

Japan: Hitting the bottom will hurt

- Japan's economy is currently experiencing an unprecedented contraction in the wake of the current global financial crisis despite the financial sector at least initially being in much better shape than in the US and Europe. In 2009 GDP is expected to contract by an astonishing 5%. The main reason for the extraordinary weakness is Japan's high dependence on exports of highly cyclical manufacturing goods combined with a comparatively weak fiscal and monetary response. A domestic credit crunch is not yet a major issue but it could become one if Japan is pushed back into a deflationary spiral.
- The Japanese economy is expected to bottom out at very depressed levels in Q2 09 and recover slightly in H2 09 when cuts in inventories will ease, the impact from fiscal easing will start to kick in, and most importantly global trade is expected to rebound slightly. However, there will not be enough strength in domestic demand for Japan to lead a global recovery. A sustainable recovery in Japan in 2010 will be dependent on some rebound in global growth next year. In 2010, we expect GDP growth to recover to 2.8% mainly on the back on a rebound in global trade from very depressed levels.
- However, the unemployment rate will continue to increase until Q1 10 and the output gap will remain substantial by the end of 2010. Hence, Japan is entering dangerous deflationary territory with both wage growth and core inflation expected to remain negative until H2 10. With fiscal policy constrained because of political uncertainty, there is likely to be increasing pressure on the Bank of Japan (BoJ) to step up quantitative easing by increasing its purchase of government and corporate bonds and possibly even stocks. With the output gap remaining large, the leading interest rate is likely to be left unchanged at 0.1% until late 2010.

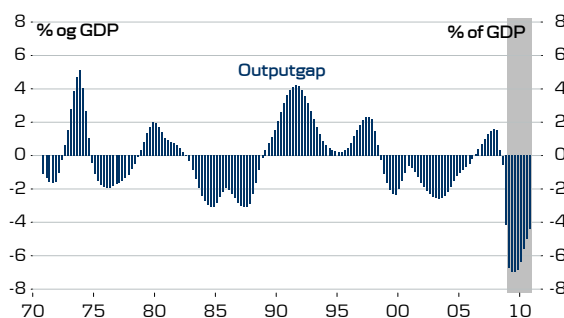
Sustainable improvement will depend on a global recovery

Sharpest downturn since the Second World War

How unfair the world must seem to be for Japanese policymakers at the moment. The global financial crisis has now hit the Japanese economy extraordinarily hard, despite the financial sector at least initially being in much better shape than in the US and most of Europe. Nonetheless, Japan will probably be one of the worst-performing global economies. We now expect Japanese GDP to contract by an astonishing 5% of GDP in 2009! This will be very difficult to beat.

By most measures, Japan is in its sharpest downturn since the end of the Second World War. The decline in the output gap in the current cycle from its peak in late 2007 and its expected trough in H2 09 is likely to be larger than during the two oil crises starting in the early and late 1970s and even larger than when the Japanese asset bubble burst in the early 1990s. In this bleak environment, the unemployment rate will probably increase above 6% by late 2009 – the highest unemployment rate ever in Japan.

The sharpest-ever downturn in Japan



Source: OECD and Danske Bank

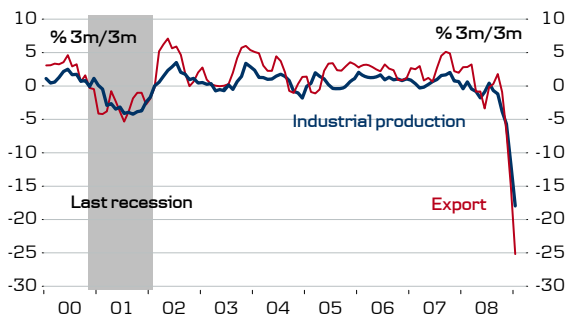
Dependence on manufacturing exports hurts Japan

Japan's main problem is the collapse in demand and global trade in the wake of the current financial crisis. The decline in Japan's export and manufacturing activity has been unprecedented, with exports and industrial production plunging 45% y/y and 31% y/y in January. Japan's export and industrial production has been hit hard because it is heavily exposed within cyclical industries such as autos, electronics and shipbuilding, all of which are currently experiencing particularly sharp declines in demand.

The 16% appreciation of the effective yen exchange rate is not yet a major issue, although it might become one at a later stage. Usually it takes at least half a year before an exchange rate change has a significant impact on exports. That demand and not the exchange rate is the main issue is underlined by

South Korea's (one of Japan's main competitors) exports currently performing just as poorly as Japan's despite a 35% appreciation of the yen against the South Korean won since September.

Unprecedented collapse in industrial production



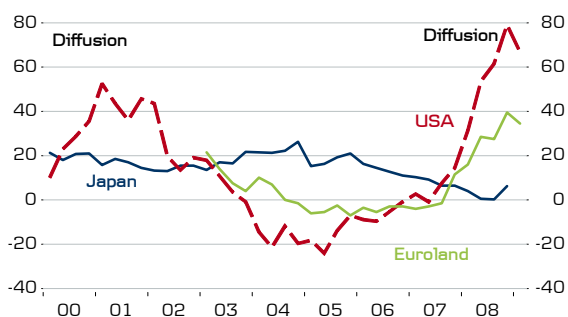
Source: Reuters Ecowin

Finally Japan's economy is currently being hit very hard because of its dependence on manufacturing exports. In Japan, manufacturing accounts for about 22% of GDP compared with just 17% and 12% of GDP in Euroland and the US, respectively. For that reason, there is a larger negative secondary impact on particularly investment demand from the recent collapse in global trade and industrial production.

Credit crunch is less of an issue at current stage

On the other hand, compared with Europe and the US, a domestic credit crunch is much less of an issue in Japan at the current stage. While lending standards according to senior loan officer surveys have been tightened significantly in both the US and Euroland, they have not been tightened significantly in Japan. That said, corporate lending standards in Japan were tightened slightly in late 2008 mainly for lending to small companies.

Lending standards on banks' corporate lending

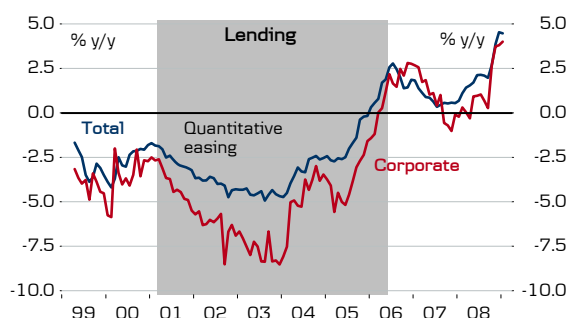


Source: Reuters Ecowin

In addition, bank lending growth has remained robust and even accelerated. We should be careful not to read too much into the latest acceleration in bank lending, as it might primarily reflect companies'

substitution of alternative sources of financing for easier access to bank lending and increased use of existing bank credit facilities on the back on increased pressures on companies' cash flows. Nonetheless, Japan is currently far from the severe credit crunch experienced from the late 1990s until the middle of the current decade, when bank lending in Japan contracted sharply.

No signs yet of a severe credit crunch in lending



Source: Reuters Ecowin

That said, it cannot be ruled out that a severe credit crunch could become an issue at a later stage if the current sharp contraction pushes the Japanese economy back into a vicious deflationary spiral. Lower stock prices are already weighing on banks' balance sheets and higher losses on the back of the weak economy might in end acting as a straitjacket on banks' ability to increase lending. However, with overall healthier balance sheets, we are still far from this situation in Japan.

Fiscal and monetary policy response has been weak

The weak Japanese growth performance is currently being exacerbated by a weak policy response on both fiscal and monetary policy.

Political uncertainty and the dismal state of Japan's public finances are currently preventing the LDP-led government to respond strongly on fiscal policy to the sharp deterioration in the economy. With the general government budget deficit likely to exceed 7% of GDP and gross government debt approaching 200% of GDP, there is a natural reluctance both among bureaucrats and politicians to go on a major public spending spree. As during the 1990s, the art of creating fiscal packages in Japan is mostly about boosting numbers without much new real spending to at least get a psychological impact on the market.

Box 1: Japan's fiscal policy response**Stimulus package 1**

- Total size JPY15trn
- JPY10trn in loan and guarantees
- JPY5trn in new spending (1% of GDP)
- ...of which JPY2trn in household disbursements
- In addition increased public spending, tax breaks for dividend income and small businesses
- Impact on GDP: +0.6%, main impact in Q2 and Q3

Stimulus package 2

- Total size is targeted JPY20-15trn
- Few specifics in the plan; its ability to survive politically is still uncertain
- A second stimulus package has not been incorporated in our forecast

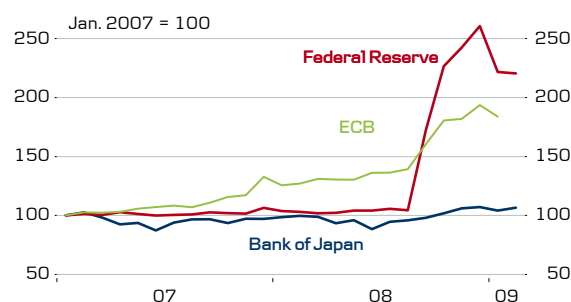
In addition, political uncertainty is increasingly preventing the government from responding fiscally. Currently the LDP-led coalition government has a majority in the Lower House, while the opposition has a majority in the Upper House. The current prime minister, Taro Aso, and his government is currently highly unpopular in opinion polls and it looks increasingly likely that the opposition will win a majority in connection with the Lower House election to be held by September this year. Hence, for only the second time since the Second World war, LDP is set to lose.

At the moment, the opposition is doing everything to force an early election to the Lower House, including blocking the government's fiscal stimulus package. We expect *stimulus package 1* to be approved soon while it is highly uncertain whether the government will be able to pass a second stimulus package before the Lower House is dissolved. While the overall impact from stimulus package 1 will be limited (+0.6pp to GDP growth in 2009), it should give some support to particularly private consumption in Q2 and Q3. While *stimulus package 2* cannot be ruled out, it has not been incorporated into our forecast because of lack of specifics and doubt about its ability to secure parliamentary approval.

BOJ can still do a lot, but will it work?

Compared with other countries, the monetary policy response in Japan has been comparatively weak. As the leading interest rate in Japan was already very close to zero, the impact from BoJ returning to some kind of zero-interest rate policy by itself has been

limited. BoJ has since gradually stepped up its non-conventional monetary easing. These measures include increasing its target for government bond purchases, and outright purchases of commercial papers and corporate bonds. However, measured by the increase in central banks' balance sheets, BoJ's unconventional monetary easing has still been modest compared with both the Fed and the ECB. One obvious explanation of course is that the credit crunch in Japan has been far from as severe as in the US and Europe and consequently there has been less pressure on BoJ to directly substitute for financial sector lending to the private sector.

G3 central banks' total assets

Source: Reuters Ecowin

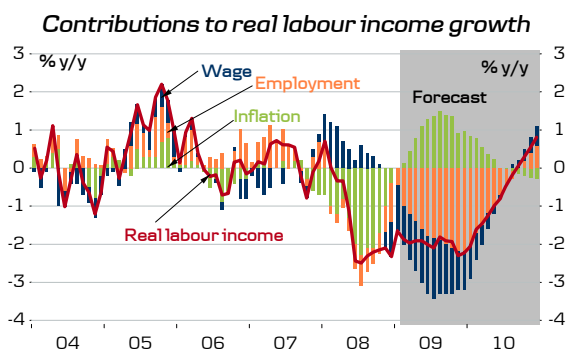
However, with the unprecedented contraction in the Japanese economy and the economy possibly being pushed back into deflationary territory later this year, we expect BoJ to accelerate its non-conventional easing measures significantly. While its impact on demand is highly uncertain, it could at least help to contain deflationary expectations.

Japan will hit the bottom in Q1 and it will hurt

To summarise, Japan is currently being hit extraordinarily hard by the collapse in global demand and trade and a comparatively weak fiscal and monetary response. A domestic credit crunch is not yet a major problem, but could become one if Japan is pushed back into deflation.

The short run outlook for the Japanese economy is dismal. Q1 will largely turn out to be a rerun of Q4 08. GDP will contract sharply driven mainly by plunging exports and weaker corporate investments. However, in Q1, inventories will be cut sharply unlike Q4 08 when inventories increased to unsustainable levels. Private consumption will continue to contract, as the recent sharp decline in inflation has been more than offset by the weaker labour market. Excluding the

impact from lower taxes, total real labour income is expected to contract by 2% in 2009.

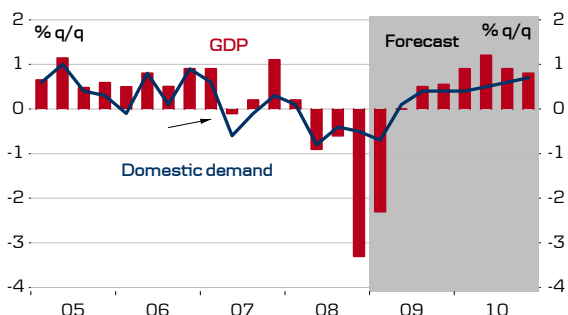


Source: Reuters Ecowin and Danske Bank

We expect the Japanese economy to hit the bottom in Q1, move along this bottom in Q2 and recover slightly in H2 09. The main reasons are:

- The negative impact from sharp inventory cuts will gradually fade. The main auto producers have already announced that they expect to increase production in Q2 following extraordinarily low production activity in Q1 to bring back auto inventories to more sustainable levels.
- Fiscal easing will start to have an impact in Q2 and Q3, when it is expected to support a slight recovery in private in private consumption.
- There are signs that global trade has started stabilising, albeit at very depressed levels. Exports should start to improve in H2 09 as the global inventory cycle gradually runs its course and the impact from the global fiscal response starts to kick in.

The economy will hit the bottom in Q1



Source: Reuters Ecowin and Danske Bank

In 2009 and 2010 there will probably not be enough strength in domestic demand to secure a sustainable recovery in the economy. A recovery will be largely dependent on an improvement in global growth and hence Japan is unlikely to lead a global recovery. Our

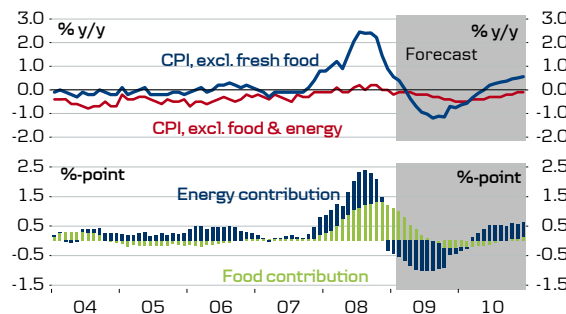
expectation that GDP growth will bounce back from a 4.9% contraction in 2009 to 2.9% GDP growth in 2010 mainly reflects our expectations that there will be some recovery in global trade next year from the current extraordinarily depressed levels.

Hence, we expect GDP growth in 2010 to be markedly above potential (about 1.3%). Before being accused of being overly optimistic, it is worth mentioning that our forecast still implies that the output gap will be close to -4% of GDP at the end of 2010. In addition, it should be remembered that following unusual large contractions, the first year of recovery is usually the strongest.

Back into deflationary territory

With the unemployment increasing to close to 6% and wage growth already negative there will be increasing downward pressure on core consumer prices. In addition, both energy and food prices will continue to drag headline inflation lower. By mid-2009, headline inflation will reach -1.5% y/y.

Consumer prices back into deflationary territory



Source: Reuters Ecowin and Danske Bank

For that reason BoJ can no longer ignore the possibility of Japan being pushed into a destructive deflationary spiral. Hence, BoJ will probably increase its attention to consumers' inflation expectations. Although the current board of BoJ overall does not regard its previous attempt at quantitative easing from 2001 to 2006 as particularly successful at boosting demand, it could at least be an important instrument to anchor price expectations.

Even without returning to explicit goals for quantitative easing, we believe BoJ will step up its non-conventional easing measures significantly by increasing its purchase of government and corporate bonds and possible even stocks. With the output gap remaining large until the end of 2010, the leading interest rate is expected to remain unchanged at 0.1%.

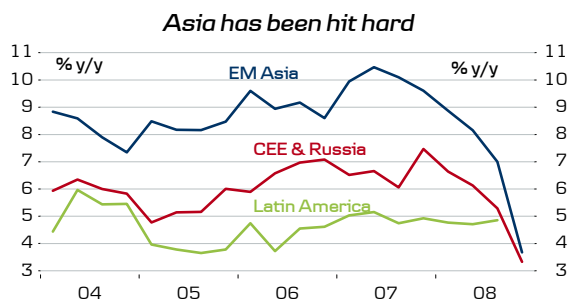
Emerging Markets: The crisis intensifies

- Emerging market growth has slowed sharply in all regions. In Asia the export dependent economies have been hit hard by the collapse in global demand and exports. In commodity exporting countries in Latin America, CIS and Middle East lower commodity prices have turned the main growth engine off. Particularly in Central & Eastern Europe finally financial stress is increasing as capital inflows have weakened and the domestic banking sector increasingly feel the strains from global financial crisis.
- For emerging markets overall we expect stabilisation in Q2 09 albeit at very depressed levels. We expect a slight recovery in H2 09 but we will have to wait until 2010 before the recovery gains a solid footing. However, with access to external financing becoming more strained and the political status quo increasingly being questioned there will be considerable downside event risk for emerging market in the short run. 2009 might turn out to be a very busy year for IMF.
- Most vulnerable are emerging markets with current account deficits, weak external liquidity positions and domestic financial institutions dependent on short term external funding. Here Central & Eastern Europe and some CIS-countries are the prime candidates. While there are signs of stabilisation in some emerging markets, particularly in Asia, there is a real danger that the crisis will intensify in Central & Eastern Europe. In addition recovery in Central & Eastern Europe will be weak compared to other emerging markets.
- Emerging Markets in Asia on the other hand is expected to outperform albeit weak global demand remains a major challenge in the short run. Besides strong current account and external liquidity positions the recent terms of trade gains in the wake of lower commodity prices is a major positive for Asia. In addition the policy response from both fiscal and monetary policy has been strong in Asia. At the moment it looks like China might turn out to be the first major economy to turn around despite being one of the last economies to be severely hit by the global financial crisis.

Unprecedented slowdown in growth

Growth slowing in all major EM regions

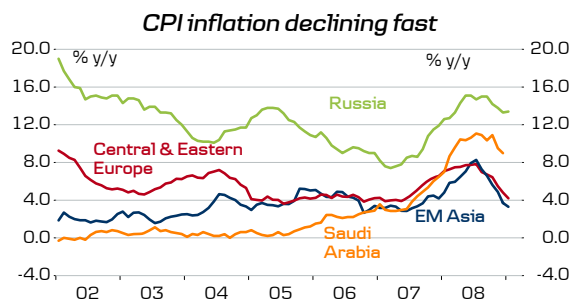
The pace of the slow down in GDP growth in Q4 08 is unprecedented and based on very sharp contractions in Q4 08 and our expectations of further contraction in Q1 09 most emerging markets (with China and India as the main exceptions) are likely to register negative growth. There are several reasons for the sharp slow down.



Note: EM Asia: China, India, Indonesia, South Korea, Singapore, Hong Kong, Thailand, Taiwan, Malaysia and Philippines. CEE: Poland, Hungary, Czech, Slovakia, Bulgaria and Romania. Latin America: Brazil, Mexico, Argentina and Chile

First, there is the impact from the decline in global demand and trade in the wake of the current financial crisis. The deterioration in global demand has accelerated sharply since the collapse of Lehman Brothers in September last year. While the decline in

global demand has hurt most emerging markets it has hit the very open and export dependent Asian economies particularly hard. Global demand and trade continued to contract in Q1 09 and is expected to stabilize in Q2 albeit at very depressed levels. The recent turnaround in manufacturing PMI's currently support the view that emerging markets overall is bottoming out in Q2. In H2 09 we expect a slight recovery before the recovery gains a more solid footing in 2010. The very cyclical Asian economies are expected to outperform in the recovery phase just as they underperform during the recent slow down.



Source: Reuters Ecowin and own calculations

Second, there is the impact from lower commodity prices. Commodity prices plunged by another 30% (measured by CRB-index) during Q4 last year but has overall stabilized in recent months. The terms of