

# Daiwa's View

## Summer is crucial for Japan's economy; fruitful autumn is awaited

- At Jul meeting, BOJ is expected to decide to persistently continue with easing, and postpone any decisions on its Covid-19 special financing operations

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**G20 was unable to release communiqué due to differing situations and positions with each nation**

**IMF warned against fiscal support, and intends to substantially lower economic growth projections**

**Eventual reworking of 2% price targets likely in Europe/US once limits of monetary policy recognized**

**Expected role of BOJ unlikely to change until Kishida administration puts more of its own personal touch on policy**

**In BOJ's Jul *Outlook Report*, FY22 and FY23 growth rate projections are expected to be lowered**

**Focus of attention includes timing of output gap turning positive and whether there is further revision**

### Summer is crucial for Japan's economy; fruitful autumn is awaited

The meeting of the G20 Finance Ministers and Central Bank Governors, held on 15-16 July in Bali in Indonesia, ended without any communiqué being released. Challenges are piling up, such as the war in Ukraine and sanctions against Russia, prolonged inflation, recession concerns, and COVID-19 measures. Working in a coordinated manner is difficult with each nation having its own situation and position. In her post-meeting interview, IMF Managing Director Kristalina Georgieva pointed out that "If help is not well-targeted, it might be that providing support to populations in an un-targeted manner creates more pressure for prices to go up." She warned against the risk that governments may undo central bankers' work in fighting inflation. The IMF also intends to substantially lower its projections for the global economic growth rate to be released by end-July.

For now, major central banks are still more eager to contain inflation than address economic risks. However, I believe that the limits of monetary policy will eventually be recognized. In that case, the US and Europe will be forced to rework their 2% price targets. In Japan, the ruling Liberal Democratic Party (LDP) won a decisive victory in the 10 July Upper House election. According to subsequently announced opinion polls by Kyodo News and Mainichi Shimbun newspaper, the approval rate of the Kishida administration has risen. However, the sudden death of former Prime Minister Shinzo Abe on 8 July has made management and coordination within the LDP difficult to predict. Indeed, it feels as if time in Japan is going to stop for a while. The initial focus will be on the party's executive appointments and a Cabinet reshuffle in early August. The expected role of the BOJ is probably unlikely to change until the Kishida administration starts to put more of its own personal touch on policy.

Amid this situation, the BOJ releases its July *Outlook for Economic Activity and Prices* report (*Outlook Report*) on 21 July. Both FY22 and FY23 growth rate projections (medians of forecasts by the majority of Policy Board members) are expected to be lowered slightly, as production is getting off to a bad start in FY22 and the global economy is expected to slow down in FY23 (Chart 1). In the previous report (April), the BOJ revised its explanatory text for the output gap to push back the timing, saying that "the output gap is projected to turn clearly positive around the second half of fiscal 2022 and then continue to expand moderately" (Chart 2). A focus of attention in the July report is whether this expression is revised to push back the timing further alongside a downward revision to the FY22 economic growth rate. From here, we can read the BOJ's fundamental-based view on the time frame of its persistent easing measures.

**Chart 1: Projections by BOJ Policy Board Members (median, y/y %)**

	Real GDP			Core CPI		
	Apr 2022*	Jul 2022**	My forecasts	Apr 2022*	Jul 2022**	My forecasts
FY22	2.9	2.4	2.3	1.9	2.2	2.2
FY23	1.9	1.7	1.8	1.1	1.2	1.3
FY24	1.1	1.2	1.1	1.1	1.2	1.4

Source: BOJ, various materials; compiled by Daiwa Securities.

\*BOJ projections.

\*\*My estimates for policy board member projections.

**BOJ expected to raise FY22 price projection to the lower 2% range**

**FY23 price projection should be smaller than FY22 projection under assumption that inflation is transitory**

**Japan exports/production weak in Apr-Jun despite strong pent-up demand**

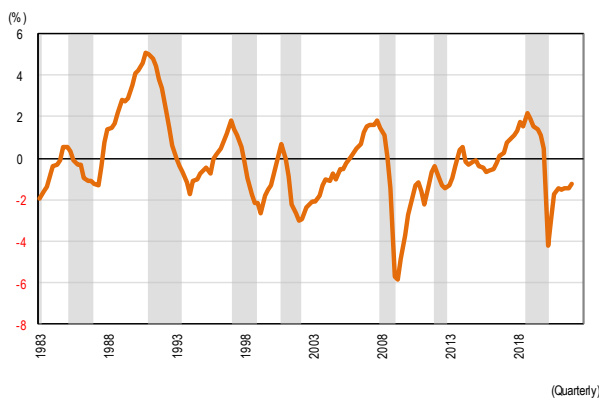
**With COVID-19 continuing to be factor, Jul-Sep will be crucial for Japan's economic recovery scenario**

**Discussions on Japan's monetary policy normalization are unlikely until autumn**

Turning to price (core CPI) projections, changes in the external environment over the past three months include a pause in an uptrend of crude oil prices (the WTI currently at \$100/bbl, almost the same level as in mid-Apr). In contrast, the yen has weakened (the USD/JPY rose from the Y126 level to the Y138 level), increasing its impact on rising import prices (Chart 6). Based on reports of companies passing on higher raw material prices to their customers by autumn(Chart 7), various media outlets now expect the BOJ to raise its FY22 price outlook from the +1.9% as of April to the lower 2% range (Chart 1). As the BOJ is expected to adhere to its position that inflation is transitory, its FY23 price projection should be smaller than its FY22 projection. Accordingly, an upward revision to the BOJ's price outlook is not going to lead to a policy change.

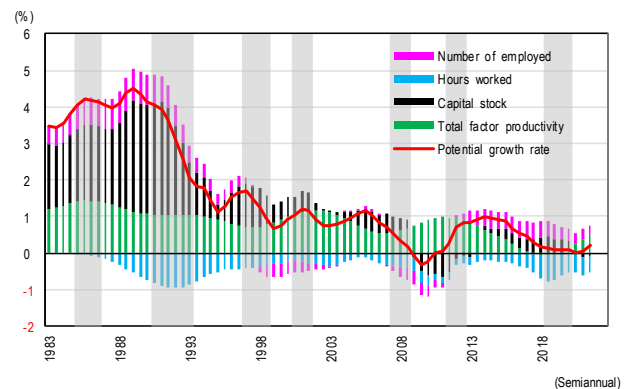
The *ESP Forecast* released on 12 July (30 Jun-7 Jul survey period; averages for 36 respondents) calls for Japan's real GDP to grow 3.18% q/q on an annualized basis in Apr-Jun and 3.38% in Jul-Sep (Chart 4). Strong consumer spending following a long period of holding back amid the pandemic is seen as the driver of Apr-Jun GDP (first quarterly estimate due out on 15 Aug). However, growth could be smaller than initially expected on weaker exports and production due to (1) shortage of semiconductors and (2) stagnant logistics caused by China's zero-corona policy. The current Jul-Sep quarter is viewed as the first summer in three years with no COVID-related restrictions on activity. As such, demand is expected to recover, mainly in the travel sector. That said, uncertainty remains high as the number of new COVID cases has begun to increase in recent months. The Jul-Sep quarter will be a key test of Japan's economic recovery scenario and successful coexistence with COVID. Meanwhile, the estimated potential growth rate for 2H FY21 (released on 5 Jul) was +0.22%, up from +0.14% in Oct-Dec (Chart 3). If a moderate rise takes root going forward, full-scale discussions on monetary policy normalization are likely to progress. We are now waiting for the figures for 1H FY22. Once October's *Outlook Report* is announced, we will have a clearer picture than we do now.

**Chart 2: Trend of Output Gap Estimated by BOJ**



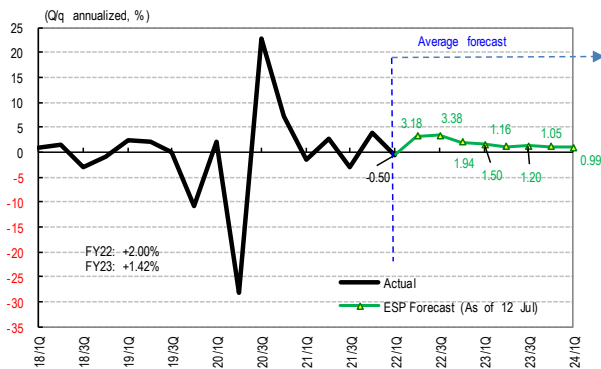
Source: BOJ; compiled by Daiwa Securities.  
Note: Shaded areas indicate recessions.

**Chart 3: Trend of Japan's Potential Growth Rate**



Source: BOJ; compiled by Daiwa Securities.  
Note: Shaded areas indicate recessions.

**Chart 4: Japan's Growth Rate Forecasts in ESP Forecast Survey (Jul 2022 survey)**



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

**Japan's core CPI is expected to stay in the lower 2% range by end-2022**

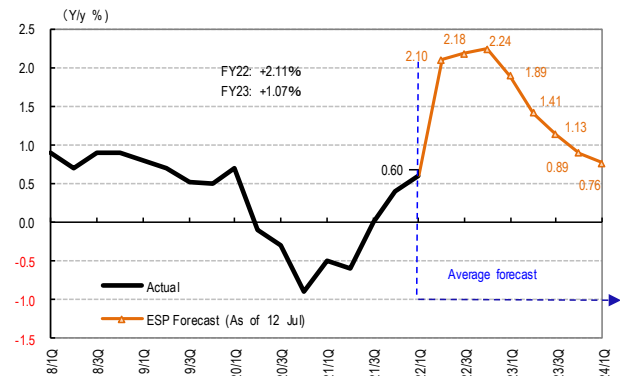
**FY23 price projection should be smaller than FY22 projection under assumption that inflation is transitory**

**As short-term measures to address price hikes are unlikely to suffice, fiscal outlays will likely increase**

**At Jul meeting, BOJ expected to tenaciously maintain easing stance, and postpone decision on special financing operations in response to COVID-19**

**Focus toward autumn on yen depreciation trend, Cabinet approval rating, percentage of JGBs held by BOJ**

**Chart 5: Japan's Core CPI Forecasts in ESP Forecast Survey (Jul 2022 survey)**

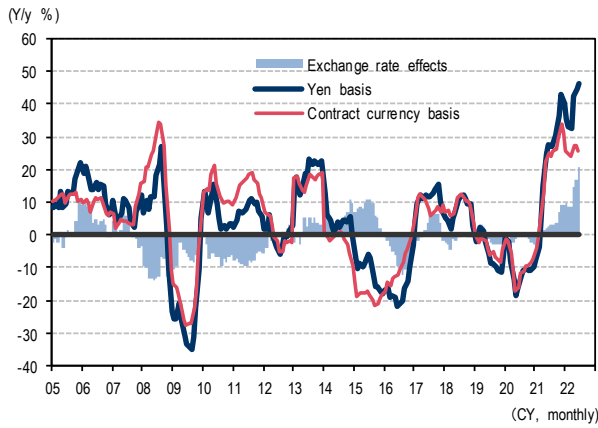


Source: Ministry of Internal Affairs and Communications (MIC), Japan Center for Economic Research; compiled by Daiwa Securities.

Meanwhile, the average forecast for Japan's Apr-Jun core CPI in the July *ESP Forecast* is 2.10% growth y/y due in part to the drag from lower mobile phone fees dropping off in April. Core CPI is then expected to grow 2.24% for the Oct-Dec quarter on a prolonging of high resource prices and yen depreciation, followed by a gradual decline thereafter (Chart 5). If the yen weakens further going forward, core CPI may approach 3%. Even if these moves are in line with expectations, short-term measures to address price hikes will not suffice and fiscal outlays will likely increase. The first step will probably be the compiling of a second supplementary budget. In the corporate inflation outlook section of the June Tankan, all-size enterprises/all industries expect 2.0% y/y inflation (general prices) three years from now. The medium/long-term inflation outlook reached 2% for the first time (Chart 9). With the environment surrounding prices in Japan changing substantially, the government and the BOJ need to discuss their views on prices once again

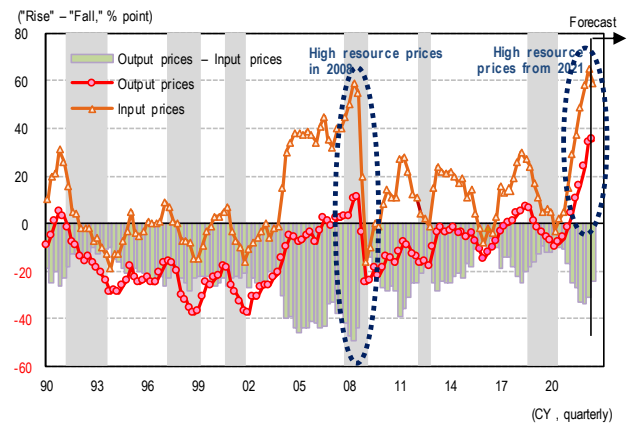
As mentioned above, Japan's economic outlook for FY22 is expected to be revised downward, while the price outlook is expected to be revised upward in the BOJ's July *Outlook Report*. Japan's economy has not returned to its pre-coronavirus level and even if the CPI exceeds 2%, that upward move would be due to cost-push inflation, which could weigh on the economy. At its Monetary Policy Board meeting on 20-21 July, the BOJ will probably tenaciously maintain its current monetary easing stance, as it has in the past. We expect the Bank will postpone any decision for its "Special Program to Support Financing in Response to the Novel Coronavirus," which is set to expire in September. This is because the government remains cautious about lifting coronavirus measures. Still, the ECB is expected to start raising interest rates on the evening of the 21 July. Looking around the world, the BOJ's stubborn easing stance is easily targeted and yen selling positions held by foreign investors is likely to swell. In the event of sharp yen depreciation, the US, which is focused on containing inflation, is unlikely to tolerate any forex market intervention that weakens the dollar. A situation in which the Kishida administration and MOF ask the BOJ to be more flexible could arise. Towards this fall it will be important to keep an eye on (1) yen depreciation trends (sudden and not due to USD appreciation), (2) approval rating for the Kishida administration, and (3) percentage of JGBs held by the BOJ.

**Chart 6: Trend of Japan's Import Price Index**



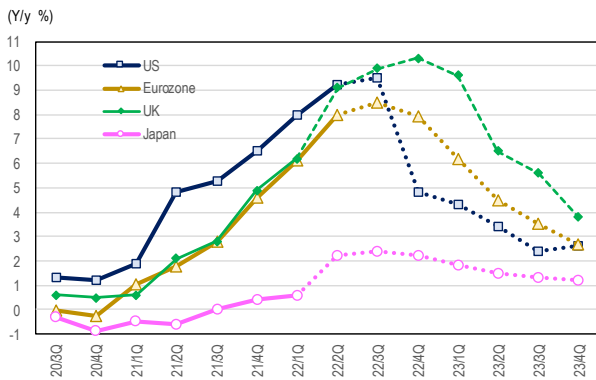
Source: BOJ; compiled by Daiwa Securities.

**Chart 7: Price DIs at Major Manufacturers in BOJ Tankan**



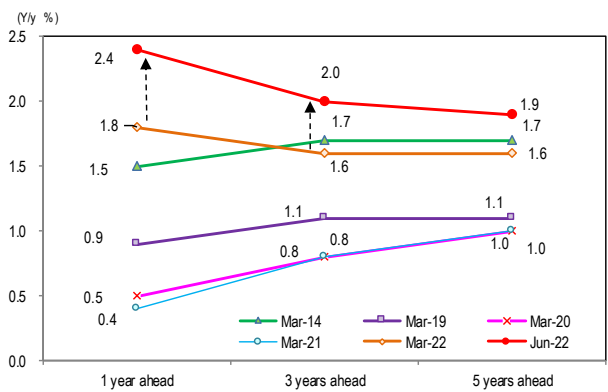
Source: BOJ; compiled by Daiwa Securities.  
Note: Shaded areas indicate recessions.

**Chart 8: CPI in Japan, US, and Europe (headline)**



Source: US Department of Labor, Eurostat, Office for National Statistics of UK, MIC; compiled by Daiwa Securities.  
Note: Regarding data from Apr-Jun quarters onwards, forecasts by Daiwa Capital Markets America are used for US, those by Daiwa Capital Markets Europe are used for Europe and UK, and my forecasts are used for Japan (core CPI).

**Chart 9: Inflation Outlook of Enterprises in BOJ Tankan (all-size enterprises/all industries)**



Source: BOJ; compiled by Daiwa Securities.

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