

Daiwa's View

BOJ to release wishful report amid declaration of state of emergency

- Main factors in FY21 are vaccinations and cut in mobile phone communication fees

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Third SOE declared in Japan; stricter restrictions than previous SOE despite short period of time

Optional service consumption accounts for about 16% of total consumption; economy will remain stagnant in Apr-Jun

Cautious response needed in lifting SOE

No change to *Outlook Report's* main scenario in which economy gradually recovers from sharp contraction

BOJ to release wishful report amid declaration of state of emergency

In Japan, the government declared a third state of emergency (SOE) for four prefectures (Tokyo, Kyoto, Osaka, and Hyogo) from 25 April to 11 May in order to contain the fourth wave of the COVID-19 pandemic. Although it is limited to certain areas and only covers the short period over the Golden Week holidays, the restrictions are stricter than those in the previous SOE in January—in particular, the requests to suspend operations at karaoke establishments and eating/drinking establishments serving alcoholic drinks, large-scale commercial facilities, and department stores (excluding daily necessities), as well as large-scale events with no audience. Optional service consumption (eating out, entertainment, transportation, travel/accommodations) accounts for around 16% of personal consumption in Japan's GDP. Due to economic activity being stopped artificially in this way, stagnation will probably not be limited to the Jan-Mar contraction, and continue in Apr-Jun. Furthermore, if the Tokyo Summer Olympics are going to be held starting 23 July, the government will have to reduce coronavirus cases by mid-May. Lifting the SOE prematurely would raise the risk of a resurgence of cases similar to India and Chile. A cautious response is necessary, at least until vaccinations of the elderly have been completed.

Amid the increasingly poor visibility for future prospects, the BOJ on 27 April will release its *Outlook for Economic Activity and Prices (Outlook Report)* for April. At the 15 April meeting of the BOJ branch managers, Governor Haruhiko Kuroda's opening remarks included new wording regarding the Bank's economic assessment. Specifically, he said that "downward pressure on the consumption in face-to-face services is likely to continue especially in the near term due to the resurgent coronavirus cases since autumn 2020." Before the declaration of third SOE, he already showed the cautious outlook. On 18 April, Minister for Administrative Reform and Regulatory Reform Taro Kono said that Japan is expected to acquire enough coronavirus vaccines by the end of September to inoculate all eligible residents. There are still expectations that Japan's economy can gain momentum toward the end of this year, provided the vaccine rollout proceeds smoothly. Even if the economy stalls in the Apr-Jun quarter, such weakness could be viewed as a temporary phenomenon, provided the economy's vector for FY21 ultimately points upward. There is probably no change to the BOJ's main scenario in which the economy gradually improves from here, recovering from the sharp contraction brought about by last spring's demand shock.

Apr Reuters Tankan: sharp improvement in corporate sentiment mainly among manufacturers; drivers shifting from autos to metal products/machinery and electric machinery

Non-manufacturers posted pronounced differences among sectors

Mar exports driven by autos and nonferrous metal

Slowing growth in exports in Jan-Mar

For now, auto production cut to continue due to chip shortage

Catch-up production is possible provided temporary supply constraints are resolved

Upward revision for FY20 growth expected

Oct-Dec economy, especially consumption, was stronger than initial estimates

Growth forecast for FY21 will remain largely unchanged, albeit different recovery path

Recovery to pre-pandemic levels expected in FY22

Growth in FY23 will be sustained and top potential growth rate

According to the April Reuters Tankan released on 16 April (2-13 Apr survey period), business sentiment, particularly among manufacturers improved sharply due to strength for the US and China economies (Chart 1). This upbeat sentiment came despite continued growth in coronavirus cases since lifting Japan's SOE with the "manbo" quasi-state of emergency measures adopted in some regions. Manufacturing, particularly processing-type manufacturing, improved to the highest level since February 2019. Going forward, the driver is expected to switch from autos/transport equipment to metal products/machinery and electric machinery. Meanwhile, sentiment among non-manufacturers improved only modestly, recovering at a slower pace compared to manufacturers. Some respondents said that stay-at-home consumption and construction demand were upbeat, but weakness among those industries providing face-to-face services was clearly evident. Differences among industries were pronounced. The forecast for non-manufacturers seems close to turning positive on expectations for improvements, but realizing such an outcome is probably challenging due to the declaration of the SOE. More time will be needed before non-manufacturers can return to pre-coronavirus levels—a feat probably not likely until the outbreak is contained.

March trade statistics, released on 19 April, grew on boosts from automobile exports to the US and nonferrous metal and plastic exports to Asia. Meanwhile, pharmaceuticals (vaccines) boosted imports. March BOJ real exports grew a strong 3.1% m/m (Chart 2), but Jan-Mar exports increased only 1.9% q/q (up for third straight quarter), a much slower pace compared to the 10.5% growth in Oct-Dec 2020. Still, Japan should benefit if there is continued strength for the US and China economies, which combined account for just under 40% of all Japanese exports. However, on the production front, the shortage of semiconductors was further compounded by the 19 March plant fire at Japanese chip giant Renesas Electronics. These temporary supply constraints are likely to result in some production cuts among the semiconductor and automobile industries at least through Apr-Jun. Regarding March industrial production data, due out on 30 April, the market median estimate is -2.0% m/m, a decline for a second straight month. The Survey of Production Forecast for Apr-May (survey as of 10 Apr) will probably confirm a downward revision from the initial outlooks. Still, a switch to catch-up production is possible from Jul-Sep provided these supply constraints are gradually resolved. Our focus is on whether the BOJ will change the wording for its assessments of current exports and production (Chart 4).

Preparing forecasts for the April *Outlook Report*, particularly for economic growth, seems challenging due to very poor visibility. According to the ESP Forecast Survey released on 8 April (Apr forecast average, survey period of 29 Mar-5 Apr with 36 responses), professional forecasters in Japan expect real GDP to contract at an annual rate of 6.09% in Jan-Mar followed by 5.63% growth in Apr-Jun (forecasts of -4.93% for FY20, +3.92% for FY21, +1.92% for FY22). An upward revision is expected for FY20 growth in line with the release of related data (Chart 3). Oct-Dec 2020 real GDP grew an annualized 11.7% q/q (second preliminary estimate) with stronger consumption compared to the assumptions as of January. Since then, the economic contraction in Jan-Mar was unavoidable in light of Japan's SOE declaration. Still, people were free to move about during the day time, which provided some support to the economy, along with the good stay-at-home consumption. The pullback that quarter could be smaller than initially expected.

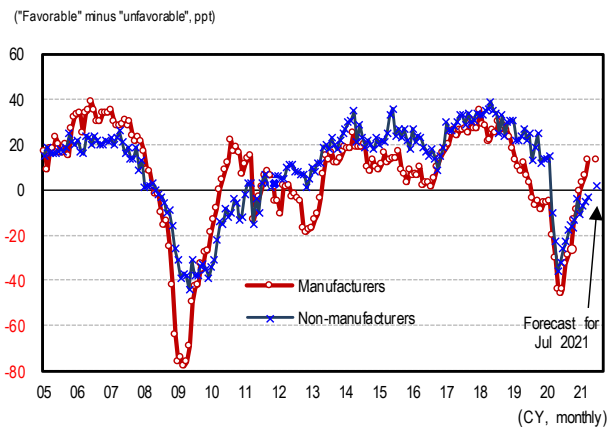
Meanwhile, a rebound in Apr-Jun (from Jan-Mar) now seems unlikely due to the SOE declaration. That said, there is the chance that the growth forecast for FY21 will remain largely unchanged (albeit different recovery path expected) provided the economic recovery accelerates from Jul-Sep on a gradual resolving of semiconductor supply constraints and better progress rolling out vaccines. The final tally will likely land near the government's projection for 4.0% growth. Even if Apr-Jun is weak, we can probably assume that growth from Jul-Sep should be stronger than expected as of January. If conditions return to normal (recovery to pre-outbreak levels) in FY22 thanks to better vaccine uptake, there is a good chance that this growth will top the potential growth rate. The outlook for FY23, released for the first time, assumes that a high growth rate trend will continue.

Slow improvement in output gap

External conditions not conducive for sudden downward price pressure

Turning to price (core CPI) forecasts, a negative output gap is expected to persist for now. In terms of externals, the yen has depreciated versus the dollar, moving below the mid-range from three months earlier (from around USD/JPY103 to around USD/JPY108), while the crude oil price rose gradually (from USD50/bbl to over USD60bbl [WTI]). All told, conditions are not conducive for sudden downward price pressure.

Chart 1: Business Sentiment DI in Reuters Tankan (400-company basis)



Source: Reuters; compiled by Daiwa Securities.
Note: Apr survey conducted during 2-13 Apr.

BOJ expects inflation to not reach 1% until FY22

2% price target will remain well out of reach even in FY23, but BOJ to maintain easing policy, positioning 2% inflation as medium/long-term target

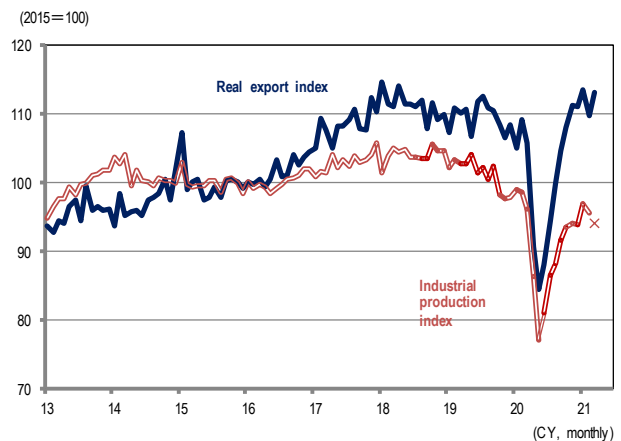
After Mar assessment, wait-and-see approach to be taken for BOJ's near-term policy

Until coronavirus is contained, top priority is to stabilize financial system

From FY21 the growth rate will turn positive and the output gap will start to improve, but a sudden rise in wages seems unlikely. Considering the lower mobile phone communication fees from April, a downward revision for FY21 seems unavoidable. April Tokyo CPI, due out on 30 April, should provide a more accurate picture of these impacts, but a drag of around -0.3% to -0.5% is expected, depending on how to deal with cheap plans. This time our focus is on whether the BOJ indicates the key indicator it uses when making its overall price assessment, namely core CPI excluding impacts from lower mobile phone communication fees, or whether it shows factors weighing on prices in the report footnotes. The 2% price target will likely remain well out of reach, even in the new figures for FY23. The BOJ has to tenaciously maintain its current monetary easing policy, positioning 2% inflation as a post-coronavirus medium/long-term target as it waits for the output gap to again turn positive. After the March assessment, a wait-and-see stance is expected for the near-term policy.

The April *Outlook Report* will continue expressing caution regarding downside risks, but that does not mean the BOJ's outlook for the economy will be revised down sharply. There are still hopes for a recovery. Going forward we want to monitor how gaps in US/Japan vaccine rollouts produce meaningful differences in their respective economic and price trends, along with differing impacts on their respective interest rates. The BOJ will also collect and analyze information, paying careful attention to trends in the US. Until the coronavirus is contained, the top priority at the BOJ is to stabilize the financial system. From its April meeting, the BOJ's Financial System and Bank Examination Department will begin releasing its report on financial system trends (four times a year).

Chart 2: Real Exports and Production in Japan



Source: BOJ, Ministry of Economy, Trade and Industry (METI); compiled by Daiwa Securities.
Note: X indicates METI's forecast (mode) for Mar production of -1.4% m/m.

Chart 3: Projections by BOJ Policy Board Members (median) and Our Forecasts (y/y)

	Real GDP			Core CPI*		
	Jan 2021	Apr 2021**	Our forecast	Jan 2021	Apr 2021**	Our forecast
FY20	-5.6 %	-5.2 %	-4.9 %	-0.5 %	-0.4 %	-0.4 %
FY21	+3.9 %	+4.0 %	+3.9 %	+0.5 %	+0.3 %	+0.2 %
FY22	+1.8 %	+2.2 %	+2.4 %	+0.7 %	+0.8 %	+0.7 %
FY23	-	+1.5 %	+1.6 %	-	+1.2 %	+1.0 %

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

*FY20 figures include impact of consumption tax hike.

**Our estimates for policy board member projections.

Chart 4: BOJ's Description on Current Conditions/Outlook for Economic Assessment

Jan-21	
Current condition ⇒ Anticipated revisions in Apr	
Japan's economy	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
Overseas economies	Overseas economies also have picked up, although the impact of the resurgence of COVID-19 has been seen in part. ⇒ Strength in US and China maybe included?
Exports	Have continued to increase ⇒ Downward revision to "recent slowdown in growth pace"?
Capex	Has stopped declining on the whole, albeit with variations across industries ⇒ Unchanged
Private consumption	Has picked up gradually as a trend, but downward pressure has increased recently on consumption of services, such as eating and drinking as well as accommodations ⇒ Revision to "downward pressure on face-to-face service consumption is likely to continue due to impact of resurgence of COVID-19 since last autumn"?
Public investment	Has continued to increase moderately ⇒ Unchanged
Housing investment	Has declined moderately ⇒ Unchanged
Industrial production	Have continued to increase ⇒ Downward revision to "recent slowdown in growth pace"? Is chip shortage touched on?
Financial conditions	Have been accommodative on the whole but those for corporate financing have remained less so, as seen in weakness in firms' financial positions ⇒ Unchanged
Prices	Y/y change in CPI has been negative, mainly affected by COVID-19, the past decline in crude oil prices, and the "Go To Travel" campaign ⇒ Unchanged except for removal of "Go To Travel" factor
Outlook	
Japan's economy	With the impact of COVID-19 waning gradually, is likely to follow an improving trend, supported by a recovery in external demand, accommodative financial conditions, and the government's economic measures ⇒ Unchanged
Prices	Y/y change in CPI is likely to be negative for the time being. downward pressure on prices is projected to wane gradually along with economic improvement. Y/y change in CPI is expected to turn positive and then increase gradually. ⇒ Unchanged

Source: BOJ; compiled by Daiwa Securities.

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[Standard & Poor's]

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