JAPAN

NEW RISK OF DEFLATION?

Like the vast majority of economies, Japan will go into recession in 2020. The expected rebound in 2021 is likely to be relatively mild. The latest economic indicators reveal an economic situation that is still highly deteriorated compared to normal times. Once again, massive fiscal stimulus has been set in motion. The Bank of Japan's monetary policy, notably through the Yield Curve Control, should largely reduce the risk of higher financing costs due to the expected rise in public debt.

The shock of the Covid-19 pandemic has hit Japan at a time when economic growth was already faltering. The combination of a VAT rate increase and a violent typhoon significantly weakened domestic demand in Q4 2019.

ANOTHER YEAR OF ECONOMIC HARDSHIP

After declining at a quarterly rate of 1.9% in Q4 2019, Japanese GDP contracted 0.6% q/q in Q1 2020. This decline can be attributed to another downturn in household consumption and a sharp drop-off in exports. Q2 2020 is bound to be much worse, with GDP plummeting by about 5% (q/q). The most recent information available to date suggests important difficulties. The Bank of Japan's Tankan indicator (see chart 1) dropped to all-time lows in both the manufacturing and non-manufacturing sectors. After bottoming out in April, the composite purchasing managers index (PMI) picked up again after the state of emergency for the country as a whole was lifted at the end of May. Even so, economic activity is still very weak. Composite PMI rose to only 38 in June 2020, after reaching 26 in April and 28 in May.

All in all, we estimate that the Japanese economy will contract by about 5% in 2020 before rebounding by a relatively mild 2.1% in 2021.

FISCAL STIMULUS AND MONETARY SUPPORT

To limit the negative economic impact of the current crisis, the government launched a massive fiscal stimulus. Estimated at about 20% of GDP, the overall package contains direct support for households and companies as well as transfers to local governments. According to the International Monetary Fund (IMF)[1], Japan's public debt, which was already the highest in the world prior to the pandemic, could reach an estimated 252% of GDP this year. Yet liquidity or solvency risks are still small because the vast majority of debt is held by local economic agents and benefits from an ample degree of monetary accomodation. One of the main policy tools will be to use the Yield Curve Control (YCC) to avoid an increase in financing costs for the Japanese government. The Bank of Japan corroborates this idea in its latest monetary policy statement[2]. BoJ also doubled the ceiling on purchases of Exchange Traded Funds (ETF). The central bank's balance sheet continues to swell, after reaching the equivalent of 100% of Japan's GDP. These dynamics fit within an environment of deflationary risk, which has long plagued Japan's economic history.

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GROWTH AND INFLATION (%)

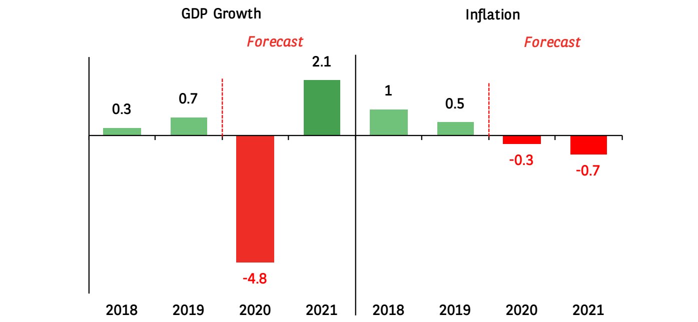

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

JAPAN: TANKAN INDICATOR

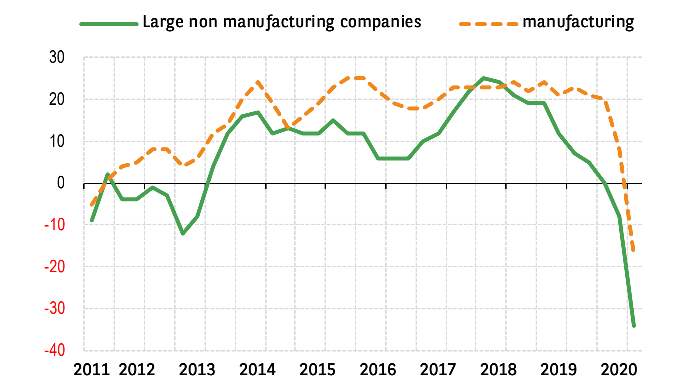

CHART 2 SOURCE: BANK OF JAPAN

1 Fiscal monitor: *Chapter 1 – Policies to support people during the Covid-19 pandemic*, IMF, April 2020
2 "The Bank will purchase a necessary amount of Japanese government bonds (JGBs) without setting an upper limit so that 10-year JGB yields will remain at around zero percent", Bank of Japan, June 2020