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# Mizuho Economic Outlook & Analysis

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September 25, 2020

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## *Impact of a prolonged “Covid-19 shock”*

### *Impact of sluggish consumption of face-to-face services*

#### < Summary >

- ◆ Amid mounting concerns of a resurgence of the Covid-19 outbreak, private consumption of face-to-face services remains flat. Should the restraints of social distancing persist, spending on face-to-face services is expected to fall by 30% to 50% compared to the pre-corona period.
- ◆ Industries engaged in face-to-face services are characterized by heavy fixed costs, and a decline in revenues mean a rise in bankruptcies and a fall in employees' income by an estimated 6 to 7 trillion yen from the pre-corona period.
- ◆ The Japanese government should provide financial relief to such industries affected by Covid-19 (required relief estimated to be about 5 trillion yen a year). In view of a prolonged “Covid-19 shock,” the government may also need to switch the target of its support policy from job maintenance to job shift.

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## **1. Introduction – Amid mounting concerns of a resurging Covid-19 outbreak, consumption of services is sluggish**

The Covid-19 pandemic (hereinafter “the Covid-19 shock”) has severely damaged the Japanese economy. The Japanese government declared a state of emergency in April, asking the general public to stay home and various entertainment facilities to close temporarily, and this situation caused private consumption to tumble centering on service spending. With many cities worldwide forced into lockdowns, the export of automobile-related items and capital goods, mainly those bound for the United States and Europe, declined, and the disappearance of inbound tourists led to a substantial fall in service exports. Not only corporate earnings and capacity utilization ratios deteriorated significantly on the back of the sudden loss of external and internal demand, but capital investment was also slashed due to rising uncertainty over the future outlook and worsening of the business sentiment. Final demand (excluding public investment) such as personal consumption, capital investment, and exports fell, and Japan’s economic growth in the April to June quarter of 2020 dropped by -28.1% from the previous quarter on an annualized basis (2nd QE), marking the biggest fall since official statistics first became available (July to September quarter of 1956) (**Chart 1**).

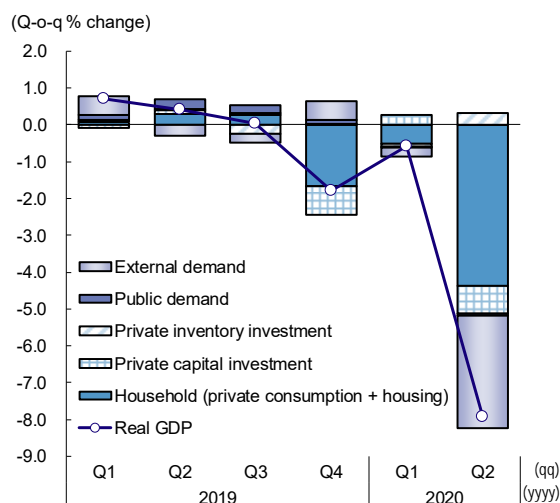
In the July to September quarter, economic growth is projected to return to a positive track, with the state of emergency order lifted in Japan and lockdown conditions relaxed in major countries. We expect the growth rate to be a two-digit number on an annualized basis driven mainly by personal consumption and exports, and also as a result of a rebound from the significant downturn experienced in the preceding quarter (the carry-over effects of the recovery in June had a big impact).

The problem is the pace of recovery expected after the October to December quarter. Mizuho Research Institute (2020) forecasts that while concerns over the resurgence of the pandemic will continue (widespread use of vaccines and therapeutics for Covid-19 is anticipated in early 2022), the pace of recovery of the Japanese economy after the October to December quarter will be slack. In particular, the report expects that spending on face-to-face services such as eating out, accommodation, travel and transportation, and amusement will only recover to around 70% to 85% of the pre-pandemic level (2019 average) by the end of FY2021 (refer to Sakai and Yamamoto (2020) for details).

While these forecasts are pessimistic enough, the recent trend of service consumption is of more concern. If we look at the movement of consumption of face-to-face services in **Chart 2**, the pace of overall recovery started to taper off in the latter half of June, albeit there are slight differences in movement depending on the industry, and such spending was almost flat on average during the July to August period. As a result of people postponing the return to their hometown during the summer vacation and avoiding travel, the trend of

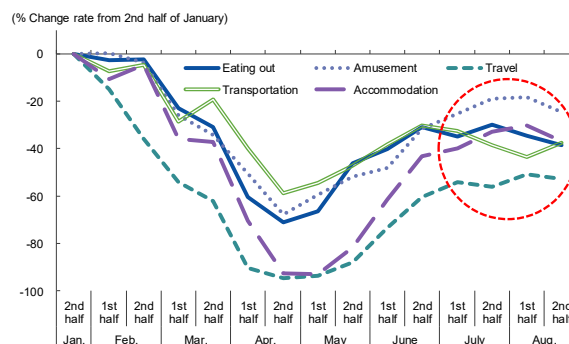
service consumption is better expressed as “stagnant” than “recovering at a slower pace.”

**Chart 1: April to June quarter 2020, 2nd QE**



Source: Made by MHRI based upon the Cabinet Office, *Preliminary Quarterly Estimates of GDP*.

**Chart 2: Personal consumption of face-to-face services**

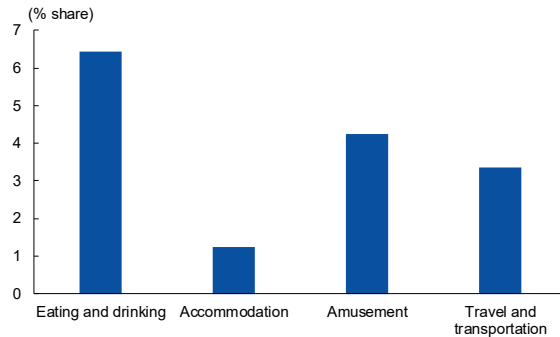


Note: Reference series.  
Source: Made by MHRI based upon JCB and Nowcast, *JCB Consumption NOW*.

Concerning vaccines and therapeutics for Covid-19, future prospects for their use are highly uncertain. Uncertainty is particularly high on whether the newly developed vaccines and treatments will be effective and safe enough, whether their mass production and supply systems will be fully developed, and whether the public will readily accept a vaccine. The scenario where relatively small-scale infections that do not reach the level of an explosive outbreak persist and the impact of the Covid-19 shock lingers even after next fiscal year is also possible. In this case, to ensure sufficient social distancing, business operation hours and customer numbers, parties and events, domestic travel (particularly travel from central to regional cities), and overseas travel will most likely continue to be curtailed. This means that spending on face-to-face services and inbound demand will not grow beyond the current level. According to the Cabinet Office, spending on face-to-face services accounts for about 15% of total personal consumption (**Chart 3**), and the number of employees working in such industries is about 11% of the total (**Chart 4**), suggesting that the trends of these industries can have a great impact on the Japanese economy.

In this report, we study how the Japanese economy will be affected if the restraints of social distancing continue in the future, hindering the recovery of consumption related to face-to-face services and inbound demand.

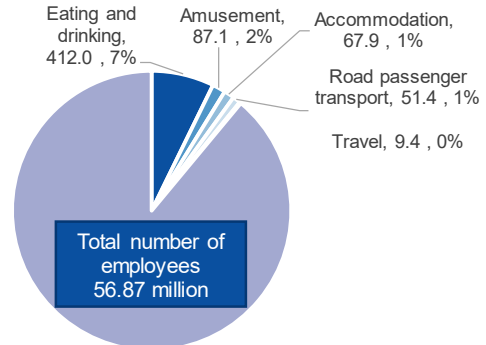
**Chart 3: Share of consumption of face-to-face services**



Source: Made by MHRI based upon the Cabinet Office, *Data Submitted to the Statistics Committee for the Verification of Re-estimated Integration Ratio.*

**Chart 4: Share of employees in industries offering various face-to-face services**

(10,000 employees, %)



Source: Made by MHRI based upon the Ministry of Internal Affairs and Communications, *2016 Economic Census for Business Activity.*

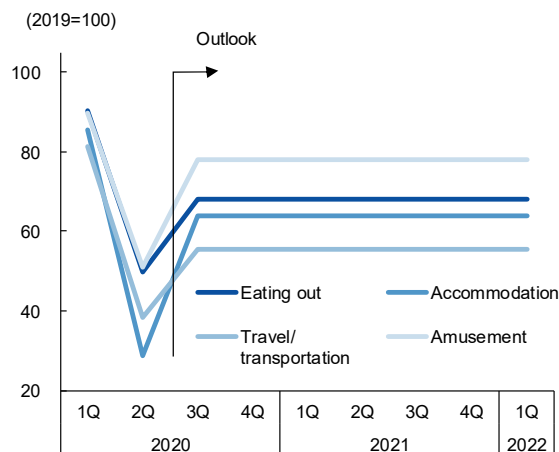
**2. Consumption of face-to-face services will slip by 30% to 50%. The negative impact on corporate bankruptcies and employment is highly likely to spread**

Assuming that consumption of face-to-face services remains flat after the October to December quarter of 2020 as seen in **Chart 5**,<sup>1</sup> how will this affect the nation’s economic activities?

**Chart 6** depicts estimates on how consumption of face-to-face services will decline in FY2020 and FY2021 compared to the 2019 average level. In FY2020, spending on eating out is down by -36.5%, accommodation by -44.8%, travel and transportation by -48.8%, and amusement by -28.9%. In FY2021, spending on eating out will fall by -32.0%, accommodation by -36.0%, travel and transportation by -44.5%, and amusement by -22.1% (in FY2020, the downturn in April to June had a big impact).

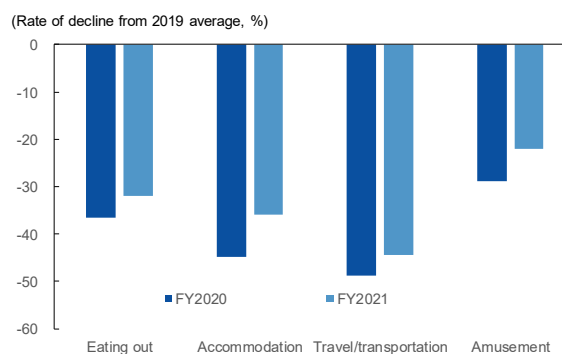
<sup>1</sup> In reality, as the pandemic comes to an end, human mobility (going out to commercial facilities and offices) will increase and service consumption grow, while a resurgence of Covid-19 will cause mobility to decrease and service consumption to contract once again. There is a high probability that the repetition of this pattern called the “sawtooth” trend will persist. Here we assumed a situation where “it will remain flat on average.”

**Chart 5: Consumption path of face-to-face services (Assuming such spending remains flat after the Oct. to Dec. quarter)**



Note: We assumed the level of consumption for each industry will stay flat after the October to December quarter of 2020.  
 Source: Made by MHRI based upon JCB and Nowcast, *JCB Consumption NOW*, among others.

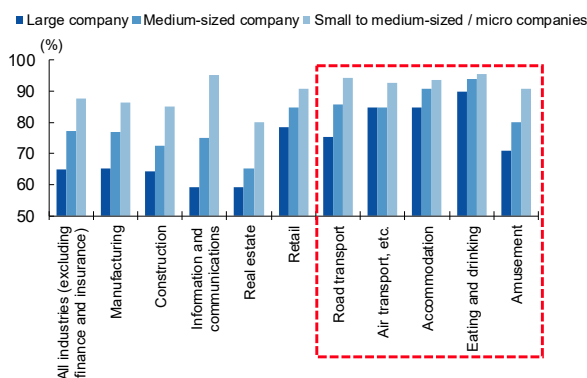
**Chart 6: Reduction rate of consumption of face-to-face services (Compared to the 2019 average)**



Note: We assumed the level of consumption for each industry will stay flat after the October to December quarter of 2020.  
 Source: Made by MHRI based upon JCB and Nowcast, *JCB Consumption NOW*, among others.

It is not hard to imagine that a reduction in personal consumption of this scale would be a huge blow to companies engaged in related businesses. According to the Ministry of Finance’s “Financial Statements Statistics of Corporations by Industry,” the breakeven point of firms in industries offering services that involve personal contact is relatively high compared to other industries, and the breakeven point of small to medium-sized companies was over 90% as of FY2018 (**Chart 7**). This situation is due to the large portion of fixed costs that comprise personnel cost and rent, and the monthly average of fixed expenses of small to medium-sized companies amounted 11.2 million yen for the land transport industry, 14.3 million yen for the air transport, etc. industry, 9.2 million yen for the accommodation industry, 3.7 million yen for the eating and drinking services industry, and 4.6 million yen for the amusement services industry (**Chart 8**). The level of liquidity on hand is equivalent to the amount that can cover a company’s fixed costs for about 4.7 to 10.7 months, a level suggesting low resilience. Should consumption demand be slashed by 30% to 50% and remain low, the profits of companies engaged in these industries will plunge into the negative territory, which will heighten the risk of bankruptcy. Any cut in personnel cost, which accounts for a majority of a company’s fixed costs, may also negatively affect the employment and wage situation.

**Chart 7: Breakeven point (By industry and size)**



Note: "Air transport, etc." is "Other transportation."  
 Source: Made by MHRI based upon the Ministry of Finance, *Financial Statements Statistics of Corporations by Industry (FY2018 Annual)*.

**Chart 8: Fixed cost burden (Small to medium-sized firms and micro companies)**

(Monthly cost per company in million yen)

	Road transport	Air transport, etc.	Accommodation	Eating and drinking services	Amusement services
Fixed costs	11.2	14.3	9.2	3.7	4.6
Personnel expense	9.3	11.8	6.7	2.9	3.6
Welfare expense	0.7	1.0	0.5	0.2	0.2
Interest expense, etc.	0.1	0.1	0.3	0.1	0.1
Real estate, goods rental and leasing expenses	0.6	2.0	1.8	0.7	0.6
Tax expense	1.2	0.3	0.4	0.1	0.3
Income tax – current	0.2	0.5	0.3	0.1	0.1
Liquidity on hand	59.9	108.1	53.6	17.4	49.5
Liquidity on hand/fixed cost (months)	5.3	7.6	5.8	4.7	10.7

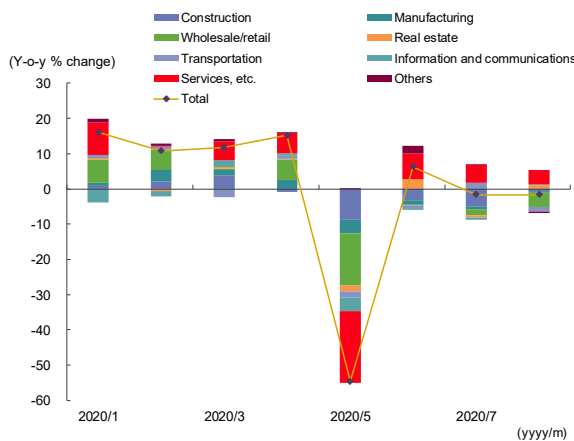
Note: "Air transport, etc." is "Other transportation."  
 Source: Made by MHRI based upon the Ministry of Finance, *Financial Statements Statistics of Corporations by Industry (FY2018 Annual)*.

We begin by considering the risk of bankruptcy. Looking at the number of bankruptcy cases up until August, there are no signs of a surge in bankruptcy cases after the Covid-19 shock (**Chart 9**). There has been no acceleration in bankruptcies even after May when bankruptcy cases dipped with the courts' reduced operation hours due to the pandemic, and the number of bankruptcy cases in August fell by -1.6% year on year, a decline of two consecutive months from the previous month (-1.6%). This figure is the third lowest for August over the last 30 years since 1991, following the 639 cases recorded in 2017. By industry, while bankruptcy cases are on an increasing trend for "Services, etc." that include face-to-face services such as eating and drinking services, the degree of growth is limited. It seems that financial support (increase in lending) offered by the government worked effectively to subdue the rise of bankruptcies.

However, if consumption demand does not bounce back and companies remain in the red in the future, more business owners may be forced to close their businesses. If there is no prospect of profit recovery, financial institutions may gradually become more cautious in their lending attitude. The lending term recently is said to be shorter than one year in most cases (according to the "Financial Statements Statistics of Corporations by Industry," short-term borrowing substantially increased by 20.8% in the April to June period of 2020 over the previous year) and hence companies may fall short of cash if banks fail to renew their lending when loans mature. In particular, financially weak small to medium-sized companies with a limited borrowing capacity will face the risk of bankruptcy if their revenues continue to be sluggish. A surge in bankruptcy cases centering on the service industry may be inevitable.

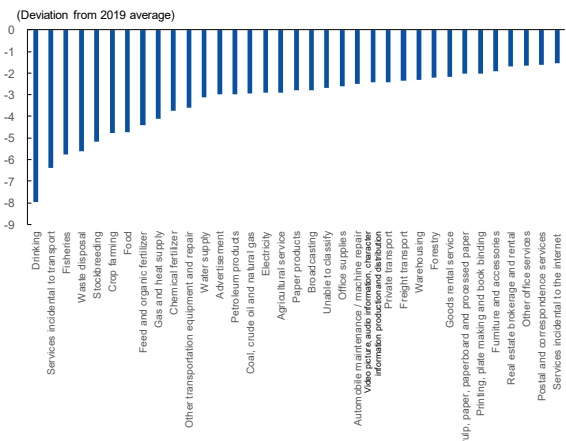
Nonetheless, the number of overall bankruptcies cases will most likely not increase to the extent seen at the time of the global financial crisis following the collapse of Lehman Brothers (16,000 cases in FY2008). Our estimate using the Input-Output Tables shows that the impact of deteriorating demand in service industries on the production (revenues) of other industries is not so significant as to cause a surge in the number of bankruptcies (**Chart 10**). Although Lehman’s demise caused substantial damage to a wide range of industries, including the manufacturing sector, this report assumes that the negative impact of social distancing would be limited to only part of the service industry. In fact, compared to the time of the global financial crisis, the spread of bankruptcies to other industries after the outbreak of the Covid-19 shock has remained limited (**Chart 11**).

**Chart 9: Bankruptcy cases by industry (Contribution rate from the previous year)**



Source: Made by MHRI based upon Tokyo Shoko Research, Ltd., *Monthly Report on Bankruptcy*.

**Chart 10: Impact on revenue by industry (Decline rate for the case with no Covid-19 shock)**



Note: Here we see the impact of reduced consumption of face-to-face services by industry, which is expressed as the reduction rate in FY2020 from the FY2019 average. The graph shows industries whose revenues fell by more than 1.5% due to the impact.

Source: Made by MHRI based upon the Ministry of Internal Affairs and Communications, *Input-Output Tables for Japan*, among others.

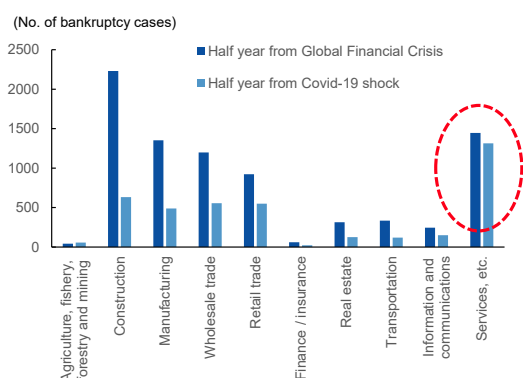
Next, we consider the impact on employment. Based on the decrease in consumption of face-to-face services calculated earlier, we estimated its impact on employees’ income using the Input-Output Tables and presented the result in **Chart 12**. We calculated the range of decline from a path that assumes no Covid-19 shock. Our estimate suggests that overall employees’ income fell by -7.3 trillion yen in FY2020 and -6.4 trillion yen in FY2021. (As the secondary impact from the decline in employees’ income, we estimated a fall in personal consumption by -0.6% in FY2020 and -0.5% in FY2021, and a contraction of GDP by -0.4% in FY2020 and -0.3% in FY2021.) To elaborate on these results by industry, the most negatively affected industries are the eating and drinking



services industries (-2.0 trillion yen, -460,000 yen per person), road transport industry (-1.5 trillion yen, -720,000 yen per person), and amusement services industry (-0.6 trillion yen, -770,000 yen per person) (**Chart 13**).

Thus, while a large-scale adjustment of personnel expenses is expected, as businesses that offer face-to-face services need to secure a certain number of workers to maintain their businesses, the adjustment will most likely be made through cutting wages (labor hours) rather than decreasing the number of employees.<sup>2</sup> Looking at the recent indicators related to employment, the unemployment rate as of July was hovering at a little below 3%. Also, as shown in **Chart 14**, the number of people placed on administrative leave skyrocketed to 5.97 million (up +4.2 million from the preceding year) in April but recovered to 2.2 million (up +0.34 million) in July (with the number leveling off year-on-year for accommodation and eating and drinking services industries). Even though we anticipate a situation where no growth in service consumption is expected, the supply and demand situation of labor is not foreseen to loosen further in the future, suggesting that the increase in the unemployment rate will stay limited. As we mention in the later section, under the situation where the impact of social distancing will be prolonged, the prospect of extending the special measures of the Employment Adjustment Subsidy may also serve as a factor subduing the rise in underemployment.

**Chart 11: Bankruptcy cases compared to the time of the Global Financial Crisis**



Source: Made by MHRI based upon Tokyo Shoko Research, Ltd., *Monthly Report on Bankruptcy*.

**Chart 12: Impact on employees' income (Decline for the case with no Covid-19 shock)**

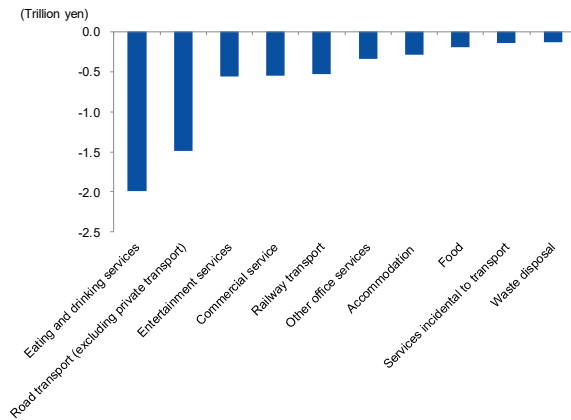
	FY2020	FY2021
Employee income inducement effect (trillion yen)	-7.3	-6.4
Personal consumption reduction range (%) (*Secondary impact from falling employees' income)	-0.6	-0.5
GDP reduction range (%) (*Secondary impact from falling employees' income)	-0.4	-0.3

Note: Decline in personal consumption from the secondary impact is calculated assuming a marginal propensity to consume of 0.25.

Source: Made by MHRI based upon the Ministry of Internal Affairs and Communications, *Input-Output Tables for Japan*, among others.

<sup>2</sup> Refer to Shimanaka (2020) who makes the same point in her report.

**Chart 13: Impact on employees' income in FY2020 (Range of decline for the case with no Covid-19 shock)**



Source: Made by MHRI based upon the Ministry of Internal Affairs and Communications, *Input-Output Tables for Japan*, among others.

**Chart 14: Number of people placed on administrative leave (Change from the previous year by industry)**

(10,000 people)

	All industries					
	Manufacturing	Wholesale and retail trade	Accommodation / eating and drinking services	Living-related and personal services and amusement services	Others	
January	8	7	-2	0	-2	5
February	19	3	4	4	0	8
March	31	3	2	2	5	19
April	420	33	68	95	48	176
May	274	21	28	71	28	126
June	90	10	13	18	7	42
July	34	6	3	0	5	20

Source: Made by MHRI based upon the Ministry of Internal Affairs and Communications, *Labour Force Survey*.

### 3. Impact on regional economies – The impact of social distancing varies from region to region

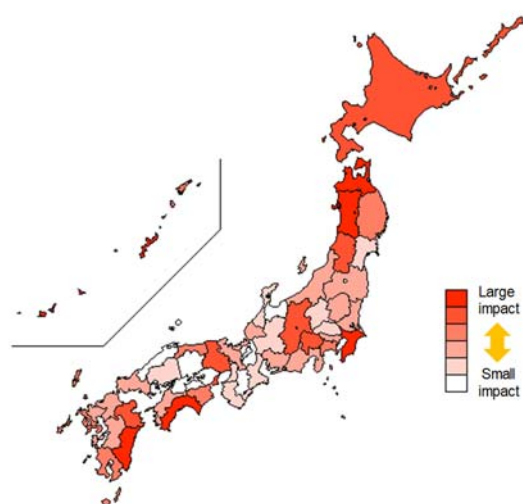
In this section we examine how the extension of social distancing may affect the regional economies.

No one would argue with the observation that social distancing is greatly affecting the regions heavily dependent on the tourism industry, including both domestic travel by Japanese citizens and inbound travel from overseas. If we look at the share of consumption in domestic travel of Japanese people in nominal GDP by prefecture, prefectures with a relatively high share include Okinawa (16.6%), Yamanashi (9.1%), Nagano (7.7%), Oita (6.6%), Ishikawa (6.5%), and Hokkaido (6.4%). Likewise, if we study the share of inbound consumption in nominal GDP, the top prefectures are Okinawa (4.5%), Kyoto (2.8%), Osaka (2.3%), Tokyo (1.7%), Hokkaido (1.5%), and Fukuoka (1.2%), showing that shares are relatively high in metropolitan areas in addition to Okinawa and Hokkaido. These areas are highly reliant on the tourism industry, which suggests that these prefectures will most likely suffer more from the economic downturn stemming from social distancing than other regions.

Furthermore, to study its potential impact on corporate bankruptcies and employment, the numbers of offices and employees engaged in face-to-face services become important indicators. **Charts 15 and 16** reveal that the shares of these indicators are high for Okinawa Prefecture with its heavy reliance on the tourism industry (number of offices: 27.4%, number of employees: 18.2%). Elsewhere, prefectures with a high share in the number of offices include Kochi (25.3%), Aomori (25.0%), Miyazaki (24.4%), and Akita (24.0%),

and those prefectures with a high share in the number of employees are Chiba (16.6%), Yamanashi (16.4%), Kochi (15.6%), and Nara (15.4%). Although Kochi, Aomori and Miyazaki prefectures are not characterized by a large share of domestic and overseas travel consumption, the small share of secondary industries in their respective local economies pushes up the relative share of offices engaged in face-to-face services. In these areas, an extension of social distancing may easily lead to a rise in corporate bankruptcies and a cut in labor hours and wages, among other negative impacts.

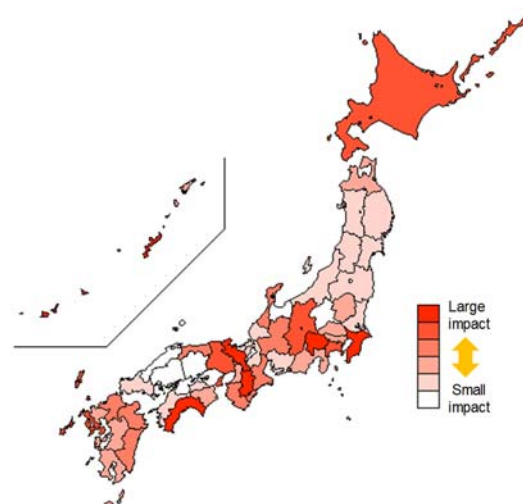
**Chart 15: Share of offices of vulnerable industries**



Note: Vulnerable industries refer to “accommodation, eating and drinking services industries” and “life-related service and amusement services industries.”

Source: Made by MHRI based upon the Ministry of Internal Affairs and Communications, *Economic Census for Business Activity*.

**Chart 16: Share of employees of vulnerable industries**



Note: Vulnerable industries refer to “accommodation, eating and drinking services industries” and “life-related service and amusement services industries.”

Source: Made by MHRI based upon the Ministry of Internal Affairs and Communications, *Economic Census for Business Activity*.

#### **4. Conclusion – Financial relief of around 5 trillion yen is required. Employment support is also needed in response to a shift in industrial structure**

We discussed the impact of prolonged social distancing in the previous sections. In view of the uncertainty over the development and distribution of vaccines and therapeutics for Covid-19, and the recent trends seen in personal spending, we believe there is some possibility of our scenarios becoming a reality. We must also consider the possibility of greater bankruptcy risk for those industries that offer face-to-face services, and that adjustments to employment and wages will be unavoidable. Under such circumstances, the government will be expected to play a significant role. In the last section, we want to consider the kind of assistance that is necessary in order to respond to this situation.

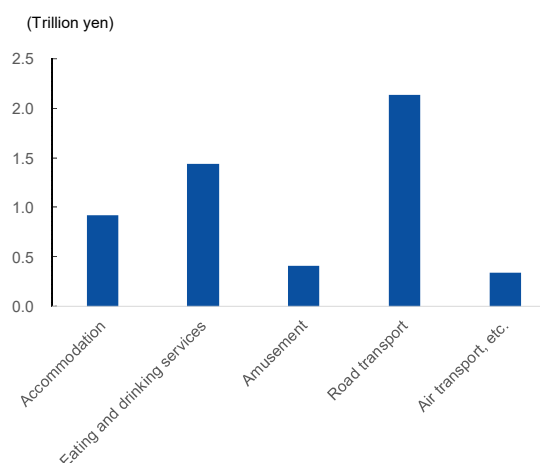
First, we believe the government should extend the period of currently available support measures, targeting industries that offer face-to-face services (**Chart 17**). Since on-going support to alleviate the burden of fixed expenses is needed, financial assistance such as loans and investment is expected to be the main pillar, in addition to various payment and subsidy measures, such as the Subsidy Program for Sustaining Businesses, Rent Support Grant for SMEs, and Employment Adjustment Subsidy. If we calculate the amount of support necessary (a portion of such fixed costs as personnel expense, interest expense, real estate and goods rental and leasing expenses and tax expense that cannot be covered by revenues) for small to medium-sized companies belonging to such industries as road transport, air transport, etc., accommodation, eating and drinking services, and amusement services in light of the anticipated decline in consumption related to domestic and inbound travel, an amount of about 5 trillion yen will be required for FY2020 as well as FY2021 (**Chart 18**).

**Chart 17: Government financial relief for companies affected by Covid-19**

	Measures	Details
Payment	Subsidy Program for Sustaining Businesses	Maximum amount set at 2 million yen for medium and small to medium-sized companies and 1 million yen for the self-employed.
Payment	Rent Support Grant	Provide rent for medium and small to medium-sized companies and the self-employed (2/3 of rent for 6 months).
Subsidy	Employment Adjustment Subsidy	Raise the subsidy rate and maximum amount (if there are no layoffs, the subsidy rates are 3/4 for large companies and 10/10 for small to medium-sized companies, maximum of 15,000 yen per day).
Loan	Loans with virtually no interest and security by the Japan Finance Corporation and others	Provide loans with no interest for 3 years with a maximum grace period of 5 years to pay the principal (can also be offered by regional banks, <i>shinkin</i> banks, and credit associations, etc.).
Capital Provision	Provision of capital fund	Enhance subordinate loans, capital, funds, etc. provided by the Development Bank of Japan, Shoko Chukin Bank, and the Japan Finance Corporation, among others.
Deferral	Deferral of the payment deadline for national and local taxes and social insurance premiums	Payment of national tax, regional tax, and social insurance premium deferred by 1 year (with no security or overdue tax payments).
Reduction and exemption	Reduction and exemption of property tax and city planning tax	Reduce the property tax and city planning tax to 1/2 or zero.

Source: Made by MHRl based upon the Cabinet Office, among others.

**Chart 18: Financial support required by service industries offering face-to-face services (SMEs and micro businesses)**



Note: We calculated the difference between revenues that reflect a decline in demand of domestic consumption and inbound demand and variable costs (assuming a fixed ratio to revenues) and fixed costs. Fixed costs exclude the tax burden. Amount of financial support required in FY2020.

Source: Made by MHRl based upon the Ministry of Finance, *Financial Statements Statistics of Corporations by Industry (FY2018 Annual)*, among others.

In particular, the role of the Employment Adjustment Subsidy is important from the perspective of alleviating the negative impact on employment. The rates of subsidy provided by the special measures of the Employment Adjustment Subsidy were lifted to 3/4 for large companies and 10/10 for small to medium-sized companies (if there are no

layoffs), and the maximum value per day was increased to 15,000 yen.<sup>3</sup> The Employment Adjustment Subsidy was provided in about 870,000 cases up until August on a cumulative basis (total subsidy amount paid: 1.1 trillion yen), already surpassing the number recorded after the global financial crisis (650 billion yen paid in 790,000 cases in FY2009). This payment is considered to have slowed down the pace of rising underemployment (while the number of people on administrative leave increased) in the accommodation and eating and drinking services industries and other sectors. An extension of such special measures is expected to restrain the upsurge in underemployment.

In addition, we hold that educational assistance (provision of recurrent education programs, etc. responding to digitalization) designed to facilitate a smooth shift of the labor force now engaged in face-to-face services to other industries will also be necessary. While the Employment Adjustment Subsidy is mainly aimed at “maintaining the job” and is meant to be more like a hemostatic agent of a short-term nature, if the impact of the Covid-19 shock persists longer than expected, the government will need to gradually change its policy so as to prompt a “shift to new employment.”

Citing the examples of Germany and France, Arita et al. (2019) propose implementing such measures as “shifting from unemployment insurance to labor insurance” (building a system to offer and enhance advice and job training before actual job loss), “opening of job training individual accounts” (providing funds for job training to individual laborers each year, such funds can be saved and used for online seminars), and establishing a job training system to prevent underemployment targeted at all laborers (granting of the right to learn).

We have stated what kind of assistance measures the Japanese government should offer. The most important element is to execute these support measures quickly for companies and workers affected by the pandemic crisis. The recent problems in executing the payment system of the Employment Adjustment Subsidy and Special Cash Payment revealed the government’s delay in its digitalization efforts (refer to Sakai and Kotera (2020) for details). The delay in implementing various grants and subsidies amid the prolonged presence of the Covid-19 shock could directly lead to an increase in bankruptcies and job losses. We hope the Japanese government will learn from the confusion arising from the payment delay and accelerate the digitalization of its administrative work.

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<sup>3</sup> The subsidy rate during ordinary times is 2/3 for SMEs, 1/2 for large companies, with the maximum amount being 8,370 yen per worker.

## **Supplementary Discussion: Impact on the economic growth rate**

### **(1) Economic growth rate of -0.2%pt in FY2020 and -0.6%pt in FY2021**

In light of what we have discussed in this report, this section touches upon the impact on the Japanese economy. Mizuho Research Institute (2020) forecasts the real growth rate of Japan's economy to be -6% in FY2020 and +3.4% in FY2021. Assuming that spending on face-to-face services after the October to December quarter of 2020 stays flat and inbound demand continues to evaporate, our forecast economic growth rates would be revised downward to -6.2% in FY2020 and +2.8% in FY2021. The factors behind the lower GDP growth rates include the decline in personal consumption and service exports (we also reflected a drop in personal spending due to the secondary impact from falling employees' income as presented in **Chart 12**). While Mizuho Research Institute (2020) provided an outlook of gradual recovery in service consumption and service exports, our report assumes they will turn flat after the October to December quarter. This difference in future scenarios reduced our GDP forecast toward FY2021.

### **(2) Potential growth rate turns negative with lower labor input and TFP**

We also want to provide our view on the trend of the potential growth rate from a mid- to long-term perspective. Sakai and Yamamoto (2020) pointed out that the decline in capital investment stemming from the Covid-19 shock has hurt the nation's capital stock, and this will lower the potential growth rate toward FY2021 to +0.1%. Here, it was assumed that the economic downturn due to the Covid-19 shock is a temporary phenomenon, and therefore its impact on the potential labor input and TFP would be limited.

But if we assume a case where social distancing is sustained over the long term, the Covid-19 shock can no longer be viewed as temporary, and we need to consider its affect on the supply side.<sup>4</sup> More specifically, shorter operation hours will reduce labor hours and curtail the potential labor input, and lower productivity in the service industry as a result of limiting the number of seats (in restaurants and so forth) will culminate in a reduction in TFP. The results of the potential growth rate estimate using the economic data up until the April to June quarter of 2020 and the assumptions made in this report are depicted in **Chart 19**. In addition to capital stock's positive contribution shrinking to almost 0%pt, the negative contribution of labor input and TFP will push the potential growth rate into the negative territory, falling to -0.5% in FY2021. (When estimating TFP and potential labor input, we standardize the data with a HP filter and extract the trend. Therefore, the potential

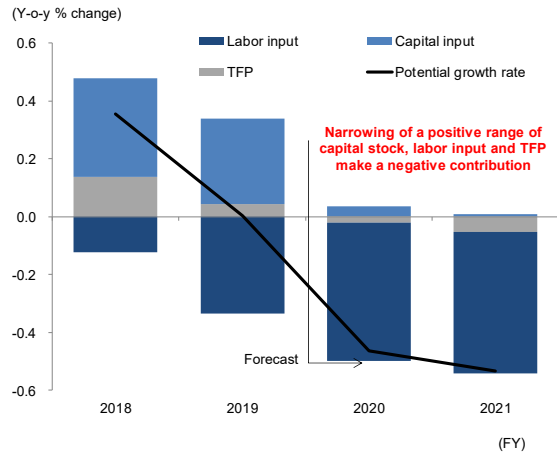
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<sup>4</sup> Ono (2020) points out that potential GDP of each country will most likely be revised downward driven by an economic recession caused by the corona crisis.

growth rate in the past (such as in FY2019) also fell affected by the lower rates in FY2020 and onwards.)

The potential growth rate we present in this report is simply an estimate. While the value may change depending on the estimation method and should be interpreted across a broader range, it suggests that if the impact of the Covid-19 shock persists beyond the anticipated period and the recovery of demand, including service consumption, is delayed, it is highly probable that the potential growth rate will contract to a significant extent. A lower potential growth rate means a lower expected growth rate of companies, and we need to be alert to the fact that this may lead to a reduction in mid- to long-term capital investment and companies' hiring appetite.

**Chart 19: Potential growth rate (Assuming the impact of the Covid-19 shock is sustained)**



Source: Made by MHRI based upon the Cabinet Office, among others.

## Reference

**Refer to the original Japanese report by clicking the URL below for the reference material.**

**<https://www.mizuho-ri.co.jp/publication/research/pdf/insight/jp200925.pdf>**