Japan Economic Update

1) Amidst its worst Covid-19 outbreak, Japan has significantly ramped up progress on vaccination

While the arrival of the Delta variant caused a record Covid-19 outbreak over the summer, the incidence of the virus in Japan remains low. Cases have fallen more recently, reflecting restrictions in 21 prefectures and – more durably – belated progress in vaccinating Japan's population, which the government aims to complete by November.

2) Japan's recovery has been set back by new coronavirus waves, but so far by less than expected

Japan's economy unexpectedly advanced modestly in Q2 as a recovery in business capex and ongoing growth in exports and government spending was joined by a surprise lift in private consumption – the latter pointing to reduced compliance with restrictions and so potentially explaining the height of the summer virus outbreak. While activity appears to have remained robust in July, consumer spending is likely to have fallen in August.

3) Pre-Covid-19 GDP peak still unlikely to be recaptured until 2023

With vaccine progress and border re-opening likely to drive a strong global economy, and domestic fiscal and monetary providing stimulus, Japan's recovery should continue. Even so, it will likely take until 2023 for Japan to recapture the pre-pandemic peak of activity, which occurred before the consumption tax hike in October 2019.

4) Beyond the unwinding of base effects, the outlook for inflation remains weak

While underlying inflation is not as weak as suggested by the exclusion-based core CPI measures, it remains weaker than prior to the pandemic with no sign of the lift in CPI inflation or inflation expectations seen in other countries. However, the BoJ will likely continue to refrain from cutting rates further given worries about possible negative side-effects, even though it continues to insist that it is ready to do so if needed.

5) No matter who wins the LDP leadership vote, the LDP will very likely win the General Election

Polls suggest that Suga's replacement as LDP president will very likely win the General Election, likely to be held in November. We expect fiscal and monetary policy continuity, with a supplementary budget of perhaps as much as ¥30trn likely to be unveiled in December, and so see no major implications for Japan's topline economic outlook.

Daiwa Capital Markets

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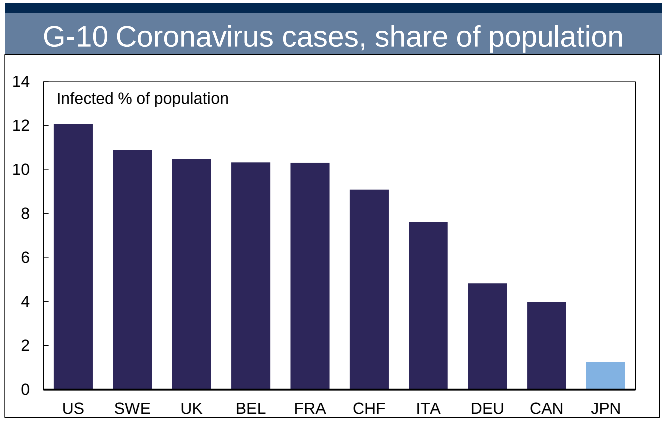
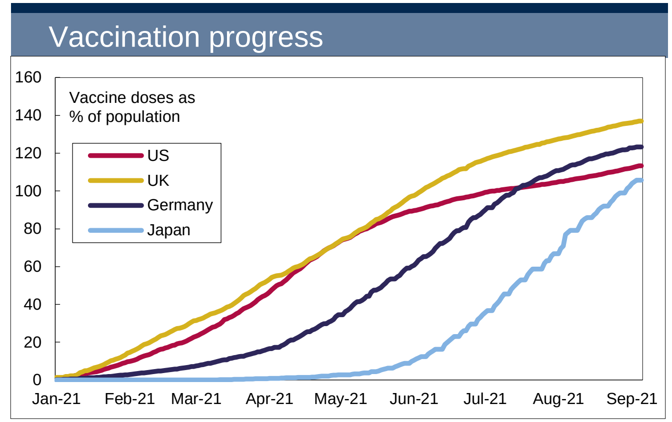
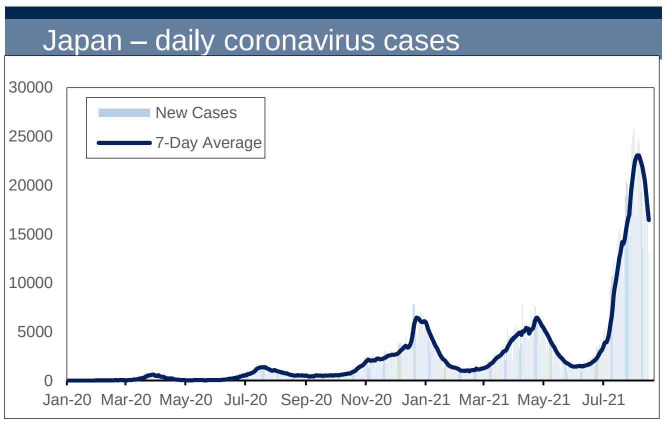
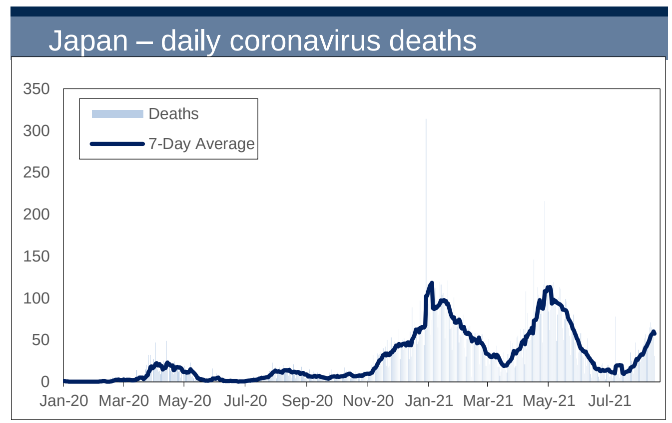
Emily Nicol, Economist Emily.nicol@uk.daiwacm.com

While the delta variant has led to record virus cases in Japan, deaths remain low with vaccination lifting after a slow start









Source: Refinitiv, Bloomberg, Wikipedia and Daiwa Capital Markets Europe Ltd.

- As elsewhere, Japan has struggled with the delta variant but cases remain low relative to other major countries. And while cases in Japan have far surpassed earlier waves of the virus, deaths remain below previous peaks amidst a vaccination drive that has developed strong momentum following a very slow start.

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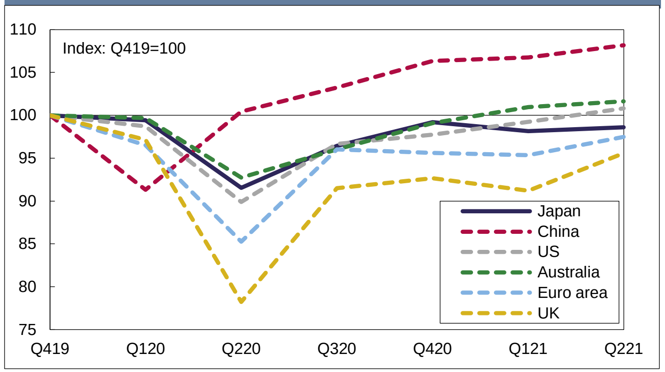
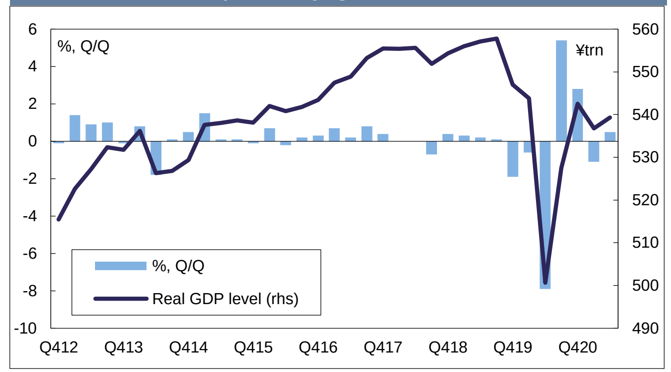
Capital Markets

Japan’s GDP still tracking below pre-pandemic levels

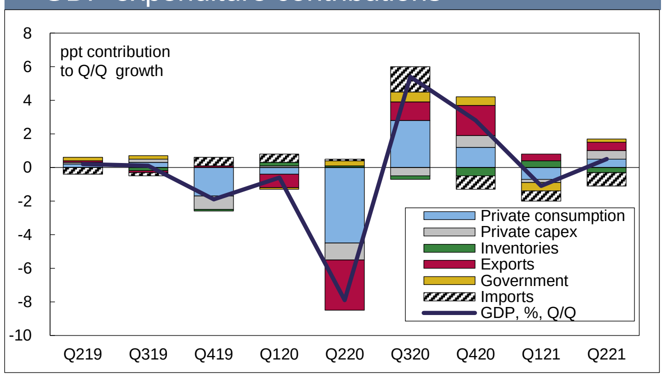
GDP level – selected economies



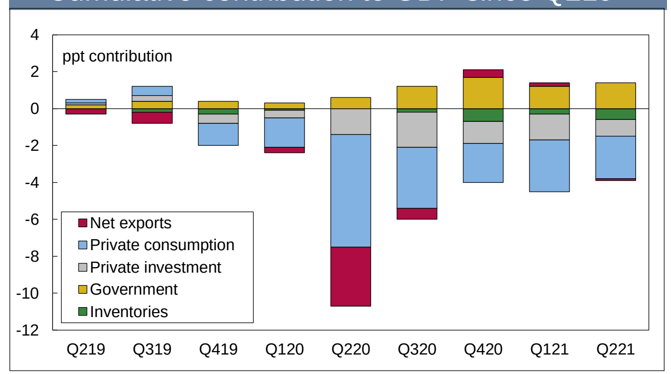
Real GDP – quarterly growth and level



GDP expenditure contributions



Cumulative contribution to GDP since Q219

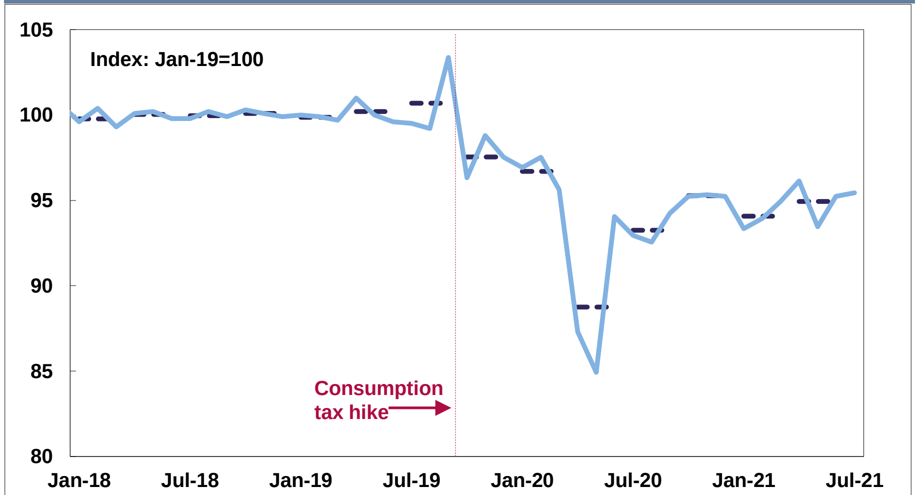


Source: Refinitiv, Bloomberg, Cabinet Office and Daiwa Capital Markets Europe Ltd.

- Japan’s GDP remains about 1.5% below its pre-pandemic level and 3.3% below the pre-tax hike level, with higher government spending failing to offset lower private consumption and investment. Japan’s performance is superior to that in Europe but lags the US, Australia and South Korea. Of course all these lag the recovery in China.

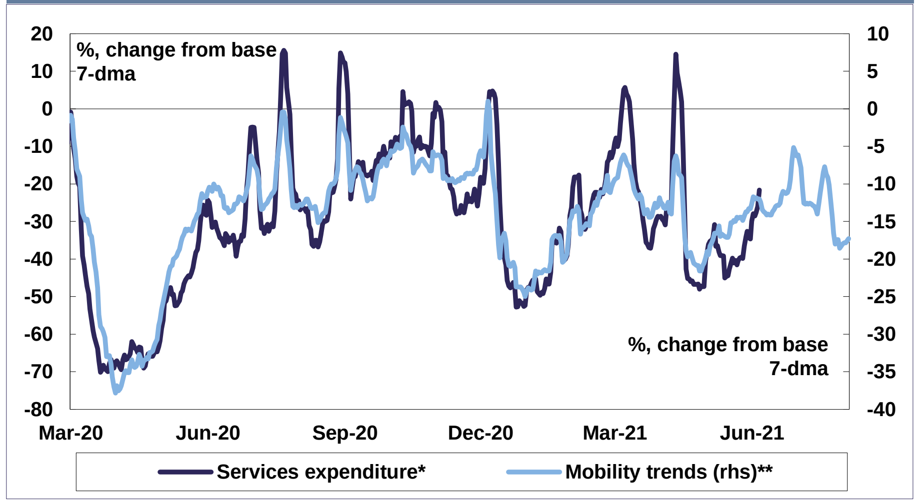
Japan's household consumption has held up surprisingly well

Cabinet office synthetic consumption index*



*Dashed dark blue line represent quarterly averages. Source: Cabinet Office, Refinitiv and Daiwa Capital Markets Europe Ltd.

Mobility trends and selected services spending



*Expenditure on public transport, accommodation, meals out and other entertainment services. **Travel for retail and recreation. The base is the median of the corresponding day of the week during period 3 Jan – 6 Feb 2020. Source: Bloomberg, Google Mobility Report, MIC and Daiwa Capital Markets Europe Ltd.

- Japanese consumption spending has exhibited a degree of resilience this year despite ongoing waves of the virus, with overall spending rising unexpectedly in Q2.
- Mobility data collected by google suggests that the significant delta wave of cases may have begun to impact spending on transport and hospitality services from around mid-August, however.

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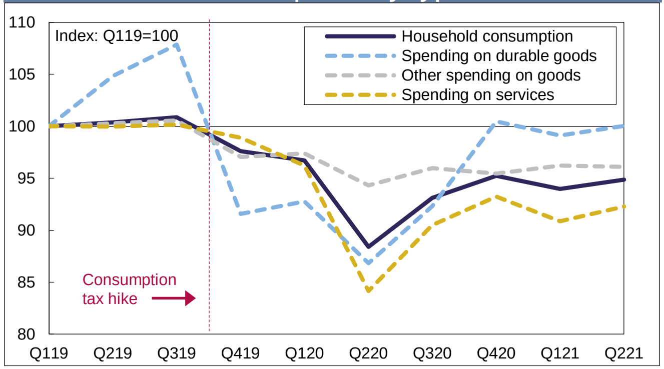
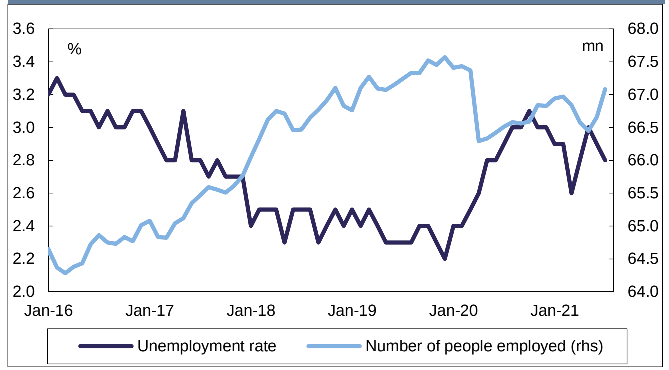
Consumption is underpinned by demand for durable goods, improved optimism and jobs market, and pandemic savings

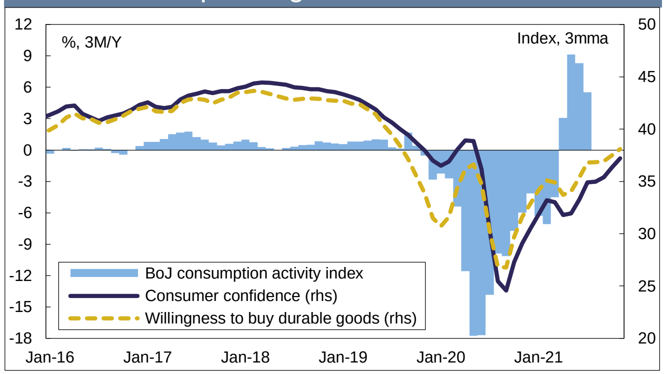
Household consumption, by type



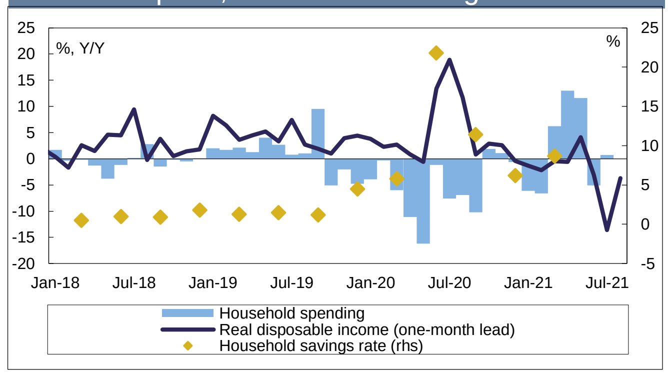
Employment and unemployment rate



Consumer spending and confidence*



Consumption, income and saving



*Consumer confidence has 3-month lead. Source: Refinitiv, Bloomberg, Cabinet Office, MIC and Daiwa Capital Markets Europe Ltd.

- While spending on services remains well below its pre-pandemic trend, spending on goods – especially durable goods – has been more resilient. Meanwhile, employment and consumer confidence have lifted off their pandemic lows and households have recourse to previously saved cash stimulus payments.

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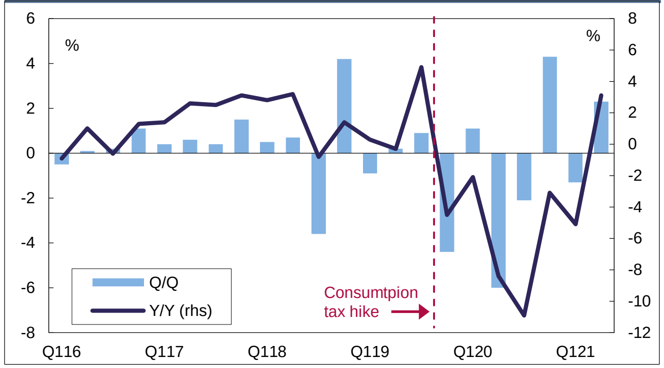
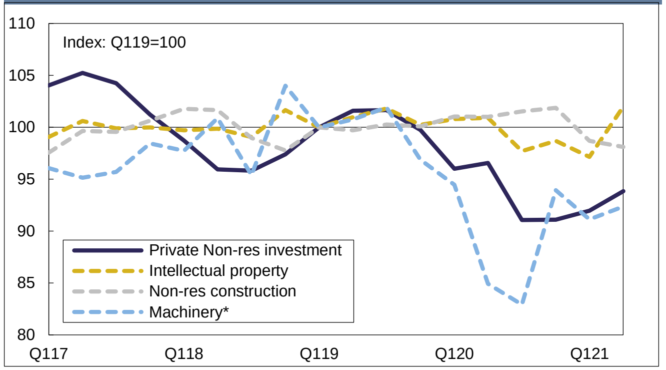
Japan's business capex recovery resumed in Q2

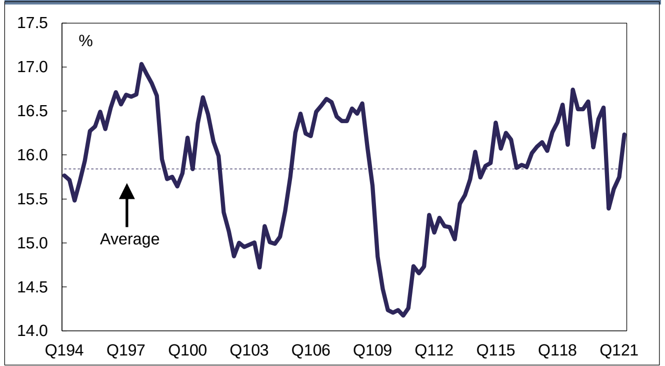
Non-residential investment growth



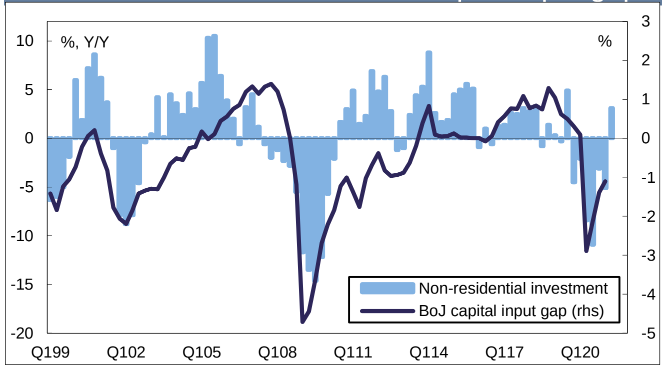
Non-residential investment, level by asset



Non-residential investment, share of GDP



Non-residential investment & capital input gap



*Machinery includes transport equipment. Source: Refinitiv, Bloomberg, Cabinet Office, BoJ and Daiwa Capital Markets Europe Ltd.

- While still well below the peaks reached ahead of the consumption tax hike in late 2019, business capex has recovered from its pandemic low-point.

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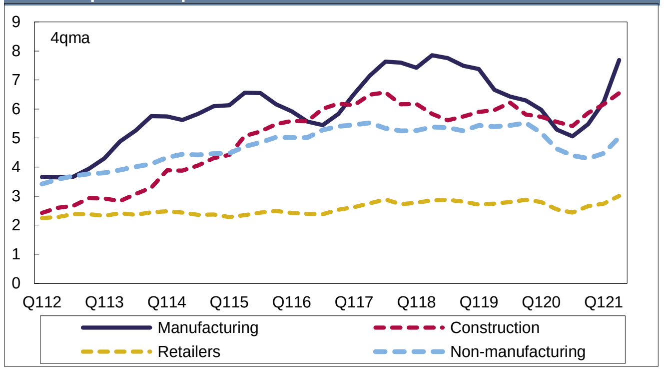
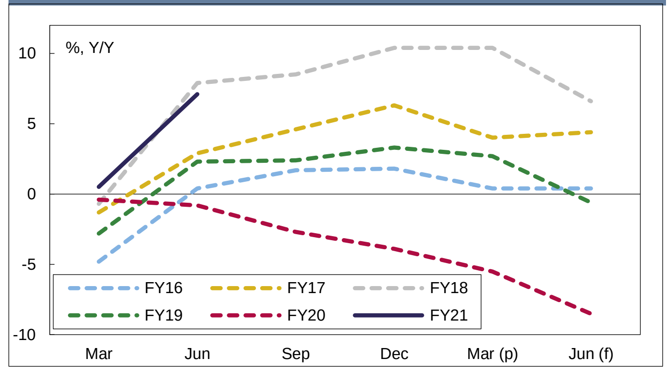
Business capex indicators appear positive

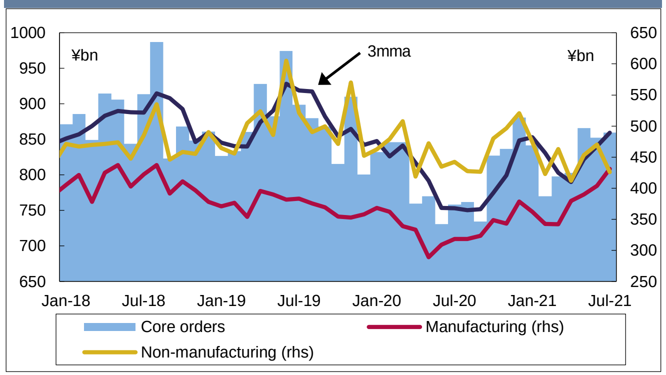
Corporate profit-to-sales ratio^



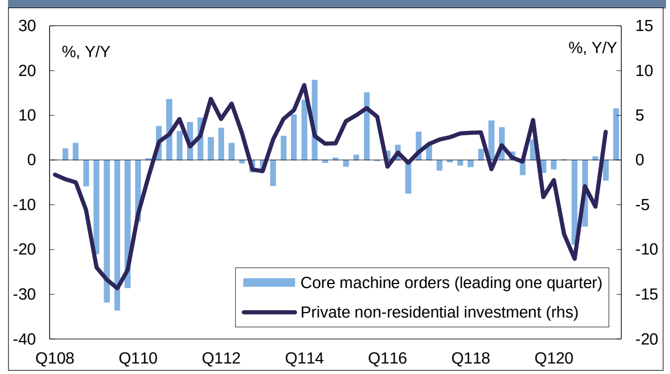
Tankan business investment forecasts*



Machine orders



Machine orders & non-residential investment



^MoF corporate survey, *All firms, fiscal year, fixed investment including land. Source: Refinitiv, Bloomberg, Cabinet Office, BoJ, and Daiwa Capital Markets Europe Ltd.

- The pick-up in business capex reflects needs created by ongoing tightness of the labour market and has been facilitated by a recovery of firms’ profits, especially in the manufacturing sector. The Tankan survey presently reports an expected 7.5%Y/Y rebound in FY21.

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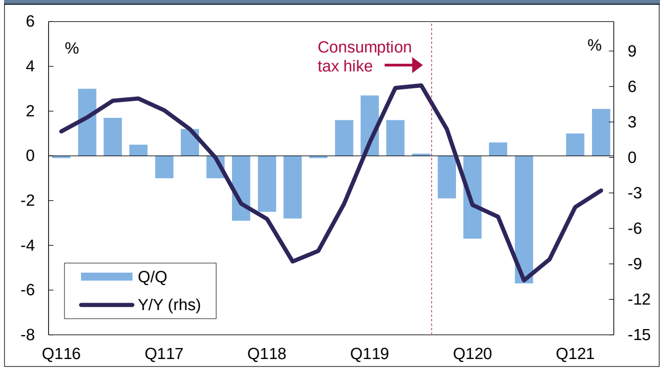
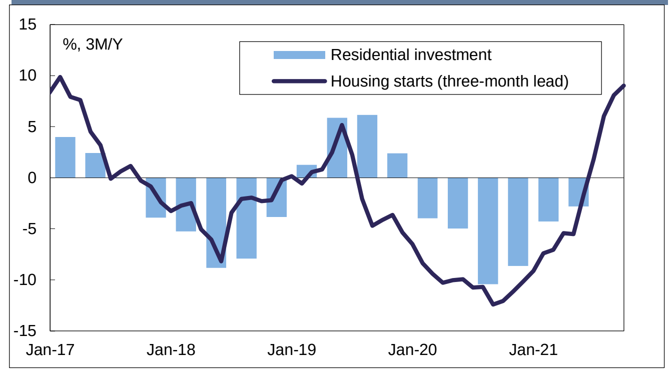
Residential building activity has also begun to move higher

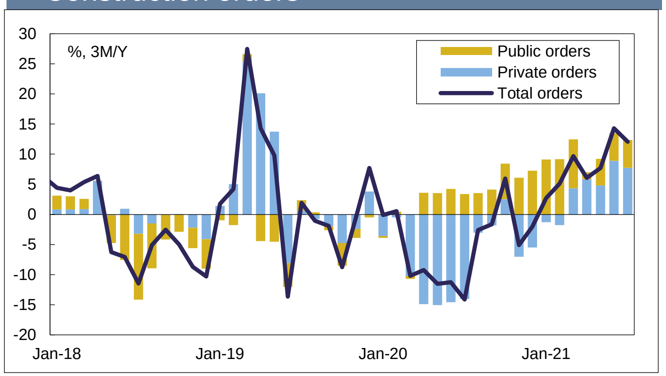
Residential investment



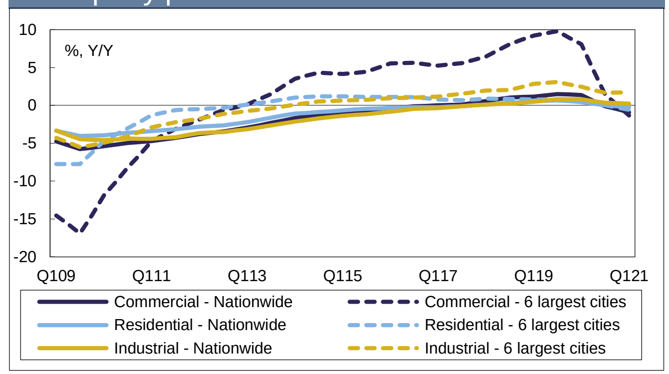
Housing starts and residential investment



Construction orders



Property prices



Source: Refinitiv, Bloomberg, Cabinet Office, MLIT and Daiwa Capital Markets Europe Ltd.

- Residential investment declined in the wake of the 2019 consumption tax hike and onset of the pandemic. However, activity has begun to lift this year, with starts rising to a more than 2-year high in July. Residential and commercial property prices have been pushed down by the pandemic, however.

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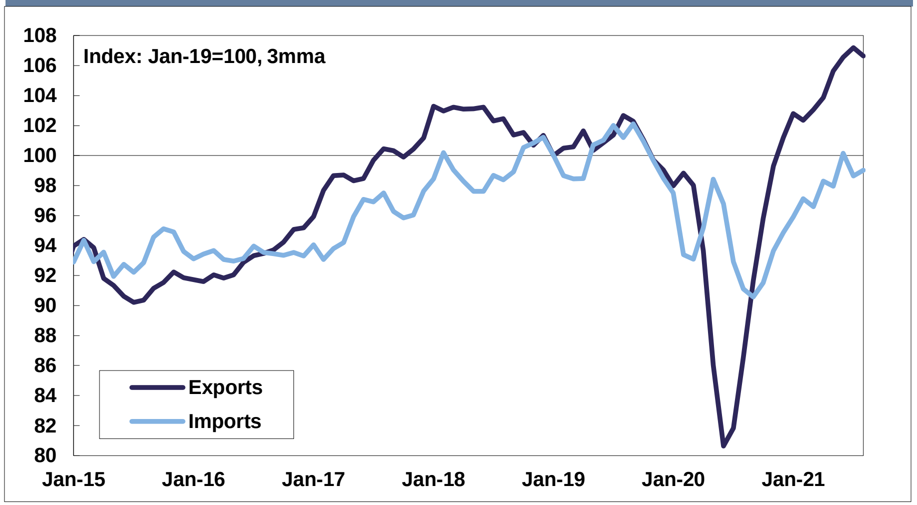
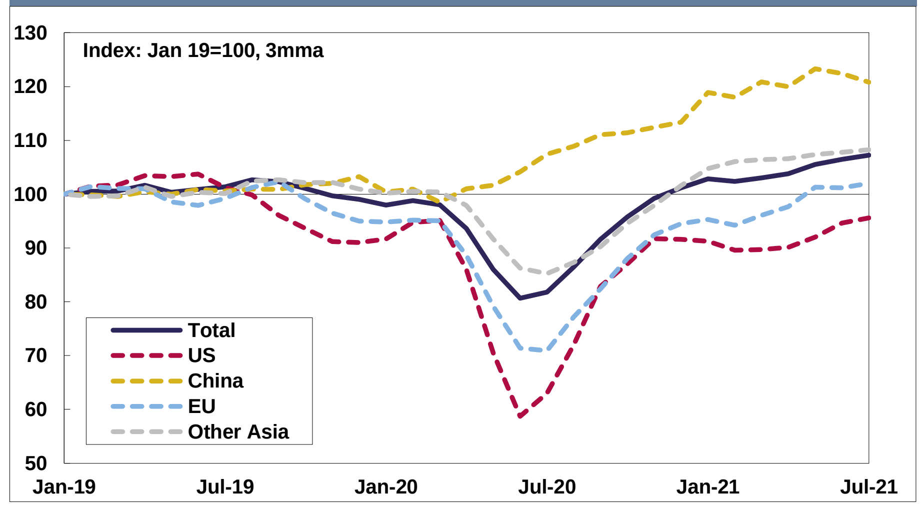
Japan’s exports have fully recovered to reach new highs

BoJ measures of real export and imports



Source: Bloomberg, BoJ and Daiwa Capital Markets Europe Ltd.

Real exports by destination



Source: Bloomberg, BoJ and Daiwa Capital Markets Europe Ltd.

- While domestic demand in Japan is yet to recover to pre-pandemic levels, exports rebounded strongly to reach new highs this year.
- That growth owed mostly to strong demand from China, which has eased somewhat in recent months. So far exports to the US have lagged despite that economy’s solid recovery and a weaker yen.

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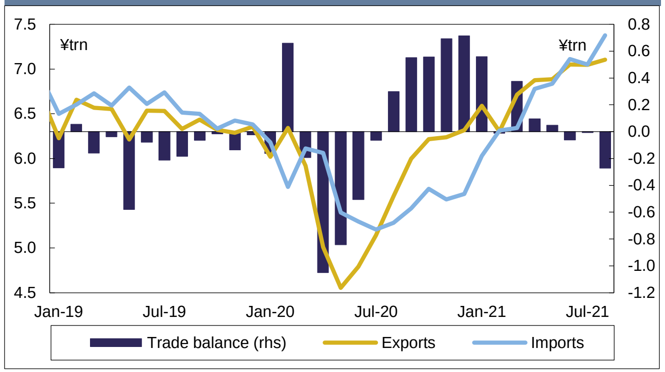
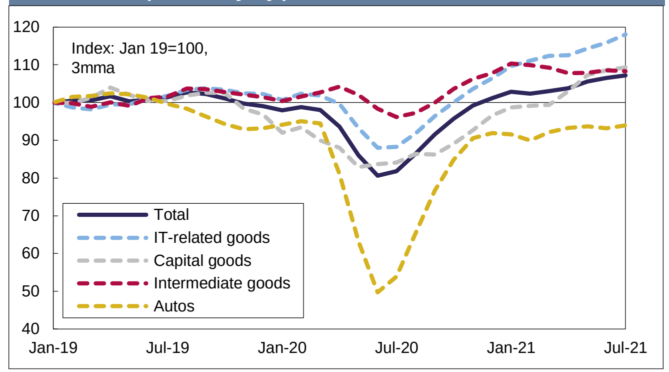
Export recovery driven by IT-related and capital goods

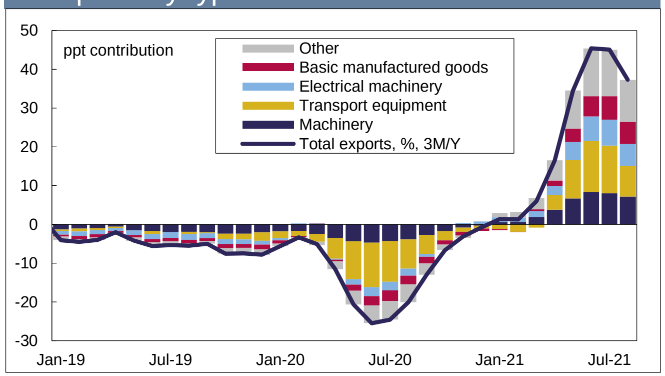
Merchandise trade balance, exports, imports



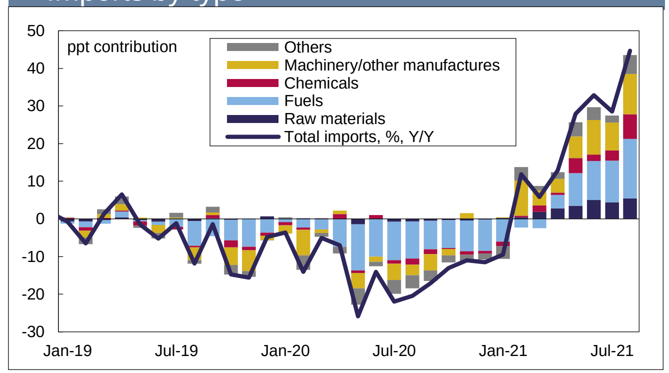
Real exports by type



Exports by type



Imports by type



Source: Refinitiv, BoJ, MoF and Daiwa Capital Markets Europe Ltd.

- Much of the recovery in Japan’s exports can be explained by record demand for IT-related goods and a recovery in demand for capital goods. By contrast, the recovery in Japan’s imports has been driven mostly by increased shipments of fuel and other raw materials, not least due to the rebound in commodity prices.

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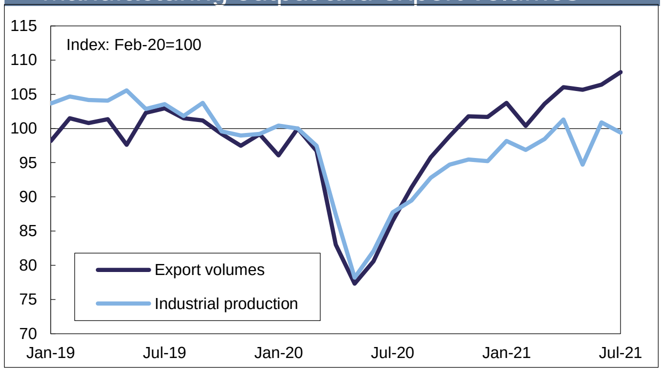
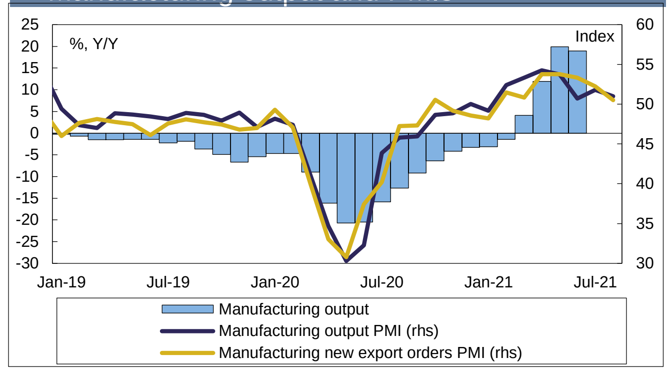
Manufacturing benefited from stronger external demand

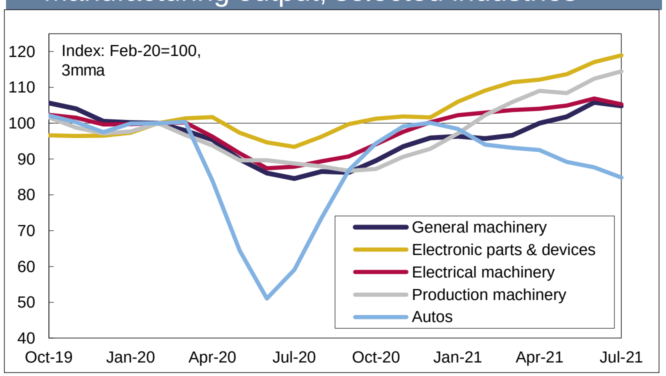
Manufacturing output and export volumes



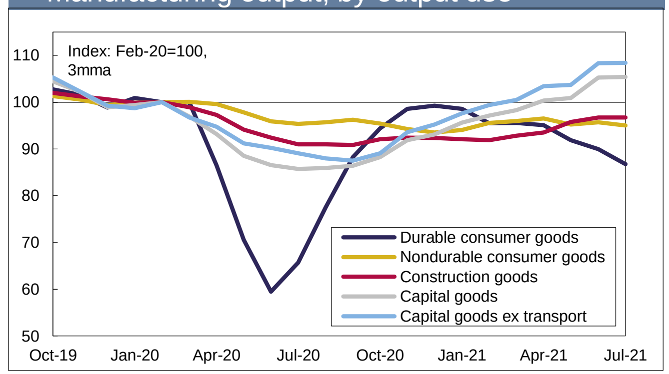
Manufacturing output and PMIs



Manufacturing output, selected industries



Manufacturing output, by output use



Source: Refinitiv, Markit IHS, METI, BoJ and Daiwa Capital Markets Europe Ltd.

- The recovery in export demand has driven the recovery in Japan’s manufacturing sector, with production now close to pre-pandemic levels despite the incomplete recovery of domestic demand and constraints on output imposed by both the virus and supply chain bottlenecks, especially in the auto sector.

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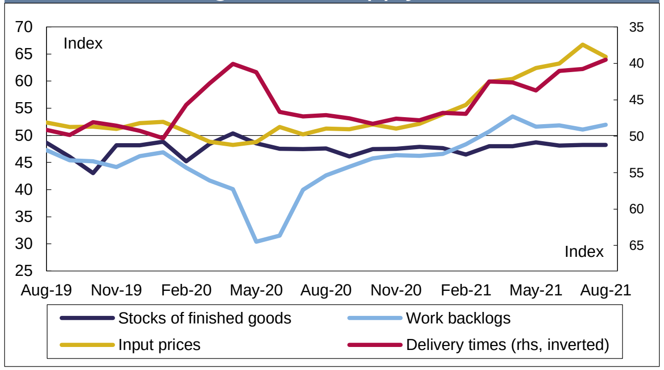
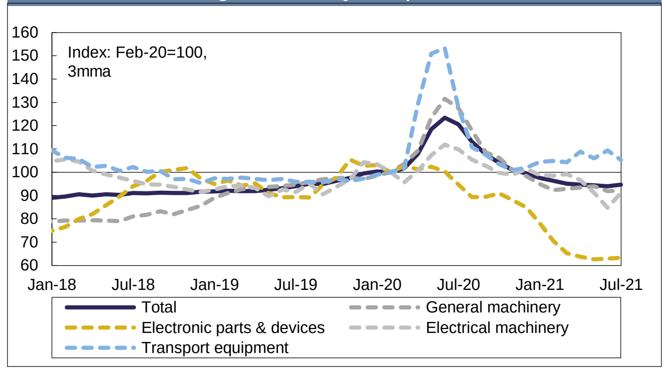
Recovery started despite ongoing supply bottlenecks

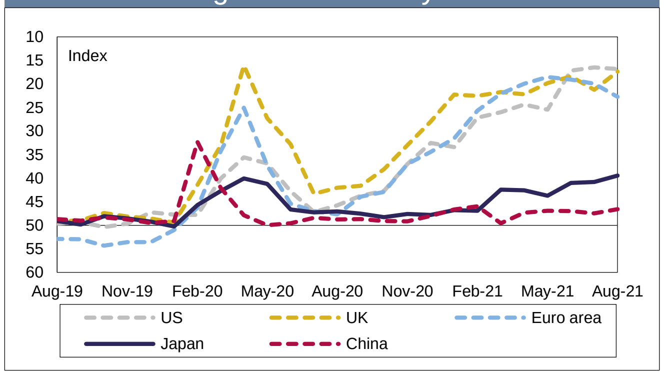
Manufacturing PMIs – supply side



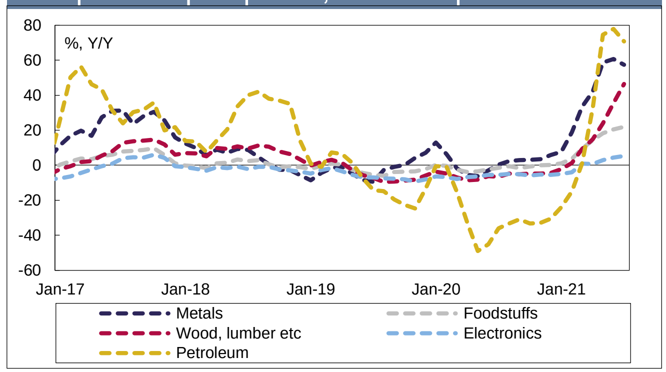
Manufacturing inventory-shipment ratio



Manufacturing PMIs – delivery times*



Japan's import prices, selected products

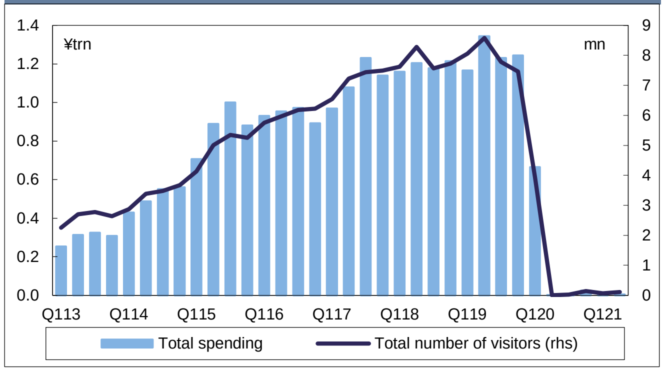


*Inverted axis. Source: Refinitiv, Bloomberg, METI, IHS Markit and Daiwa Capital Markets Europe Ltd.

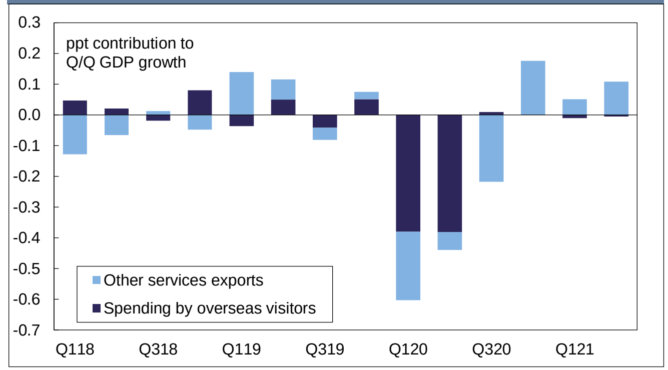
- Pipeline inflation pressures have emerged due to a sharp rebound in global commodity prices, a weaker yen and supply-side bottlenecks. But supply pressures remain far less acute than in Europe and the US.

The halt to tourism continues to weigh on the service sector

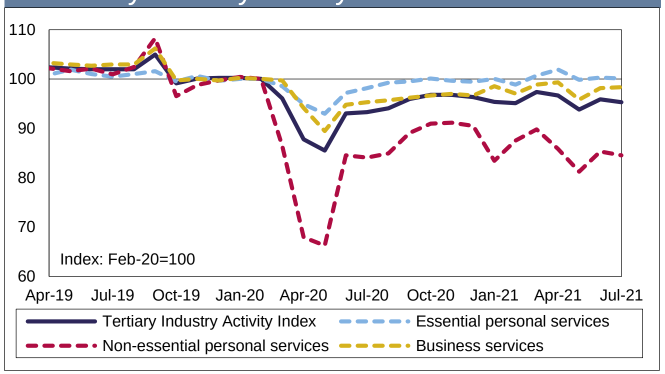
Overseas visitor numbers and spending*



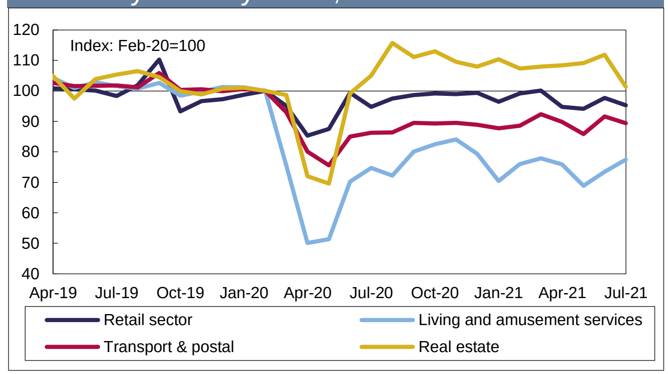
Services exports, contribution to GDP growth



Tertiary industry activity index



Tertiary industry index, selected sectors



*Average spending per visitor from Q220 onward is assumed to be same as Q120 due to survey cancellation. Source: Refinitiv, JNTO, JNTA, Cabinet Office, METI and Daiwa Capital Markets Europe Ltd.

- Even with the Olympics taking place, less than 52k foreign visitors entered Japan in July, compared with a monthly average of 2.65mn in 2019. This is continuing to play a role in depressing activity in the services sector, especially in the hospitality industry.

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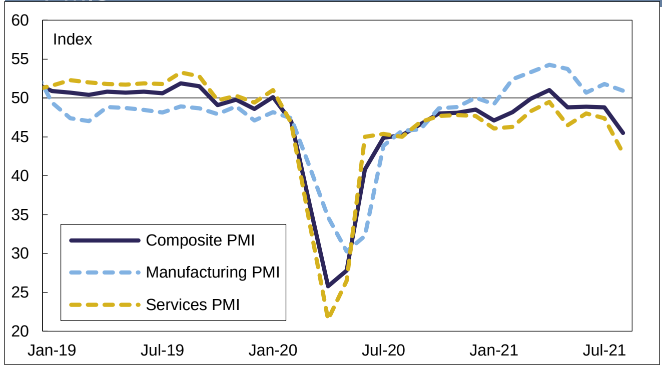
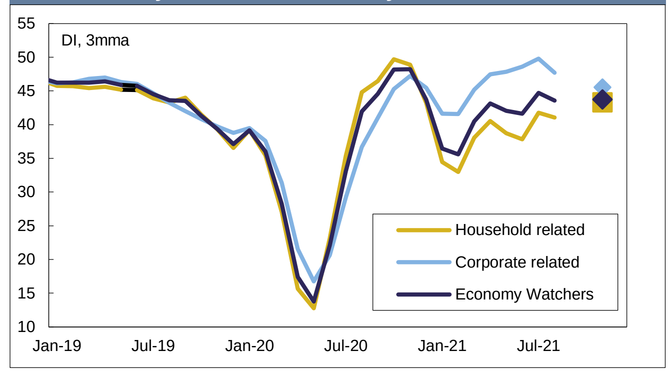
Some sentiment and activity indicators have softened of late

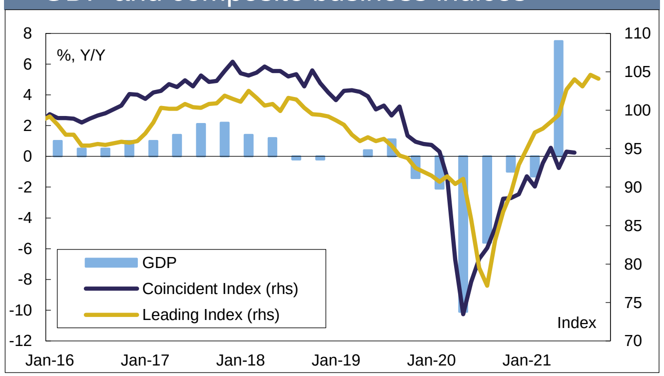
PMIs



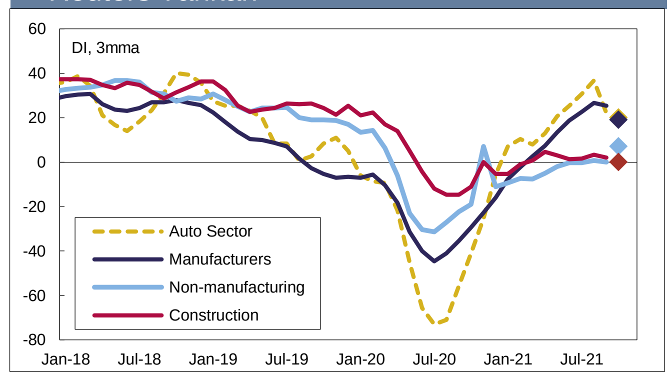
Economy Watchers Survey*



GDP and composite business indices^



Reuters Tankan**



*Diamonds/square are latest readings for the outlook index. ^Leading index has three-month lead. **Diamonds represent latest reading of forecast index. Source: Refinitiv, IHS Markit, Cabinet Office and Daiwa Capital Markets Europe Ltd.

- Key indicators of activity and sentiment have largely recovered from their early-pandemic lows. But some have softened a little of late as they have begun to reflect the disruption caused by the delta wave of coronavirus cases and associated restrictions on trading activity.

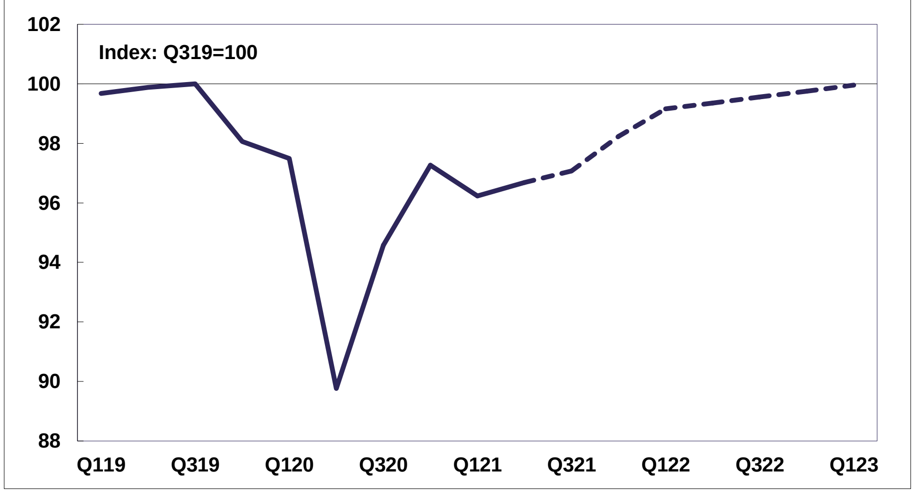
Economy expected to return to its pre-tax hike in FY23

GDP growth forecast*

Y/Y growth	FY19	FY20	FY21	FY22
Private consumption	-1.0	-5.8	3.3	3.4
Private residential investment	2.5	-7.2	1.9	1.9
Private non-residential investment	-0.6	-6.8	4.6	4.5
Public consumption	2.0	3.4	1.0	0.1
Public investment	1.5	4.2	-0.2	1.0
Exports	-2.2	-10.4	14.4	6.1
Imports	0.2	-6.8	9.9	3.7
GDP growth, %, Y/Y	**-0.5**	**-4.4**	**3.4**	**3.3**
BoJ GDP growth forecast (July)	-	-	3.8	2.7

*Figures may not sum due to rounding. Source: Cabinet Office and DIR

Forecast for level of real GDP*

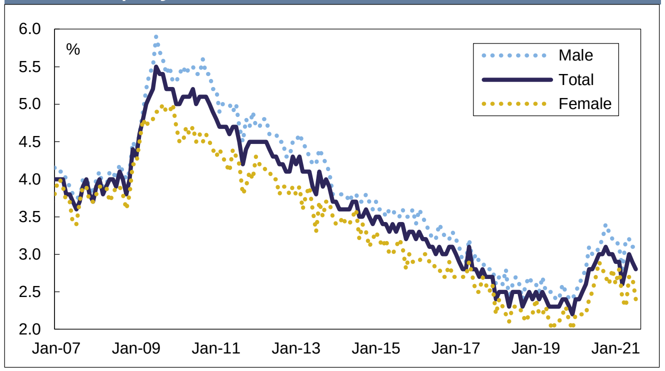


*Dashed line represents forecast. Source: Cabinet Office, Refinitiv and Daiwa Capital Markets Europe Ltd.

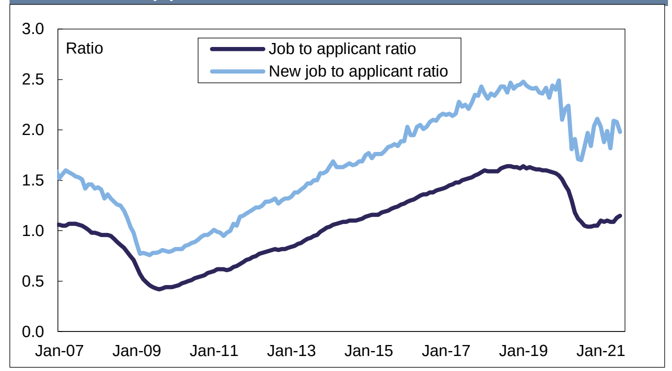
- Despite the delta outbreak, it now appears likely that the economy will avoid a further contraction in the near term, thanks to a continued recovery in private consumption and business investment and growth in net exports.
- Even so, at this stage it is still likely to be sometime in 2023 before Japan will recapture the peak level of GDP seen prior to the consumption tax hike and pandemic.

Japan’s labour market has remained tight despite the pandemic

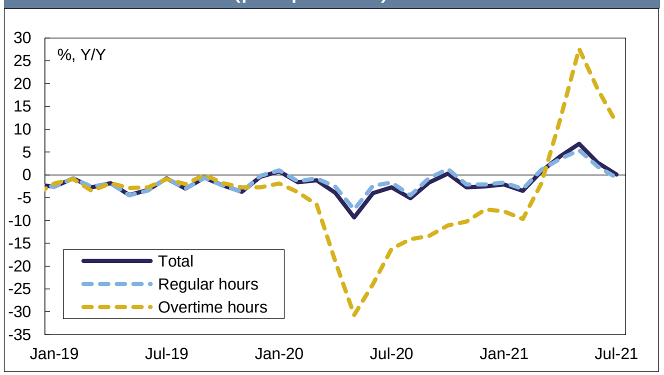
Unemployment rate



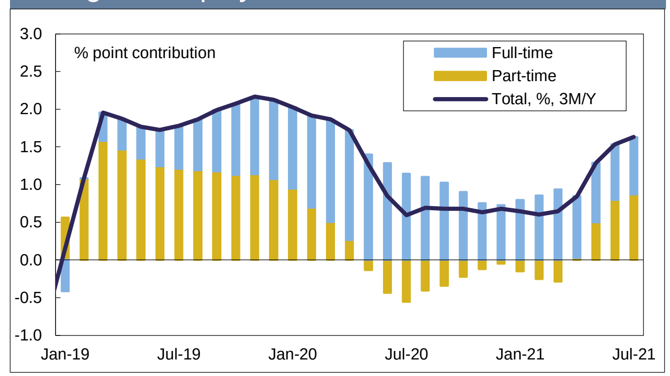
Job to applicant ratio



Hours worked (per person)



Regular employment



Source: Refintiv, Bloomberg, MIC, MHLW, BoJ and Daiwa Capital Markets Europe Ltd.

- Household employment is now just 350k below the pre-pandemic peak and at 2.8% the unemployment rate is just 0.6ppt above the historic pre-pandemic low. Firms’ earlier reduced demand for labour was manifest mostly in a reduction in over-time hours worked/part-time employment, which has now begun to reverse.

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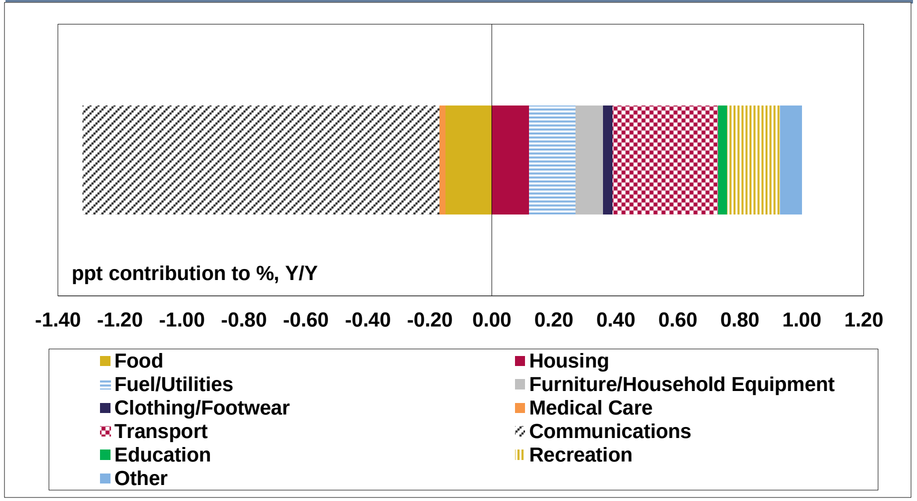
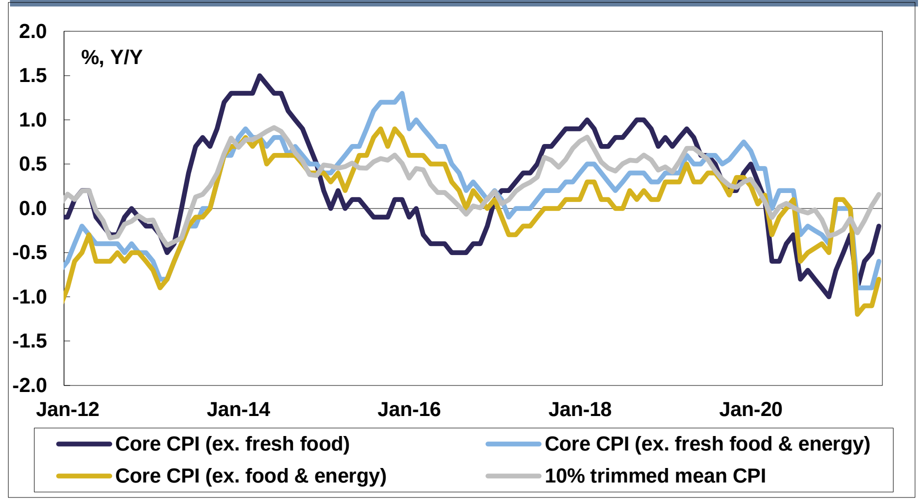
Japan’s underlying CPI inflation rate is fractionally positive

Contributions to national CPI inflation, July 2021



Source: Bloomberg, MIC and Daiwa Capital Markets Europe Ltd.

Measures of underlying and core CPI inflation

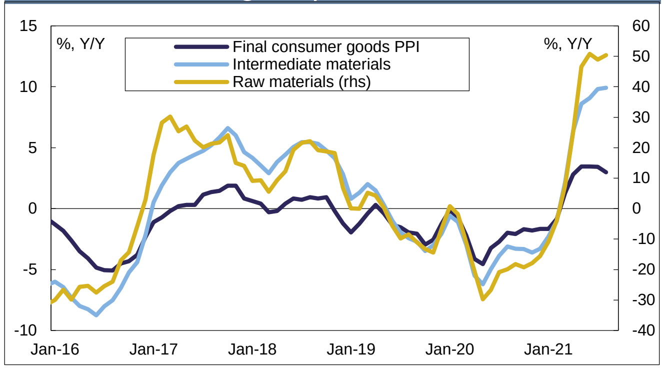


Source: Bloomberg, BoJ, MIC and Daiwa Capital Markets Europe Ltd.

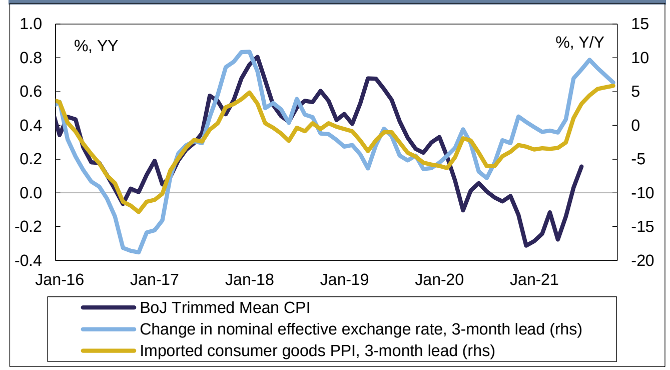
- While the pandemic has had a negative impact on Japan’s inflation, the conventional ‘exclusion-based’ measures of core inflation overstate the weakness in underlying inflation dynamics, especially after the impact of the steep decline in mobile phone call charges in April was amplified by a move to a new 2020 base year.
- The BoJ’s measures of underlying inflation – less influenced by extreme price movements – suggest that the trend in inflation was fractionally positive in July, with the trimmed mean up 0.2%Y/Y.

Commodity prices and weaker yen boost production costs

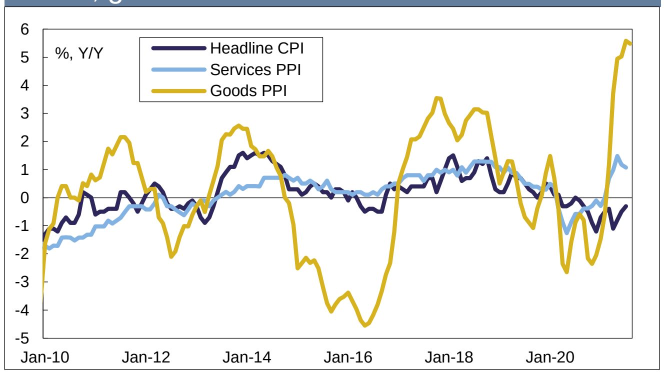
Goods PPI, stage of production



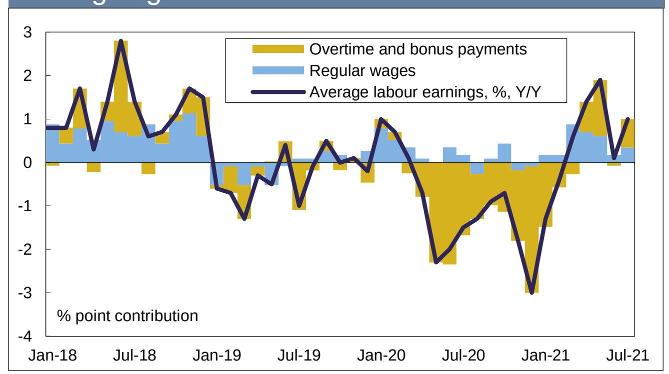
Trimmed mean CPI, yen & import prices



CPI, goods PPI and services PPI



Wages growth

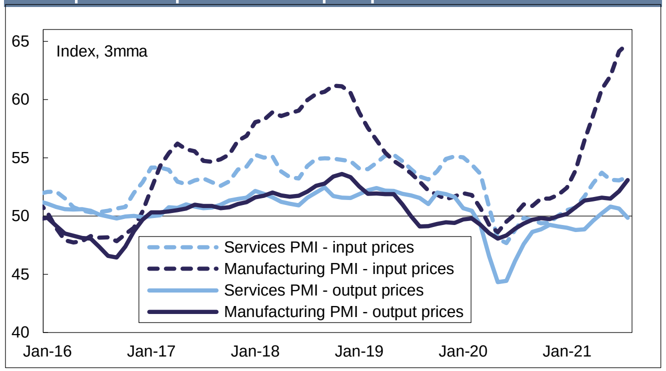


Inflation measures are excluding the impact of the consumption tax, Source: Refinitiv, BoJ, MIC, BIS, MHLW and Daiwa Capital Markets Europe Ltd.

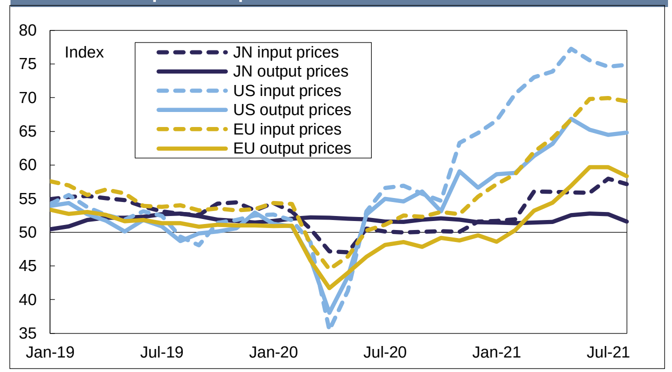
- Pipeline inflation pressures have emerged in the goods sector due to a sharp rebound in commodity prices, a weaker yen and supply-side bottlenecks. However, with wages growth still subdued, inflation in the services sector remains very muted, with the recent lift in the services PPI simply reflecting last year's decline in prices.

Despite factory pipeline pressures, CPI inflation is likely to remain low

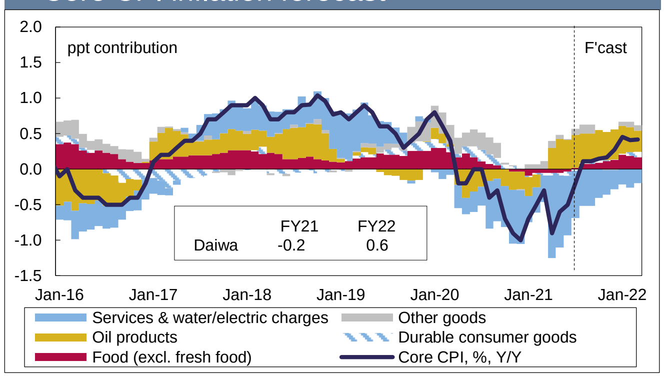
Japan's input and output price PMIs



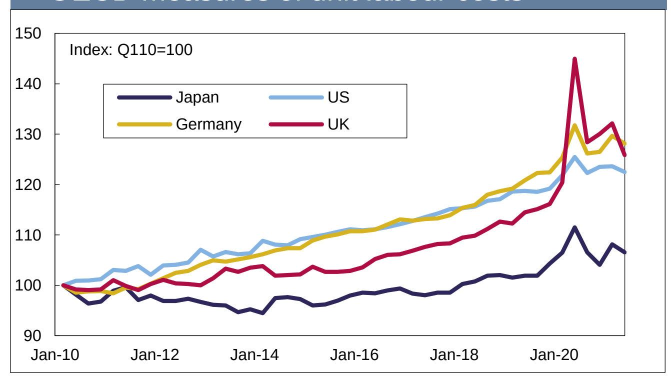
G3 composite price PMIs



Core CPI inflation forecast*



OECD measures of unit labour costs



*Core CPI excluding fresh foods. Source: Refinitiv, BoJ, MIC, Markit IHS, OECD and Daiwa Capital Markets Europe Ltd.

- Japan's core inflation is likely to turn modestly positive from August, not least due to the rebound in energy prices. However, PMI indicators suggest that Japan's inflation will remain low relative to other countries with few signs that the BoJ will achieve the 2% target amidst stubbornly low inflation expectations.

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BoJ Monetary Policy Framework

Yield Curve Control	QQE	Loan facilities
■ Negative policy rate (-0.1%) on marginal excess reserves ■ New mechanism in place to mitigate impact on bank profits if policy rate needs to be reduced further in the future ■ 10Y yield target of ‘around zero per cent’ - although yields may now move upward and downward by up to 0.25%, depending on developments in economic activity and prices ■ JGBs with a wide range of maturities eligible for purchase, but no guideline for the average maturity ■ JGB purchases under fixed-rate operations to achieve yield target	■ JGBs will be purchased as required at an unlimited pace to achieve target for 10Y JGB yield ■ BoJ ETF holdings to increase as required with an upper limit of ¥12trn ■ BoJ J-REIT holdings to increase as required with an upper limit of ¥180bn ■ BoJ will raise holdings of CP and corporate bonds with an upper limit of ¥20trn until end March 2022, with the split depending on market conditions.	■ ‘Stimulating bank lending’ facility, ‘Growth-supporting’ funding facility, new ‘Climate Change’ funding facility and special facility for banks located in earthquake affected areas, all offering loans at 0% ■ Up to ¥110trn ‘Special Funds-Supplying Operations to Facilitate Financing in Response to the Novel Coronavirus’ facility, providing 0% loans to financial institutions that make loans. Facility available until end-March 2022

- Inflation over-shooting commitment: The BoJ commits itself to expanding the monetary base until inflation exceeds 2%Y/Y and stays above 2%Y/Y in a stable manner

Source: BoJ and Daiwa Capital Markets Europe Ltd.

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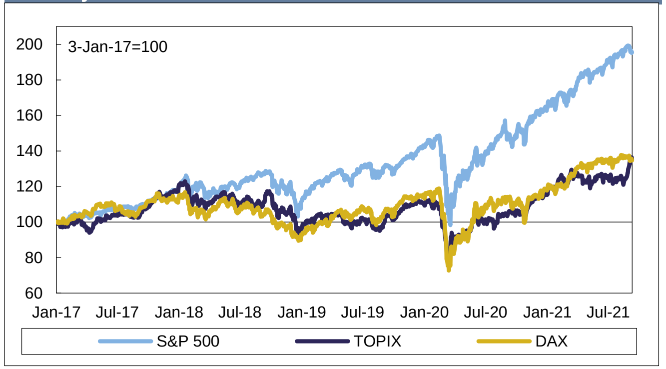
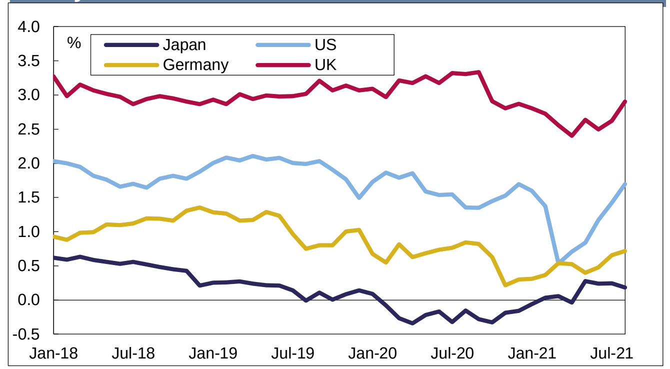
BoJ policy supported stock market but inflation expectations remain stubbornly low

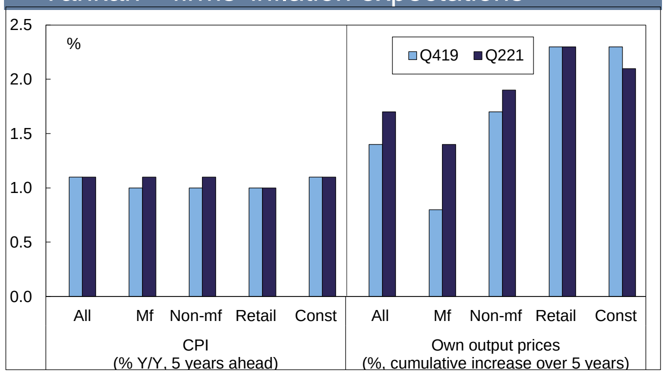
Major stock markets



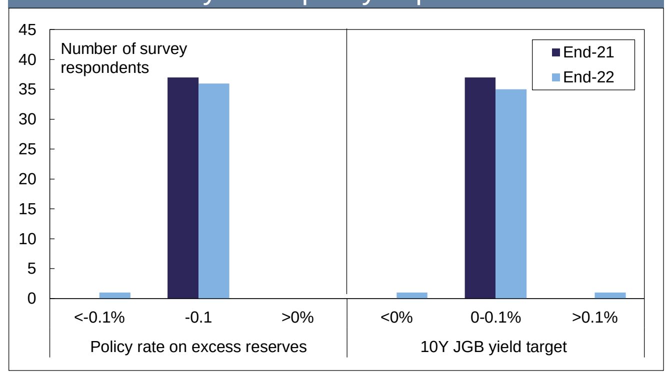
5-year inflation breakevens



Tankan – firms' inflation expectations



JCER survey - BoJ policy expectations

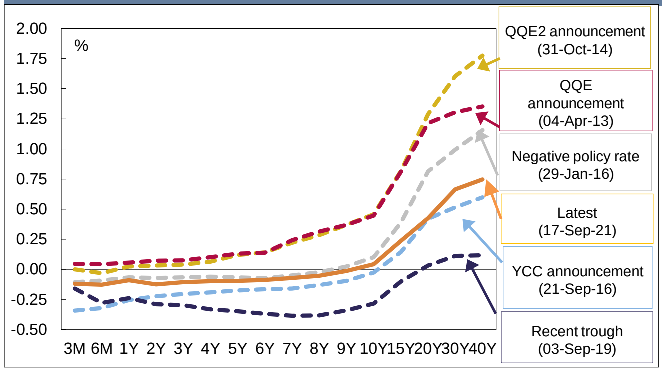


Source: Refinitiv, Bloomberg, BoJ, JCER and Daiwa Capital Markets Europe Ltd.

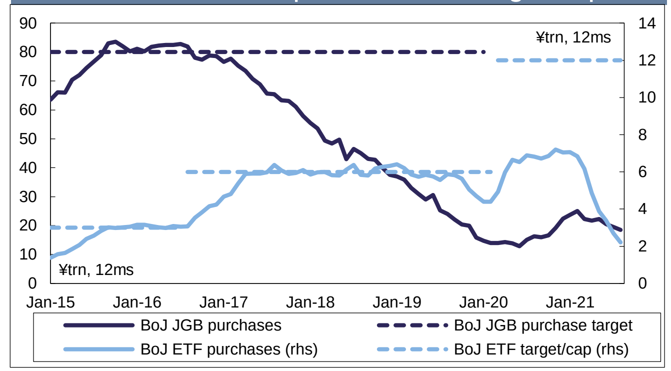
- While the BoJ's policy has helped lift the stock market, inflation break-evens remain very low. Disappointingly, recognition of the Bank's 2% inflation target amongst the general public has failed to increase at all, so it is little wonder that surveys also suggest little prospect of the BoJ lifting its policy rate or JGB yield target.

The BoJ's asset purchases have slowed

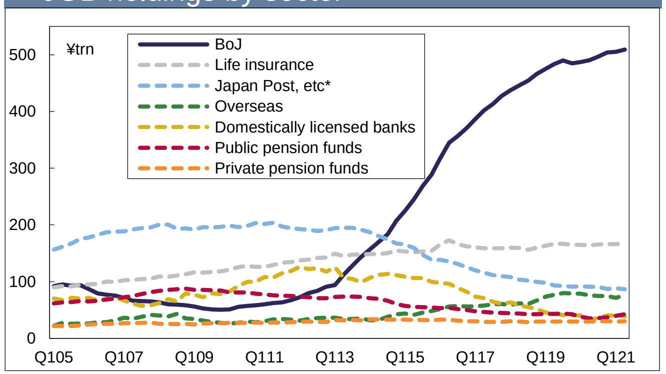
JGB yield curve



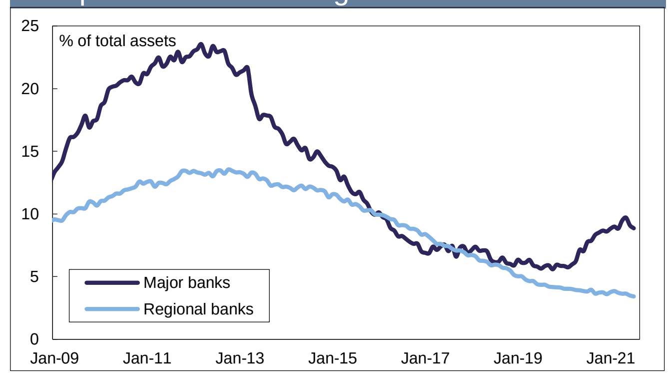
BoJ JGB and ETF purchases vs target/cap



JGB holdings by sector



Japanese bank holdings of JGBs



*Category includes agricultural cooperatives, etc. Source: Refinitiv, Bloomberg, BoJ and Daiwa Capital Markets Europe Ltd.

- While the BoJ's rinban purchases picked up slightly at the onset of the pandemic, total purchases over the past year are less than ¥19trn – a quarter of the earlier peak. The BoJ's ETF purchases have also slowed to a trickle, amounting to less than ¥0.1trn in the three months to August.

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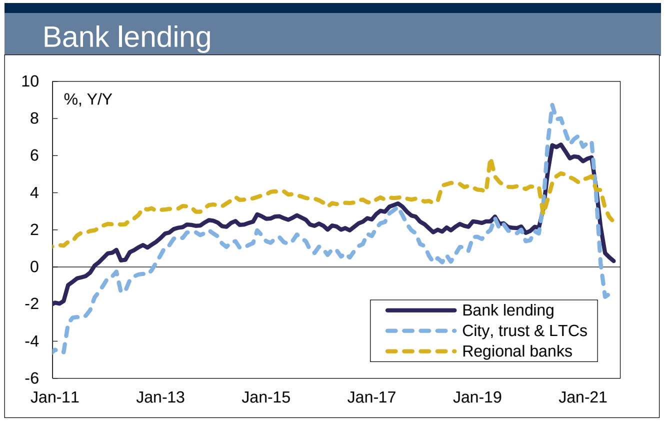
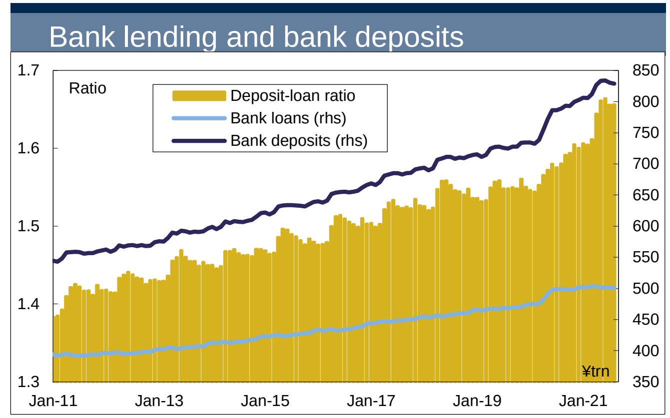
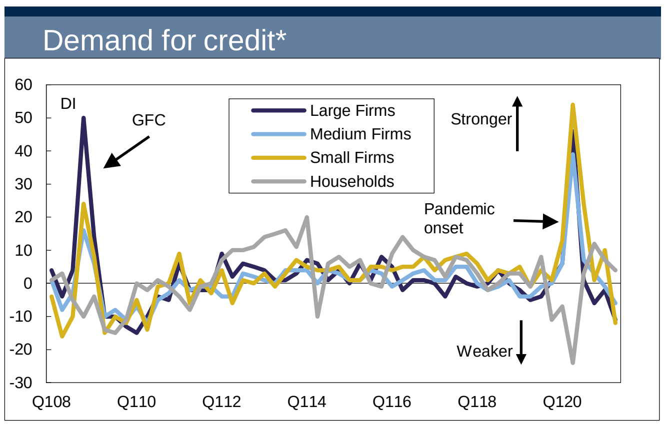
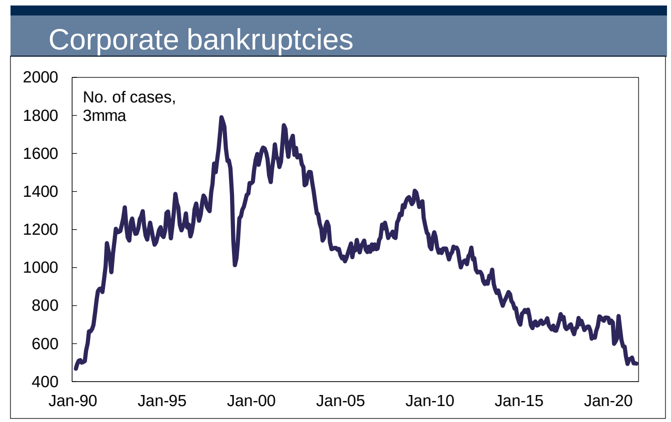
Japan's bank lending growth slowing as liquidity needs dissipate while the need for capex funding remains low









*BoJ Senior Loan Officer Survey. Source: Refinitiv, BoJ, Bloomberg and Daiwa Capital Markets Europe Ltd.

- With demand for credit now low, bank lending growth has slowed from rates inflated by last year's scramble for emergency liquidity. Bank deposit growth has also slowed from rates inflated by unspent government support payments. Assisted by banks and government guarantees, corporate bankruptcies are sitting near a 30-year low.

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Following the counting of votes on 29 September, the next LDP President will likely be one of three people

Taro KONO

Constituency: Kanagawa 15
Number of Times Elected: 8
Born: 10 January 1963
Study: International Politics, Georgetown

Career:
Chair of the National Public Safety Commission
Minister in charge of Administrative Reform/Civil Service Reform
Minister of State for Consumer Affairs and Food Safety/Regulatory Reform/Disaster Management
State Minister of Justice
Chair, Committee on Foreign Affairs, HR
President, Central Institute of Politics, LDP
Chair, Administrative Reform Promotion Headquarters, LDP

Articulated policy positions:
Believes in small government/fiscal soundness; seeks good relation with US and China; proactive on regulatory reform; favours free trade; against nuclear power; in favour, but sees no rush to amend self defence force constitutional role, in favour of immigration to secure workers

Fumio KISHIDA

Constituency: Hiroshima 1
Number of Times Elected: 8
Born: 29 July 1957
Study: Law, Waseda

Career:
Long-Term Credit Bank of Japan
Minister for Foreign Affairs
Minister for Consumer Affairs/Space Policy
Minister of State for Okinawa and Northern Territories Affairs/Science and Technology Policy/Quality-of-Life Policy/Regulatory Reform/"Challenge Again" Initiative
Chair, Committee on Health, Labour and Welfare, HR
Chair, Policy Research Council, LDP
Chair, Diet Affairs Committee, LDP

Articulated policy positions:
Favours fiscal adjustment; wants monetary easing to continue, but important to consider endpoint; seeks strong diplomacy, mainly with the US; neutral on regulatory reform; neutral on free trade; in favour of nuclear power; in favour of constitution reflecting changing time, but see no current need for amendment

Sanae TAKAICHI

Constituency: Nara 2
Number of Times Elected: 2
Born: 7 March 1961
Study: Business Management, Kobe

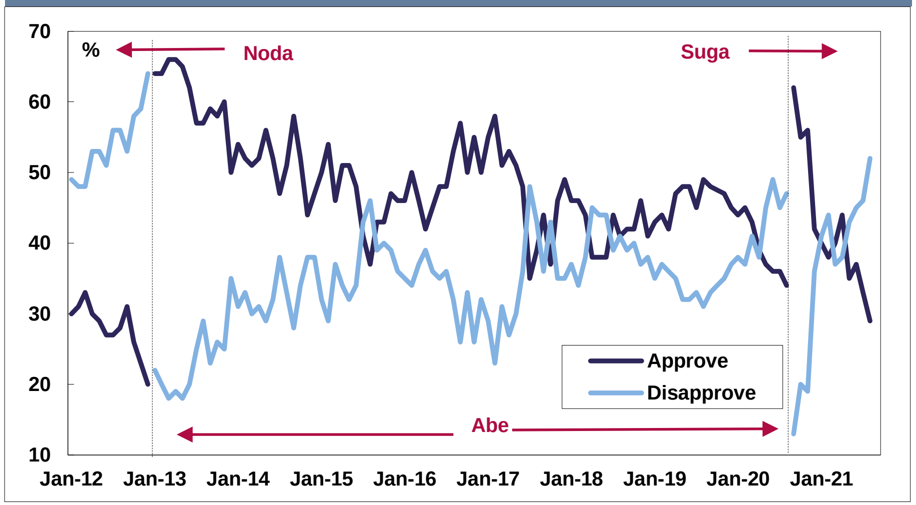
Career:
Minister for Internal Affairs and Communications
Minister of State for the Social Security and Tax Number System
Minister in charge of Science and Technology
State Minister of Economy, Trade and Industry
Chair, Committee on Education, Culture, Sports, Science and Technology, HR
Chair, Policy Research Council, LDP

Articulated policy positions:
Favours fiscal expansion, including relaxing primary balance target until 2% inflation achieved; wants major monetary easing to continue; believes Japan should bolster security due to risks from China; conservative on regulatory reform and against same-sex marriage; against TPP; in favour of nuclear power; in favour of amending entire constitution; would visit Yasukuni Shrine as PM

Source: The Liberal Democratic Party of Japan, media reports and Daiwa Capital Markets Europe Ltd.

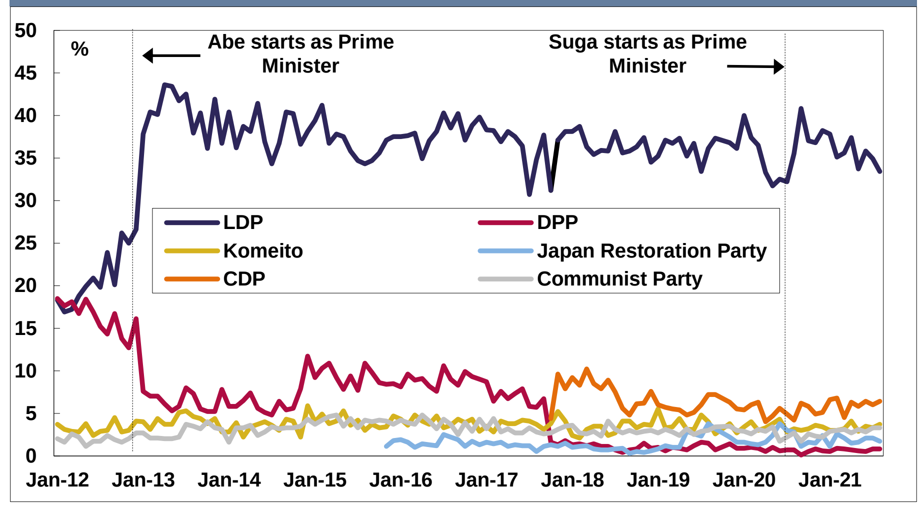
While Suga was unpopular, the LDP remains in the box seat and its new leader will likely enjoy a honeymoon period

NHK cabinet approval ratings



Source: NHK and Daiwa Capital Markets Europe Ltd.

NHK opinion poll party ratings



Source: NHK and Daiwa Capital Markets Europe Ltd.

- Despite PM Suga's slide into unpopularity, opinion polls indicate that the LDP has remained by far the most supported party in Japan.
- Looking ahead, whoever is elected as the new leader might reasonably expect a honeymoon period that will boost the LDP's present party rating, ensuring that they are in the box seat to form a new government following a Lower House election that will probably take place in November.

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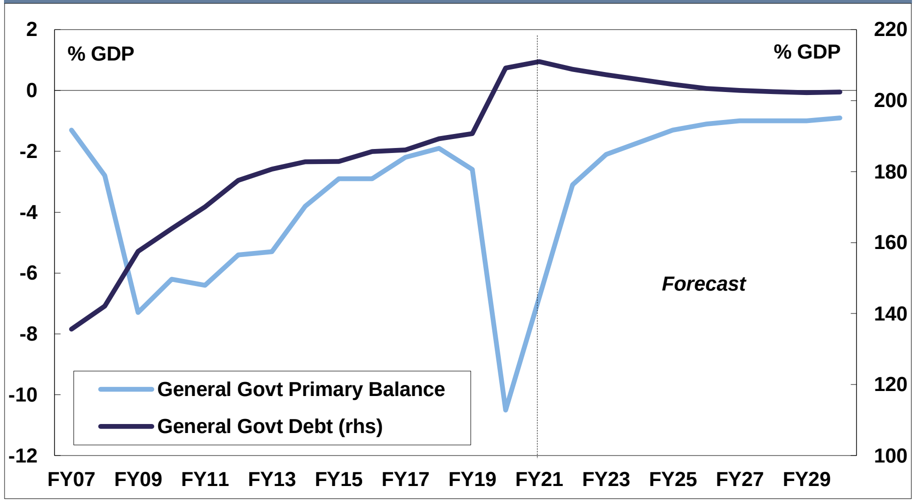
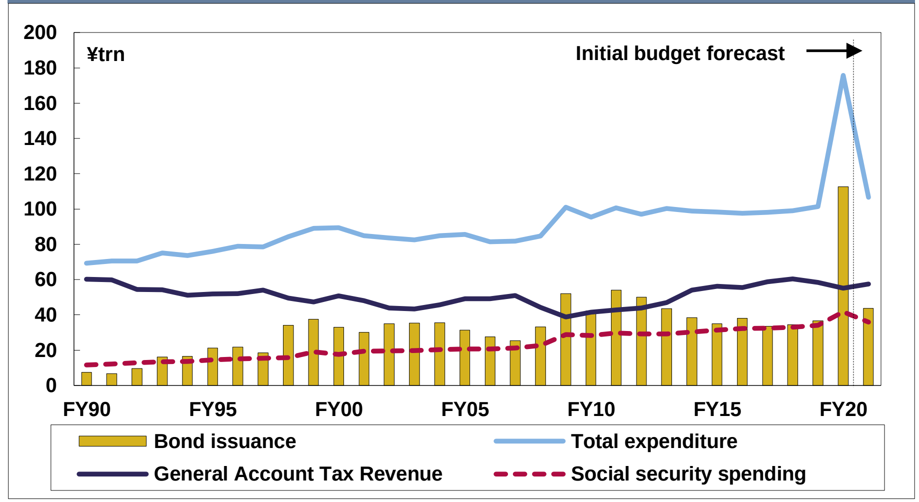
Japan's fiscal position remains tenuous and yet the pressure to stimulate the economy will continue in the near term

Cabinet Office baseline medium-term projections



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Spending, revenue and bond issuance



Source: MoF and Daiwa Capital Markets Europe Ltd.

- The most recent Cabinet Office medium-term fiscal projections, prepared in July, suggested that the present baseline would see the central government primary balance remain in deficit throughout this decade. Using a more optimistic growth scenario, the general government primary balance would turn positive in 2027.
- However, no matter who is the PM after the General Election, the Government will remain under pressure to do more to support the recovery from the pandemic, starting with the likely delivery of a supplementary budget before the end of this year, perhaps worth as much as ¥30tn.

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