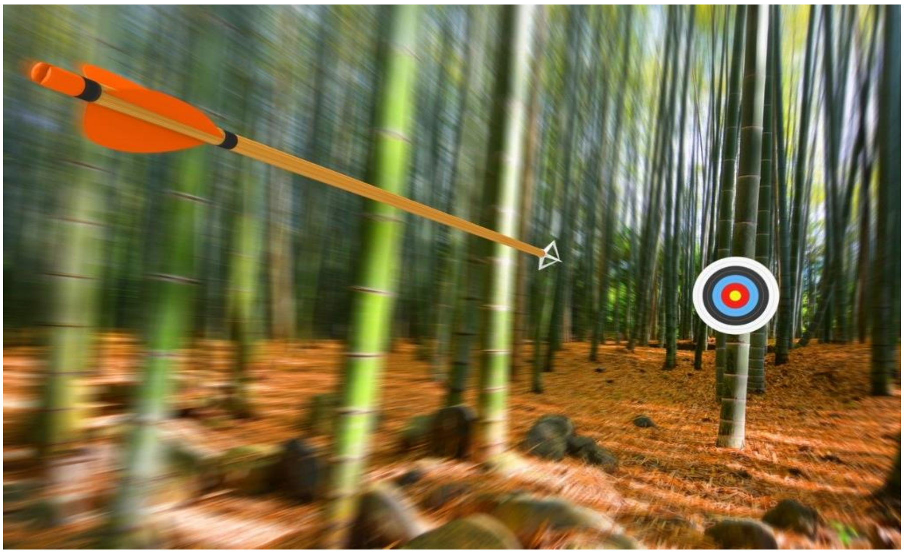
December 12, 2019

Abe’s second arrow is still flying …

… but Japan’s JPY 26tn stimulus package will have limited impact

The second of PM Abe’s three policy arrows, fiscal stimulus, has just been boosted again and is likely to prevent a major lull in Japan’s economy after the Olympics. However, the direct impact on growth is much smaller than the headline number suggests. It may at least act as a catalyst to encourage other countries to provide a fiscal impetus amid slowing global growth and the fading impact of monetary policy.



Source: iStock

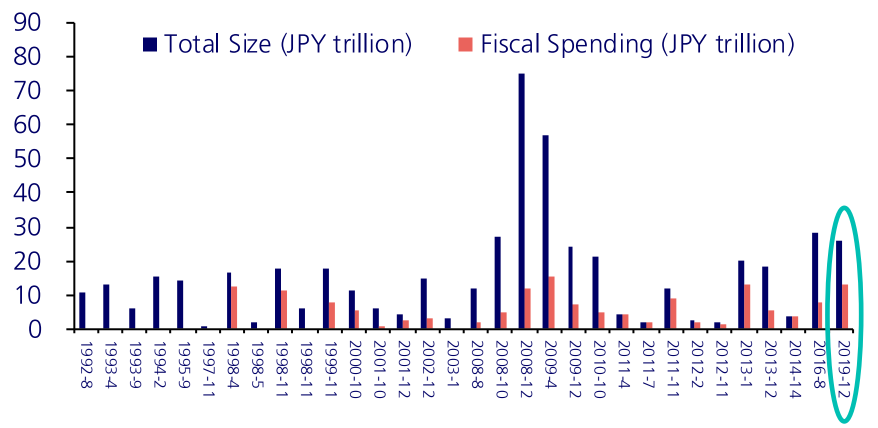
> “We have crafted a powerful policy package aimed at … helping overcome economic downside risks.”
>
> Shinzo Abe (Japan's Prime Minister)

Japan’s Cabinet approved a JPY 26 trillion (USD 240bn) economic stimulus package on Thursday last week to give a boost to the economy amid slower global growth and the negative impact of the consumption tax hike on consumer spending. The size of the package exceeded market expectations quite significantly, even raising some eyebrows.

An unprecedented stimulus package in a time of solid growth and a strong labour market

Since 1990, 32 stimulus packages have been released in Japan. However, fiscal stimulus of this size has never been implemented in times of a positive GDP gap and nearly full employment, as Japan is experiencing currently. To us, the package thus seems to be a pre-emptive measure to counter the risks of a US led global recession (in line with our base case) and the negative consequences of the recent consumption tax hike on consumer spending. The Cabinet has also acted to mitigate a potential slowdown of the economy after the Olympic and Paralympic games next summer.

Japan's JPY 26tn package ranks among the biggest of 32



Source: Bloomberg

Focus on the ‘fresh water’ impact

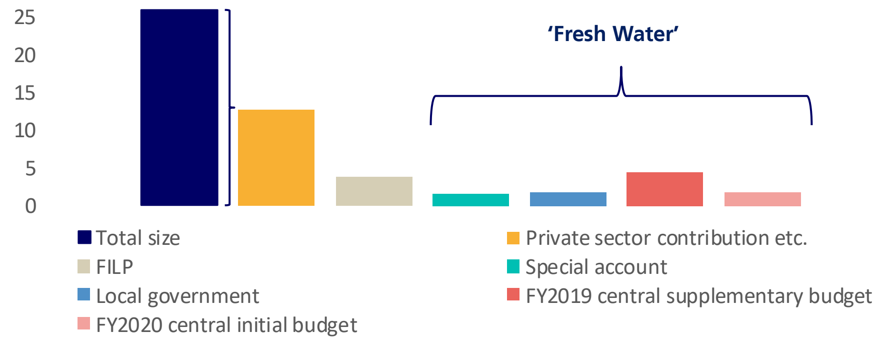
Usually Japanese fiscal stimulus packages tend to create huge headline figures, but in the end have much less of an impact on economic growth than suggested. In particular, we need to make a distinction between the total size of the package (事業規模) and the so called ‘*fresh water*’, or ‘*mamizu*’ (真水) impact that directly impacts economic growth.

Japan’s fiscal packages tend to include expected contributions from the private sector and lending by government-affiliated financial institutions. However, there is no guarantee that credit lines will be used, or if and when private entities will effectively spend in line with government expectations, particularly as there is no specified timeline for spending.

Focus on government expenditures

By deducting loans and expected private sector contributions, only about half of the

The 'fresh water' portion is more important than the total size



Source: Cabinet Office, BofA Merrill Lynch

headline sum remains, adding up to JPY 13.2tn. From this sum we need to deduct the JPY 3.8tn spending under the Fiscal Investment and Loan Program (FILP), as this spending does usually not give a direct boost to GDP. Projects financed by the FILP tend to be already underway or are in the planning stage. FILP financed projects include infrastructure projects such as highway maintenance, expanding runways at Narita Airport, and putting electric pylons underground.

Following these deductions, we finally come to the 'fresh water' impact of JPY 9.4tn, or about one-third of the headline number, that sums up central and local government spending. This number is not too far away of what the market had expected. Local government spending is budgeted at JPY 1.8tn, while the size of the special account adds another JPY 1.5tn. This finally leaves JPY 6.1tn of spending in the central government's account, available for traditional public works projects.

Drilling it down to effective public works projects

The budgeted funds available for public works projects will be channelled to reconstruction and restoration of infrastructure damaged by the latest Typhoon 'Hagibis', or No. 9, as it is called in Japan. Funds will be allocated to support SMEs, to give relief to agricultural industries that are negatively impacted by the US-Japan trade agreement and to subsidise employment and job training for the middle-aged unemployed. Finally, funds will be pledged to encourage the use of cashless payments by smartphones, to pay for PCs in elementary and middle-schools, to prevent car accidents by the elderly using new technologies and to subsidise R&D for domestic firms that develop post-5G technology projects.

What will be the impact on economic growth for this and the next fiscal year?

The Cabinet Office estimates that the boost to real GDP from the announced package will be 1.4%. The estimate is based on the supplementary budget for FY2019 amounting to JPY 5.1tn. However, the government's growth contribution estimate includes both FY2020 and FY2021. We need to consider that over the last few years government spending has had a rather small impact on GDP growth, which is mainly driven by private domestic demand and net trade. The impact of the structural primary fiscal balance excluding net interest payments (fiscal thrust), has been hovering in negative territory since 2011, and is expected to remain negative in the next two years, according to the IMF and the OECD. Considering the latest package, we believe a shift towards a positive net contribution of fiscal policy is highly likely. However, the impact will be spread out over several years, as GDP statistics are only based on a 'completed' basis. Overall, the net impact of the announced package should be limited to only 0.1%-0.3% for FY2020.

Supply-side constraints may bite

The positive impact on growth may be delayed due to supply-side constraints particularly in the construction sector, which is suffering from severe labour shortages. The government may not be able to implement the budgeted funds for public works by the end of FY2020 (i.e. before April 2021). Some funds may need to be rolled over to FY2021, which in a way helps to avoid a growth cliff and helps to smooth the impact on growth.

Give and take

The latest fiscal stimulus package begs the question of why such sizeable funds were made available so shortly after the consumption tax hike was implemented in a bid to improve the domestic debt situation? Effectively the new measures mean that the government is now spending more than revenue created by the hike in the consumption tax. We understand that the impact of the typhoons and the worse than previously expected slump in consumption after the tax hike required additional spending, but we are somewhat concerned about a potential extension of the budget deficit. However, to get a transparent picture, we need to wait until the details of the FY2020 budget are released.

The equity market is not impressed

Following the news about the higher than expected fiscal boost the Topix gained only 1.1% in the following three trading days to move to a high for 2019. However, it did not outperform global equities. This shows that equity market participants were not that impressed by the package, as they are aware from previous packages that the headline number usually differs significantly from the 'fresh water' impact on economic growth. However, following a surge in outperformance in September, and continuous foreign net buying, we believe that Japanese equities are in a relative bottoming process after underperforming other regions in the first half of 2019.

Japan as a global role model

Summing up, we believe that the stimulus package will lend some support to economic growth, but it seems more intended to avoid a slump within the next two years amid the difficult domestic and global growth outlook rather than improving trend growth. PM Abe may also have wanted to create a smooth environment until his term as PM ends, being aware that his 'three arrows' to achieve 2% real growth and a primary balance surplus are unlikely to be achieved.

The Bank of Japan may also applaud the fiscal boost, as it reduces the pressure to cut the JGB rate target further or implement innovative easing measures. Though this remains an option, the BoJ certainly wants to avoid taking this step as long as possible due to the negative consequences for financial intermediaries, particularly the regional banks. We thus believe that the BoJ will likely stay on hold.

All over the world the discussion about the need for further fiscal stimulus in addition to monetary easing is heating up, with Germany being criticised internally and externally for maintaining its zero deficit target amid the slowdown in the economy and structural impediments. In that respect Japan's stimulus program may act as a catapult to prompt other governments to take advantage of low rates to invest.

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