MHRT Brief **September 21, 2022**

Relaxation of border control accelerates Japan's inbound recovery

Boosts GDP by 0.2% in FY2022. Limited effect to restrain the yen's decline

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Early relaxation of border control measures will accelerate the pace of inbound demand recovery through the first half of 2023

The Japanese government plans to remove the daily cap on arrivals (the current cap is 50,000), introduced earlier as a border control measure during the COVID-19 crisis, by October. In addition, lifting of the entry ban on individual travelers and exempting short-term visitors from visa requirements are also under consideration. With the easing of border control measures at hand, inbound (foreigners visiting Japan) demand is expected to increase, boosted by the yen's decline.

In its economic outlook for July, Mizuho Research & Technologies (2022) forecast a gradual recovery in the number of inbound visitors mainly from outside of China and Hong Kong (about 60% of all visitors to Japan) until the first half of 2023, based on the assumption that China's "zero-COVID" policy will be lifted by the end of June 2023, with a full recovery of inbound visitors, including travelers from China and Hong Kong, expected in the second half of 2023 or later (**Chart 1** "Baseline"). In this report we will use the July forecast of the number of inbound visitors by Mizuho Research & Technologies (2022) as a baseline and compare it with the current forecast to examine the impact of relaxing the border control measures.

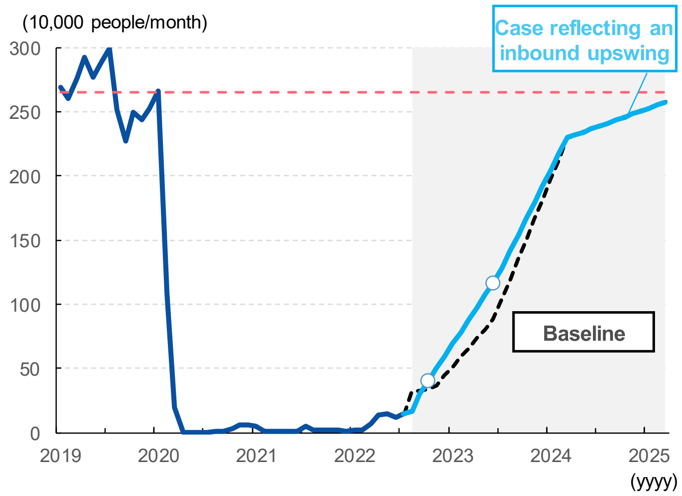
If the border control measures are substantially eased as described above, the recovery of inbound demand is expected to accelerate, fueled by the progress of the yen's depreciation. However, the view remains unchanged that China's zero-COVID policy will continue through the April-June 2023 period, and that the influx of Chinese inbound tourists, who account for about 30% of inbound demand, will remain sluggish for the time being. In addition, as pointed out by Suwa and Sakai (2022), the economic recession expected in Europe and the US from this winter through the first half of next year and the recent supply constraints on international passenger flights[1]

[1] Sakai et al. (2021) found that Japan's supply constraints on international passenger air travel are less severe than those in the US, as Japan has not reduced its workforce and aircraft to the same extent as in the United States. (Airline companies are believed to have been waiting for demand to recover while keeping personnel on loan.) But they also point out that about half of international flights are operated by overseas carriers, and that their financial strength and management base were weak even before the pandemic, which may cause supply constraints for Southeast Asian full-service carriers (FSCs) and other carriers implementing bold restructuring measures in the wake of the pandemic. Low cost carriers (LCCs) will also likely face a slowdown in the number of travelers caused by downward pressure from social distancing restrictions and other factors.

are expected to impede the recovery of inbound demand.[2] Therefore, it should be noted that even with the lifting of border control measures, the number of inbound visitors will not immediately recover to the pre-pandemic level.

As shown in **Chart 1**, based on the information currently available, we revised our forecasted number of inbound visitors upward, mainly from the second half of FY2022 to the first half of FY2023 ("case reflecting an inbound upswing"). With the number of travelers from outside of China and Hong Kong bouncing back through the first half of 2023, we assumed a recovery to about 44% of the pre-COVID level (2019 average) by June 2023. The number of inbound visitors is expected to recover to about 72% of the pre-pandemic level by the end of 2023, and to about 97% by the end of FY2024, as China's zero-COVID policy is lifted. We share the same view with Mizuho Research & Technologies (2022) that business travel demand will partially hollow out with the penetration of online conferencing and other such changes, and will not return to the pre-pandemic level in FY2024 and beyond. In its March 2022 forecast, IATA (International Air Transport Association) projected that Asia-Pacific's air passenger volume will average 68% in 2022 and 84% in 2023, compared with 2019, and the "case reflecting an inbound upswing" in this report is generally consistent with IATA's view.

[Chart 1: Actual and projected numbers of inbound customers]



Note: The red dotted line represents the pre-COVID level and the gray shading represents the forecast period.
Source: Made by MHRT based upon the Japan National Tourism Organization (JNTO), *Visitor Arrivals to Japan and Japanese Overseas Travelers*.

Accelerated inbound recovery will boost FY2022 GDP by +0.2%

Next, we look at the impact of the accelerated recovery of inbound demand on the economy. With the effects of the coronavirus crisis lingering longer than in Europe and the US, economic activity in Japan has been slow to recover, especially in the service sector related to inbound demand and the consumption of in-person services such as food service, accommodation, travel and transportation, and recreation (Sakai, 2022). However, this also

[2] In addition to the shortage of international flights, supply constraints such as car rentals have been seen in tourist destinations such as Okinawa. Reference: NHK, "Unusual situation: Rental car battle! Okinawa's Weaknesses are Highlighted" (Japanese only, https://www3.nhk.or.jp/news/html/20220823/k10013783351000.html, accessed on September 21, 2022.)

Concerning supply constraints in terms of domestic labor, while the sense of labor shortages is expected to intensify as inbound demand and consumption of in-person services recover, the impact is expected to be limited compared to the US, where employment has declined significantly due to the pandemic. As Kazama (2022) points out, the employment adjustment subsidy in Japan has produced a pool of job-holders (workers who would have become unemployed without the employment adjustment subsidy; as of June, there were 250,000-360,000 job-holders remaining (about 0.4-0.5% of the labor force)). For the time being, companies are likely to prioritize the use of these job holders over new job openings, a situation that differs from that in the US, where job openings increased markedly with the resumption of economic activities.

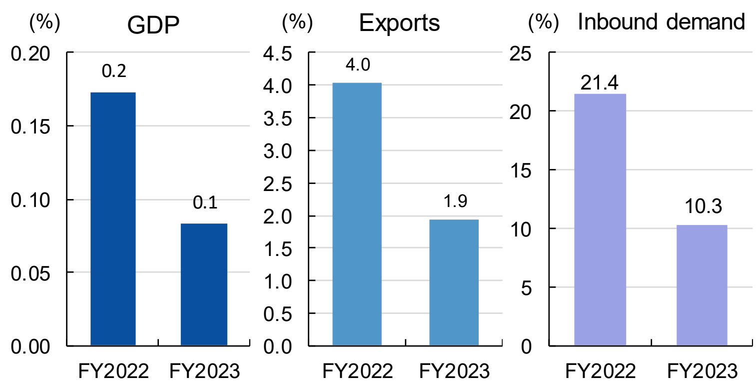
means there is more potential for economic recovery in the future. The impact on the Japanese economy of the accelerated recovery of inbound demand due to the early relaxation of border control measures compared with the baseline (July forecast) is estimated to be +21.4% for inbound demand, +4.0% for exports, and +0.2% for GDP in FY2022, and +10.3% for inbound demand, +1.9% for exports, and +0.1% for GDP in FY2023 (**Chart 2**). If the "case reflecting an inbound upswing" (**Chart 1**) is realized, the expansion of inbound demand is expected to boost GDP by 0.94% (or roughly 5 trillion yen) over FY2023 relative to the current level (April-June 2022). This shows just how large the impact of a recovery of inbound demand on the Japanese economy will be.

In addition to the accelerated recovery of inbound demand, rising consumption of in-person services, driven by receding fears of infection, and the implementation of nationwide travel support measures will also provide a tailwind (see Sakai, 2022, for details). Looking ahead, business conditions in the service sector are expected to improve. **Chart 3** shows the outlook of sales in the in-person services sector in FY2022 and FY2023 compared with the pre-pandemic (2019) level. Sales in FY2022 are expected to remain low at -10% to -30% of the pre-pandemic level, while sales in FY2023 are expected to improve to -1% to -10%, close to the level seen before the pandemic.

By region, a recovery in sales can be easily expected in areas highly dependent on inbound travelers. We confirmed the degree of inbound dependence of accommodation facilities by prefecture based on the share of total foreign overnight guests to total domestic overnight guests as of 2019, and Tokyo (38.6%) and Osaka (38.2%) lead the way, with Kyoto (35.4%), Hokkaido (27.8%), Okinawa (22.5%), and other prefectures with popular tourist attractions also highly dependent on inbound travel (see Sakai et al., 2021, for details). We expect the recovery of inbound demand, especially in these regions, will boost business conditions in the service sector.

Thus we can see that accepting more inbound visitors will have a significant economic impact. The rapid rise in inflation, particularly in Europe and the United States, and the relative undervaluation of Japanese prices, combined with the historic depreciation of the yen, has increased the price competitiveness of Japan's inbound tourism. As mentioned above, although it is necessary to keep in mind the supply constraints and other factors restraining the inbound demand recovery, promoting greater acceptance of inbound visitors under tailwind conditions seems to be an effective economic policy.

[Chart 2: Impact of accelerated inbound recovery on exports and GDP (vs. baseline)]



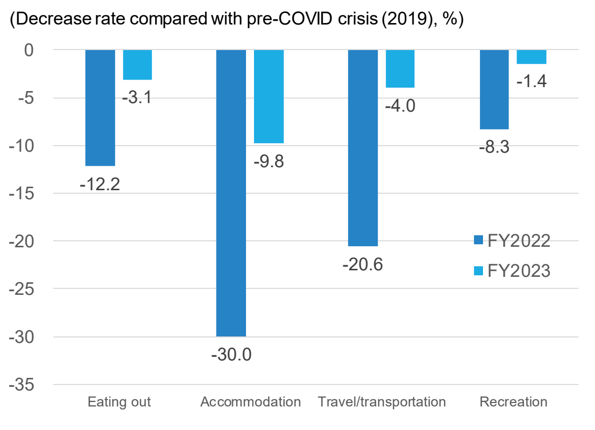
Source: Made by MHRT based upon the Cabinet Office, *Quarterly Estimates of GDP*.

The effects of yen appreciation driven by the recovery of inbound demand are limited. The yen will continue to weaken this year

Finally, we consider how the recovery of inbound demand will affect the foreign exchange rate. Growth in inbound demand means an increase in Japan's service exports through inbound travelers, a situation that will lift the current account balance through an improved balance of services (travel balance) in the balance of payments statistics. An improvement of the current account balance is expected to restrain the progress of the yen's decline to a certain degree because inbound visitors to spend money in Japan need to exchange foreign currency for yen, which in turn increases the demand for yen. In this section we quantify the extent of improvement of the current account balance and its impact on the exchange rate based on the outlook of inbound demand described earlier.

Chart 4 shows the projected travel balance by the end of FY2024. While inbound demand, which means travel balance receipt, is a positive factor expected to recover, outbound demand (overseas travel by Japanese), which means payment and serves as a negative factor, is also expected to climb higher. But the pace of outbound recovery will likely be slower than inbound, as higher prices in Europe, the US, and elsewhere and the weaker yen exert a downward pressure. Therefore, travel receipts are expected to rise faster than travel payments, and the travel balance (and thus the current account balance) is expected to continue expanding to a net surplus. The travel balance in FY2024 is forecast to be in the range of 2 trillion yen per year, close to the level before the pandemic.

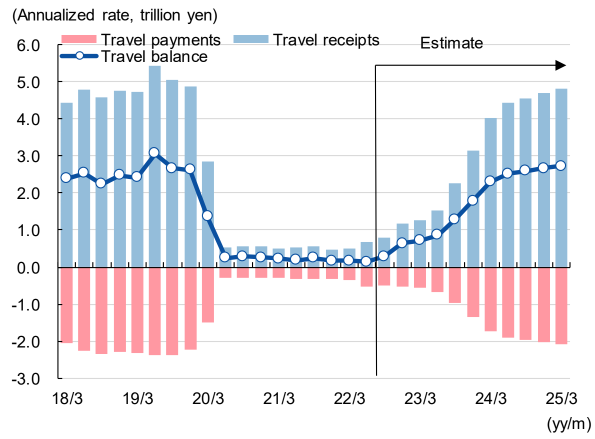
[Chart 3: Sales forecast of in-person services (FY2022 and FY2023 vs. before the COVID crisis)]



Note: In addition to inbound demand, personal consumption demand and corporate demand (business trips, banquets, etc.) were also considered in calculating the above data.

Source: Made by MHRT based upon JCB/Nowcast, *JCB Consumption NOW*, among others.

[Chart 4: Travel balance forecast]

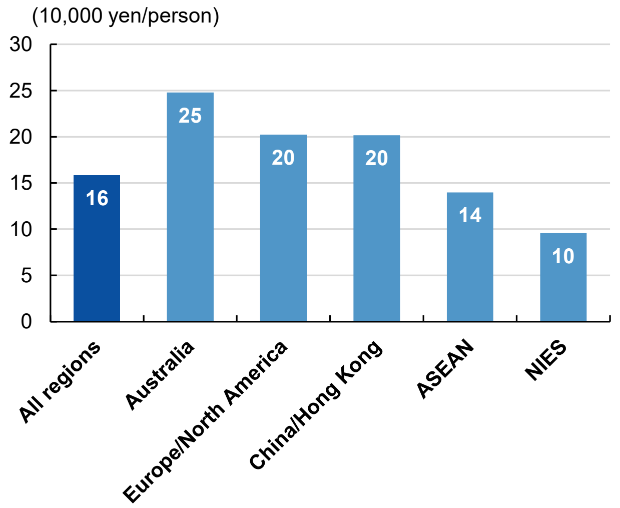


Source: Made by MHRT based upon the Ministry of Land, Infrastructure, Transport and Tourism, *Consumption Trend Survey for Foreigners Visiting Japan*, and the Bank of Japan, *Balance of Payments Statistics*, among others.

As for inbound travel, the recovery in the number of visitors from China and Hong Kong will be delayed for the time being, as mentioned above, and the share of visitors from Europe, North America, and other countries is expected to rise temporarily. Since the difference between Europe/North America and China/Hong Kong in terms of per capita spending by inbound visitors in 2019 was small (**Chart 5**), the impact on the balance of payments due to different paces of recovery by country and region of inbound tourists seems to be limited. Furthermore, we expect inbound and outbound per capita spending to remain high for the time being relative to the pre-COVID crisis (2019) level due to high domestic and international prices and revamped demand especially among higher income groups. As shown in **Chart 6**, current per capita spending by inbound visitors is about 1.6 times higher than the pre-pandemic level,[3] and the travel balance forecast in **Chart 4** incorporates a certain degree of this upward movement in per capita spending.

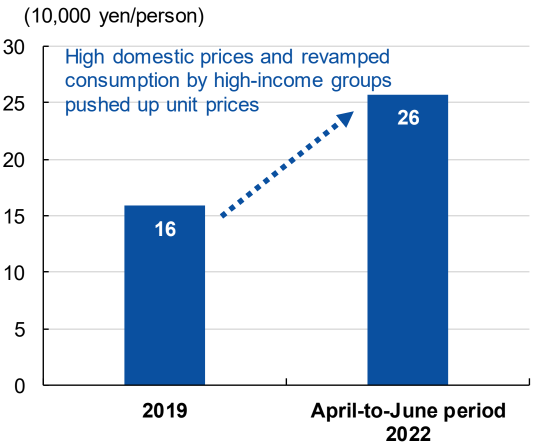
An increase in the current account surplus due to the recovery of inbound demand (travel receipts) is expected to give appreciation pressure on the yen against the dollar in the future, as mentioned earlier. Below, we estimated the degree of pressure on the yen's appreciation using exchange rate sensitivity to the current account balance in the macroeconomic model of the Economic and Social Research Institute, Cabinet Office (2015).[4] Specifically, we calculated the effect of yen appreciation using the increase in the current account surplus associated with the recovery of inbound demand and the exchange rate elasticity of the cumulative current account balance to nominal GDP ratio, based on the April-June period of 2022. (Since the Cabinet Office model assumed a distribution lag of one to three periods, we assumed a two-period lag in our estimation.)

[Chart 5: Per capita spending by nationality of inbound visitors (2019)]



Note: The above chart shows the unit price of general visitors. The values for the Europe/North America, ASEAN, and NIES are weighted average calculations using the number of inbound foreign visitors as weights for the countries for which data are available.
Source: Made by MHRT based upon the Japan National Tourism Organization (JNTO), *Visitor Arrivals to Japan and Japanese Overseas Travelers*, and the Ministry of Land, Infrastructure, Transport and Tourism, *Consumption Trend Survey for Foreigners Visiting Japan*.

[Chart 6: Inbound per capita consumption (compared with the pre-COVID crisis level)]



Source: Made by MHRT based upon the Ministry of Land, Infrastructure, Transport and Tourism, *Consumption Trend Survey for Foreigners Visiting Japan*.

As shown in **Chart 7**, even if inbound demand recovers to the level of about 5 trillion yen per year by the beginning of 2025, the appreciation pressure on the dollar-yen exchange rate is estimated to be only about 2 yen.[5]

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3 With the number of inbound visitors not expected to recover to the pre-pandemic level in the near future, raising the unit price per visitor will be an important issue for companies in the service industry, etc. Companies will be required to raise per capita consumption by adding more value to services and travel products, such as enriching their content (nature, food, traditional performing arts, activities, etc.) to provide extraordinary experiences unique to the region and specific location.

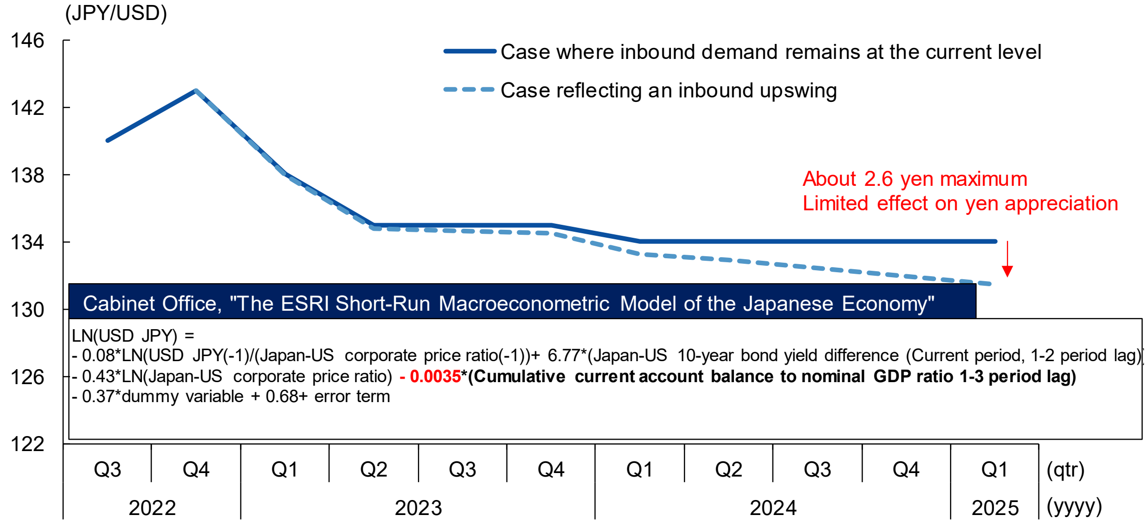
4 Although the 2018 version of the Cabinet Office's short-term Japanese economy macroeconomic model is the most recent, the 2018 version does not include the current account balance as an explanatory variable in the exchange rate estimation. There are cases where the current account balance is not included as an explanatory variable because financial transactions are considered to have had a more significant impact on the exchange rate in recent years. But to estimate the impact of the current account balance on the exchange rate, this report refers to the 2015 version in which the current account balance is employed as an explanatory variable in the exchange rate estimation equation.

5 The calculations here are made mechanically, leaving nominal GDP unchanged from the April-June 2022 results. If GDP increases in

And even if the current account balance improves thanks to the recovery of inbound demand, the impact on yen appreciation will be extremely limited, at least in 2022.

Sakamoto (2022) states there is currently significant selling pressure on the yen from speculators who are aware of the widening gap between domestic and foreign interest rates and differences in monetary policy between Japan and the United States. As long as the monetary policies of Japan and the US remain unchanged, we expect the dollar-yen exchange rate to hover in the 140-yen range in the immediate future.

[Chart 7: Impact of improvement of the current account balance on the foreign exchange rate]



Note: The above data are on a quarterly basis. The interest rate differentials and the current account balance to GDP ratio elasticities are three-period lagged cumulative values.
Source: Made by MHRT based upon the Cabinet Office and Bloomberg.

Reference

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

https://www.mizuho-rt.co.jp/publication/report/2022/pdf/express-jp220921.pdf

the future, the effect of the yen's appreciation on expanding the cumulative current account balance to nominal GDP ratio is expected to be even more limited.