

# Daiwa's View

## Cooperation between gov't and BOJ to continue amid COVID-19 pandemic

- BOJ likely to upgrade economic assessment at Sep MPM, focusing on stability of financial system

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**Suga elected as new LDP president in overwhelming victory, to become prime minister on 16 Sep**

**If new Cabinet's approval rating is high, possibility of early snap election more likely**

**Good chance of long-term administration, instead of interim one**

**Suga more aggressive toward structural reform and deregulation than Prime Minister Abe**

**Conversant with bureaucracy due to experience as Chief Cabinet Secretary; most qualified to proceed with structural reform**

**During stage of crisis responses, BOJ likely to focus on stability of financial system**

**Fiscal spending should shift from shotgun style to targeted style**

### Cooperation between gov't and BOJ to continue amid COVID-19 pandemic

In the LDP presidential election on 14 September, Chief Cabinet Secretary Yoshihide Suga was elected as leader in a landslide victory, as expected (377 votes, around 70% of total votes). Following his appointment as prime minister on 16 September at an extraordinary Diet session, he will continue with Abenomics, facing the challenge of preventing the spread of COVID-19 alongside an economic recovery. Currently, the second wave of infection is showing signs of containment, which is good news. On 16 September, members of the Cabinet will be selected, in which the main point is who will become Chief Cabinet Secretary. Regarding Secretary-General Toshihiro Nikai and Deputy Prime Minister Taro Aso, Mr. Suga emphasized that "both are extremely important in policy operations" at an inaugural press conference. In addition, Hiroshi Moriyama, chairman of the Diet Affairs Committee, appears to be a key person as Mr. Suga places "very high value on his ability." If the new Cabinet's approval rating is high, the possibility of an early snap election is more likely. On 13 September, Mr. Aso made a remark implying early dissolution.

Mr. Suga will take over the rest of Prime Minister Abe's term (one year). However, if (1) he makes the administrative base rock-solid via the snap election and (2) maintains a high approval rating by skillfully getting the economy back on a recovery path, a long-term administration instead of an interim one would be more likely. The long-term administration would face the need to end the series of crisis response measures to the pandemic. Mr. Suga's characteristics are likely to be revealed when he proceeds with Abenomics. Since his 2 September announcement on joining the LDP leadership race, Mr. Suga has stated his ideas on the establishment of a Digital Agency, reduction of mobile phone charges, and consolidation of regional banks. As such, he is obviously more aggressive toward structural reform and deregulation than Prime Minister Abe. However, time is needed for these measures and thus a long-term administration would be desirable to realize these ideas. It is said that Mr. Suga knows how to move the organization as he is conversant with the bureaucracy given his lengthy experience (over seven years and eight months) as Chief Cabinet Secretary. As he is the most qualified person to proceed with structural reform in Japan, we look for his ability.

Amid the COVID-19 pandemic in the near term, I think that macro policy to cope with the crisis will not change much regardless of who the leader is. While the government will implement economic measures for sustaining businesses and maintaining employment levels, the BOJ is likely to focus on the stability of the financial system by continuing with measures to support corporate financing. The cooperation between the government and the BOJ will continue. Mr. Suga clarified his stance of supporting additional easing if needed. However, if currency exchange rates/stock prices remain stable, he would leave monetary policy to the BOJ. The real value of the new administration will be tested when further public spending is needed. Because of budgetary constraints, it is necessary to move away from the shotgun-like benefit payments pursued thus far (focus on project scale) and to shift toward targeted fiscal spending that is more efficient and effective, such as assistance to companies/people with real need of funding, supplemental payments for medical related fees, and larger allowances paid to healthcare workers.

**Japan's summer consumption sluggish due to resurgence of infections in Jul**

**Consumption of goods faced absence of one-off boosts in Jun, services consumption 80% of pre-pandemic level**

Confirming the current status of the Japanese economy, we see that summer consumption has apparently been more sluggish than the scenario presented in the BOJ's July *Outlook for Economic Activity and Prices* report (*Outlook Report*) as the pandemic again expanded after the release of that report (15 Jul). The BOJ's July Real Consumption Activity Index (travel balance adjusted) showed that the start of the new quarter was strong, up 5.6% vs. the Apr-Jun quarter (Apr-Jun reading down 11.9% q/q). Durable goods hit a lull after a strong recovery in June. The solid consumption of goods in June was due in large part to boosts from the special cash payment (Y100,000 per person) to stimulate the economy and the expiration of the cashless payment reward point program. The effects of such measures likely dropped off in July. Still, the consumption of goods has topped the level seen in February, just before the COVID-19 outbreak. That said, services, which account for just over 50% of consumption, is around 80% the February level (Chart 1).

**Travel sluggish during Obon holiday; clear deterioration in consumption outside of home**

**Current conditions DI in Aug *Economy Watchers Survey* topped pre-pandemic level**

Service consumption weakness continued in August. Such conditions were proved by JCB Consumption Now, a domestic consumption index based on credit card transaction data. Travel was sluggish in the first half of August, even during the *Obon* holiday, due to the coronavirus again spreading. Airline and railway demand also pulled back to the level in the first half of June. There was a clear deterioration in consumption outside of the home (department stores, amusement parks, dining out [Japanese-style taverns]). We need to check whether service consumption in September will exceed around 80% of the pre-pandemic level. Under the circumstances, the August *Economy Watchers Survey* (25-31 Aug survey period) showed that the DI for current conditions improved for the fourth straight month and even topped the level for January before the outbreak (responses made at time when infections slowing). The DI for future conditions also improved, so sentiment appears to be making a V-shaped recovery after bottoming in April. The next key point is whether improvement in sentiment will lead to improvement in consumption expenditures in September and beyond.

**Pickup in exports and production**

**Auto-driven catch-up production to continue, but momentum likely to weaken**

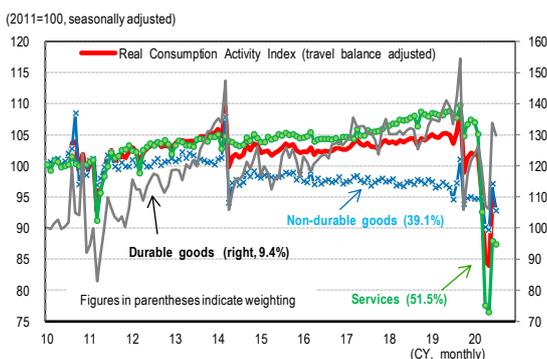
Meanwhile, exports and production have been picking up since June. The driver of catch-up production in Jul-Sep is transport machinery. There was a good boost in July as some production sites gave up their four-day holiday to continue operating. However, the forecasts as of 10 August call for a gradual slowing of this momentum (Chart 2). While the recovery is continuing, it is likely that the strong momentum in July will not be sustained and will weaken considering (1) the lull for new-car sales growth in Japan and (2) economic weakness along with a further spread of COVID-19 (particularly in India) in the Asian region.

**Keys for forecasting future conditions are services consumption, capex, export trends**

**Changes in corporate behavior should be monitored**

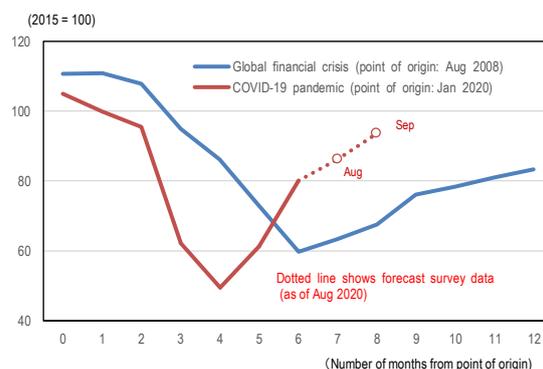
Japan's economy will probably not return to conditions like the worst phase seen in Apr-May, provided the pandemic does not worsen this winter and the lessons learned until now are effectively applied. The keys for forecasting future conditions are services consumption, capex, and export trends. However, we still do not know when a vaccine will be made available and we still cannot predict when travel restrictions will be lifted. Our view is that a return to pre-virus economic levels will take at least two years. In the near term, changes in corporate behavior should be monitored.

**Chart 1: Consumption Activity Index in Japan**



Source: BOJ; compiled by Daiwa Securities.

**Chart 2: Production Trends of Transport Machinery in Japan**



Source: Ministry of Economy, Trade and Industry; compiled by Daiwa Securities.

### Amid new normal, severe solvency issues likely to persist

### Detailed analyses anticipated in Oct *Financial System Report*

### BOJ to upgrade economic assessment at Sep MPM by confirming pickup

### Economic recovery scenario for 2H 2020 to be maintained; degree of recovery to be checked for now

For now, the government and industry must work together and endeavor to apply their fundamental strengths amid the “new normal.” Lagging employment data will likely start to worsen from here. Severe solvency issues are likely to persist for those industries hard hit by COVID-19 and corporations without good prospects for earnings recoveries. In the near term, “a negative feedback loop between the real economy and the financial sector” warrants caution. During the market disruptions in April, the BOJ issued a shortened *Financial System Report*. Detailed analyses are anticipated in the October version.

The BOJ will hold a Monetary Policy Meeting (MPM) on 16-17 September. We expect the central bank to maintain the status quo for its monetary policy as data for Jun-Aug released since the last meeting on 14-15 July confirmed recovery trends after reopening the economy, which has provided some stability for financial markets. In its statement, we expect the central bank will upgrade its economic assessments for overall conditions, overseas economies, exports, and production by adding the expression “picking up” (Chart 3). Data for Jul-Aug showed a lull for momentum compared to the data for June. However, recoveries will likely continue from September provided progress toward containing the virus is sustained. As such, the BOJ can retain its economic recovery scenario for the second half of the year. The period from Jul-Sep to Oct-Dec will likely remain a key period for ascertaining the degree to which economic activity is recovering.

Chart 3: Descriptions of BOJ's Economic Assessment (Jul 2020, Sep forecast)

	Jul	⇒ Expected revision in Sep
<b>Current condition</b>		
Japan's economy	"has been in an extremely severe situation with the impact of COVID-19 remaining at home and abroad, although economic activity has resumed gradually"	⇒ "showing signs of a pick-up, although it is in a severe situation"
Overseas economies	"have been depressed significantly, reflecting the impact of the COVID-19 pandemic, although they have shown signs of heading toward a pick-up"	⇒ "showing signs of a pick-up from the depressed condition"
Exports	"have declined substantially"	⇒ "showing signs of a pick-up"
Capex	"has been more or less flat"	⇒ "has been more or less flat" or "weakened"
Private consumption	"has decreased significantly, mainly in services such as eating and drinking as well as accommodations, it has shown signs of a pick-up recently"	
Public investment	"has increased moderately"	
Housing investment	"has declined moderately"	
Industrial production	"have declined substantially"	⇒ "picking up mainly on catch-up production of automobiles"
Financial conditions	"have been accommodative on the whole but those for corporate financing have remained less so, as seen in deterioration in firms' financial positions"	
Prices	"The y/y change in the CPI (all items less fresh food) is at around 0%, mainly affected by the decline in crude oil prices. Inflation expectations have weakened somewhat."	
<b>Outlook</b>		
Japan's economy	"with economic activity resuming, is likely to improve gradually from the second half of this year through the materialization of pent-up demand and supported by accommodative financial conditions and the government's economic measures"	
Prices	"Downward pressure on prices is projected to wane gradually along with economic improvement...The y/y change in the CPI is expected to turn positive and then increase gradually"	

Source: BOJ; compiled by Daiwa Securities.

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