

# Japan Outlook

## A little help from my friends

- Japan started to recover in Q2 09 driven by a strong rebound in exports to the rest of Asia, inventory cuts gradually easing and fiscal stimuli. The recovery appears to be on a solid footing for the rest of the year, as these recovery drivers will largely remain in place.
- In 2010 the recovery will lose some steam, as the positive impact from fiscal stimuli and the inventory cycle starts to wane. The current strong pull from Asia will be hard to sustain in 2010, although Japan's dependence on the rest of Asia remains a structural advantage.
- Deflationary pressure has increased and inflation is likely to remain negative until late 2010. For that reason, the Bank of Japan (BoJ) is unlikely to start tightening until late in 2010. We think the BoJ will lag in the global monetary tightening cycle likely to start next year.
- We have only made minor changes to our forecasts. GDP growth for 2009 has been adjusted upwards and 2010 marginally downwards, largely reflecting our expectation that the recovery has been pushed slightly forward in addition to upward revisions of Q1 09 GDP.

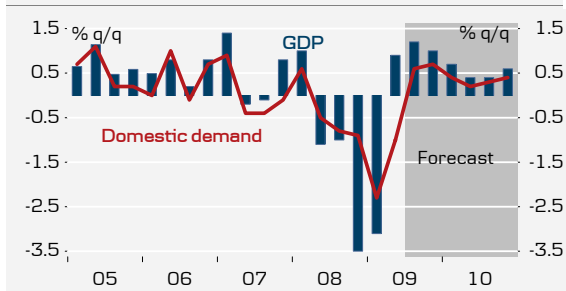
### Recovery on a solid footing for the rest of the year

Just as the contraction in the Japanese economy was unusually sharp in the wake of the global financial crisis, the recovery has so far been strong. In Q2 09 GDP growth rebounded 3.9% q/q AR and is on track to exceed 4% q/q AR in Q3 09. Hence the development in Japan has so far been broadly in line with our forecast in *Global Scenarios, June 2009*, where we argued for very strong GDP growth in the early recovery phase. The main drivers in the Japanese recovery have been:

- Strong export recovery, driven mainly by exports to the rest of Asia.
- Easing pace of inventory cuts.
- Fiscal easing with a particularly strong impact on private consumption.
- Improved financial conditions.

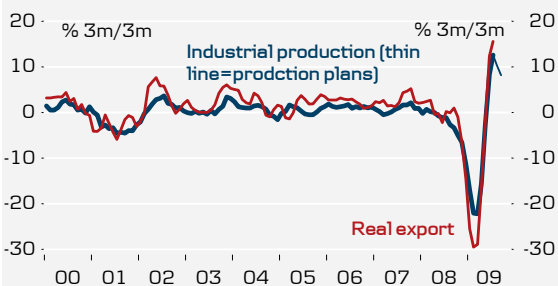
So far it has been a typical Japanese export-led recovery with the main beneficiary being the manufacturing sector. In Q2, net exports alone added more than 1.3pp q/q to GDP growth. The sharp rebound in exports has mostly been driven by exports to the rest of Asia, not least China. Manufacturing exports to the rest of Asia – accounting for about 50% of Japan's total exports – soared 15% q/q in Q2. Net exports to Asia alone probably added around to 1pp q/q to Japan's GDP growth in Q2. Japan is currently without doubt benefiting substantially from its dependence on Asian export markets.

### Recovery continues



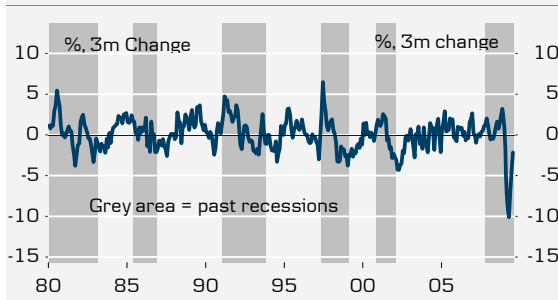
Source: Danske Markets, Bloomberg, OECD, IMF

### The downturn was sharp, the recovery has been strong



Source: Reuters Ecowin and Danske Markets

### Pace of inventory cuts is easing



Source: Reuters Ecowin

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While exports should remain a big positive for Japan, the extraordinarily strong growth in exports to Asia in Q2 and Q3 can probably not be sustained, see *Emerging Markets*. Exports to Asia are likely to start slowing in Q4 09, but this should be at least partly offset by stronger exports to Europe and the US in the short run as these economies start to recover. Hence, the important export driver appears to be solidly in place until early 2010. However, we have some doubt about its strength later in 2010.

**'Cash for clunkers' will give a short-term boost**

In addition, Japan's exports are being supported by a particularly strong improvement in demand for Japan's two most important exports articles: autos and electronics. Global demand for passenger cars has soared in recent months on the back of the very popular 'cash for clunkers' programmes around the world (including Japan). While production of passenger cars has increased by more than 50% since production hit the bottom in early 2009, production of cars still appears to be lagging both global and domestic passenger car demand.

**Inventory cycle still has some way to go**

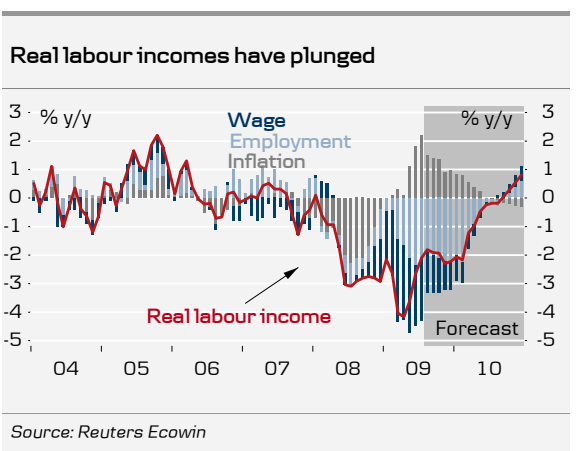
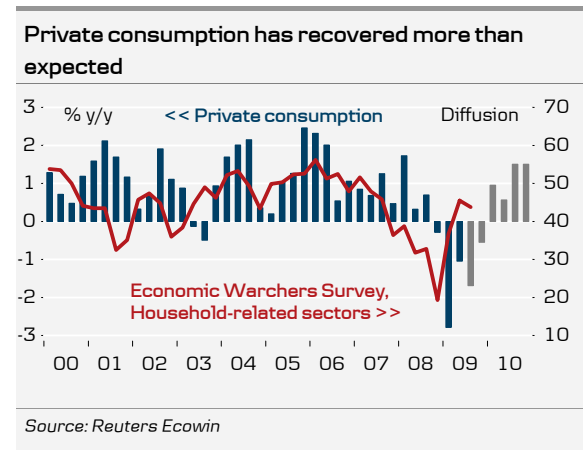
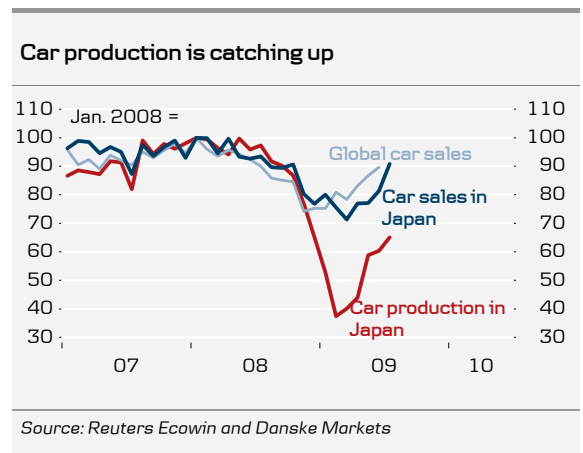
With inventories in the auto industry at record lows, we believe that the auto industry will remain an important driver for industrial activity in Japan in the coming months (the auto industry accounts for about 18% of total industrial production in Japan). As can be seen in the chart on the previous page, inventories are still being cut but the pace has eased substantially, suggesting that inventories could add substantially to GDP growth in Q3 09 and Q4 09. However, while the inventory cycle may still have some way to go in Japan, it is unlikely to add substantially to growth next year. In other words, the development in industrial activity next year will largely depend on the development in final demand.

**Fiscal policy remains supportive through H2 09**

Two fiscal stimulus packages have been implemented in Japan. The first consisted of mainly one-off tax cuts to households in Q2 while the second consisted mainly of a boost to public investments in H2 09. We believe the overall impact on GDP growth from the fiscal stimulus packages is around 2pp with the main impact in H2. Thus fiscal policy should remain supportive in the coming months, although growth in private consumption is likely to ease substantially in Q3 as the impact from the Q2 tax cuts starts to wane. However, it should be offset by a large increase in public investments.

The positive news is that the policy response for a change has been very effective. Despite a sharp drop in employment and real labour incomes, private consumption in Q2 surprised everyone by jumping 3.3% q/q AR.

However, as most measures in 2009's stimulus packages were one-offs, the net impact from fiscal policy next year will be negative without further fiscal easing. While the new Democratic Party of Japan (DPJ) government might ease fiscal policy in 2010, the impact on GDP growth is likely to be just 1pp even assuming no financing at all.



### Cautious outlook for 2010

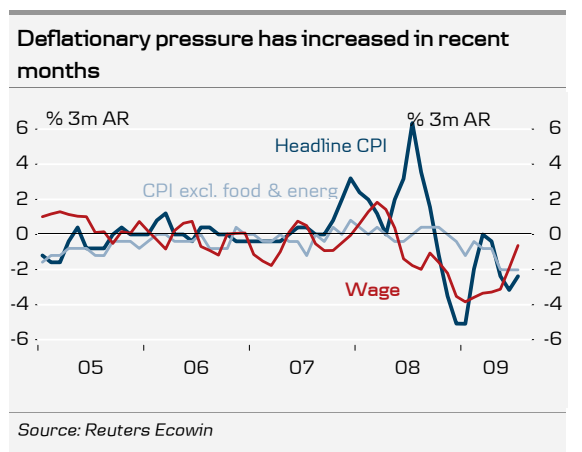
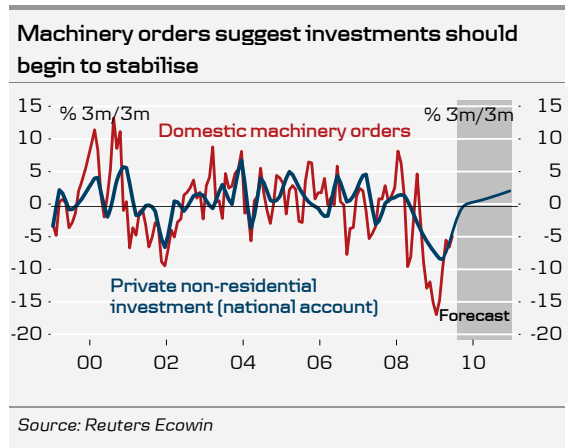
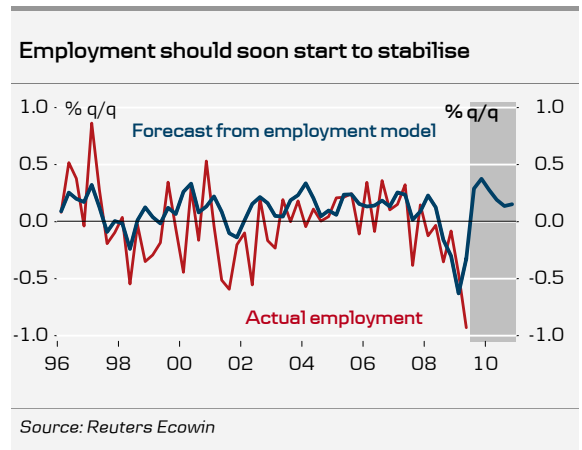
While we believe the recovery in Japan looks quite solid in the short run, we are a bit cautious about the strength of the recovery next year, because some of the important recovery drivers will weaken (exports to Asia) or possibly disappear completely (fiscal easing and boost from inventories). For that reason, continued strong growth in Japan will become more dependent on the US and Europe recovering and the export recovery in Japan increasingly spilling over into stronger domestic demand. Our base scenario is that this will indeed happen in 2010. Overall the recovery remains on track, albeit the pace of the recovery will slow.

Based on the development both in and outside Japan since *Global Scenarios, June 2009*, we believe that the likelihood that it will actually happen has increased. Compared with our forecast in *Global Scenarios, June 2009*, the economy has actually started to recover faster than we expected. Based on the development in exports and industrial production, we are quite confident that GDP growth in the current quarter will be at least as strong as Q2 09 (2.3% q/q AR).

If this is the case, employment should start to stabilise in the current quarter and increase in Q4 09, if we use the historical relationship between GDP and employment. As seen in the chart, the decline in employment in Q2 was actually substantially larger than predicted by our model. One explanation might be that Japanese companies have been planning for a worst-case scenario in early 2009 and for that reason we might end up with a sharper increase in employment than forecast, because companies might be understaffed even at the current depressed activity levels. Hence, the labour market should soon turn more supportive private consumption.

### Deflation remains a real threat

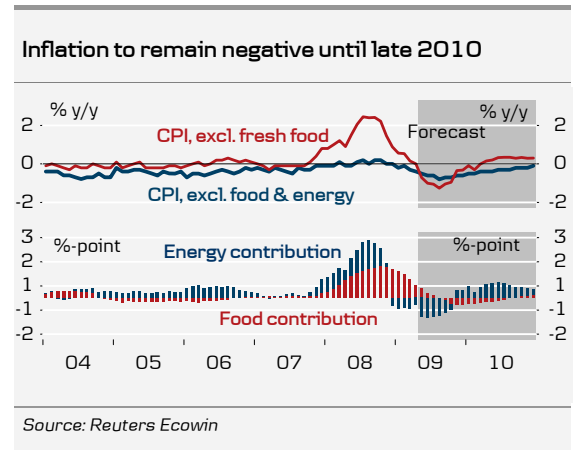
We cannot completely ignore the possibility that Japan will be pushed back into a destructive deflationary spiral, depressing asset values and boosting the real debt burden. While the economy appears to be recovering, deflationary pressure has increased substantially. In July headline inflation declined below 2% y/y. This is of course partly due to the base impact from higher energy and food prices last year. However, core CPI inflation excluding both food and energy has declined substantially in recent months and in July was running at around -2% 3m/3m AR. The recent decline in core inflation has been much stronger than expected, and despite recent higher crude oil prices and the base impact from higher crude oil prices now starting to wane, it increasingly looks like the headline year-on-year inflation will remain in negative territory for most of 2010.



### BoJ will lag in the global monetary tightening cycle

We believe that the year-on-year headline inflation turning back into positive territory is a necessary condition for the Bank of Japan (BoJ) to start to increase its leading O/N target rate and BoJ might at some stage make this condition explicit to the market. With inflation now likely to remain in negative territory for most of 2010, we now believe that BoJ is unlikely to hike the O/N target rate until very late in 2010 or possible even well in 2011. For that reason, it now looks as if BoJ will lag in the coming monetary tightening cycle, particularly its Asian neighbours China, South Korea and Taiwan, the most obvious candidates for monetary tightening in early 2010.

However, we believe BoJ is likely to start to pull back some of its non-conventional easing measures as early as Q1 10. These non-conventional easing measures include purchase of commercial papers and corporate bonds and providing liquidity in the interbank market at a fixed interest rate for longer maturities. Demand has waned for the commercial paper programme in particular as well as the corporate bond programme and they have lost their relevance. Hence, these programmes could terminate without any major impact on credit conditions.



### Japan macro forecast

% Change q/q AR	2009				2010				Calendar year average		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2008	2009	2010
GDP	-12.6	2.4	5.7	4.9	2.8	1.6	1.6	2.4	-0.7	-5.3	3.0
Private Consumption	-4.7	3.2	0.8	1.2	1.2	1.6	1.6	1.6	0.6	-1.2	1.4
Private Fixed Investments	-24.9	-8.9	9.8	9.5	3.6	-4.5	-2.7	7.1	-5.1	-12.0	1.7
Residential	-20.9	-32.9	1.2	1.6	1.6	1.6	1.6	1.6	-8.0	-9.0	-2.2
Non-residential	-29.9	-17.9	0.0	0.8	2.4	4.1	6.1	8.2	-4.1	-19.1	1.5
Change in invent. <sup>1</sup>	-1.2	-2.8	0.0	0.8	0.4	0.4	0.0	0.0	-0.2	-0.4	0.2
Public Consumption	0.4	-1.2	0.8	0.4	0.8	1.6	1.6	1.6	0.8	0.7	0.9
Exports	-63.9	28.2	36.0	21.6	14.8	12.6	12.6	12.6	2.0	-24.5	18.2
Imports	-47.6	-18.9	8.2	12.6	11.2	8.2	8.2	8.2	0.9	-15.8	1.1
Net exports <sup>1</sup>	-6.2	5.3	3.2	1.6	0.9	0.9	0.9	1.0	0.2	-2.4	0.7
Unemployment rate (%)	4.4	5.2	5.6	5.8	5.7	5.5	5.1	4.6	4.0	5.2	5.2
CPI, ex fresh food (y/y)	0.0	-0.9	-2.2	-1.5	-1.0	-0.6	-0.3	0.0	1.5	-1.2	-0.5
Core CPI (y/y)	-0.2	-0.5	-0.9	-0.8	-0.5	-0.4	-0.3	-0.1	0.0	-0.6	-0.3
Public Budget <sup>2</sup>									-5.6	-9.8	-8.0
Public Gross Debt <sup>2</sup>									196	212	220
Current Account <sup>2</sup>									3.3	2.4	3.6
O/N Target Rate (%)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.25	0.1	0.1	0.25

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

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### First date of publication

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