Impact of Covid-19 on Financial Markets – Japanese Economy Peaked Prior to the Virus

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Nations around the world have suffered dramatic economic slowdowns caused by the coronavirus pandemic, starting around the spring of 2020. Japan, however, had already been in a recession since 2018, caused by two different shocks. *Chart 1* shows, along with the price index of the Nikkei stock average, the economic diffusion index released by Japan's Cabinet Office, which clearly indicates the general direction and size of the economy.

The first shock was the US-China trade war that began in 2018. Global trade volumes peaked and began to decline as a result of increased tariffs that the US and Chinese governments imposed on each other. Japan's economic structure makes it highly vulnerable to changes in foreign demand, and as a result the Japanese economy reached a ceiling in October 2018 and entered a recessionary phase thereafter.

The second shock was the Japanese government's hike of the consumption tax rate from 8% to 10% in October 2019. The Japanese have an expression for this – "tax pain". Because tax pain happens every single time a consumer spends money, a higher consumption tax automatically leads to lower consumption. This tendency is fairly unique to Japan, as it is not often seen in other countries. In fact, the exact same phenomenon was observed during the last tax hike, when the consumption tax was raised from 5% to 8% in April 2014.

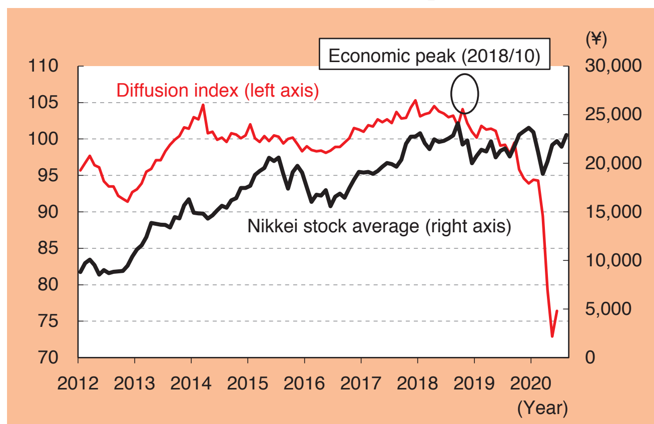
In addition to these two shocks, a third shock was the coronavirus. The number of people per 10,000 infected with the virus (as of August 2020) was low in Japan at five or six, compared to 50-180 per 10,000 in the United States and developed European countries. Still, in observance of the government's pandemic guidelines, Japanese people have tended to stay home, resulting in a significant negative impact on the economy.

Meanwhile, the current situation is that the economic slowdown caused by the coronavirus was so great that it required fiscal policy involving huge sums of money to address it. This very likely led to a recovery phase after the economy bottomed out in May-June 2020. However, despite the trend toward recovery, the level of economic activity remains far lower than before the coronavirus pandemic.

According to the updated IMF World Economic Outlook released in August 2020, the Japanese economy grew at a rate of +0.7% for 2019. Projections for 2020 and 2021 were -5.8% and +3.4% respectively. The general government fiscal deficit to GDP ratio stood at 3.3% for 2019, while projections for 2020 and 2021 climbed to 14.7%, and 6.1% respectively.

In the US, Jerome Powell, chairman of the Federal Reserve Board, speaking at a press conference following the Federal Open Market Committee of July 2020, remarked that the economic outlook remains extremely unclear and will largely depend on how well the coronavirus can be controlled. This statement is also true of Japan. Projections will very likely be upwardly revised if a vaccine is successfully developed, or downwardly revised if governments fail to contain the virus.

CHART 1
Diffusion index & stock prices



Note: The diffusion index is published by Japan's Cabinet Office. Stock prices are monthly averages.
Source: Resona Asset Management Co., Ltd. compilation based on publicly available data from Haver Analytics

Policies Fail to Revitalize Japanese Economy

Since the launch of the second administration of Prime Minister Shinzo Abe in December 2012, the Japanese government has steered economic policy with a view not only to recovery but to an ambitious revitalization of the Japanese economy. To this end, the administration devised the "Three Arrows" policy, with specific ambitious goals. The first and second of these arrows – dramatic monetary easing and a robust fiscal policy – were intended to boost the economy, while the third arrow, growth policies to stimulate private investment, which included deregulation and other measures, has also been implemented. In all, the Three Arrows comprised a scenario designed to jump-start the economy and achieve self-sustaining economic growth.

In reality, however, as government bond and stock purchases were deregulated as part of monetary policy, fiscal policy was financed by massive government deficit. The result of the two arrows of monetary easing and robust fiscal policy resulted in a long-term economic

recovery, spanning 71 months of expansion from December 2012 through October 2018.

Put conversely, however, without the monetary and fiscal policies of the Three Arrows, the recovery would not likely have been viable. In other words, because the economic growth during the period of December 2012 to October 2018 was not self-sustaining, the expansion that occurred over this period cannot be deemed a successful economic recovery. This is evident in the World Bank Ease of Doing Business index.

Japan dropped in the rankings from No. 17, at the outset of the second Abe administration in 2012, to No. 29 in 2019 – belying the pledge Abe made when he won the general election to "top the list". The Cabinet Office conducts a periodic survey of stock market-listed companies regarding their projections for real economic growth over the next five years. The results of the 2019 survey were the lowest since the survey was first conducted in 1989 (*Chart 2, which excludes Japan's asset price "bubble economy" period*).

Further, the coronavirus pandemic and the restrictions keeping people from going out, revealed the fact that virtually no progress had been made in areas such as online classes, telehealth and online administrative procedures over the past 20 years. This was despite the fact that online initiatives had been assigned priority following the destruction of schools, hospitals, and administrative offices following the Great East Japan Earthquake in March 2011. In the wake of the coronavirus pandemic, a major policy shift is expected to help resolve these issues.

Inbound tourism had been the government's most successful area of growth strategy. The number of foreign visitor arrivals in Japan rose from 8 million in 2012 to 38 million in 2019. These tourists brought in added revenue of ¥3.8 trillion (0.7% of GDP). The tourism sector was dealt a heavy blow when travel to and from Japan by foreign nationals was virtually halted during the coronavirus pandemic.

Long- & Short-Term Financial Markets

Prior to the coronavirus pandemic, Japan was already implementing broad-based monetary easing on a scale never seen before. The Bank of Japan (BOJ) began monetary easing subsequent to the second Abe administration. The government entered into an agreement with the BOJ, setting the goals of overcoming deflationary trends and an inflation rate of 2%. BOJ Governor Haruhiko Kuroda proceeded to significantly alter monetary policy by instituting what became known as a "reflation" policy. Prior to the coronavirus pandemic, the BOJ had guided the key interest rate to -0.1% and yields on 10-year government bonds to around 0%.

The BOJ calls this guidance method Yield Curve Control. Other major monetary easing techniques include quantitative easing through government bond buying, and lowering risk premiums by buying stock ETFs and REITs. The annual target for ETF buying was ¥6 trillion.

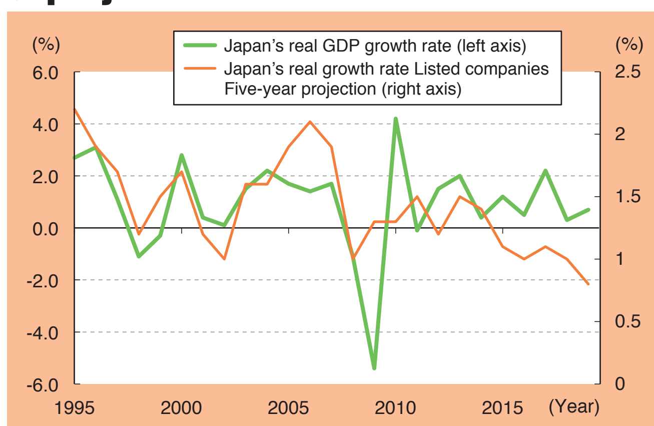
In responding to the coronavirus pandemic, the total value of stock ETF buying was increased from ¥6 trillion to a maximum of ¥12 trillion. At this time, new purchasing of CPs and corporate bonds was also launched with a maximum purchase value for each of ¥7.5 trillion through March 2021. A special program providing cash flow support for private corporations was also established with a total budget of ¥110 trillion.

However, markets continued to look for deeper negative interest rates and lower 10-year bond interest rates. In addition, the determination of guideposts for 20- and 30-year government bonds incited expectations of lower interest rates. However, this did not materialize. As indicated in *Chart 3*, the 10-year government bond interest rate fell deeper into the negative range for a limited time, but recently has tended to hover around zero.

The main reason the BOJ chose to avoid lower long-term interest rates was the inherent disadvantages of lower interest rates. Regional banks, whose sales shares of international and securities businesses are low, face severe business conditions, while the price book-value ratio (PBR) at many banks remains low at 0.2-0.3. Book value per

CHART 2

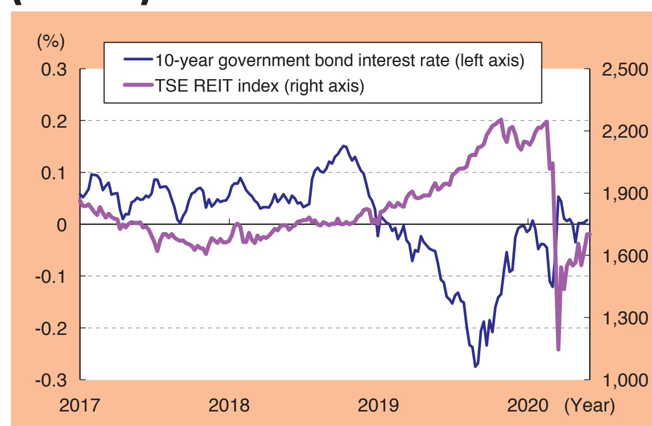
Economic growth rates: performance & projections



Source: Resona Asset Management Co., Ltd. compilation based on publicly available data issued by the Cabinet Office

CHART 3

Long-term interest rates & TSE REIT (J-REIT) index



Source: Resona Asset Management Co., Ltd. compilation based on publicly available data from Haver Analytics

share (BPS) is also known as the liquidating value of a company. Theoretically speaking, a PBR of less than a value of 1 means that the business is no longer viable. The shares retain greater value if the company chooses to liquidate and distributes the remaining assets to shareholders.

Avoiding "Japanification" – a Global Issue

Japan's monetary policy has been criticized by some analysts for being incapable of stopping the deflationary cycle from 1990 through 2010. At the same time, the central banks of numerous developed countries around the world have implemented monetary easing via asset buying and have also adopted negative interest rates. This is an indication that Japan is now viewed not as behind the times but rather as a pioneer of this strategy.

This perspective can be considered a test of Modern Monetary Theory (MMT), which suggests that as long as government bonds are issued in the currency of the issuing country, then large deficits should not be seen as problematic.

Meanwhile, it remains highly likely that central banks of many developed countries will consider the issue of how to avoid following the experience of Japan or "Japanification" in responding to the coronavirus pandemic.

The Stock Market

Chart 1 shows trends in the Japanese stock market. In reality, the price movement of the Japanese stock market is linked to the US stock market, except in cases where there is a determining factor very specific to Japan. This has been the case since the launch of the second Abe administration, and these trends are unlikely to change significantly following the pandemic. Regarding current stock price levels, the recovery of stock prices had been considered too fast to accurately reflect the real state of the economy. This is true of both the Japanese and US markets.

It should be noted, however, that the international distribution of earnings of Japanese companies differs greatly. As the process of globalization has intensified, there is less of a correlation between the Japanese stock market and the Japanese economy. A current topic of interest is the discrepancy between consolidated and nonconsolidated financial statements at Japanese companies.

Nonconsolidated financial statements include only companies in Japan, while consolidated financial statements include Japanese-company affiliates and subsidiaries overseas. Even where nonconsolidated financial statements show a deficit, in many cases consolidated financial statements may indicate large surpluses. This phenomenon is a clear indication that while some Japanese companies have lost the ability to earn large sums in Japan due to the nation's dual issues of low birth rates and a rapidly aging population, they are able to prosper overseas, particularly in developing nations.

The decline in revenue opportunities in Japan has led to fewer investment opportunities and is a reason why companies have chosen to accumulate cash or shareholder equity. On the basis of the Tokyo Stock Price Index (TOPIX), the total amount of shareholder equity has increased, from ¥303 trillion in January 2013 to ¥525 trillion in January 2020. Accumulating cash or shareholder equity was not considered aggressive corporate management during normal times but has been successfully employed as a risk-lowering measure during the coronavirus pandemic.

Corporate Governance Reform at Japanese Companies

Increasing capital stock is considered the flip side of a company's lack of enthusiasm on shareholder returns, capital expenditure, and so forth. For this reason, the Abe administration promoted a policy of corporate governance reform with a view to striking a balance among corporate stakeholders. Over the past few years, a governance code, similar to that of the United Kingdom, has been adopted as a listing requirement for the Tokyo Stock Exchange (TSE). Rules include mandatory independent directors, specific Return on Equity (ROE) goals designed to clear the international standard of 8%, and more. Though the pandemic has cut into corporate revenues on a practical level, governance reform has nonetheless been steadily implemented.

Chart 4 shows PBR (vertical axis) and ROE (horizontal axis) for TOPIX companies. Figures as of 2002, after the burst of Japan's economic bubble and resolution of the bad debt problem, are plotted on the chart. The vertical axis shows how PBR, which stands around 0.8, has reached the lower limit. During the height of uncertainty surrounding the pandemic, around March-April 2020, stock prices plummeted, but the lower limit remained approximately 0.8. ROE shown on the horizontal axis, meanwhile, improved from 4.3% in December 2012, at the outset of the Abe administration, to 6.7% in December 2019, prior to the pandemic.

J-REIT & Real Estate Markets

Japan's real estate investment trust (J-REIT) market, as shown in *Chart 3*, was trending higher due to the robust real estate market prior to the coronavirus outbreak. The reason for the popularity of J-REITs was their high dividend yield of 4% on average. However, due to the pandemic the market lost liquidity, resulting in violent fluctuations in market prices. Breaking it down into market segments, distribution facilities such as warehouses trended higher thanks to increased Internet shopping, while buildings such as offices and condominiums – concentrated in urban areas – were also robust. The hotel segment, however, declined dramatically as a result of sharp drops in inbound tourism.

The government has privately requested real estate owners, included REITs, to reduce or exempt rents to help real estate rental companies to survive the pandemic, resulting in lower dividends across the board. The severity of the cuts will depend on how the pandemic plays out.

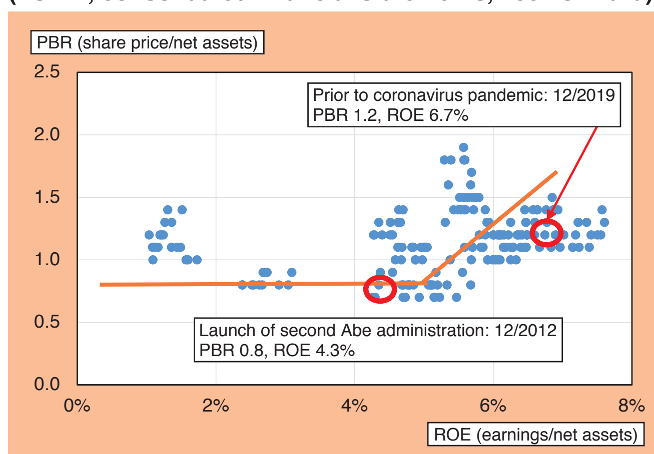
Some analysts take the view that demand for urban center office and condominium buildings will fall over the long term due to increases in the number of people working at home. According to one survey, if 10% of people make the shift to telework, the office vacancy rate in urban centers will surpass the 2009 peak of 9.1% to rise to 14.4%. The rate was 1.7% for 2019.

In Tokyo, however, despite problems with overconcentration –

CHART 4

Verification of earning power

(TOPIX, consolidated financial statements, 2002 onward)



Source: Resona Asset Management Co., Ltd. compilation based on publicly available data from Haver Analytics

especially evident after the 2011 Great East Japan Earthquake – the population rose 7% from 13.09 million (2010) to 13.85 million (2019). A significant number of analysts project even further overconcentration of the population in Tokyo when the pandemic comes to an end with a vaccine or some other solution.

Currency Markets

Since the "reflation" policy was explicitly adopted in 2013 by the BOJ, the long-term trend of the rise of the yen – dating to the "Nixon shock" of 1971 – came to a close. As of 2017, the yen-dollar rate has remained within the core range of ¥105-¥115.

In Japan, when the global economic risk is high, the demand for safety assets is higher, and thus the yen trends higher. The primary reason is that the yen is considered a safe haven. At the end of 2019, Japan held the world's highest volume of net external assets at ¥364 trillion. During times of crisis, Japan repatriates overseas assets, engendering massive yen buying and increased demand, which pushes the yen higher.

Since 2000, such crises include the 9/11 terrorist attack of 2001, the Great Financial Crisis of 2007-2008, and the Great East Japan Earthquake of 2011. During the pandemic of 2020, the yen temporarily neared ¥100 to the dollar, but the rate has generally remained in the ¥105-¥115 range.

As long as extreme uncertainty with regard to the stability of the dollar, which is often associated with the surge of gold or Bitcoin, is absent, the yen-dollar rate is generally seen to remain in the ¥105-¥115 range.

Long-Term Outlook After Covid-19

The outlook for the economy and financial markets for the next few years, as Fed chairman Powell has said, depends on the outcome of the coronavirus pandemic. The problem should be resolved within a few years depending on a vaccine and herd immunity.

The pandemic is often compared to a war. It is true that on the financial front, during wartime, the budget deficit was inflated to finance war operations, and monetary policy was placed under government control. A somewhat optimistic view is that the pandemic is actually a winnable war. Still, even when the war against the coronavirus is won, there will be no direct reparation. In this sense, the real question is what will happen when the pandemic is over.

For comparison purposes, let's look at the US during World War II. Due to wartime procurement spending, the budget deficit to GDP ratio rose from 38% in 1941 – when the US entered the war – to 111% in 1945 when the war came to a close. Under the government-controlled monetary policy of the time, three-month short-term government bonds (Treasury bonds) and 10-year government bonds were guided by the artificial fixed interest rates of 0.25% and 2.5% respectively.

Yet the real test was steering the postwar economy. Government spending after the war, primarily military procurement, fell by one-third. Real GDP for 1946 stood at -11%, while consumer prices rose by 8%. In 1946, real GDP improved to -1%, yet consumer prices rose by 14%. Finally, in 1948, real GDP rose by 4%, while consumer prices climbed 8%.

The cheap money policy was abandoned due to rising inflation, such that both short-term interest rates and long-term interest rates were reverted to the free market in 1947 and 1951 respectively via agreements between the Fed and the Department of the Treasury. There was a three-year period of instability after the war as the shift was made from a wartime to a peacetime economy. An additional three years were required to fully restore the market economy.

Stock prices during World War II rose after the decisive Battle of Midway was won in 1942 and after the Normandy landings of 1944. Adjusted for the consumer price index, real stock prices generally rose during the war. However, with the exception of a short-term increase at the end of the war, stock prices took eight years – until 1954 – to fully recover. A long wait was also required for wartime debt consolidation, normalization of monetary policy, and the shift from the wartime economy, which had been powered largely by military equipment demand, to the peacetime economy.

It is possible that the coronavirus pandemic, which is often likened to a war, could play out the same way. From the perspective of the monetary economy, the equivalent of winning the critical battles would be controlling the coronavirus infection rate, formulating treatment protocols, and the development of a vaccine. A war on the coronavirus ending in victory will mean widespread use of a vaccine and the development of herd immunity, both of which could take a number of years to affect the entire world.

A number of issues will need to be resolved following the war on the virus, including government debt consolidation, corporate debt repayment, and normalization of monetary policy. A sound investment strategy would be to go with the flow while taking this whole big picture into consideration. JS

Koichi Kurose joined Resona Bank in 1987 and has been an investment strategist since 1999. He is presently chief strategist and chief economist at Resona Asset Management Co., Ltd. He is the author of "Reading the Invisible Crisis of the Times – Where Will the Market Land?" (Keio University Press, 2020).