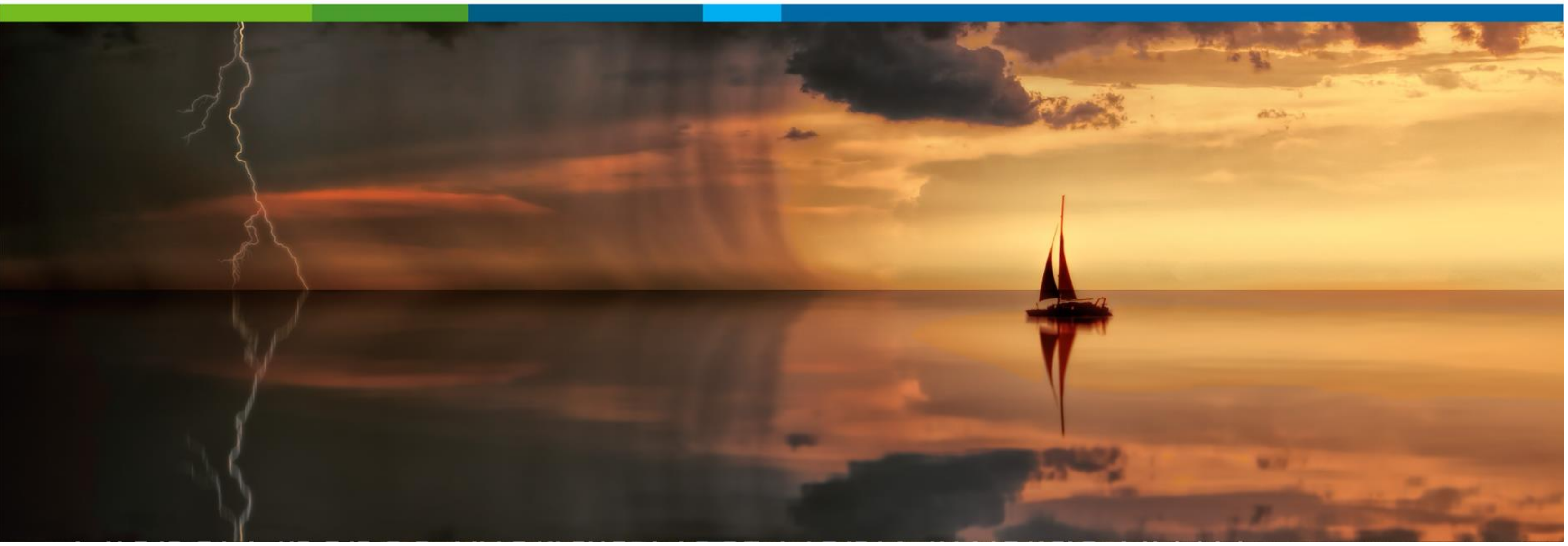

Japan: Double whammy

Even before the pandemic, Japan's economy was weakened by last October's consumption tax hike, which pushed down private consumption and investment. We now believe it is likely to fall into recession, leading us to downgrade our forecast for 2020 GDP growth to -1.8 per cent from -1.5 per cent. The delay of the Tokyo Olympics for a year, likely to further erode business confidence, also influenced our prediction. In addition, exports have been falling since December 2018 and are likely to weaken further.

While we previously expected industrial production and retail sales to recover in the second quarter in anticipation of the Olympics, this source of support has faded with the Olympics delay and the intensifying global spread of the coronavirus. We now expect a stronger recovery in 2021 driven by the delayed positive impact of the Olympics and the base effect of weak growth in 2020. We raise our 2021 growth forecast further to 1.5 per cent from 1.1 per cent (after recently raising it from 0.8 per cent).

We expect investment to slow due to the Olympics delay, boosting the current account surplus. While exports are likely to decrease amid the global recession, we think imports will decline much faster, particularly given low oil prices.

The Bank of Japan (BoJ) has limited tools at its disposal, compared to other central banks.

Policy response: provide liquidity via quantitative easing

The Bank of Japan (BoJ) has limited tools at its disposal, compared to other central banks. It kept yield targets unchanged at its emergency meeting on 16 March (called after the US Federal Reserve cut its base rate by 100 basis points). The BoJ doubled its buying of ETFs and J-REITs to reassure a volatile market, and announced additional commercial paper and

The key challenge is its inability to lift inflation expectations, which have fallen below zero.

corporate debt purchases of JPY2 trillion to provide relief to borrowers.

The BoJ has also introduced 'special fund-supplying operations' to facilitate corporate financing for companies struggling with the impact of the coronavirus outbreak. Its incremental pace of easing is in contrast to aggressive easing by other central banks that have more policy room. We think that the BoJ's policy limits will constrain scope for further easing to support the economy. The key challenge is its inability to lift inflation expectations, which have fallen below zero; as a result, it cannot push real yields lower as it faces an effective lower bound on nominal yields.

The government's fiscal policy response has been aggressive, with two stimulus packages of USD4.6 billion and USD15 billion (amounting to 0.4 per cent of GDP) to cope with the coronavirus, providing targeted support for SMEs. Prime Minister Shinzo Abe has pledged further aggressive stimulus, joining global efforts to cushion the economic blow from the pandemic. Japan's total stimulus in response to COVID-19 is likely to exceed USD100 billion, closing in on the USD137 billion stimulus package during the global financial crisis. The government has also raised the possibility of cutting the consumption tax, which could help to cushion the blow to consumption as social distancing reduces activities such as dining out and entertainment.

A snap election?

Hosting the Olympics was meant to boost domestic sentiment and Prime Minister Abe's political capital. He was expected to ride the wave of positive sentiment into a snap September election. Now, with the Olympics facing a one-year delay, he may call a snap election in the summer instead. The resulting political uncertainty is likely to be negative for sentiment, which could weigh on the post-coronavirus economic recovery.

Currency outlook

In the medium-term, we remain bullish on the yen. Real yield differentials are likely to turn in the yen's favour as the Fed and other central banks ease policy aggressively, while the BoJ has limited room to push real yields lower given its inability to lift inflation expectations. Weak growth and risk sentiment are also likely to benefit the yen as a safe haven. In this context, we forecast USD-JPY at 100 by end-2020.