

Japan's last mile before the Olympics

COVID-19 concerns linger while the economic path is bumpy

Though it appears likely that the Tokyo Olympic and Paralympic Games will be held this summer, public euphoria has turned sour. The pandemic remains in full swing and concerns about a potential super-spreader event persist. Private consumption remains lacklustre and dependent on public support campaigns, while the manufacturing sector is in good shape and capex plans are promising.



Source: iStock

“ Japan is determined to deliver hope and courage to the world through the Games.

PM Suga at the WEF 2021 ”

On New Year's Day 2020 Japan was in a festive mood, not only because 'oshogatsu' (お正月) is Japan's prime festive season, but because the year of the Tokyo Olympics and Paralympics had begun. TV reports showed athletes expressing their excitement about

participating in the exceptional events. Only a few weeks later SARS-CoV-2, otherwise known as the corona virus, started to spread from China to the rest of the world and the Olympics were postponed by a year. At the time, there had been hopes that the pandemic would be over by now, making the 2021 Olympics a global celebration of victory over the virus. With just two months to go the mood in Japan has completely changed. Excitement has turned into concern, fear, and disappointment.

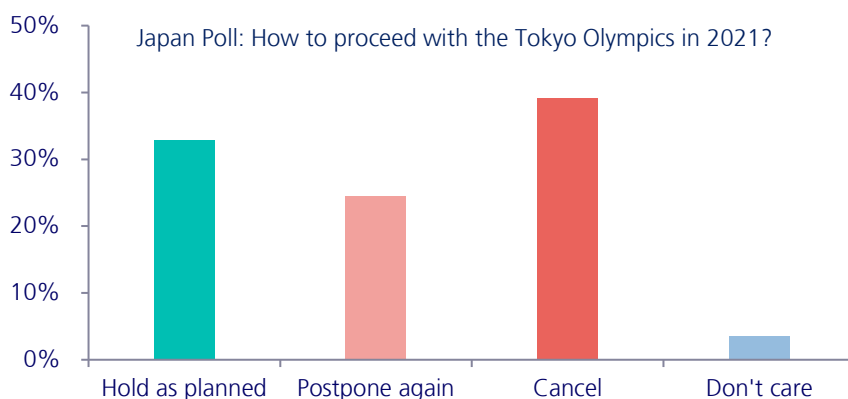
The economic implications of the Olympics and how it impacts tourism

Japan has already incurred most of the substantial costs of hosting the Olympics. While construction of the Olympic sites has benefitted growth in pure GDP terms, the usual economic benefits of hosting will not be as much as previously anticipated, worse still, at a time when the economy needs it most.

It must be mentioned that holding the Olympics and Paralympics was also seen as an investment to help further open the nation of Japan to the rest of the world. Remember that it was PM Abe who started to open up the country to migrant workers, particularly in the health and construction sector, but also to more foreign visitors, mainly tourists. This gave a boost to certain segments of the economy like department stores, electronic goods retailers, tour operators and hotels, which benefitted particularly from tourist arrivals from Mainland China, Taiwan and South Korea, but it also helped to create a reputation of Japan becoming more globally integrated. The Olympics were seen as an accelerator of this process, but instead COVID-19 has yielded the opposite outcome.

Economic prospects for Japan now face a number of major issues for the new Suga administration, which we will outline later in this report.

More than 70% prefer that the Olympics not be held this year



Source: Kyodo News 14. April 2021

Foreign visitor arrivals have collapsed following a long surge



Source: JNTO, Bloomberg

The mood has changed dramatically

The impending arrival of about 15,000 athletes and even more officials and coaches from around the globe, and potentially new virus mutations, has transformed the Olympics into the spectre of a super-spreader event. Both China and a well-known German/US vaccine producer have offered to vaccinate all athletes for free, but a public discussion is underway as to whether Japanese athletes should accept the offer when many among the vulnerable domestic groups have not yet had a chance to be vaccinated.

Surveys, including those from Kyodo News and NHK, show that a big majority of the population would prefer the Olympics to be cancelled or postponed again, an option that has recently been promoted by some politicians, including the Secretary General of the ruling LDP, Toshihiro Nikai. However, PM Yoshihide Suga confirmed that the Olympics will take place as scheduled when he visited US President Joe Biden in April. The President of the International Olympic Committee (IOC), Thomas Bach, has also stated that there are no intentions to cancel the Olympics in Tokyo, and tournaments with international participants are already underway, without spectators, however.

What is clear so far is that foreign visitors will not be allowed to join and that only a limited number of foreign officials will be invited to accompany their athletes. According to NHK, the IOC also guaranteed that there will be no contact between the athletes and the public in order to avoid any potential infections and that all athletes will be tested regularly, putting safety as a top priority. It has not yet been decided whether local spectators will be allowed. We believe there are only two options, either no spectators at all or a limited number of local spectators under a strict testing regime. 49% of participants in a recent poll by Asahi Shimbun prefer the first option, 42% the second.

In our Economic and Market Outlook 2021 ([page 16](#)), we outlined that the economic impact of the 2020 Olympics on Japan's economy should not be overestimated, but an event with no or only few spectators will certainly have a dampening impact on related hospitality and retail sectors. This is not only

the case during the event, but also in a medium- to long-term perspective as the Olympics are a rare opportunity to attract foreign visitors.

COVID-19 is a major risk for the Olympics

On the domestic front, the pandemic is already having an impact on the Olympic Torch Relay that started on March 25 in Fukushima, the city that was devastated by the tsunami and nuclear catastrophe ten years ago. Spectators in all Japanese prefectures have been encouraged to keep a safe distance during the relay and not to cheer loudly. In some instances, the route has been kept secret to avoid too many spectators while some of the invited celebrities have refused to join. We mention these examples to illustrate that it is the pandemic that dominates the news and public mood, pushing aside any joyful thoughts about the Olympics.

There has recently been a public outcry about the fact that 500 nurses must be delegated to the Tokyo Olympics at a time when there is a severe scarcity of medical emergency staff in many hospitals. Indeed, several patients died at home in the Kansai region around Osaka while waiting to get treated in hospitals due to a lack of doctors, medical personnel, and equipment. The region is experiencing the worst outbreak yet of COVID-19 while

nationwide infections are matching the record high marked early this year.

The fourth wave of the pandemic is taking its toll

There have been four waves of COVID-19 infections since the outbreak. The first one in April 2020 saw strict lockdown measures and was less severe. The second wave in the summer of 2020 affected more younger people, resulting in a relatively lower death toll. New virus strains caused infections to surge again late last year, culminating in a third wave that peaked in January 2021. The following curve flattening was rather short lived before new infections picked up steam again, with new cases during the fourth wave matching the prior peak while emergency hospitalisation rates even climbed to a record, based on data published by Worldometers and Our World in Data.

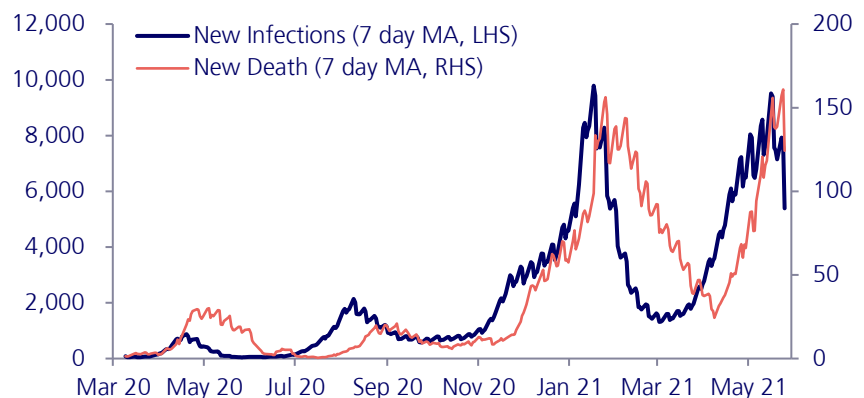
The rather low rate of infections during the first and second waves compared to those in China, Europe and the Americas was believed to have been related to the high standard of hygiene in Japan, the fact that wearing masks is common even when suffering from a cold, and the fact that public hugging and kissing is not common. Furthermore, academic studies by Kyoto University had shown that the Japanese virus was less aggressive than the ones that had been spreading in China and Italy, for example.

Slow vaccination progress and medical bottlenecks are reasons for concern

Japan's authorities have been challenged this year because the vaccination process has been slow. So far, about 5% of the population have received the first shot, which ranks at the lower end of OECD countries. Not even all medical personnel have got their second vaccine shot while vaccinating the elderly only started in mid-April. Vaccine delivery problems from overseas has been quoted as a reason.

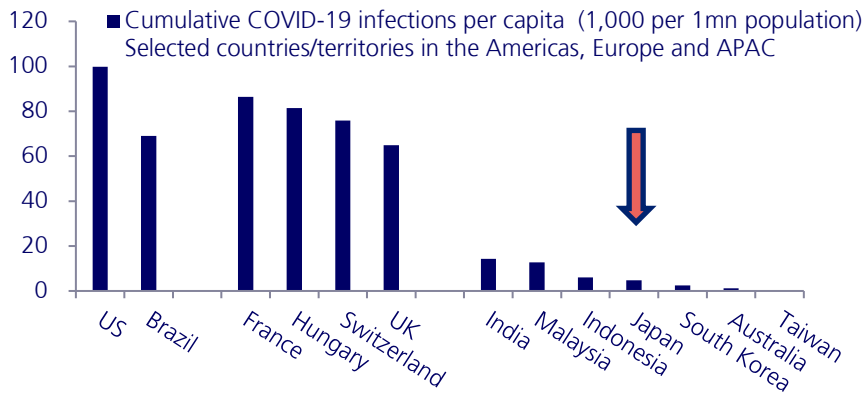
Another reason refers to the fact that Japan's health authorities are doing their own extensive clinical studies on vaccines before releasing them to the public, even when the WHO, the U.S. Food and Drug Administration (FDA) or the European Medicines Authority (EMA) have given clearance. The diligent,

A fourth wave of COVID-19 is fully in swing



Source: WHO, JHU, Bloomberg

Japan's COVID-19 cases remain low in per capita terms



Source: worldometers.info

official Japanese analysis may help to increase public acceptance of vaccines in a country where the population has at times been more sceptical toward vaccines than most Western countries. However, the slow process has been hotly debated. Some consider the studies to be counterproductive at a time when virus mutations are spreading, and opponents are urging a quicker pace of vaccinations as new virus strains are developing.

Countries like Israel, the US, the UK, and Chile are examples of countries with a more rapid pace of vaccinations. Only countries and territories where the spreading of the virus has been successfully tackled by rapid testing and tracing technologies like Taiwan, Hong Kong and New Zealand can afford a slower vaccination pace.

Japan's infections remain low on a per capita basis

We would like to highlight that despite the recent surge, Japan's infection rate is still low on a per capita basis in an international comparison, which is true for many Asian countries (see graph). However, it seems that despite this fact, public concerns about the pandemic in Japan are comparable to those in countries with far higher infection rates per capita. One reason may be that the pandemic features highly in the media, including the regular evening news with politicians and virologists commenting on the pandemic during TV news broadcasts.

Another reason may be the fact that despite a well-developed nationwide medical system and highly qualified doctors, and the fact that Japan ranks top among all OECD countries in terms of general acute care hospital beds, there seems to be a surprising scarcity of emergency ICU units and qualified personnel to take care of COVID-19 patients on a per capita basis compared to many other OECD countries. In addition, about 80% of hospitals are privately owned, and particularly the smaller ones are not able to take COVID-19 patients. Despite the fact that Japan has one of the highest number of hospital beds per capita in the world, based on OECD statistics, only public hospitals and a minority of private hospitals are taking COVID-19 patients in critical conditions, according to the 'Intensive

Care Medical' Journal. Tragically, several of these patients died at home while waiting for emergency care in hospitals, as reported by Yomiuri Shimbun.

Accordingly, the actual COVID-19 ICU bed count is staggeringly low in an international comparison. This is a by-product of the way Japan's health care has developed. The government picks up 70% of the costs of universal basic health insurance, but the system relies on private hospitals for most of its capacity, according to Japan Kokuho. In addition to the political power of medical associations, the post-war constitution limits the power of the government to encroach on civil liberties even in times of crisis. In other words, Japan cannot lock down and order hospitals to take in patients as most other governments can do.

How is the economy developing while the pandemic is being tackled?

Turning to the economy, growth had already deteriorated before the pandemic in the aftermath of the consumption tax hike in October 2019. On a sequential basis the economy contracted both in Q4 2019 and Q1 2020, before collapsing by nearly 30% in Q2 2020 in annualised sequential terms, a contraction that was far steeper than the one experienced during the global financial crisis in 2008/2009.

A steep recovery followed in the second half of last year with growth rates of nearly 23% in Q3 and 12% in Q4, again in annualised sequential terms. Overall, Japan's GDP contracted by 4.7% YoY last year, which was followed by a sequential annualised contraction of 5.1% in Q1 this year, mainly driven by weak private consumption.

Inward tourism has come to a standstill

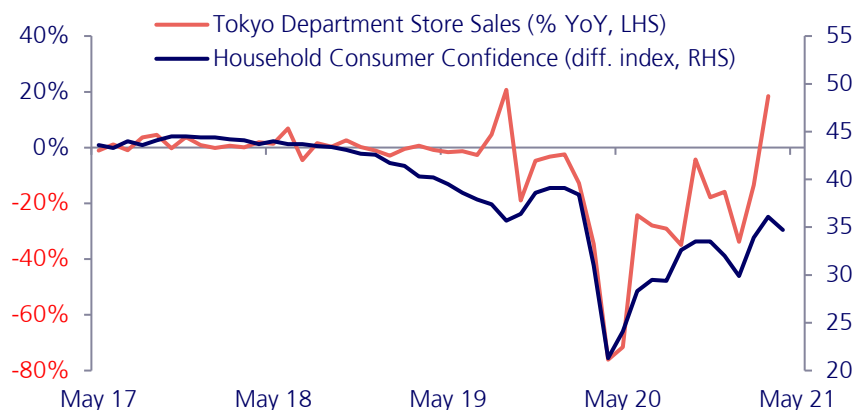
Private consumption in general and retail sales specifically have encountered strong swings in conjunction with the sales tax hike and the pandemic. The collapse was particularly steep during the first lockdown in Q2 last year, when mobility collapsed, followed by a steep recovery in the second half of last year. The 'Go To' and 'Go Eat' campaigns, in which the government subsidised hotel, restaurant, and transport expenditures, had been a big success in spurring a boost to these categories, but was paused following new waves of the pandemic.

Department store sales have been hit particularly hard, with sales in Tokyo collapsing 76% YoY in April last year, not only because sales of daily necessity have a lower share in overall sales compared to supermarkets and convenience stores, but also because overseas tourists, particularly from China, had become a major contributor to sales. Following travel restrictions both in China and Japan, sales by these customers have come to a complete standstill.

Pandemic waves are dominating consumption patterns

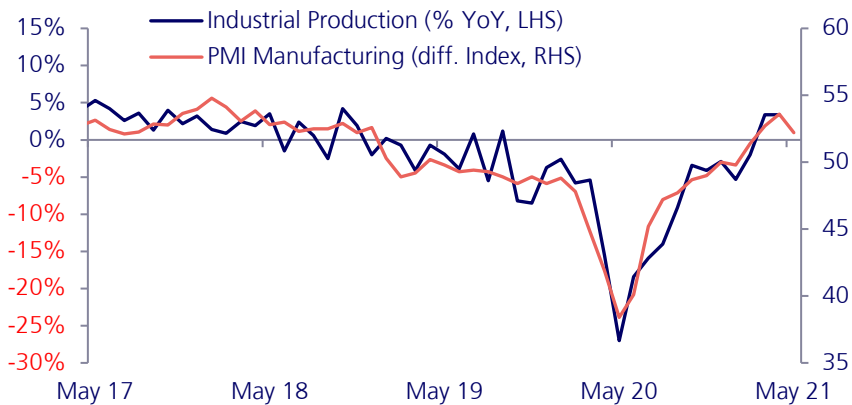
While retail sales recovered in March, following the end of the third infection wave, leading indicators like consumer confidence, the Eco Watchers survey and mobility data suggest that this was just a blip as the fourth wave of the pandemic is in full swing. Even though the renewed activity restrictions that were recently expanded to ten prefectures are not as fierce as they were during the first wave, they are nonetheless described as 'short but powerful' by the authorities. These measures impact a significant part of Japan's total population and are likely to remain in effect until June 20, striking another blow to the services and tourist related industries.

Consumer confidence is moving in tandem with COVID-19



Source: ESRI, JSDA, Bloomberg

Japan's manufacturing sector is back to normal



Source: METI, Markit, Bloomberg

Brisk manufacturing activity despite supply side issues

Meanwhile, the manufacturing industries are faring better. Industrial production for March showed a rise in both sequential and YoY terms, though consensus had expected a drop. Nine of 15 sectors reported an upswing with the auto and material sectors as the driving forces while the machinery sector is lagging due to supply side constraints.

The global bottlenecks in chip supplies have been exacerbated by supply disruptions caused by an earthquake and a fire in a major chipmaking factory. Overall, however, we note the continuous recovery of the Manufacturing PMI from a low of 38.4 in May last year to the latest value of 52.5, which is encouraging. Meanwhile, the Services PMI has been hovering below the boom/bust line of 50 since June last year, with the latest value falling to 45.7. We believe that a recovery in the services industries will only be achieved once significant progress has been made in terms of vaccinations and when foreign tourists are allowed to visit Japan again, which seems to be more a story for 2022.

Strong Tankan suggests solid capex plans

Japan's Q1 Tankan, the quarterly corporate survey conducted by the Bank of Japan released on April 1, came in much stronger than consensus had expected. The headline diffusion index for large manufacturing companies surged from -10 to 5, while consensus had expected it at -1. We prefer to look at the 'all industry index', comprised of large companies and SMEs both in manufacturing, construction, and service-related industries. The spike from -15 to -8 is encouraging. Even though small non-manufacturing companies tended to show negative numbers across the board, we want to highlight the positive direction.

We also note that capital expenditure plans for this fiscal year are the strongest they have been in the last 18 years and surprised consensus expectations to the upside as well. Firms intend to increase capex by 3%, but this is just a first shot as companies tend to become more optimistic over the course of the year, particularly as the global capex cycle is dynamic. Stable financing and employment

conditions add to the overall positive Tankan 'cocktail' while prices are expected to rise. This encouraging picture has been confirmed by the monthly Reuters Tankan for May.

Fiscal policy to stay loose despite lower expenditures this year

Last year, Japan's government implemented three supplementary budgets to counter the impact of COVID-19 following the expansive policies that other governments, particularly in the US and the EU, had passed. This year, the fiscal balance is expected to shrink from the extraordinary level of -14% to closer to -9% of GDP, even when incorporating a record high regular budget and another supplementary budget in the second half of the fiscal year.

IMF Fiscal Monitor data for 2020 show that in terms of additional spending and foregone revenue relative to GDP, Japan's fiscal support ranked roughly in line with the average of all advanced economies, though below the US. In terms of equity, loans and guarantees, Japan significantly exceeded the average, as did Germany and Italy. Without digging into the details, it also has to be noted that the amount of additional spending in the supplementary budgets tends to overstate the increase in overall public spending, and that headline grabbing numbers should be interpreted with some caution.

Monetary policy to stay on course

Monetary policy is expected to stay on course with the latest policy tweaks introduced during the Bank of Japan's (BoJ) March policy meeting not hampering the outlook. Yield curve control as well as quantitative and qualitative easing are not subject to revisions but may be reconsidered when BoJ Governor Kuroda's term ends in two years' time. We believe that emergency support to tackle COVID-19 is likely to be withdrawn but may be replaced by a new lending program to support the government's digital transformation and green society policies. It also seems inevitable that the BoJ's 2% price target will not be met during Kuroda's term as the latest BoJ projection shows an expected CPI inflation rate of 1% for FY 2023.

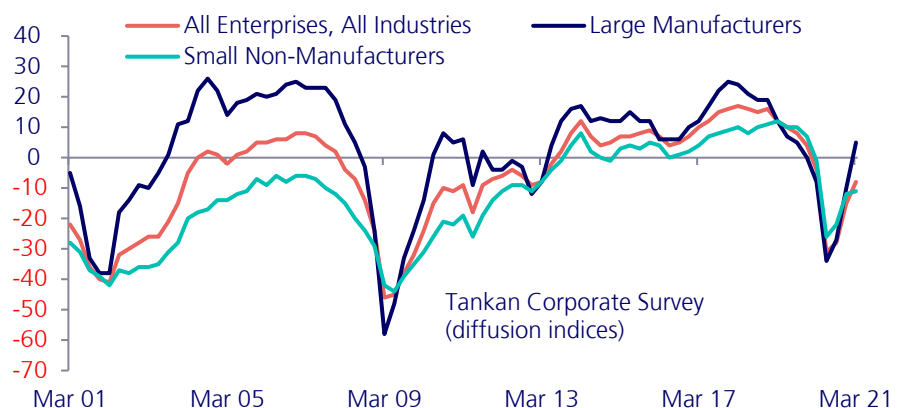
Will snap elections be held before or after the Olympics?

Regular elections are due in late October as the term for Lower House lawmakers ends on October 21. There is a reasonably high chance that the LDP will call for earlier snap elections as was indicated in a recent statement by PM Suga, who is also facing LDP leadership elections this summer. A reasonable date could be July 4, together with the Tokyo Metropolitan Assembly elections. The LDP is hoping for both a subsiding of the fourth wave of the pandemic due to the current state-of-emergency in the most affected prefectures as well as an acceleration of the vaccination process by then. The LDP may also want to prevent closer cooperation of various opposition parties, which recently managed to win three by-elections for Lower and Upper House seats.

Reforming Japan's economy

Were the LDP to win the Lower House elections, PM Suga would be in a stronger position to tackle his main policy targets including decarbonisation of the economy, increasing immigration, strengthening SMEs, restructuring the regional bank sector, and hiking minimum wages. Should PM Suga achieve significant progress in these tasks, some might believe that he would deserve a gold medal for reforming Japan.

Tankan survey suggests strong corporate capital investments



Source: Bank of Japan, Bloomberg

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