RETURN TO "REVOLVING DOOR" PRIME MINISTERS?

The economy is likely to rebound in Q4 as health restrictions are being eased. Moreover, despite supply chain disruptions, the manufacturing sector should profit from the worldwide recovery. The consumption boom is likely to peter out soon, as wages growth is to remain sluggish. The main domestic support will come from the government spending, backed up by Bank of Japan (BoJ) 's yield curve control policy, and business investment thanks to improved profitability. Prime Minister Suga's resignation, although welcomed by financial markets, has rekindled fears that Japan may return to the "revolving door" era, in which the country changes prime minister every year.

A SHORT-LIVED REBOUND

The Japanese economy rebounded modestly by 0.3% in Q2 helped by solid business investment and strong consumption. However, the upswing was short-lived as the resurgence of the pandemic forced the authorities to declare the state of emergency in early July in the Tokyo area. This was later extended to almost half of the prefectures, covering 80% of the population. As a result, private consumption has remained stagnant, which in particular affected the hospitality sector. The Tokyo Olympic and Paralympic Games went ahead, although without spectators. At the same time, Japan's industry has been heavily impacted by supply chain disruptions and weak overseas demand. Semiconductors and other component shortages have forced plants to suspend operation, in particular in the automobile-related sector. These disruptions are likely to continue in Q4.

Economic surveys indicate that the economy could have contracted again in Q3. In August, the Economy Watchers reported a sharp deterioration in current and future conditions. The deterioration was confirmed by the PMI services activity index, which declined to 42.9. Although manufacturers reported a slight expansion in activity, the composite PMI Output Index fell from 48.8 in July to 45.5, a lowest since May 2020. By end September, the fifth wave of Covid-19 infection has largely subsided, while the vaccination has progressed largely as planned, with over 60% of population now having received at least one dose and more than 50% having received the second dose.

UNCERTAINTY AFTER SUGA'S DEPARTURE

As the government approval ratings slumped over the mishandling of the pandemic, Prime-minister Yoshihide Suga announced in early September that he would not seek re-election as leader of the Liberal Democratic Party and would step down as prime minister. The announcement was welcomed by the Tokyo Stock Exchange. The LDP has selected Mr Fumio Kishida, a former foreign affairs minister, as president to lead the party in the lower house election in October. Mr Kishida promised to shift away from the deregulation policies of his predecessors. However, restoring confidence in government will be a tough task, given the weakness of the Japanese health system and the institutional constraints. The risk is that Japan returns to a "revolving door" era, in which prime ministers only last for one year.

Independent of who becomes prime minister, the fiscal stance is likely to remain very accommodative despite the worsening of the government accounts: public sector debt amounts currently to around 240% of GDP. The policy is supported by the Bank of Japan, which is buying as much government bonds (JGBs) as necessary to keep the 10-year JGB yields at around zero percent. The BoJ's official inflation objective is 2%, but the central bank has few instruments left to achieve this target. In fact, Japan is among the few industrialised countries that have not experienced a substantial rise in the inflation rate in recent months.

GROWTH AND INFLATION (%)

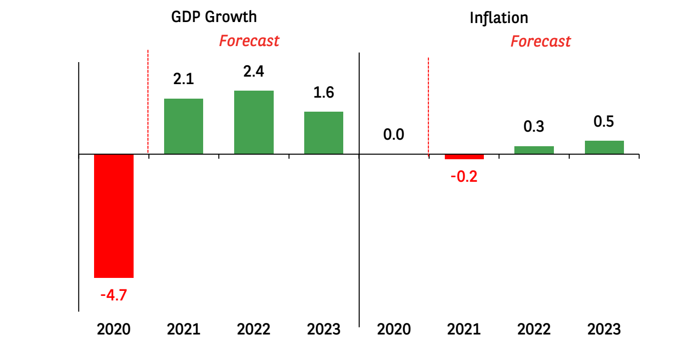

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

A ROBUST RECOVERY IN 2022-23

In Q4, the economy should strongly rebound, as sanitary restrictions could be lifted due to the sharp decline in new infections. However, the consumption boost is likely to peter out quickly as wages growth is expected to remain very sluggish. In 2021, exports are likely to remain the main driving force behind the recovery, thanks to the ongoing upturn in the main trading partners, such as the US, China and other countries in East and South East Asia. Moreover, supply chain disruptions are likely to diminish next year. Domestically, growth will be supported by an expansionary fiscal policy, which is likely to focus on digitalisation and green growth. Furthermore, the improved financial position of the corporate sector in conjunction with the worldwide upswing in industrial activity is likely to boost business investment. However, inflation is likely to remain below 0.5%.

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