

Research

Japan: From underperformer to outperformer

- Japan is returning to growth. We expect growth in H2 09 to exceed potential growth significantly and outperform both the US and Euroland. In addition to fiscal easing, the main explanation is a rebound in industrial activity driven by an extraordinarily strong inventory cycle and recovery in exports particularly to the rest of Asia.
- However, the outperformance will be temporary and should, in our view, mainly be regarded as a catch-up on the earlier strong underperformance. Hence, we still do not expect the Bank of Japan to be among the first major central banks to tighten monetary policy.

Japan set to outperform Euroland and US in H2 09

We currently expect Japan's GDP growth to rebound above trend in H2 09 and outperform both the US and Euroland. Besides fiscal easing, the main driver will be a sharp rebound in industrial activity. While industrial production in Euroland and the US continues to decline, industrial production in Japan is rebounding sharply. In April, industrial production increased by 5.9% m/m – the biggest monthly increase in industrial production recorded for more than 50 years. However, this record will probably not last long, as we expect industrial production to have surged by another 8% m/m in May. The main reasons for the strong rebound in industrial activity are an extraordinarily strong inventory cycle within the auto and electronics industry and renewed growth on the increasingly important Asian markets.

Benefits from recovery in Asia...

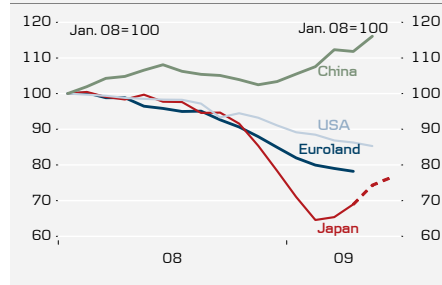
Japan is currently benefiting from its greater dependence on Asian markets, which appear to have resumed growth. The importance of the Asian markets has grown immensely in recent years. Currently 54% of Japanese merchandise exports are shipped to other Asian markets, while less than 30% is currently destined for the EU and the US. In 2002, the rest of Asia on the one hand and the EU and US combined on the other accounted for a more or less equal share of Japan's exports. The importance of the Asian markets for Japan's economy is magnified by the relative openness of the Japanese economy. We estimate Japan's exports to Asia to be about 9% of GDP, while US exports to Asia is less than 3% of GDP.

With a resumption of growth in other parts of Asia, the Japanese export engine has been turned on again. In volume terms, exports to the rest of Asia are up by 12% since February, while volume exports to the US and Europe have been broadly unchanged in the same period. As seen in the chart to the right, our indicator for net exports' contribution to GDP growth now suggests there will be a significant positive contribution to GDP growth from net exports. We expect the contribution to GDP growth from net exports to exceed 3% q/q AR in both Q2 and Q3. One important implication is that Japan's trade balance should return to surplus after being in deficit since July last year.

...and extraordinarily sharp inventory cuts coming to an end

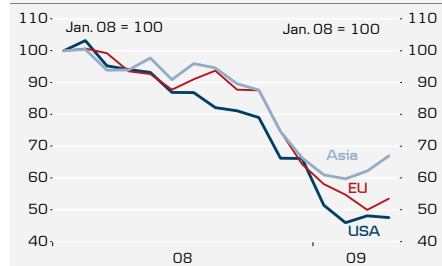
Before getting too excited about the recent rebound in industrial production in Japan, it is important to remember that Japan's industrial production and exports underperformed enormously during the downturn. From September last year to February this year, industrial production contracted by close to 40%. This is more than twice the contraction experienced in Europe and the US during the same period.

Japan's industrial production has started to outperform



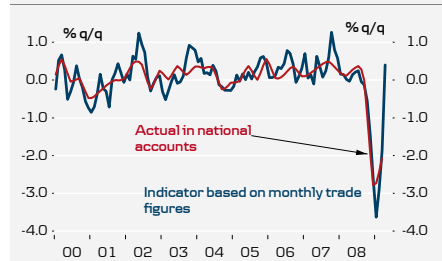
Note: Dotted line according to production plans
Source: Reuters EcoWin and own calculations

Japan's export to rest of Asia has resumed growth



Note: Shows seasonal adjusted volume exports
Source: Reuters EcoWin and own calculations

Net exports' contribution to GDP growth



Source: Reuters EcoWin and own calculations

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The main explanation is that Japan's industrial production and merchandise exports are heavily dependent on cyclical products such as autos and electronics. Between them the auto and electronics industries account for close to 50% of industrial production while exports of passenger cars alone accounted for close to 20% of Japan's merchandise exports in 2008.

In addition to a severe drop in demand for cars and electronics, cuts in inventories have been extraordinarily sharp in these industries. Hence production has been cut much more than demand. In the auto and electronics industries, our indicators for demand suggest an unprecedented large gap between demand and production. As seen in the chart to the right, passenger car sales both globally and in Japan have dropped by about 20% since the beginning of 2008. During the same period, passenger car production in Japan has been cut by a whopping 60%. There is a similar picture within electronics.

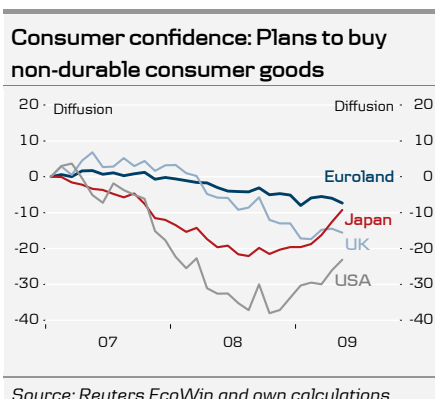
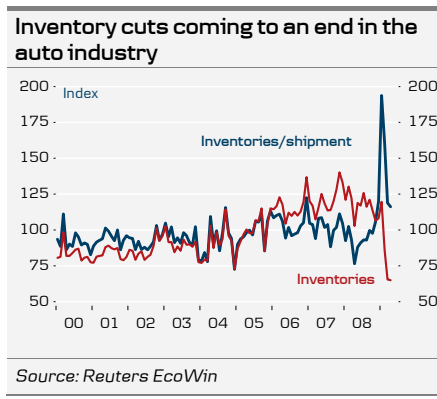
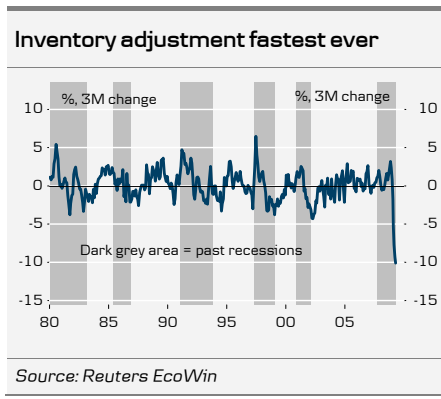
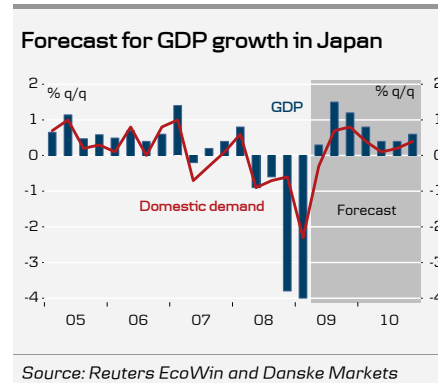
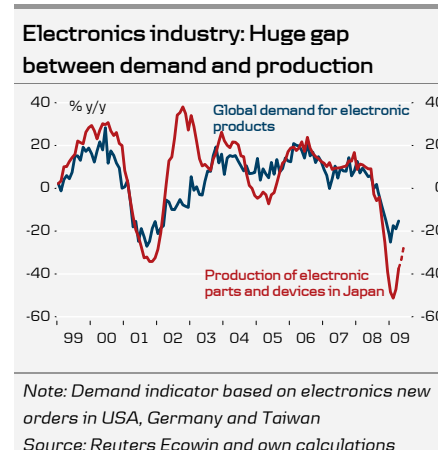
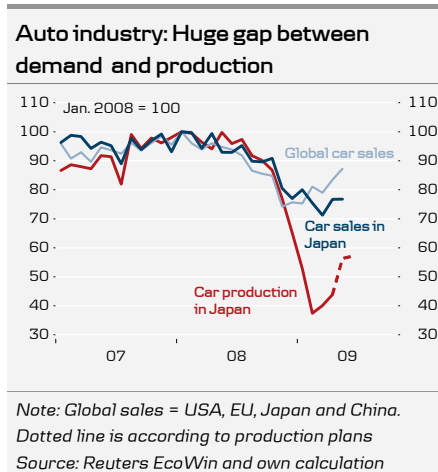
The logical implication of a huge gap between demand and production is that inventories are being cut fast. As seen in the chart at the bottom of the page, inventories are currently being cut more than twice as fast as during Japan's past recessions since 1980. In the auto industry, inventories are now at their lowest level since 1980 and with shipments expected to pick up in the coming months, the inventory-shipment ratio should soon decline below its historical average. To us this suggests inventory cuts should ease and probably end soon – not least in light of some recovery in demand recently. While the easing of inventory cuts is a general global theme at the moment, its impact on industrial production will be particularly strong in Japan. In May, the auto industry could well have boosted its production by close to 30% m/m.

Questions about sustainability remain

Our main message is that Japan is returning to GDP growth and will probably be significantly above trend in H2 09. However, the impact from the inventory cycle and fiscal policy easing will be temporary and the big question is to what degree will it be able to change the negative dynamics in the Japanese economy on a more permanent basis. At least for now there are some very encouraging signs. The deterioration in the labour market appears to be easing and there has been a surprisingly sharp jump in consumer confidence in recent months (see the chart below). Nonetheless we believe that following a very strong H2 09, GDP growth will probably slow early next year as the temporary impact from the inventory cycle and fiscal policy wanes.

The expected outperformance of the Japanese economy in H2 09 should to a large degree be regarded as a catch-up on the recent underperformance – particularly in Q4 08 and Q1 09. Hence, despite the sharp rebound in growth in H2 09, we do not expect the Bank of Japan (BoJ) to be among the first major central banks to tighten monetary policy (first BoJ interest rate hike expected in Q3 10). In our scenario of continued improvement in the global risk environment, it will probably not be able to prevent JPY weakening modestly.

However, despite the Japanese economy being the absolute master of 'false starts', we should not rule out the possibility that we could be in for a couple of years of Japanese outperformance. Structurally Japan will benefit from its larger dependence on Asia and having been through two decades of financial deleveraging private saving and financial health will probably weigh less on the recovery than in the US and Europe. In this scenario, the BoJ might tighten sooner and by more than the US and Europe and JPY might end up losing some of its funding currency status.



Macroeconomic forecasts for Japan

% Change q/q AR	2009				2010				Calendar year average		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2008	2009	2010
GDP	-15.1	0.2	6.1	4.9	3.2	1.6	1.6	2.4	-0.7	-6.2	3.2
Private Consumption	-4.3	-0.4	1.2	1.6	1.2	1.6	1.8	2.0	0.6	-1.7	1.3
Private Fixed Investments	-33.0	-10.8	0.2	0.9	2.3	3.6	5.3	7.0	-4.8	-16.7	1.8
Residential	-19.9	-7.8	1.2	1.6	1.6	1.6	2.0	2.0	-8.0	-1.8	-0.8
Non-residential	-35.5	-11.5	0.0	0.8	2.4	4.1	6.1	8.2	-4.2	-19.3	2.0
Change in invent. ¹	-1.2	-2.8	0.0	0.0	0.4	0.4	0.0	0.0	-0.2	-0.4	0.2
Public Consumption	1.2	1.2	1.6	1.6	1.6	1.6	1.6	1.6	0.8	1.7	1.6
Exports	-70.0	31.1	36.0	23.9	17.0	12.6	10.4	8.2	1.9	-27.0	19.3
Imports	-47.8	-7.8	8.2	12.6	12.6	8.2	8.2	7.4	0.9	-13.1	1.1
Net exports ¹	-8.1	4.1	3.2	1.6	0.8	0.8	0.8	0.8	0.2	-2.9	0.6
Unemployment rate (%)	4.4	5.2	5.6	5.8	5.7	5.5	5.1	4.5	4.0	5.3	5.2
CPI, ex fresh food (y/y)	0.0	-0.7	-1.1	-0.5	-0.1	0.3	0.4	0.3	1.5	-0.6	0.2
Core CPI (y/y)	-0.2	-0.5	-0.7	-0.6	-0.5	-0.4	-0.3	-0.2	0.0	-0.5	-0.3
Public Budget²									-5.6	-9.8	-8.0
Public Gross Debt²									196	212	220
Current Account²									3.3	2.4	3.6
O/N Target Rate (%)	0.1	0.1	0.1	0.1	0.1	0.1	0.25	0.5	0.1	0.1	0.5

1: Contribution to GDP growth, 2: Pct. of GDP

Disclosure

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