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Global economy and Japanese economic policy in 2022

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Executive Summary

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In 2022, the global economy will likely decelerate moderately into midyear in response to a confluence of headwinds, including China's Evergrande default woes and crude oil price inflation. The Japanese economy should resume growing, though a strong rebound in consumption driven by revenge spending looks unlikely. In its post-pandemic economic policy, Japan should prioritize structural reform and growth strategy over wage increases and redistributive policies.

Global economic growth set to slow into mid-2022

The IMF's October 2021 World Economic Outlook (WEO) projects global real GDP's 2021 growth rate at +5.9%, a big bounceback from -3.1% in 2020, when global growth was heavily depressed by the pandemic. For 2022, the IMF is forecasting continued brisk growth of +4.9%.

While the global economy is indeed likely to remain on the mend in 2022, we doubt it will meet the IMF's forecast, which does not adequately factor in several growth drags that have emerged since the October WEO's release. The first is a Chinese real estate market downturn precipitated by the still unresolved Evergrande default crisis. China's housing market slump is a stiff headwind for the entire global economy. The Chinese economy is heavily dependent on real estate. Although its real estate sector directly accounts for a modest 7% of GDP, total economic activity related to real estate amounts to some 30% of GDP. The real estate market downturn thus poses substantial Chinese recession risk.

Evergrande's insolvency is unlikely to either roil global financial markets or spark a domestic financial crisis because most of Evergrande's debt is owed to large, financially strong state-owned banks in China. Only 6% or so of its debt is USD-denominated. China's share of global GDP, by contrast, is now 18% (per the IMF). A pronounced downshift in Chinese economic growth triggered by a real estate market downturn would have a material adverse impact on the global economy.

Another growth drag is a surprisingly persistent pickup in inflation, including energy

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inflation. The pandemic has prompted a major shift in demand toward goods from services, particularly services that expose consumers to COVID infection risk. In goods sectors dealing with demand surges, suppliers are unable to keep up with demand. The resultant supply strains are fueling inflation. Meanwhile, goods production increases are boosting demand for raw materials and electric power and, in turn, exacerbating inflation in energy and other commodities.

Such supply strains should gradually dissipate as rising prices induce companies to increase production of hotly demanded products and services and rising wages draw more workers into such sectors. Inflation may start to wane as early as spring 2022. However, the current outbreak of surprisingly sticky inflation is already depressing consumer sentiment and dampening consumption's recovery from the pandemic, mainly in highly import-dependent economies.

A third growth drag is resurgent COVID infection risk. In Europe, an unexpected flare-up in new cases in late 2021 is weighing on economic activity. Additionally, the public remains acutely concerned about new variants. In addition to adversely affecting personal consumption, the pandemic disrupts supply chains and production activities also. Meanwhile, uncertainties surrounding the pandemic's future course are weighing on both consumption and capex and otherwise constraining economic activity. We expect these three growth drags, compounded by the global roll-off of pandemic relief policies' stimulus effects, to moderately detract from global economic growth into mid-2022.

No catch-up consumption in Japan?

Japan's real GDP contracted an annualized 3.6% in 3Q21. Personal consumption has since rebounded after the government's emergency declarations expired. The economy is expected to resume growing from 4Q21, though a strong recovery driven by catch-up consumption seems unlikely for several reasons. First, Japanese consumers continue to act cautiously in light of infection risks. Second, inflation is dampening consumption as already mentioned. Third, consumption has undergone compositional changes, with spending on, e.g., dining out and travel yet to return to pre-pandemic levels. Additionally, exports, historically a key driver of the Japanese economy, were down sequentially in 3Q21 and are expected to continue to decline for a while. Japanese economic recovery in 2022 is consequently likely to be subdued.

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On November 19, Japan’s Cabinet approved an all-time record ¥55.7tn economic stimulus package. The Cabinet Office estimates the package’s stimulus effect at 5.6% of GDP. Although this estimate is likely overly optimistic, the stimulus package will undeniably bolster the economy to some extent. On the downside, previous pandemic relief measures’ stimulus effect will fade, giving rise to growth-suppressive fiscal cliff dynamics. The newly unveiled stimulus package will avert a full-blown fiscal cliff and concomitant downshift in growth. Its net boost to growth, however, will likely be fairly modest.

Structural reform and growth strategy over redistributive policies

When looking beyond the pandemic at Japan’s longer-term economic prospects, we cannot ignore the impact of economic policy. The Kishida Government has been championing a virtuous cycle between growth and redistribution since its inception, but its economic policies to date seem to prioritize redistribution over growth. Whereas short-term pandemic relief has to include cash benefits and other income assistance, longer-term economic policies should prioritize growth over redistribution. If the government puts forth a credible structural reform agenda and growth strategy, companies may upwardly revise their growth expectations in response. Effective measures might include mitigation of population decline through, e.g., measures to boost the birth rate and a revamped strategy to promote inbound international tourism, which has been decimated by the pandemic.

The government should also place priority on capitalizing on the pandemic as an opportunity to implement structural reforms that make the economy more efficient. One such reform is digitalization. The current teleworking boom spawned by the pandemic presents a perfect opportunity to promote private-sector digitalization. PM Kishida is personally committed to rolling out 5G connectivity throughout suburban, exurban and rural Japan under the government’s Digital Garden City-State initiative. Additionally, with teleworking now widely prevalent and COVID contagion fears deeply rooted in the public psyche, now is an opportune juncture to rebalance the Japanese economy away from overconcentration in Tokyo. The government should take the lead by proactively relocating ministries and agencies from Tokyo to outlying regions. If people and business activities relocate to nonurban areas, increased utilization of those areas’ land, transportation

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infrastructure and human resources should improve Japan's overall economic efficiency.

The Kishida Government aims to increase wages through tax reform. Such an approach is prone to end up merely exacerbating economic distortions. Fostering an environment in which companies raise wages of their own accord may seem like a circuitous approach but it is actually a shortcut to wage growth. To create such an environment, the government should forge ahead with structural reforms and growth strategies that upgrade economic efficiency and boost companies' growth expectations. The Japanese economy's post-pandemic prospects largely depend on such economic policies.

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