7tn (5.5% of GDP), after we allow for other financial support and budget reserves. Historic estimates of fiscal multipliers suggest an impact of 2.6 percentage points of GDP
- The Bank of Japan has strengthened its monetary policy to support the government's action. It is likely to use its Yield Curve Control policy extensively, reducing the risks of rising financing costs. In parallel, it has promoted targeted measures to ensure smooth credit provisions throughout the banking sector.

The COVID-19 pandemic has resulted in an unprecedented response from governments and central banks worldwide. In previous papers we have considered **the steps the US has taken** with fiscal and monetary stimulus to alleviate the shock to its economy[1] and **considered the impact in China**[2]. In this piece, we focus on the different measures promoted by the Japanese government and Bank of Japan (BoJ).

Government's total package worth 43% of GDP

Japan's government approved a fresh package of economic measures, worth ¥117.1tn (21.5% of GDP), roughly the same adopted in April. Prime Minister Abe has stressed that while these measures now exceed 40% of GDP, they are designed to shield the economy from the impact of the pandemic. They are ultimately aimed at protecting jobs and shoring up individuals and companies that are struggling financially.

However, the headline figure includes a significant amount of private sector projects. These include spending by local governments and municipalities, previously approved and repackaged expenditures, and assistance via government-affiliated financial institutions and other entities. Excluding these items and the Fiscal Investment and Loan Program

[1] Page, D., "COVID-19 Update – US policy response", AXA IM Macro Research, 3 June 2020

[2] Yao, A., "China: Fuelling recovery with an extra policy kick", AXA IM Macro Research, 9 June 2020.

(FILP)[3], the actual spending in the supplementary budget approximates ¥57.6tn or 10.6% of GDP (Exhibit 1).

Exhibit 1: Summary of COVID-19 economic packages

¥ tn (*% of GDP*)	April package	June package	Total
Total programme size	117.1 (*21.5%*)	117.1 (*21.5%*)	234.2 (*43%*)
Total gov. fiscal contribution (including FILP)	48.4 (*8.9%*)	72.7 (*13.3%*)	121.1 (*22.2%*)
Central gov. general account expenditures (bond issuance)	25.7 (*4.7%*)	31.9 (*5.9%*)	57.6 (10.6%)

Source: Ministry of Finance

The supplementary budget includes:

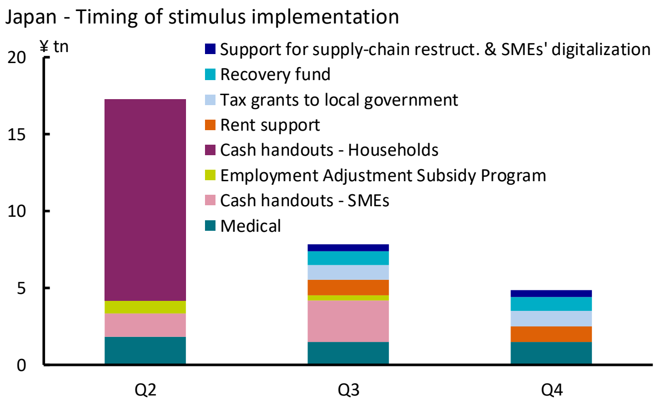
- The Employment Adjustment Subsidy Program (EASP)'s daily subsidy has been doubled to ¥15,000 ($150) and extended to September 2020. In a previous paper[4], we highlighted the impact of the EASP, which heavily subsidises companies that furlough workers, rather than cutting their jobs
- A monthly cash handout of ¥330,000 ($3,300) to individuals working at small- and medium-sized enterprises (SMEs) who have been furloughed, but not integrated to the EASP programme
- One-off payment of ¥100,000 ($1,000) for each citizen, totalling ¥12.9tn and ¥200,000 for health care workers.
- Cash handouts for SMEs that have been heavily impacted during the crisis where sales have dropped by half or more. The maximum an SME will get is ¥2m ($18,700) and self-employed ¥1m from a total package of ¥4.2tn - 0.8% of GDP
- Offering rent relief for struggling firms of up to two-thirds rent subsidy of ¥1m for six months at maximum
- Beefing up medical response (¥4.8tn)
- Tax grant to local government of ¥2tn
- Building a strong economic structure – support supply-chain restructuring and SME's digitalisation - with ¥0.9tn. The government is leveraging on FILP and the private sector to reach ¥15tn, invested over several years
- Reviving the economy in the recovery phase (vouchers) for ¥1.8tn
- ¥11.5tn has been set aside as a budget reserve fund to be used in case of emergency spending

Finally, the government provides interest-free and unsecured loans for up to five years to affected SMEs. The budget includes ¥13tn to cover the costs of interest and guarantees, as well as potential losses from loans to be extended (see below). It also includes a measure to raise the upper limit of a possible capital injection (¥2.4tn or 0.4% of GDP). We do not account for these measures as loans will be subject to uncertain demand – making estimating the quantity involved difficult – as they must ultimately be reimbursed. Only interest rate and guarantees are direct costs to government, but the former are close to 0%, while the latter is difficult to forecast. This scheme may indeed boost lending and we will monitor activity under these schemes, but we do not consider them to be direct fiscal stimulus.

Overall, net fiscal stimulus is therefore just ¥30.7tn (5.5% of GDP), after allowing for additional financial support and the additional increase in budget reserves – a buffer for future spending – from the supplementary budgets (Exhibit 2).

April's budget has seen significant delays in providing the urgently needed cash payments and employment adjustment subsidies that it promised. This raises concerns about how quickly funds will materialise from this second package.

Exhibit 2: Fiscal stimulus and timing of implementation



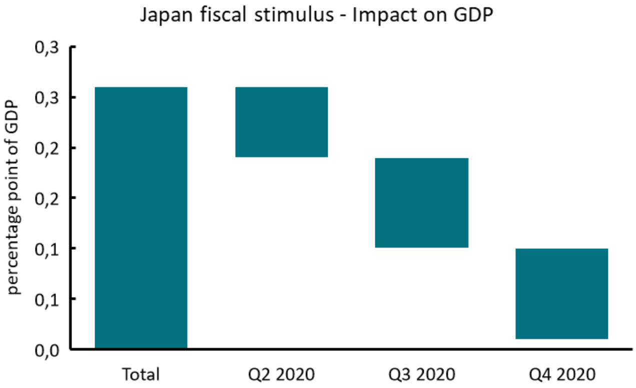
Source: Cabinet Office and AXA IM Research, as of June 2020

Academic literature suggests that Japanese fiscal multipliers differ depending on where they are directed. Historically, only public investment has had a high multiplier (above one). Direct payments to households – cash payments and wage supplements – saw a relatively low multiplier (0.3) in 2009. We assume this experience will be repeated. For corporates, the Cabinet Office uses a multiplier of 0.4. There will also be a lag between disbursement and spending, particularly for capital projects and we only expect elements, including in the modernisation plan – supply-chain restructuring and digitalisation – to provide a small impact this year. By applying the appropriate fiscal multipliers, we estimate an impact of 2.6ppt of GDP in 2020 and approximately 3ppt from the investment plan but spread over several years (Exhibit 3).

[3] The Fiscal Investment and Loan Program (FILP) in Japan collects funds through government financial institutions and uses them to finance public projects undertaken by government affiliated corporations or to finance government loans to borrowers in targeted areas. It includes also the government guarantees scheme.

[4] Page, D., Yao, A., Menut, A. and Le Damany, H., "COVID-19 Update: Labour market deterioration to dampen rebound", AXA IM Research, 7 May 2020

Exhibit 3: Fiscal stimulus and impact on GDP



Source: Cabinet Office and AXA IM Research, as of June 2020

In total, we continue to believe GDP growth is going to fall by 5.8% in 2020 and rebound to 3.3% in 2021. Fiscal deficit is likely to rise by 11ppt to 14% in 2020.

Financial assistance: Welcome to the jungle

Financial assistance remains the core government intervention even if it appears to overstate its impact on the economy. It is difficult to unscramble the detail in financial assistance. But it seems that among the figures announced by PM Abe, approximately 80% of the ¥234tn would be "financial assistance" – loans from the private-sector and loan guarantees from public financial institutions such as the FILP and other policy banks and deferred tax payments.

The only figure we are sure about is the ¥15.7tn detailed in the supplementary budget. The rest is rather opaque.

- Total government fiscal contributions (including FILP and policy banks) account for half of the economic package, meaning the government is expecting the other half to come from the private sector – at ¥113.1tn or 21% of GDP (Exhibit 1). Most of this constitutes loans for affected companies. The government will subsidise and guarantee a share of these loans, but private banks will carry the burden on their own balance sheets
- Outside the government account, there are loans and loan guarantees from public financial institutions such as the FILP and other policy banks. These include interest-free rates and unsecured loans to affected companies (mainly SMEs) using both policy banks and private financial institutions
- In parallel, the government is also leveraging on both the private and public sectors to participate in some measures such as the recovery plan or the reconstruction of the supply chain
- Finally, the government has deferred tax payments to next year for SMEs and individual businesses heavily affected. This measure may reach ¥26tn

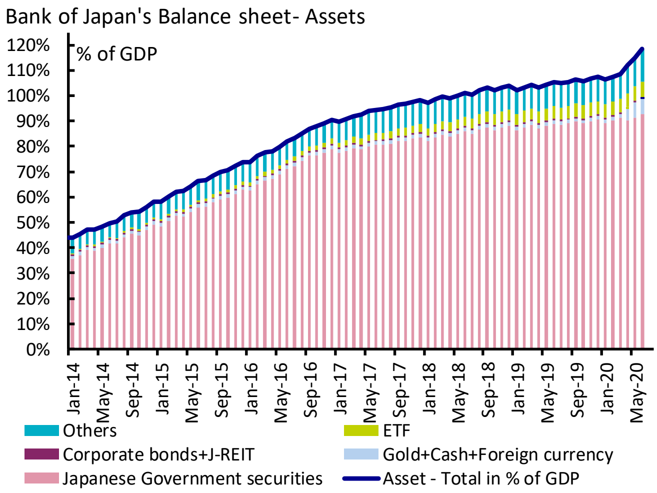
As mentioned earlier, the government moved quickly and massively to protect key pillars of the Japanese economy, namely jobs and companies. Recovery will depend a lot on demand. We believe the government will focus on consumption and investment in a third supplementary budget.

Bank of Japan's monetary policy supporting government stimulus

The actual government spending in the supplementary budgets (¥57.6tn) will be fully debt funded. This large increase in Japanese government bond (JGB) issuance could put upward pressure on financing costs. However, BoJ policy should directly curb yield increases, through its Yield Curve Control policy (fixing the JGB 10-year yield around 0%). Moreover, should current purchases exceed the official guideline (¥14tn versus ¥80tn), the BoJ has removed its annual purchases target, suggesting a more flexible approach to purchases and a willingness to backstop government action.

On the other aspect of the quantitative easing, the BoJ doubled its target amount of exchange-traded funds and Japanese Real Estate Investment Trusts annual purchases to ¥12tn and ¥0.18tn respectively (Exhibit 4).

Exhibit 4: BoJ's balance sheet increased sharply since March



Source: BoJ and AXA IM Research, as of June 2020.

On liquidity measures, the BoJ provided one-week and three-months dollar liquidity to financial institutions associated with other major central banks. Following changes by the US Federal Reserve, the lending rate was cut by 25 basis points (bps) and the new rate was the US Overnight Index swap rate plus 25bps.

Board members do not appear ready to go deeper into negative interest rate policy (NIRP). Deeper negative interest rates could put additional pressure on commercial bank lending and the BoJ needs buoyant commercial banks to implement credit measures. Moreover, this could weigh on household sentiment. Adjustments to forward guidance provide the BoJ with some room for manoeuvre on this front, as the policy rate path has been untied from inflation momentum. On balance, we consider that the BoJ has probably admitted having hit the lower bound of the NIRP.

Alleviating the burden on commercial banks

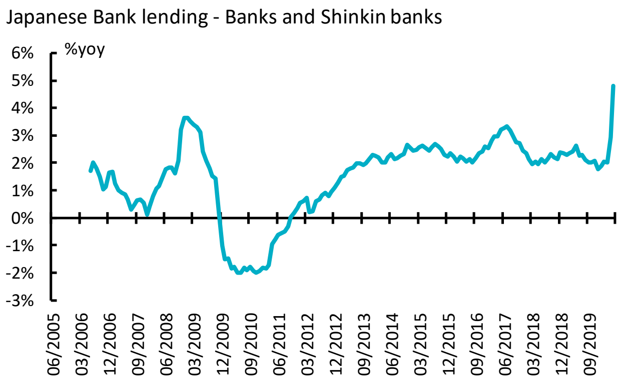
At the peak of the crisis, the BoJ increased its purchases of commercial paper and corporate bonds up to a maximum of around ¥20tn, but it didn't stop here. As the lockdown eases, continued low growth could weaken the banking system's credit intermediation, meaning that the BoJ's incentives in credit supply are crucial:

- A "Special Funds-Supplying Operations to Facilitate Financing in Response to the Novel Coronavirus" which supplied funds against private debt pledged as collateral for a maximum amount of around ¥25tn as of end-April
- The interest rate is 0% on these funds with maturity of up to one year. Additionally, twice as much as the current amount outstanding of the loans will be included in the Macro Add-on Balances in current accounts held by financial institutions at the BoJ (the middle tier at 0% in the tiering system), while a positive interest rate (+0.1%) will be applied to the amounts outstanding of loans provided
- The BoJ designed a new fund-provisioning measure for SMEs (around ¥30tn). The central bank will pay 0.1% interest on the loans to encourage lenders
- Credit measures have been extended until end-March 2021 (from end-September 2020)

On the regulatory side, the authorities have agreed to defer full implementation of the Basel III standards by one year and have encouraged banks to use their regulatory capital and liquidity buffers. Similarly, in early April, the Financial Services Agency and the BoJ announced an easing of regulations on leverage ratios.

Up to now, credit provision to firms has been relatively smooth given the size of the economic shock, reflecting both government and central bank easing policies (Exhibit 5).

Exhibit 5: Bank lending has risen sharply in May

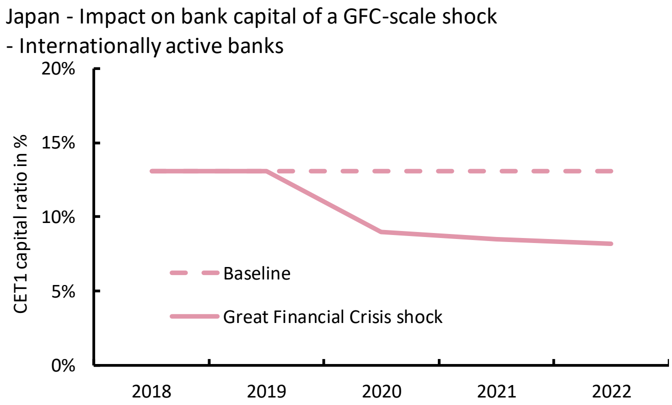


Source: BoJ, Senior Loan Officers survey and AXA IM Research, as of May 2020

But even with the BoJ's existing measures, prolonged low growth may tighten funding conditions, potentially eroding financial system resilience and impeding credit provision.

The BoJ's latest Financial System Report (April 2020) includes a stress test, assuming a global financial crisis scale shock. The COVID-19 demand shock is larger, but the impact on financial markets – stock prices, yen appreciation and cost of funding in foreign currencies - has been less severe. Assuming no growth for two years, the simulation results indicate that banks' net incomes would fall substantially and remain negative for three years with capital adequacy ratios declining in parallel. However, key capital ratios would remain above the regulatory requirements on average at 8% for internationally active banks and 4% for domestic banks (Exhibit 6).

Exhibit 6: The BoJ's Financial System Report points to the relative resilience of the Japanese banking sector in a global financial crisis-scale shock stress test.



Source: BoJ, Financial System Report and AXA IM Research, as of April 2020.

Looking ahead

Alongside other international authorities, the Japanese government and BoJ have implemented a bewildering array of new measures designed to support key economic pillars. PM Abe has described a package in excess of 40% of GDP. While true, we consider this description as misleading in terms of the amount of support it will ultimately provide to the economy. To our minds, much of this 43% is hard to quantify as it will depend on demand for borrowing. This could add to total stimulus and we will monitor progress in lending over the coming quarters. Otherwise, we estimate that the direct spending commitment from the Japanese government will total around 5% to 6% of GDP. Based on historic estimates of fiscal multipliers, this would bolster GDP growth by 2.6ppt in 2020 and 3.3% % in 2021.

Finally, the BoJ has been active in providing liquidity and ensuring that the economic shock does not morph into a financial one. It has provided modest further accommodation in terms of monetary policy, but we tend to the view that the BoJ's biggest contribution beyond financial stability will be to cap any upward pressure on yields to facilitate further fiscal stimulus.

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