Daiwa Securities

Daiwa's View

Monetary policy has no magic wand, but it can provide preventative measures

- Main focus in Jun BOJ MPM is confirmation of economic trends

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Monetary policy has no magic wand, but it can provide preventative measures

Provided COVID-19 second wave does not emerge quickly, economy should hit major bottom in Apr-May

Improvement expected in Jul-Sep, but V-shaped recovery unlikely

Three weeks have passed since a phased reopening of economic activities following the government decision to lift the state of emergency on 25 May. I thought that the first hurdle was whether the government could lift limits on regional travel inside Japan, and that such limits would probably be lifted from 19 June. Provided a second wave of infections does not emerge quickly, we can easily assume that business activity will start to gradually recover from June (after hitting major bottom in Apr-May) with improvement (avoiding negative growth) in Jul-Sep. That said, a V-shaped recovery seems unlikely, even if there is a fair degree of pent-up demand, as we do not expect a strong recovery for automobile production, which has come to symbolize the demand shock. We continue to envision a checkmark recovery. Meanwhile, COVID-19 infections are accelerating in the winter southern hemisphere, and there are still concerns about a second wave in the northern hemisphere this fall and winter. We probably need to keep such a "tragic W-shaped path" in mind as a risk scenario.

Global economy projected to contract at 6% level for 2020

Assumption of second wave of infections now mainstream

Authorities have quite cautious stance, given great uncertainty, medium-term downside risks

In its economic outlook announced on 10 June, the OECD projects the global economic contraction at 6% for 2020 (in real terms) and 7.6% in the case of a second outbreak. On 4 June, the ECB announced two additional economic scenario premises (mild and severe), in addition to the baseline scenario. The central bank feels that the risk of the economy undershooting its baseline scenario remains high and the "severe" scenario still must be considered as a second wave has become the mainstream assumption over roughly the past two months. In the Fed's economic projections released on 10 June as well, the projection range has widened, reflecting a great degree of uncertainty. Fed chair Jerome Powell stated that deteriorating employment is having a large impact on the low-income group and minorities (racial inequality). Despite the reopening of the economy, the unemployment rate is unlikely to return to the pre-pandemic level during the projection period. It will take considerable time before we see a recovery in the labor market. In addition, sluggish demand will push down prices, and it remains difficult to assume wage hikes for the time being. Unlike some market participants reacting to the recovery of economic indicators, the authorities are taking a quite cautious stance. What all central banks share is a great degree of uncertainty and medium-term downside risks to the economy from the pandemic.

Jun MPM falls between emergency meeting in May and Jul *Outlook Report*

Main focus will be confirming economic trend and impacts from enhanced easing measures; status quo expected on policy

In such a situation, the BOJ will hold its Monetary Policy Meeting (MPM) on 15-16 June, less than three weeks after the unscheduled meeting on 22 May. In the interim, although some bad data has been announced, there is not enough reliable data to understand what has changed since the state of emergency was fully lifted. The July policy meeting, when the *Outlook for Economic Activity and Prices* report *(Outlook Report)* is to be released, will be held earlier than usual on 14-15 July (schedule set to accommodate initially planned G20 meeting and Tokyo Summer Olympics). That is about a month away, and the BOJ's economic assessment at that point will be key. Because this makes the upcoming meeting less important, the main focus will be on confirming economic trends and the impacts from the enhancement of easing measures since March. With the markets having settled down, we expect the BOJ to stand pat on policy.

Limits on new liquidity supplying measures to be increased in line with gov't second extra budget, which will not be positioned as additional measures requiring vote

Various media reports have speculated that the BOJ will double the limits on its new liquidity supplying measures (about Y30tn decided on 22 May and set to begin in late Jun) in step with the government expanding its interest-free unsecured loan program as part of the second supplementary budget that was passed on 12 June. Although a regular press conference by BOJ governor Haruhiko Kuroda was not held on 22 May, that evening Finance Minister Taro Aso and Mr. Kuroda held a joint press conference announcing that the government and BOJ were working together to proactively provide funding support to businesses. We had thought that the upcoming enhancement would serve to emphasize that cooperation, but a number of media outlets have reported that the increases would be commensurate with the government's budget and would not be positioned as additional measures requiring a vote.

BOJ expected to purchase enough JGBs to keep 10-year yield from rising, playing role of lateral support for fiscal measures

In its latest written statement, the Fed added new language indicating it would continue purchasing bonds at its current pace, and BOJ governor Kuroda's regularly scheduled press conference after the policy meeting should provide an opportunity to reaffirm its intentions. Under its policy of yield curve control (YCC), the BOJ has set a target for the 10-year JGB yield of around 0%. We expect the BOJ to meet the increased JGB issuance needed to fund the government's fiscal stimulus by purchasing enough JGBs to keep that yield from rising, and thus maintain its lateral support. As the YCC target is the 10-year yield, the BOJ would accept yield levels in the zone longer than the10-year sector as long as they are in the permissible range for the 10-year yield.

Plunge of Apr exports and output would lead to downward revision in economic assessment

On production front, structure returned to pre-pandemic one—increased production of IT-related items, cutbacks in auto production

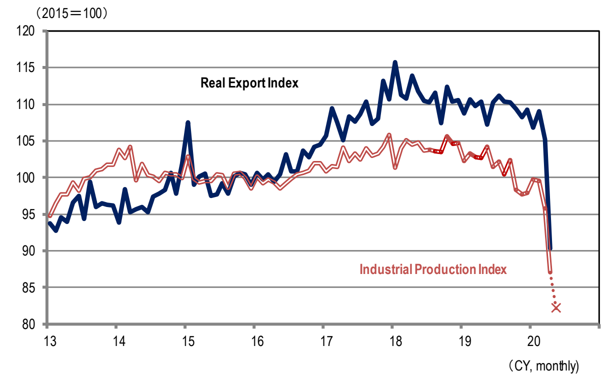
Let's confirm current economic trends. April exports and output plummeted in Japan (Chart 1). In the production plan as of 10 May, the average for Apr-May fell 14.8% vs. the Jan-Mar result. Therefore, a substantial decline in the Apr-Jun quarter is inevitable. In its June economic assessment, the BOJ will probably be forced to make downward revision to items such as exports and production (Chart 3). Meanwhile, new car sales volume fell sharply in May (Chart 2). We expect a small recovery from June, but not the sort of rapid growth that China experienced by implementing measures to stimulate consumption. Even in the pre-pandemic world, automobile production cuts dragged down increased production of IT-related items. This situation is likely to continue in the near term.

Economy Watchers Survey showed that department stores, dining/drinking, tourism/transportation-related hit hard by pandemic

Some industries unable to assume recovery in 'new normal' of coronavirus era

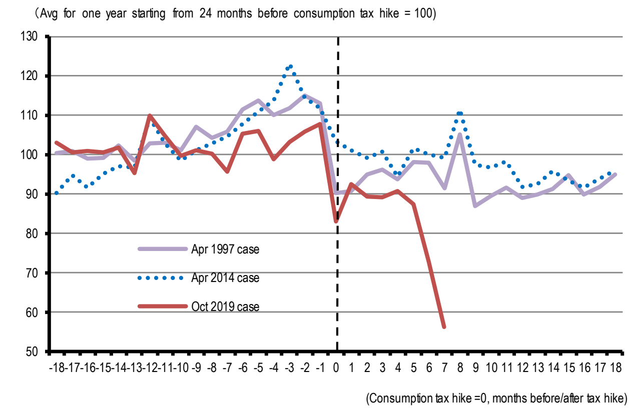
The May *Economy Watchers Survey*, which was taken after the state of emergency was fully lifted (25-31 May), finally stopped declining. The sectors that were hit hardest by the pandemic and dropped to near zero in April were department stores, dining/drinking establishments, and tourism/transportation-related. Although these sectors have bottomed out, levels remain low in May and mean that a return to pre-pandemic levels looks impossible. We need to think of the possibility that risks will spread from SMEs to large companies at some point if demand from inbound tourists does not recover due to the continued preventive economic activities and closure of borders. At some point, additional measures would be needed for (1) industries where it is hard to assume a recovery in the new normal of the coronavirus era and (2) sectors that require time to recover from the demand shock

Chart 1: Real Exports and Production in Japan



Source: BOJ, Ministry of International Trade and Industry; compiled by Daiwa Securities.
Note: MITI forecast (down 5.7% m/m) used for May production data.

Chart 2: New Passenger Car Unit Sales Around Consumption Tax Hike in Japan



Source: Japan Automobile Dealers Association; compiled by Daiwa Securities.

Monetary policy has "no magic wand," but it can provide "preventative" measures

Regarding responses to the COVID-19 crisis, the BOJ gave away the store—deciding on (1) measures to enhance easing in April, following such a move in March, and (2) expansion of the amounts and extension of the deadline of operations under the special program in May. This is proof that the central bank has been in crisis mode with respect to access to funding, credit risk, and future fiscal expansion. There was a global shortage of dollar funding in March, and with anxiety over SMEs' access to funding having over time spread to large companies, the focus of policy now revolves around credit risk. Rather than immediately using all steps, the BOJ decided to increase asset purchases in April to give itself more flexibility early on in preparation for the near future. Former BOJ governor Toshihiko Fukui once said that monetary policy had "no magic wand," but we think it can provide "preventative" measures.

Crisis-response preventive measures by gov't and BOJ will be tested going forward

In the government's second extra budget, safety nets were established by expanding the pool of public funds for supporting lenders to Y15tn. However, as rules of operations have not yet been formulated, the judgment ability will be tested in the case of actual corporate relief. Meanwhile, as the unprecedentedly large Y10tn amount was booked as discretionary reserves, there should be no need to hastily prepare a third supplementary budget. We can say that the government has bought some time. Still, there is a risk of corporate bankruptcies due to a delay in administrative procedures. Lagging employment statistics are also likely to worsen from here. We thus think that ongoing expectation-driven stock rallies are too optimistic. If we see no prospect of an earnings recovery in Jul-Sep, even large companies may face trouble in financing. As we may see a severe situation at companies before the second wave of infections, crisis-response preventive measures by the government and the BOJ will be tested going forward. We need to monitor the sectors identified in the April *Financial System Report* (air transportation, lodging, auto sales).

Chart 3: Descriptions of BOJ Economic Assessment (Apr 2020, Jun forecast)

	Apr-20
Current condition	*⇒ Expected revision in Jun*
Japan's economy	"has been in an increasingly severe situation due to the impact of the spread of COVID-19 at home and abroad"
Overseas economies	"have become depressed rapidly, reflecting the impact of the COVID-19 pandemic"
Exports	"have declined" ⇒ "have declined substantially"
Capex	"has deteriorated, and the deceleration in the pace of increase in business fixed investment has become evident recently" ⇒ "has weakened somewhat"
Private consumption	"has decreased significantly, mainly in services such as eating and drinking as well as accommodations"
Public investment	"has increased moderately"
Housing investment	"has been more or less flat" ⇒ "has weakened somewhat"
Industrial production	"have declined" ⇒ "have declined substantially"
Financial conditions	"have been accommodative on the whole but less so in terms of corporate financing, as seen in deterioration in firms' financial positions"
Prices	"the y/y rate of change in the CPI is at around 0.5%. As for inflation expectations, relatively weak indicators have been observed" ⇒ "has slightly weakened to around 0%"
Outlook	
Economy	"is likely to remain in a severe situation for the time being due to the impact of the spread of COVID-19 at home and abroad"
Prices	"is likely to be somewhat weak for the time being, mainly affected by the spread of COVID-19 and the decline in crude oil prices" ⇒ "is likely to remain somewhat weak"

Source: BOJ; compiled by Daiwa Securities.

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