

Daiwa's View

Japan's policy discussions, and path BOJ must take

- BOJ's Sep MPM to decide to continue monetary easing due to delay in economic recovery scenario

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Four running in LDP presidential election; Kono appears to be leading

Regardless of who becomes next prime minister, that person will implement measures to address pandemic and economic measures

Energy policy is vital

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The presidential election of the Liberal Democratic Party (LDP) was announced on 17 September, with four contending candidates—Mr. Fumio Kishida, Ms. Sanae Takaichi, Mr. Taro Kono, and Ms. Seiko Noda. A younger generation taking the lead and the fact that half of the candidates are women are signs of changing times. With the number of candidates increasing to four, the range for policy discussions has widened, which is good from the public's perspective (Chart 1). Combatting the coronavirus will be the top priority for whoever becomes the next prime minister, and, therefore, fiscal spending is inevitable. At a debate session on the 18th (held by the Japan National Press Club), the path Japan must take after containing the coronavirus was discussed, and subjects of particularly heated debate were pension issues and energy policy. Energy policy, in particular, is now at a crucial crossroads. It will be difficult to suddenly raise the renewable energy weighting within Japan's energy mix. Unless there is a realistic roadmap, Japan's standing in the world in 2050 could be lost. Hopefully, the new government will be able to tackle these issues with the proper sense of crisis.

Chart 1: Policies Held by Four LDP Leadership Election Candidates

	Age	Policy Stances	Specific Stances
Fumio Kishida Former Chair of Policy Research Council (Kishida faction)	64	Income redistribution Favors fiscal reconstruction Inclined towards monetary policy normalization Experience as foreign minister, defense minister	First switchover from neoliberalism since Koizumi reforms. Targeting favorable cycle from growth + income distribution. • "Reiwa Version of Double Income." Raise incomes for medical care, nursing care, and child care workers. • 4 pillars of coronavirus measures: (1) zero medical care refugees, (2) economic measures allowing people to stay at home, (3) use of vaccine certificates, (4) emergency responses to infections * (2) Allocate tens of trillions of yen for handouts, financial support by next spring. ⇒ Aggressive fiscal stimulus in times of emergency with no hurry to normalize monetary policy. • Maintain goal of carbon-free society. Promote restarting of nuclear power plants before building new plants.
Sanae Takaichi Former internal affairs minister (no faction affiliation)	60	Wants to carry over Abenomics Inclined towards expansionary fiscal policy, refutation policies Sanaenomics Conservative	Monetary easing, fiscal stimulus, investment in crisis management, growth investment as pillars of economic policy. Proposes freezing primary balance surplus target until 2% inflation target is reached. Investment in disaster response and growth fields such as semiconductor industry, artificial intelligence (AI). Revise financial income tax system, tax cuts for those working while raising children, providing nursing care. • "Reiwa reorganization of government ministries" with establishment of Environmental Energy and Cyber Security ministries. • Consider enacting new constitution, revising Self-Defense Forces Law.
Taro Kono Administrative reform minister (Aso faction)	58	Promotes decarbonization, digital transformation Fiscal soundness Inclined towards monetary policy normalization Distances himself from Abenomics Experience as foreign minister, defense minister	To move Japan forward with the power of digitization. Sees need to invest in the future. • Tapping emergency funds unavoidable. Views JGBs as funding source for new economic measures, to study scale. • Reaching 2% price target difficult under current conditions. To entrust monetary policy to BoJ. • Restarting nuclear power plants realistic option for realizing carbon free society → softened stance on breaking from nuclear energy. • Wants to quickly proceed with vaccination rollout, prepare for necessary third shot ⇒ As an active minister, has strong image of working on reforms.
Seiko Noda Executive Acting Secretary-General (no faction affiliation)	61	Diversity Green Recovery Party reforms	Women, children as key to growth. Aggressive investment in children. • Establish agency dedicated to children , encourage women to take active roles in society • Achieve zero carbon emissions goal for future generations, must increase supply of renewable energy, spend ¥20tn over 10 years on green-related facility investment • Create sub-hospitals as coronavirus measure, aim to ensure supply of wonder drugs

Source: A variety of information; compiled by Daiwa Securities.

Kono is leading due to expectations of reform, but every election has elements of chance

Hopefully, new prime minister will have practical abilities, driving force, and courage

Long and stable administration is desirable to achieve growth strategy and structural reforms

Takaichi's proposals would entail considerable involvement with BOJ's monetary policy

Amid pandemic, Kishida and Kono would probably rely heavily on BOJ

BOJ not the main focus

Top priority will be reviewing/having discussions about 2% price stability target

New administration will exercise its influence on procedures for choosing BOJ Governor Kuroda's successor

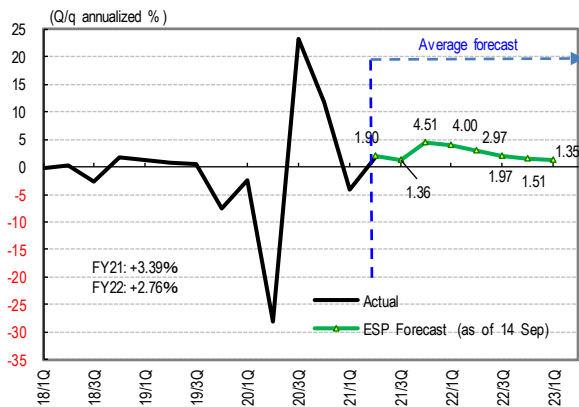
Economic downturn in Jul-Sep caused by (1) spread of coronavirus, (2) chip shortages, and (3) high resource prices

A Kyodo News' survey for LDP rank-and-file members (announced on the 18th) suggested that 48.6% of the votes will go to Kono, 18.5% to Kishida, 15.7% to Takaichi, and 3.3% to Noda (with 13.9% undetermined). As such, Kono has an overwhelming lead. As for trends relating to reform, stability, and conservatism, reform, which has the support of the younger generation, has the momentum. With rank-and-file members voting via reply-paid postcards, their response should be fast. Therefore, one could assume that Kono will win the majority. However, as every election has elements of chance, it is difficult to tell what will happen until all the votes have been counted on the 29th. If the election goes into a run-off, we may find ourselves in an unexpected situation. In any case, we want the new prime minister to present a clear blueprint for Japan's place in the world, its role, and the path it must take, while explaining and pursuing a macro view. Hopefully, the person will have the practical abilities, driving force, and courage needed to weather the Lower House election slated for this fall, as well as the summer 2022 Upper House election. A long and stable administration is desirable, since that is what it takes to achieve a growth strategy and structural reforms.

Takaichi, who has touted her "*Sanaenomics*," would freeze primary balance goals until the 2% inflation target is achieved. This would entail considerable involvement with the BOJ's monetary policy. In her interview with media companies on the 19th, she insisted that the BOJ should give more consideration to employment, although it has not completely disregarded the issue. In contrast, although Kishida and Kono had previously indicated their intentions to normalize monetary policy, for now they would probably rely heavily on the BOJ as the coronavirus crisis response continues. Nonetheless, the BOJ has no option but to continue implementing crisis response measures in partnership with the government until the coronavirus is contained. In the near term, the BOJ's monetary policy will not be the main focus.

Over the medium/long term, it will be important for the BOJ to continue expressing its strong intention for Japan to break free from the grip of deflation. There is also room for discussing employment as a mandate. Nevertheless, the top priority will be reviewing/having discussions to allow for increased flexibility in terms of interpreting the 2% price stability target and how monetary policy is conducted. Moving forward with monetary policy normalization (revising frameworks, abolishing negative interest rates) after containing the coronavirus is also desirable. Consideration will probably be given to concrete methods for removing ETFs from the BOJ's balance sheet as part of an exit strategy that must be prepared ahead of time. In any event, we think the new administration will exercise its influence on procedures for choosing BOJ Governor Haruhiko Kuroda's successor. (Kuroda's term expires on 8 April 2023, and his successor is to be determined from 2H 2022 onwards.) But it is premature to speculate about Kuroda's successor now.

Next, we confirm the current economic conditions. Having had repeated extensions and expansions to the targeted areas, the fourth state of emergency in Japan has been extended until 30 September. Therefore, an economic downturn in Jul-Sep is unavoidable. Compared to initial projections, the global economy is also on a downtrend in that quarter due to (1) the spread of the Delta variant, (2) prolonged shortages of semiconductors, and (3) resource prices hovering at a high level. Japan's economic recovery scenario for 2H 2021 will likely be delayed by about one quarter, which would force us to lower the growth rate projection for FY21 slightly (Chart 2).

Chart 2: Forecasts for Japan's GDP Growth Rate (ESP Forecast Survey)


Source: Cabinet Office, Japan Center for Economic Research; compiled by Daiwa Securities.

Chart 3: Real Exports and Production in Japan


Source: BOJ, Ministry of Economy, Trade and Industry (METI); compiled by Daiwa Securities.

Note: X indicates METI's Aug forecast (mode) of +0.1% m/m.

Industrial production in Jul-Sep will decline q/q

Due to delay in eliminating chip shortages, timing of catch-up production will be pushed back

A concrete issue that is of concern is the fact that the pandemic's resurgence in Southeast Asia has been suspending plant operations and slowing the procurement of components. Toyota Motor was forced to announce twice that it will cut its global production in September and October. The predominant view had been that production constraints would be gradually eliminated between autumn and spring, but that timing is clearly being pushed back. As a result of auto production cuts, overall industrial production in Jul-Sep will decline significantly q/q (my current estimate: -2.0%). This weakness may drag on into the Oct-Dec quarter. The BOJ's Nagoya branch lowered its economic assessment for the Tokai region in September, describing a pause in recovery activity. This was its first downward revision in 16 months and reflects production cutbacks in the core auto industry. For both production and exports, it lowered its assessment from "have been on an increasing trend" to "are treading water."

Cut in mobile phone communication fees had major impact on CPI after revision to base year, pushing down readings

Turning to price trends, resource prices remain high, which is worsening Japan's terms of trade. It is feared that this will put downward pressure on corporate earnings. Because of the change in the CPI base year, the reduction in mobile phone communication fees had a major impact on the nationwide July core CPI, pushing it into negative territory at -0.2% y/y. Nevertheless, the core CPI remained slightly positive when excluding the reduction in mobile phone communication fees, and we expect underlying price trends to remain firm. Inflation is still far from the 2% price stability target, however.

Sep MPM is expected to be uneventful

These are the circumstances under which the BOJ will hold a Monetary Policy Meeting (MPM) on 21-22 September. Given that downside risks to the economy remain because of the spread of the Delta variant, we expect the current policy accommodation to continue. The BOJ will probably decide at its December policy meeting whether to extend its special pandemic programs, now set to expire at end-March 2022. Regarding its fund provisioning measures to address climate change (the basic outline of which was announced at the July MPM), we hope for the formulation of the principal terms and conditions in order for operations to start by the end of the year. The BOJ is expected to review terminology in response to situational changes, giving consideration to usage.

Can BOJ formulate principal terms and conditions of fund provisioning measures to address climate change?

We are focusing on how description of production will be revised

The BOJ will likely modify its description of current production in its upcoming monetary policy statement. Key will be how it writes about the auto production cuts caused by the shortage of semiconductors (Chart 4). While there are transitory weaknesses in some areas, the scenario for a future recovery as supply constraints are eliminated remains in place. We think downward revisions to the FY21 outlook for growth and prices in the October *Outlook for Economic Activity and Prices* report are unavoidable, but as long as there is no change in the outlook for future improvement, we expect policy to remain on hold.

Chart 4: Change in Description of BOJ's Economic Assessment on Current Conditions

	Jul-21
Current condition	⇒ Anticipated revisions in Sep
Japan's economy	Has picked up as a trend, although it has remained in a severe situation due to the impact of COVID-19 at home and abroad ⇒ Unchanged or addition of description of weakness?
Overseas economies	Have recovered on the whole, albeit with variation across countries and regions ⇒ Unchanged
Exports	Have continued to increase steadily ⇒ Removal of "steadily" ?
Business fixed investment	Has picked up, although weakness has been seen in some industries ⇒ Unchanged
Private consumption	Has been stagnant due to strong downward pressure on consumption of services, such as eating and drinking as well as accommodations ⇒ Unchanged
Public investment	Has continued to increase moderately ⇒ Remains flat at high levels?
Housing investment	Has stopped declining ⇒ Signs of recovery?
Industrial production	Has continued to increase steadily ⇒ Downward revision may be made—"weakness is partially observed" regarding auto production cut due to chip shortages
Financial conditions	Have been accommodative on the whole, although weakness in firms' financial positions has been seen ⇒ Unchanged
Prices	Y/y change in CPI has been at around 0% recently due to the rise in energy prices, despite being affected by COVID-19 and the reduction in mobile phone charges. Meanwhile, inflation expectations have been more or less unchanged. ⇒ Revision to negative territory due to change in base year

Source: BOJ; compiled by Daiwa Securities.

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