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Japan's Economy: Monthly Outlook (Sep 2020)

Gradual economic recovery continues; hopes and challenges for *Suganomics*

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Summary

- Japan's economy has been in a gradual recovery trend ever since hitting bottom in May when the state of emergency was lifted. The recent increase in the number of persons newly infected with COVID-19 has not necessarily led to a decrease in people going out, and it is our opinion that the economy's resistance to the effects of COVID-19 is increasing both in the domestic and overseas markets.
- Looking at recent trends in the economy, we see that exports have grown for three consecutive months since June, while recovery in personal consumption has ceased since July. Considering trends in consumer turn-out and industrial statistics, as well as information from individual corporations, there appears to have been a slight decline occurring from August through early September. The real GDP growth rate in the Jul-Sep period is expected to achieve double-digit growth not only in Japan but in the US and Europe as well. While there is of course the tendency for the Jul-Sep period growth rate to be high in those countries where the decline in GDP during the Apr-Jun period was especially steep, the level of Jul-Sep period GDP is expected to fall around 4-5% below Jan-Mar period figures in Japan, the US, and Europe.
- The new Yoshihide Suga Cabinet was inaugurated on September 16. An overview of the efforts of the former cabinet shows that while positive changes have been seen in the financial markets, employment, and the apprehension of external demand, the strengthening of growth potential and social security reforms have not progressed as much as intended by original targets. The way to fiscal consolidation ultimately eluded the former administration. The immediate task for the Suga Cabinet is to respond to the coronavirus crisis and balance socio-economic activities with prevention of infection. At the same time, however, for Japan, where the population is declining and aging, strengthening growth potential is also an urgent issue. While enhancing the effectiveness of existing growth strategy, the new administration is expected to make use of the coronavirus crisis as an opportunity to promote a "digital society" and the "dynamic engagement of all citizens."

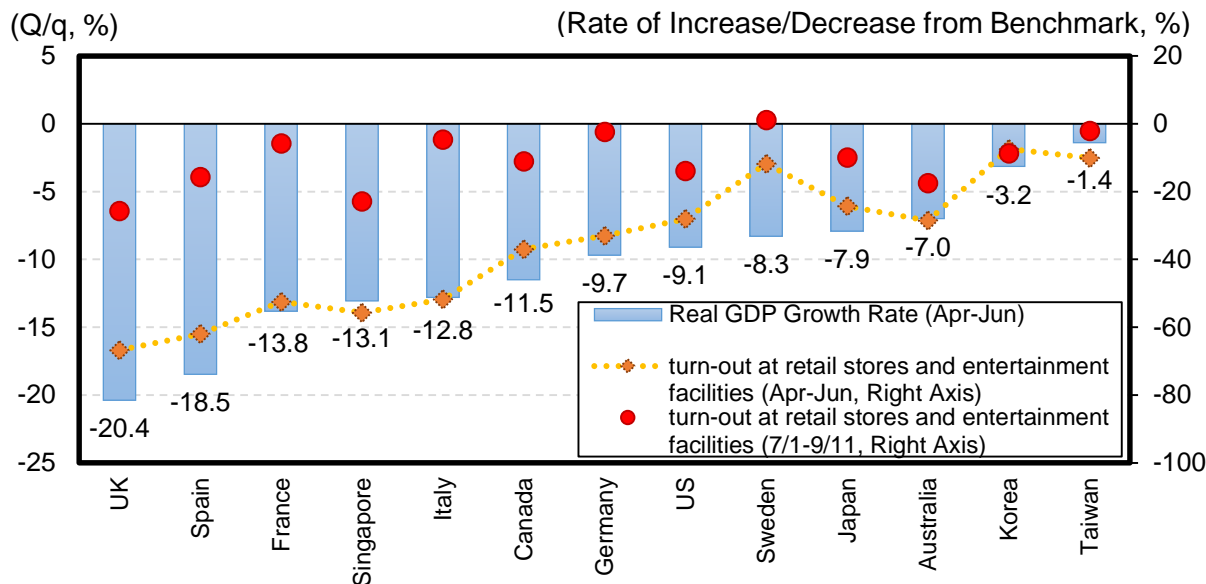
1. Economic Recovery Continues, but Domestic Demand is Marking Time

Economy's resistance to effects of COVID-19 increasing in most countries and regions

Japan's economy has been in a gradual recovery trend ever since hitting bottom in May when the state of emergency was lifted. Behind this lies the resumption of economic activities both in Japan and abroad, as well as the effectiveness of various government benefits and support for corporate cash flow. Also of note is the fact that the recent increase in the number of persons newly infected with COVID-19 has not necessarily led to a decrease in people going out.

Looking at daily mobility data by country as collected from Google Maps, we see that most countries and regions are maintaining a tendency toward recovery or marking time in the number of people going out, and patronizing retail stores and entertainment facilities¹, even with recent increases in the number of COVID-19 infections. In Japan, there was a resurgence of COVID-19 infections in late June, with the number of new infections per day setting a record high by early August. The number of people going out to patronize retail stores and entertainment facilities remained flat during this time. The same tendency has been seen in the US, Spain, and France where the spread of COVID-19 has been more serious than Japan. While there is no doubt that the spread of the infection has inhibited the recovery of economic activity, the knowledge of treatment methods and measures to prevent the spread of infection have deepened, and medical care and testing have been strengthened. The proportion of severely ill and dead is significantly lower than during the first wave of the pandemic. Although COVID-19 remains a threat, and though strict measures to prevent the spread of infection have to be implemented in areas where explosive growth in infections has occurred, it seems that economic resilience (resistance) to the disease has increased.

Real GDP Growth Rate of Major Countries & Regions, and Turn-Out at Retail Stores & Entertainment Facilities Chart 1



Source: Cabinet Office, Google, Haver Analytics; compiled by DIR.

Note: Figures for turn-out at retail stores and entertainment facilities represent daily rates of average increase or decrease, with the Sunday median between January 3 and February 6, 2020 set as the benchmark.

Real GDP suffered its steepest decline since the start of current statistics in most countries and regions during the Apr-Jun period. This was the result of the decline in the number of people going out (consumer turn-out) due to severe measures taken to prevent the spread of the COVID-19 infection. This was strongly reflected in economic trends (Chart 1). The UK recorded negative real GDP growth rate at -

¹ Shopping centers, eating & drinking establishments, amusement parks, and movie theaters are included in this calculation, however, stores selling daily necessities, such as super markets, fresh produce markets, and drugstores, are not included.

20.4% (in comparison with the previous period), which is nearly three times as much as Japan. The rate of decline in consumer turn-out at retail stores and entertainment facilities in the UK was also nearly three times greater during the same period. Japan suffered the worst economic deterioration of the entire postwar period between April, when the state of emergency was declared, and May. Even so, the effects of the coronavirus crisis were relatively small in comparison to other countries and regions as is shown in Chart 1.

Characteristics differing from the other countries were seen in Sweden². Sweden implemented moderate prevention measures against the spread of COVID-19, which were based on the independent efforts of its citizens. The decline in consumer turn-out at retail stores and entertainment facilities which it experienced was limited. However, its economy deteriorated more than Japan and some other countries during the Apr-Jun period, with real GDP growth rate at -8.3% q/q (Chart1). In addition to a sharp decline in exports, household disposable income suffered a major decline, which significantly suppressed consumption. In Japan, the special fixed benefit (a uniform benefit of 100,000 yen per person), along with other benefits and government support contributed to a sharp increase in disposable income, but in Sweden, the employment and income environment deteriorated, and economic measures were small-scale. Even if households were relatively free to go out, they were forced to reduce the amount of their consumption.

The circles in Chart 1 represent the average turn-out between July 1 and September 11. In comparison to the Apr-Jun period, most countries and regions experienced growth in turn-out, with growth in Germany and Italy especially noticeable. In Japan, turn-out recovered about half of the percentage of decline experienced during the Apr-Jun period. As for the real GDP outlook for the Jul-Sep period, which will be presented in more detail later in this report, possibilities are great that positive growth will be considerable in most countries including Japan considering consumer turn-out at retail stores and entertainment facilities alone.

Personal consumption will continue to mark time in July and beyond

Next we take a look at personal consumption and exports, the keys to understanding the most recent trend in Japan's economy. Some of the demand that was suppressed during the state of emergency which limited personal consumption in June reappeared as pent-up demand. In addition to this element, last minute demand triggered by the termination of the reward points program associated with cashless payments, as well as the special fixed benefit encouraged a sharp recovery. However, these factors bringing upward pressure either disappeared or reduced the extent of their influence in July, while bad weather and a resurgence of COVID-19 infections brought a pause in recovery. Considering trends in consumer turn-out and industrial statistics, as well as information from individual corporations, there appears to have been a slight decline occurring in August with this trend continuing through early September.

Taking a look at consumption by goods and services according to the Bank of Japan's Consumption Activity Index (index of monthly GDP-based personal consumption), we see that consumption of durables has maintained a steady undertone (Chart 2). In June and beyond, consumption of durables clearly exceeded the level experienced before the coronavirus crisis, with household electronics especially favorable. Pent-up demand and the special fixed benefit most certainly provided a tail wind, but pent-up demand is a factor that will soon disappear. Moreover, one of the unique characteristics of durable goods is that once they are purchased, it will be a number of years before replacement demand is generated. One of the effects of the special fixed benefit is that it merely produces temporary,

² Taiwan, which had a rate of decline in consumer turn-out at retail stores and entertainment facilities similar to Sweden, experienced only a slight decline in its Apr-Jun period real GDP. Taiwan got an early start in holding down the first wave of the spread of COVID-19, using moderate prevention measures. It is possible that its export structure is one that was not easily effected by the coronavirus crisis, being that its major export is electronic parts.

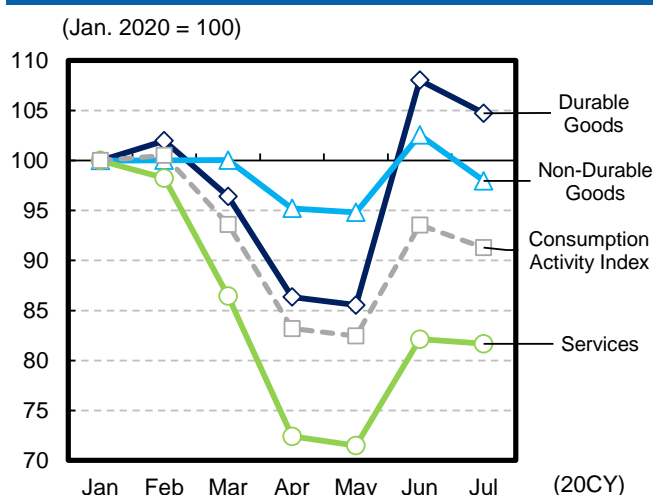
exaggerated demand. It would be difficult to expect consumption of durables to continue to maintain the level seen recently.

Meanwhile, non-durable goods, including food and beverages, daily necessities, and clothing, are maintaining a steady undertone. Looking at trends in unit purchase price and retail price by item according to the Family Income and Expenditure Survey and the Consumer Price Index as published by the Ministry of Internal Affairs and Communications, we see that for some items such as home-cooked meals and prepared meals, growth in unit purchase price has exceeded growth in retail price, and it is thought that households have become more price-oriented (so-called “small luxury” or enjoyment of simple things). Conversely, with the decline in the frequency of going out, demand for clothing has shifted from the fashionable to everyday wear, hence preferences have turned toward lower priced items.

On the other hand, recovery in the consumption of services has been sluggish. The level of consumption in July also fell nearly 20% below that seen before the coronavirus crisis (Chart 2). Eating out, travel, and entertainment related consumption is shown in Chart 3, as well as consumer turn-out at retail stores and entertainment facilities originally introduced in Chart 1. Here we see a weak trend continuing, reflecting ups and downs in turn-out associated with eating out, travel, and entertainment related consumption, all of which tend to involve close contact and moving from place to place. Turn-out at retail stores and entertainment facilities in July and beyond has continued at a low of as much as 10% below that seen before the coronavirus crisis. Recovery in eating out, travel, and entertainment related consumption lags even further behind at a low level 45% below that seen before the coronavirus crisis.

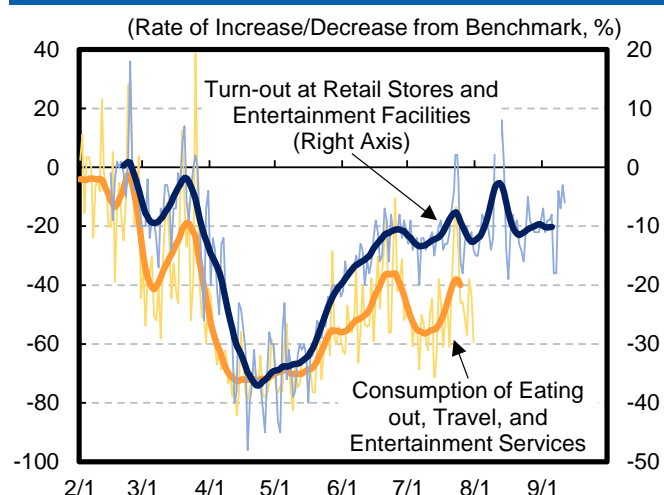
The spread of COVID-19 has recently been slowing down, and the request to practice voluntary restraint in business operations for the Tokyo Metropolitan Area was terminated on September 15. Meanwhile, the government eased up conditionally on the restriction on holding events on the 19th. Plans include trips with Tokyo arrivals and departures in the Go To Travel Campaign as of October 1. These developments are expected to boost consumption of services, but with the increase in infections expected to continue for the long-term, a full recovery for consumption of services will likely take time.

Consumer Activity Index by Individual Goods and Services
Chart 2



Source: Bank of Japan; compiled by DIR.
Note: Real values, seasonally adjusted. The Consumption Activity Index is adjusted for the travel balance. Individual goods and services are not adjusted for the travel balance. Non-durables include those listed in the National Accounts.

Eating Out, Travel, Entertainment Related Consumption, and Turn-Out
Chart 3



Source: Ministry of Internal Affairs and Communications, Google; compiled by DIR.
Note: The benchmark used in the left side of the chart is the daily median between January 3 and February 6, 2020. The thick lines represent the 7-day central moving average. Eating out, travel, and entertainment related consumption is the total value of eating out, transportation, and cultural & entertainment services.

Exports improved due to pent-up demand, but are expected to slow down in the future

As was the case for personal consumption, exports were also strongly affected by the coronavirus crisis, but have been picking up rapidly since June. The August export volume index recorded its third consecutive month of growth at +10.5% m/m (Chart 4). However, the level of the export volume index remains low, falling as much as 10% below the level seen in February before the effects of the spread of COVID-19 appeared.

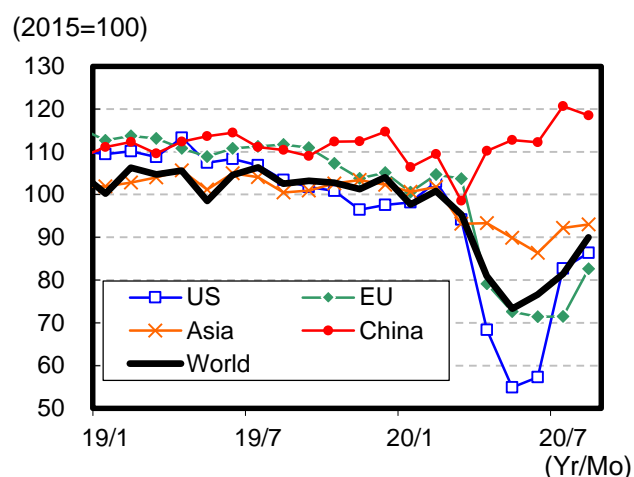
Looking at performance by industry, contribution to the recovery in exports has been especially notable in transport equipment. Export volume of motor vehicles to their major destination, the US, grew sharply in July due at least in part to pent-up demand appearing after the lockdown was lifted (Chart 5). August declined somewhat, but managed to maintain levels seen in March. On the other hand, exports to the EU and Asia (excluding China) are maintaining a gradual recovery.

The recovery in exports is expected to gradually slow down as pent-up demand dissipates in the future. There is a strong sense of uncertainty regarding the future with the increase in COVID-19 infections, and it is difficult for corporations to increase their motivation to invest while factory operating rates are sluggish. A large proportion of exports to Europe and the United States are accounted for by capital goods such as general machinery, and hence recovery is expected to lag behind consumer goods. For the time being, overall exports will likely be supported by exports to China, which experienced an early V-shaped recovery in export volume.

China's economic recovery is being led by investment. Retail sales have continued to record year-to-year declines since the beginning of the year, but exceeded the previous year in August. We expect the real GDP growth rate in 2021 to accelerate to +7.1% y/y from the +2.1% y/y of 2020 as the recovery trend in personal consumption continues with the resumption of economic activity.

Export Volume Index by Country & Region

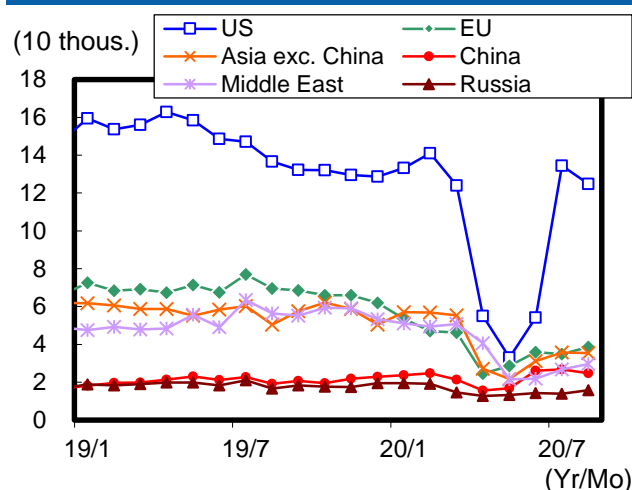
Chart 4



Source: Ministry of Finance; Cabinet Office; compiled by DIR
Notes: Seasonal adjustment by Cabinet Office (China handled by DIR).

Export Volume of Motor Vehicles by Region

Chart 5



Source: Ministry of Finance; compiled by DIR
Note: Seasonally adjusted by DIR

Jul-Sep period real GDP for Japan, the US, and the Eurozone to record low levels at around 4-5% less than the Jan-Mar period

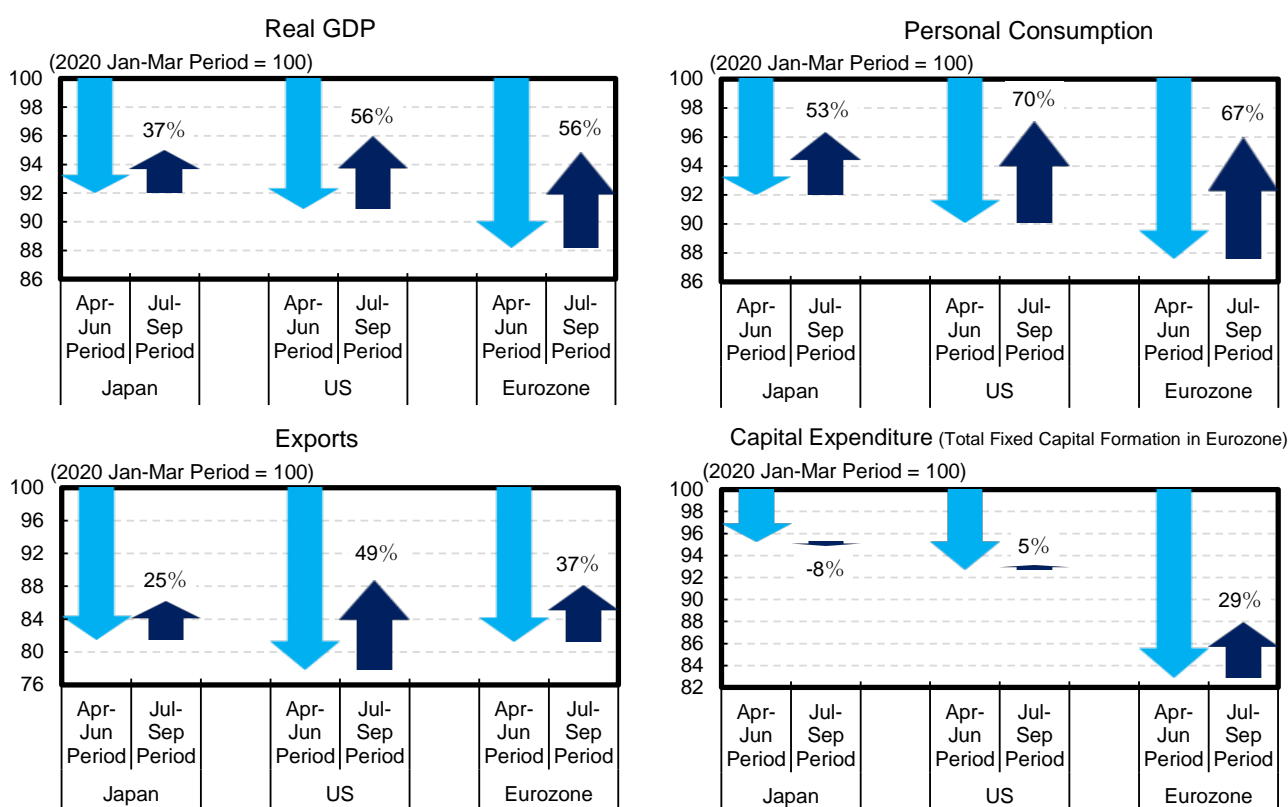
The Jul-Sep period real GDP growth rate is expected to achieve double-digit growth in q/q annualized terms not only in Japan, but in the US and the Eurozone as well. Japan is seen at +13.2% q/q annualized, with the US at +24.2%, and the Eurozone at +33.4%. The Jul-Sep period growth rate is expected to trend higher in those countries where the decline in GDP during the Apr-Jun period was especially steep, but

the level of Jul-Sep period GDP is expected to fall around 4-5% below the results of the Jan-Mar period for each of these regions (Chart 6).

Looking at the major demand components, Jul-Sep period personal consumption in Japan is expected to recover about half of the percentage of decline experienced during the Apr-Jun period, while a recovery of around 70% is seen in the US and the Eurozone. Looking at the actual levels, Japan, the US and the Eurozone are each expected to fall around 3-4% below the results of the Jan-Mar period, with consumption of services especially remaining below the levels seen before the coronavirus crisis. The recovery for exports during the Jul-Sep period is more sluggish than personal consumption, with Japan expected to be at just under 30% of the extent of its Apr-Jun period downturn, and the Eurozone at less than 40%, while the US is expected to recover less than 50% of its Apr-Jun period decline.

Capital expenditure is also expected to remain sluggish after the Jul-Sep period. Japan's capital expenditure during the Jul-Sep period is expected to decline further from the Apr-Jun period, while US capital expenditure and total fixed capital formation in the Eurozone are expected to increase slightly. Even though investment is expected to increase in the Eurozone and the US, it will be well below levels seen before the coronavirus crisis. There is a strong sense of uncertainty regarding the future with the long-term increase in COVID-19 infections, and it is difficult for corporations to increase their motivation to invest while factory operating rates are sluggish, a situation held in common between Japan, the US, and the Eurozone.

Apr-Jun Period & Jul-Sep Period Outlook for Real GDP & Major Demand Components in Japan, US, and Europe Chart 6



Source: Cabinet Office, BEA, Eurostat, Haver Analytics; compiled by DIR.

Note: All figures expressed in real terms and seasonally adjusted. Figures appearing above the dark blue arrows are the percentage of decline experienced during the Apr-Jun period. Jul-Sep period figures for each country are based on outlooks produced by DIR researchers specializing in those areas.

2. Hopes and Challenges for *Suganomics*

(1) Overview of initiatives since the inauguration of the Second Abe Cabinet

Former cabinet realized long-term economic growth and successes in financial markets, employment, and apprehension of external demand

The new Yoshihide Suga Cabinet was inaugurated on September 16. The Japanese economy experienced its second longest economic expansion of the postwar period between December 2012, when the second Shinzo Abe Cabinet was inaugurated, and October 2018 according to provisional statistics. The economic policy of the former Cabinet, "Abenomics," achieved a variety of results, but many issues remain.

An evaluation of the major issues which occurred after the second Abe Cabinet was inaugurated is shown in Chart 7. Particularly positive changes were seen in the financial markets, employment & work styles, and the apprehension of external demand. The trend toward a strong yen shifted in the fall of 2012 when the European government's debt problem settled down, and the change of governments from the opposition (Democratic Party of Japan) to the Liberal Democratic Party, which advocated bold monetary easing, became a reality. The exchange rate has been relatively stable to date, partly because the Bank of Japan has implemented a series of monetary easing measures since April 2013 under Governor Haruhiko Kuroda. As for the stock market, market capitalization of the first section of the TSE reached a record high at the end of 1989 reflecting domestic and overseas economic expansion and global monetary easing.

In terms of employment, the ratio of job offers to applicants reached its highest level in about 45 years, exceeding 1x in all prefectures. Labor force participation on the part of women and the elderly progressed, and the number of employees (excluding executives) increased by 5.19 million between the Oct-Dec period of 2012 and the Oct-Dec period of 2019. This greatly exceeds the longest postwar "Izanami economy" (between the Jan-Mar period of 2002 and the Jan-Mar period of 2009, which saw an increase of 2.14 million people). A little less than 70% of the increased employment was for non-regular employees, and although the regular employment increase was only 1.78 million, the quality of employment improved in comparison with the Izanami economy, when the number of regular employees decreased by 860,000.

Evaluation of Major Issues Since Inauguration of 2 nd Abe Cabinet		Chart 7	
Area	Evaluation	Comments	
Financial Markets	◎	<ul style="list-style-type: none"> Corrected strong yen trend which began after financial crisis of 2008. Stock prices rose, with market capitalization of TSE reaching historic highs. 	
Economy	Business Conditions	◎	<ul style="list-style-type: none"> Achieved second longest period of growth in postwar period.
	Employment & Work Style	◎	<ul style="list-style-type: none"> Labor force participation on the part of women and the elderly progressed, and the number of employees (both regular and non-regular) increased. The ratio of job offers to applicants reached its highest level in about 45 years, exceeding 1x in all prefectures. Work style reforms progressed, including correction of tendency toward long work hours.
	Apprehension of External Demand	◎	<ul style="list-style-type: none"> Inbound demand grew (sharp growth in foreign tourists). Trade liberalization progressed (TPP11, Japan-EU/EPA).
	Wages & Prices	○	<ul style="list-style-type: none"> Annual spring labor offense won progress in wage increases and minimum wage. Broke out of deflation trend, but failed to reach target of 2% inflation.
	Strengthening Growth (Productivity Up)	△	<ul style="list-style-type: none"> System and regulatory reform progressed in a broad range of areas including strengthening of corporate governance, deregulation of electricity & gas utilities, and agricultural policy reform. Potential growth rate and labor productivity growth rate did not increase as much as originally expected.
Social Security	△	<ul style="list-style-type: none"> Integrated reform of social security and tax began in 2012, but ended with the two separated. Did not find way to sustainability of social security system, and social security for all generations. 	
Fiscal Health	×	<ul style="list-style-type: none"> Targeted year FY2020 for national and local primary balance getting back into the black, but target later extended to FY2025. Budget deficit grew sharply due to coronavirus crisis, making fiscal consolidation after the disease is brought under control all the more difficult. 	

Source: Produced by DIR using data from various sources.

There was also clear improvement in working conditions. The Act Promoting Measures to Prevent Death and Injury from Overwork was enforced in November 2014, and in April 2019, the Work Style Reform Law was partially enforced, which includes restrictions on the upper limit of overtime work and requires companies to make sure that employees take five days of paid leave per year. With this new law, the correction of long working hours has progressed regardless of the size of the company. The number of employees who work more than 260 hours a month (overtime hours exceed 100 hours if the scheduled working hours are 160 hours a month) was 2.4 million in FY2013, but it decreased to 1.65 million in FY2019.

As for the apprehension of external demand, the number of foreign tourists visiting Japan grew from a total of 8,370,000 in 2012 to 31,880,000 in 2019, with inbound consumption increasing to nearly 5 trillion yen. After the spread of COVID-19, global movement of people across borders virtually stopped. The growth in inbound demand prior to that point was due not only to the weak yen and growth in overseas economies, but the result of successful public and private efforts as well. In addition, trade liberalization progressed, with TPP11 going into effect in December 2018, the Japan-EU EPA going into effect in February 2019, and the Japan-UK EPA reaching a general agreement on September 11, 2020.

Wages grew moderately during this period of long-term growth, and the economy managed to break out of its former deflation trend. Real wages, according to the Ministry of Health, Labour and Welfare's Monthly Labour Survey, decreased by 4.4% between 2012 and 2019. The decrease is due to the fact that statistics show the average wage per employee and reflect the decrease in working hours associated with efforts to correct long working hours. The real hourly wage, according to the Cabinet Office's National Accounts (real employee compensation divided by total working hours) rose by 7.2% during the same period. Amid tight labor supply and demand, base-pay increases were won in yearly spring labor offensives, and widely implemented since 2014. The minimum wage was raised by about 20% between FY2013 and FY2019, and this helped to raise the real hourly wage. However, the annual rate of increase in real hourly wages of +1.0% is lower than initially expected. Behind this lies the problem of sluggish labor productivity. The target inflation rate of 2% remains uncertain. The Bank of Japan's unprecedented monetary easing policy has been forced to go into the long-term, and there are concerns about side effects such as deterioration of the profitability of financial institutions and a decline in industrial renewal and innovation.

Labor productivity rises to level of major advanced nations, but fails to achieve intended target

Institutional and regulatory reforms have progressed in a wide range of fields, including the strengthening of corporate governance, full liberalization of electricity and gas retailing, agricultural policy reform, reduction of the effective corporate tax rate, and reduction of mobile phone charges, but the mid to long-term economy of the country, its potential growth rate, did not accelerate toward the 2% target of the Abe Cabinet. According to estimates of the Bank of Japan, the potential growth rate, which was +0.8% y/y in the latter half of FY2012, fell to +0.2% in the first half of FY2019 before the coronavirus crisis. Efforts to strengthen growth potential have not been sufficiently successful.

In this regard, the Second Abe Cabinet, when it was first inaugurated, set out the "three arrows" of Abenomics, which consisted of a bold monetary policy, flexible fiscal policy, and growth strategy to stimulate private sector investment. In the fall of 2015, the second stage of Abenomics began with the announcement of the "new three arrows" whose purpose was said to be to maintain a population of 100 million 50 years in the future, and to achieve the "dynamic engagement of all citizens." The former three arrows were bundled together to form the new first arrow, which targeted nominal GDP of around 600 trillion yen, while the second arrow targeted child-rearing support in order to achieve the desired birth rate of 1.8. The third arrow was the development of social security aiming for zero turnover in nursing care. After that, other policy programs were launched, including the "Human Resources Development

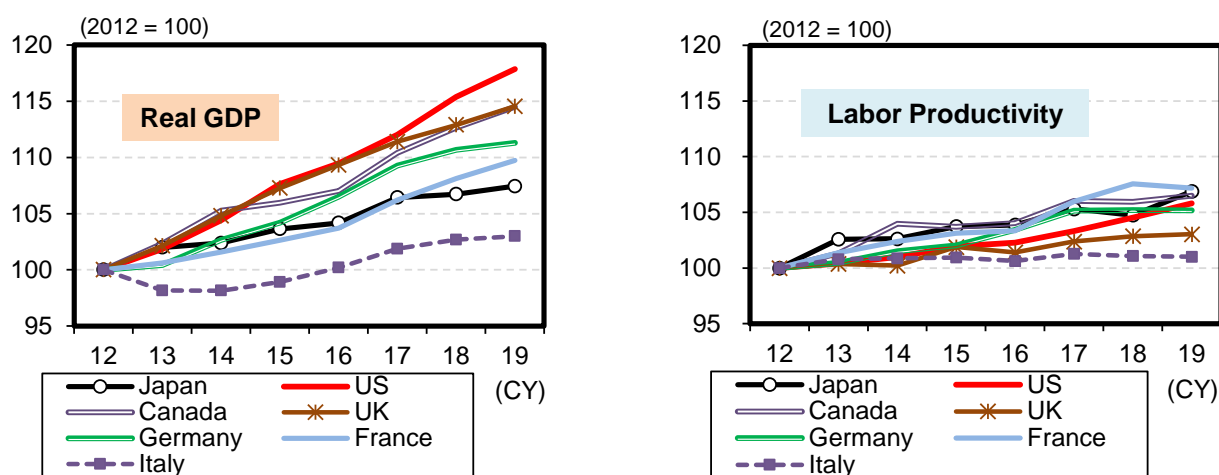
Revolution" (free education, etc.), "Society 5.0", "Comprehensive Social Security Reform" (reforms affecting all age groups), and "The Digital New Deal" (Promotion of Next Generation Administrative Services, Digital Transformation, etc.).

However, none of the goals of the three arrows was achieved. At the time nominal GDP of 600 trillion yen was targeted, the actual nominal GDP was at 500 trillion yen annualized³. It was predicted at the time that the target could be reached or even exceeded by the year 2020 if annual growth of just over 3% were achieved⁴. An increase of about 100 trillion yen was required to achieve the target, but by the Jul-Sep period of 2019 when nominal GDP peaked, the increase was only about 25 trillion yen (seasonally adjusted, annualized). In addition, despite the fact that expansion of childcare support measures included a significant expansion of the overall childcare program and free early childhood education and childcare, the total fertility rate in 2019 was at 1.36, lower than it was in 2012 when it was at 1.41.

However, the rate of increase in labor productivity since the inauguration of the second Abe Cabinet is not unfavorable in comparison to that of major developed countries. Chart 8 shows real GDP and labor productivity in the G7 countries. Comparing the levels of 2019 with 2012 which acts as the standard, Japan's real GDP was the second lowest (the third highest per capita after the United States and the United Kingdom), but this was largely affected by population changes. On the other hand, labor productivity was not much different in the five countries with the exception of Italy and the UK⁵. Japan's labor productivity growth rate has been declining since the 1990s, but the recent sluggish productivity growth is a common issue for major developed countries. In that sense, it is an ambitious goal to accelerate the rate of increase in productivity in Japan where the population is declining and aging, and to raise the potential growth rate to around 2%. It can be said that what is more necessary is to change the economic and social structure on a larger scale.

Trends in G7 Member Nations GDP (Left Side), and Labor productivity (Right Side)

Chart 8



Source: Cabinet Office, Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications, OECD, Haver Analytics; compiled by DIR.

Notes: 1) Labor productivity is real GDP per hour worked per capita.

2) Total hours worked in Japan in 2019 were estimated using data from Monthly Labour Survey and the Labour Force Survey.

³ Due to the revision of the GDP statistics standards in December 2016, the nominal GDP for the Jul-Sep period of 2015 was revised upwards from 501.5 trillion yen to 532.7 trillion yen (seasonally adjusted, annualized).

⁴ Yomiuri International Economic Society (YIES), 2015 Presentation, Prime Minister Abe Speech (November 6, 2015)

⁵ It has been suggested that the level of Japan's labor productivity is low in comparison to international standards.

According to OECD statistics, Japan's labor productivity scored 22nd amongst 36 member countries in 2018, in comparison to the US which was around 60%. However, Belgium's labor productivity is 5% higher than that of the United States and Ireland is 40% higher. It is necessary to examine the causes of the productivity gap. In this regard, GDP, which is an element of labor productivity, includes goods and services traded in the market amongst its components, but does not include unpaid work such as housework and childcare. In addition, Japanese-style employment practices that emphasize employment stability make it difficult to link employee achievements with wages. The productivity gap is affected not only by production efficiency and technical level, but also by differences in lifestyle and employment systems.

Social security reform is only halfway there, and the way to fiscal consolidation is unclear

In the field of social security, part of the financial resources from the consumption tax hike from 5% to 10% went toward enhancement of social security, while the rest was used for stabilization of social security. In other words, integrated reform of social security and tax was implemented up to a certain point, but was taken no further after completing that stage. Under the Social Security Reform Program Law enacted in December 2013, benefits will be optimized by reviewing the medical and long-term care provision system (community medical concept, community-based comprehensive care system, etc.), and promoting the use of generic drugs. The concept of fair burden according to ability was promoted. Further integrated economic and fiscal reforms have been promoted since FY2016. While continuing the efforts made thus far, drastic reforms of the drug price system and incentive reforms were implemented, and the increase in social security-related expenses in the national general account was held down in line with the established bellwether. In December 2019, the interim report on the All-generation Social Security Review Council was compiled, and the final report will be compiled toward the end of 2020.

However, the cost structure of social security remains unchanged, in that a portion of costs are covered by deficit-financing bonds, and this is a major factor behind the government's budget deficit. This means that future generations will bear part of the cost of social security services that the current generation directly benefits from. The idea of an all-generation social security, which aims to build a social security system that all generations can feel secure about while suppressing the increase in burden on workers is important, but the increase in burden on insurance premiums for workers will continue for the long-term, and after retirement, they are also likely to receive lower benefits. The consumption tax rate will eventually have to be raised to over 10%, and many households will be less willing to spend with the higher tax rate.

Regarding fiscal consolidation, the Abe Cabinet initially set a goal of getting the primary balance (PB) of the national and local governments back into the black by FY2020, but in June 2018 they ended up having to push the target back to FY2025. The reasons for this were a change in how the consumption tax increase was being put to use and the supplementary budget, but the main reason was that tax revenue was sluggish due to low economic growth. The ratio of public debt to GDP, which has been rising since the early 1990s, has continued to increase yearly since FY2013, and is expected to grow significantly in FY2020 in response to the coronavirus crisis. With the spread of infection expected to continue for the long-term, it will extremely difficult for PB to get back in the black by FY2025.

(2) Hopes and Challenges for *Suganomics*

Future benefits for households and corporations should be made more robust if the economy allows

For the time being, the challenge for the Suga Cabinet will be to respond to the coronavirus crisis and balance socio-economic activities with prevention of infection. The worst is over for the Japanese economy, and it has now entered a period of moderate recovery. However, the business environment for services involving face-to-face contact and movement of people from place to place remains difficult, and the employment situation is worsening. On the other hand, for many households, savings have increased significantly due to self-restraint of consumption and the special fixed benefit. Meanwhile, corporate cash flow has not deteriorated as much as it did after the financial crisis of 2008, partly due to the support measures of the government and the Bank of Japan.

There are still many households and corporations that need assistance, but the situation no longer requires government assistance as widespread and generous as in April and May. While it is undeniable that a state of emergency could be reissued if there is an explosion of infections, it is necessary to provide robust economic measures in the future, including considering the prioritization of benefits and additional support to people and companies who need it, while narrowing the scope of support based on the infection situation and economic conditions. In addition, it is still important to strengthen the medical care system and testing, as well as supporting corporations in keeping the infection under control, while stimulating demand at the same time as preventing the spread of infection. Conversion of business models also needs support with an eye to ending infection.

Effective rotation of PDCA growth strategy cycle and acceleration of work efforts required

Strengthening growth potential, for which the Abe Cabinet has not achieved sufficient results, is an urgent issue for Japan, whose population is still declining and aging, despite the coronavirus crisis. According to future estimates by the National Institute of Population and Social Security Research, the population aged 20-64 is expected to decrease by about 40% by 2065, and the aging rate is expected to increase by about 10 percentage points (medium-fertility (medium-mortality) projection). By region, many local governments are expecting further declines in workers and an aging population. Unless we aim for an economy and society in which the decline in workers can be suppressed and each individual can demonstrate their motivation and abilities, the local economy, social security, and finances will eventually become unsustainable.

The improvement of productivity is realized by the ingenuity and investment of the private sector, and it is not possible to grasp in advance how much the various government measures will raise the productivity. That is why the Abe Cabinet's growth strategy created a process chart, set KPIs (performance targets) for each policy group, and managed progress. However, the percentage of KPIs with a B rating, which have not progressed sufficiently, has risen from about 20% in FY2016 to nearly 50% in FY2019, leaving doubts as to whether the PDCA cycle was running effectively.

The World Bank's business environment ranking stated that KPI will be in the top 3 amongst developed countries by 2020, but as of 2019, six and a half years later, it remained in 18th place. In December 2017, the government established the Relevant Ministries and Agencies Liaison Conference for Improving the Business Environment, and is working on digitizing administrative procedures and reviewing business regulations, but the Suga Cabinet is expected to establish a new Digital Agency. It is necessary to accelerate the process further under this new agency.

In addition, the KPIs for labor productivity in the manufacturing and service industries are each increasing by 2% per year, but both were recently given a B rating. In connection with this, the Suga Cabinet will start considering a review of the Small and Medium-sized Enterprise Basic Act. By reviewing the definition of SMEs that can receive tax incentives and subsidies according to their actual

situation, it seems that the aim is to promote autonomous corporate efforts and reorganization, and to increase the productivity of SMEs. A full 99.7% of domestic companies fall under the category of SMEs under the Basic Act, but SMEs vary greatly, and their growth potential and financial situations differ from company to company. Until now, SME support measures have tended to be implemented in multiple layers, uniformly regarding them as vulnerable. As a result, there is room to consider whether SME support measures are discouraging companies from growing or hindering the renewal and innovation of the industry.

Expectations for promoting a digital society and a dynamic engagement of all citizens that sees the coronavirus crisis as an opportunity

Maintaining social distance and refraining from going out as a means of preventing the spread of infection has diminished the economic benefits of people and corporations gathering together in limited spaces. However, at the same time, it has become an opportunity for society as a whole to review work styles that are premised on commuting to an office to work, and business practices based on face-to-face contact, hard-copy printouts, and the use of traditional name stamps. The coronavirus crisis has forced both the public and private sectors to rapidly set up an infrastructure for remotely conducting various socio-economic activities. Various online services have also become widespread. These efforts have much in common with Society 5.0 concept, which the government was aiming for before the coronavirus crisis began. Society 5.0 is the concept of a society in which restrictions on space and time are eased and eliminated by expanding the use of IoT, AI, and robots, and the development of new goods, services, and business models are born, leading to more advanced and sophisticated lifestyles.

According to WHO, as of September 21, there were 38 vaccine candidates under clinical evaluation and 149 vaccine candidates in the pre-clinical evaluation stage. Although unpredictable, the post-corona era will soon come, and COVID-19 will no longer be a threat to humankind. If digitalization is promoted throughout society during the pandemic, the growth potential of the post-corona era when the economic benefits of gathering together return may exceed that before the spread of the infection began. The Suga Cabinet is expected to promote a digital society that sees the corona shock as an opportunity.

The dynamic engagement of all citizens program was launched by the Abe Cabinet in the fall of 2015, and has now become easier to realize because of the spread of working from home (telecommuting) during the coronavirus crisis. Telecommuting makes it easier to work for people who are raising children or nursing elderly people, and people with disabilities who feel burdened by commuting. According to analytical results of a survey conducted by the Recruit Works Institute on a sample of more than 40,000 people in 2017, men who telecommute spend significantly more time on housework and childcare than those who do not. This improves the work-life balance of the women who are their spouses, while promoting employment and a lower turnover rate. In Japan, the gender gap in wages, which can be said to be a proxy variable for labor productivity, is larger than in the US and European countries (Chart 9). The spread of telecommuting will encourage the accumulation of female human capital, which has plenty of room for gains in productivity.

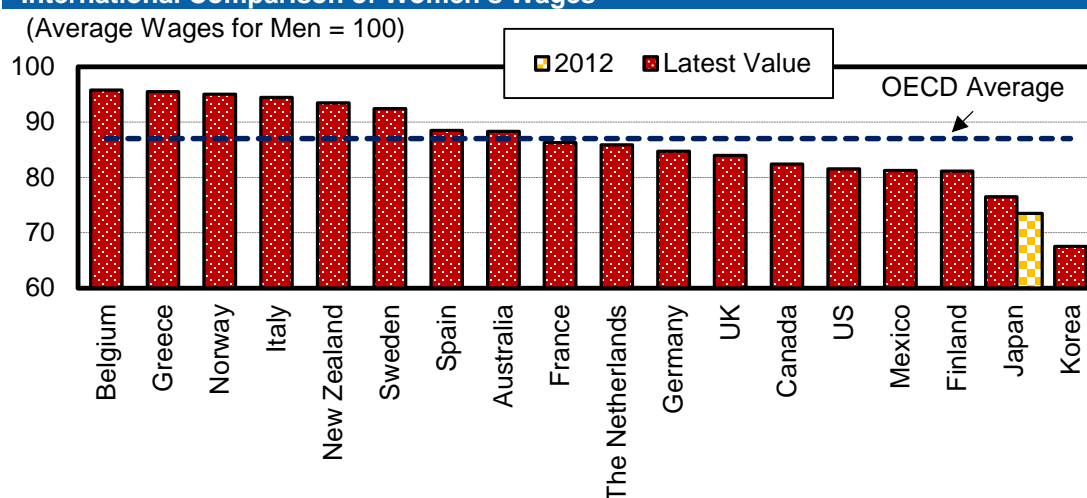
In recent years, the number of corporations that allow side jobs is increasing. For example, it is conceivable that people working in urban areas could work remotely for regional companies several times a week. If the expertise, experience, and human networks of highly-skilled human resources, which tend to be biased toward large companies in urban areas, are widely utilized by regional companies, there will be more opportunities for corporate profits to expand, leading to the revitalization of local economies.

However, there are many challenges to establishing telecommuting. According to a private survey conducted during the state of emergency, the majority of workers who telecommute said they were less productive. Companies need to not only improve IT equipment and networks and make various

procedures online, but also use work and telecommuting properly according to the nature of their work, and review work rules and the cost burden during telecommuting. It is expected that the Suga Cabinet will strongly support such private sector efforts.

International Comparison of Women's Wages

Chart 9



Source: OECD; compiled by DIR.

Note: The Latest Value is the most recent value available in usable data before 2019. Japan's Latest Value is from 2019.

It is necessary to materialize future self-help, mutual assistance, and public assistance in social security, and to strengthen redistribution policy

In the LDP presidential election, Prime Minister Suga listed "self-help, mutual assistance, public assistance, and the connections between people" as his political philosophy. In the area of social security, the issue is that there is no concrete discussion about the future of self-help (self-pay), mutual assistance (insurance premiums), and public assistance (public expenses). Looking back on social security reforms thus far, there is only a vague image of the magnitude of the problem, the effects of various reforms, and the scale of the final necessary benefit restraint and burden increase. Individual reforms are being carried out gradually with no blueprint for the future, and as a result, the burden of insurance premiums and public expenses is steadily increasing. What exactly is the best balance of self-help, mutual assistance, and public assistance required to build a sustainable social security system, keeping in mind the fact that the population of elderly people will reach its peak in around 2040. The Suga Cabinet needs to hold concrete discussions on what kind of reforms are necessary based on future estimates. This will greatly advance fiscal consolidation, but it is also necessary to discuss securing financial resources for expenditures that have increased sharply in response to the coronavirus crisis after the infection has subsided.

On the other hand, the digitization of administrative services, which is expected to be promoted with the Digital Agency as the command tower, will also contribute to strengthening Japan's redistribution policy, which is showing signs of eventual collapse. The payment of the special fixed benefit caused confusion in many local governments, but the root cause is that the Social Security and Tax Number System has not yet been effectively utilized. If the infrastructure for managing national income information and bank accounts by number was in place as in Europe and the US, it would have been possible for the government to select the target people and transfer payments to their bank accounts at an early stage. To streamline execution, for example, administrative expenses (budget basis) of 145.9 billion yen for the special fixed benefit could have been significantly reduced, and that amount could have been used for benefits to people in need. This means that it would be useful to incorporate the concept of basic income, which is gaining increasing interest at home and abroad, into the existing system. In order to build an efficient and effective safety net, it is expected that the Suga Cabinet will actively promote the effective use of the Social Security and Tax Number System.

Japan's Economic Outlook No. 206 Update (September 8, 2020)

Chart 10

		2019				2020				2021				2022	FY2019	FY2020	FY2021
		Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar			
Real GDP	Q/q %; annualized	2.8	1.6	0.2	-7.0	-2.3	-28.1	13.2	4.6	4.6	2.6	1.5	1.3	1.4			
	Y/y	0.8	0.9	1.7	-0.7	-1.8	-9.9	-7.3	-4.5	-3.0	6.1	3.3	2.5	1.7	0.0	-6.1	3.4
Private spending	Q/q %; annualized	0.3	2.1	1.8	-11.0	-2.8	-28.2	19.7	4.1	3.6	2.8	1.2	1.0	1.0	-0.5	-5.8	3.4
Private housing investment	Q/q %; annualized	5.8	-0.6	4.9	-8.7	-15.0	-2.0	-14.4	-5.9	-0.8	0.0	0.4	0.8	1.2	0.6	-7.9	-1.6
Capex	Q/q %; annualized	-1.9	3.3	0.9	-17.6	7.0	-17.5	-1.6	3.4	3.0	1.6	1.2	0.8	1.2	-0.3	-5.4	1.7
Government final consumption	Q/q %; annualized	0.4	4.2	3.4	1.3	0.1	-2.3	1.8	1.0	0.8	0.8	0.7	0.6	0.5	2.3	0.4	0.8
Public investment	Q/q %; annualized	10.2	5.6	4.4	2.5	-1.8	4.6	1.4	1.4	1.9	1.1	2.5	0.5	1.0	3.3	2.1	1.4
Exports	Q/q %; annualized	-6.8	0.6	-2.5	1.6	-19.9	-56.0	24.8	21.6	17.0	7.8	5.3	4.9	4.5	-2.6	-15.5	10.9
Imports	Q/q %; annualized	-16.8	7.3	3.0	-9.4	-15.6	-1.9	1.2	4.9	4.2	3.6	2.6	2.2	1.7	-1.5	-3.5	3.2
Nominal GDP	Q/q %; annualized	5.0	1.9	1.7	-5.7	-1.8	-27.2	10.4	3.6	4.0	2.9	1.9	1.4	1.5	0.8	-6.1	3.1
GDP deflator	Y/y	0.2	0.4	0.6	1.2	0.9	1.3	0.1	-0.4	-0.7	-1.0	-0.2	0.0	0.2	0.8	0.1	-0.2
Industrial production	Q/q	-2.1	0.0	-1.1	-3.7	0.4	-16.9	6.2	2.1	2.3	1.4	1.0	0.6	0.6	-3.7	-13.2	7.0
Core CPI	Y/y	0.8	0.8	0.5	0.6	0.6	-0.1	-0.2	-1.4	-1.7	-0.9	-0.5	-0.2	-0.1	0.6	-0.9	-0.5
Unemployment rate	%	2.5	2.4	2.3	2.3	2.4	2.8	3.3	3.5	3.5	3.4	3.3	3.2	3.1	2.4	3.3	3.3
Trade balance (goods, services)	Y tril; annualized	0.3	-1.2	0.3	1.6	2.5	-7.2	-5.4	-3.2	-1.0	-0.8	-0.3	0.2	0.6	0.7	-4.2	-0.1
Current account balance	Y tril; annualized	19.8	19.4	18.8	21.2	19.4	8.5	10.7	13.4	15.6	16.3	16.9	17.4	18.0	19.7	12.0	17.1
Major assumptions																	
Crude oil price (WTI futures)	\$/bbl	54.9	59.9	56.4	56.9	45.8	28.0	40.7	40.0	40.0	40.0	40.0	40.0	40.0	54.7	37.2	40.0
Exchange rate	Yen/\$	110.2	109.8	107.3	108.7	108.9	107.6	106.4	106.3	106.3	106.3	106.3	106.3	106.3	108.7	106.6	106.3

Source: Compiled by DIR.

Note: GDP through Apr-Jun 2020: actual; thereafter: DIR estimates.