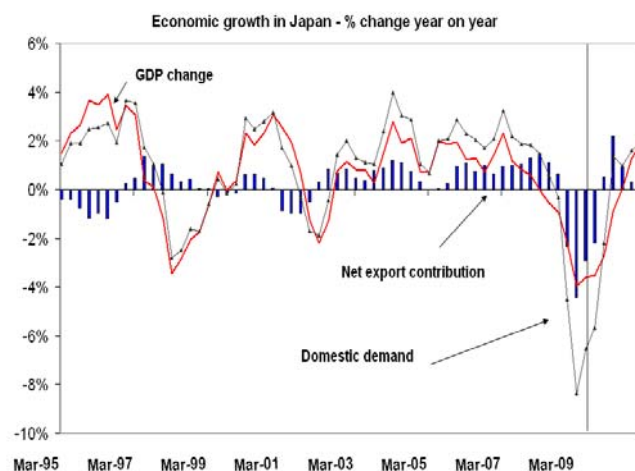
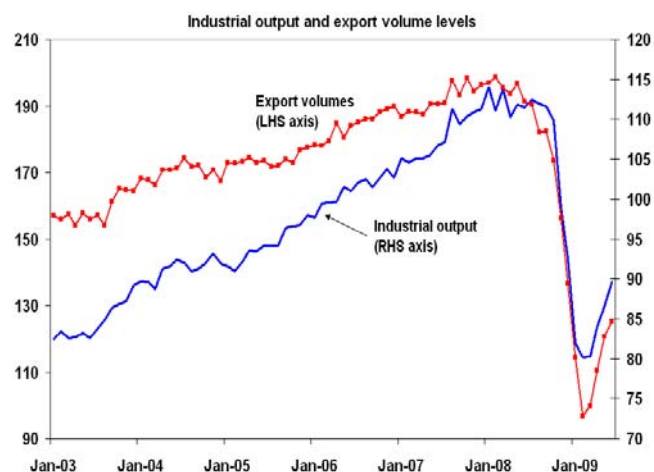


Economic growth resumes in Japan

Key trends

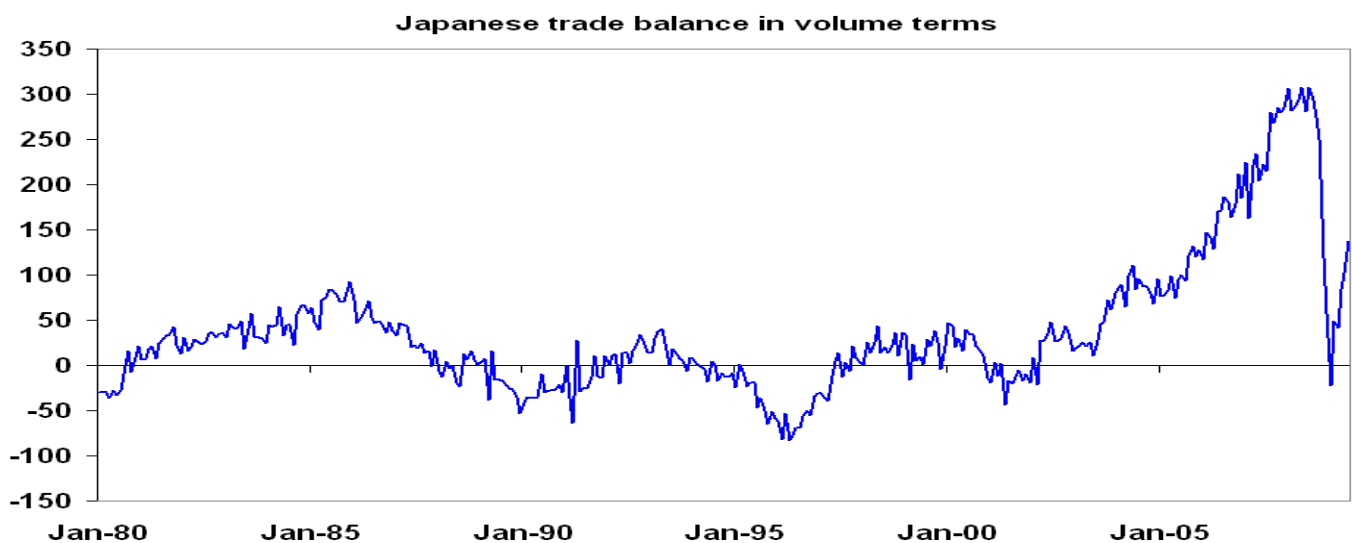
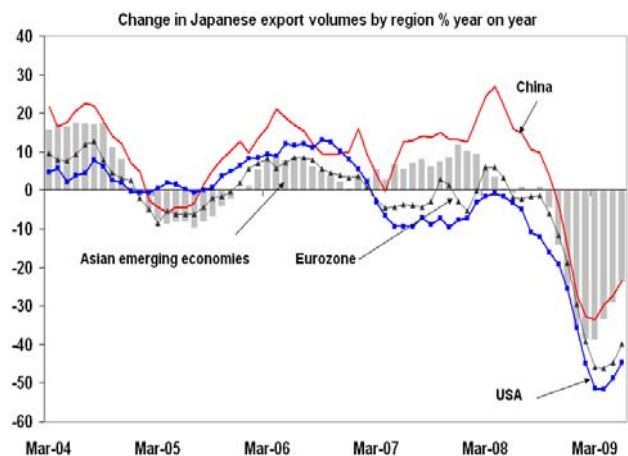
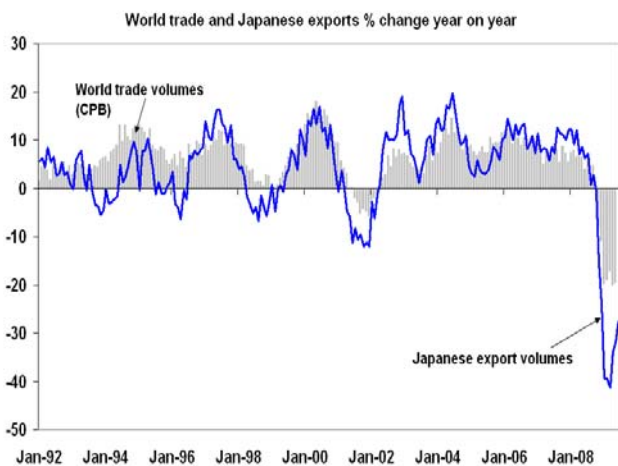
- After experiencing four consecutive quarters of falling output which cumulated in GDP fall of 8½%, some recovery in output was seen in the June quarter. The economy expanded by 0.9%, mainly driven by an increased contribution from trade with exports rising by around 6½% while imports fell by 5%. This upturn in exports has helped drive some recouping of the big losses in industrial output seen over the last year. Production is still, however, still running well below year-earlier levels.
- The Government sector was the other main driver of economic growth - via a combination of direct spending on public investment and cash transfers to the household sector. Consumer spending rose by around 0.8% in June quarter, a surprisingly strong increase after two very weak quarters and in an environment of rising unemployment and downward pressure on household earnings.
- We have revised our forecasts for Japanese output in the wake of these better than expected numbers and now expect GDP to fall by around 5¼% in 2009. Much of the Japanese economy is still very weak with rapidly declining business investment, large amounts of excess capacity and falling employment. Despite this, the business surveys suggest that growth should continue, but, unless a V-shaped global upturn lifts exports, the upturn should be modest.



Export driven recession slowly unwinds

Exports were the key driver of Japanese growth prior to the onset of the global recession as persistently weak domestic spending held back the pace of output growth. As a result, when world trade experienced its sharpest fall since the 1930s, Japan was one of the hardest hit economies in the world. According to the CPB measure of world trade volumes, global exports fell by almost 17% between November 2008 and January 2009 but the pace of decline then slipped to a cumulative 2% between January and May. Japanese export volumes fell by almost 40% between October and February but subsequently recovered about a third of those losses.

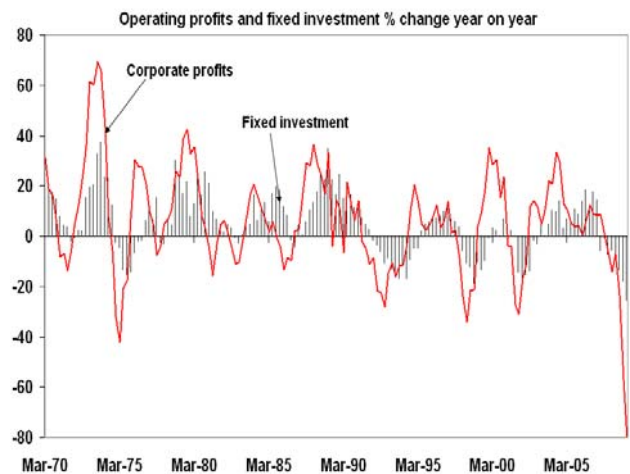
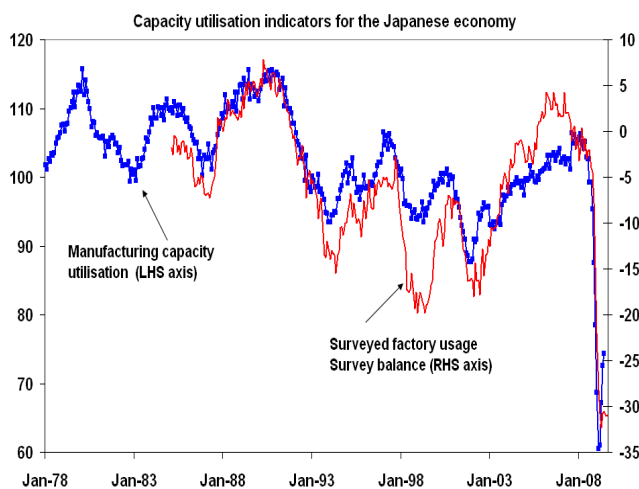
The decline in Japanese exports has been broadly based, reflecting the geographical extent of the downturn in world trade. Rising shipments to China and the emerging market economies of East Asia had driven the pre-crisis strength in Japanese manufacturing. The deterioration in sentiment after the collapse of Lehman Brothers, however, resulted in big declines in imports across East Asia with 30 to 40% falls in Japanese export volumes to the region. The situation in the US and Eurozone export markets was even worse with declines at the trough of almost 50% in volumes. The magnitude of the drops has been scaled back in the last few months and that, along with falling imports, has boosted the trade surplus and resulted in renewed GDP growth.



Investment spending falling sharply

Business investment was the other main engine of growth in the Japanese economy through the previous growth period but it has gone sharply into reverse. The June quarter national accounts showed the fifth successive reduction in non-residential investment, resulting in a drop of over 20% yoy. The weakness of business investment is hardly surprising as all the drivers of fixed investment are extremely negative. The manufacturing capacity utilisation measures are easily the lowest since the data starts in 1978 and the Shoko Chukin business survey shows a similar picture for respondent plant utilisation - so there is no need to invest to lift economy-wide capacity.

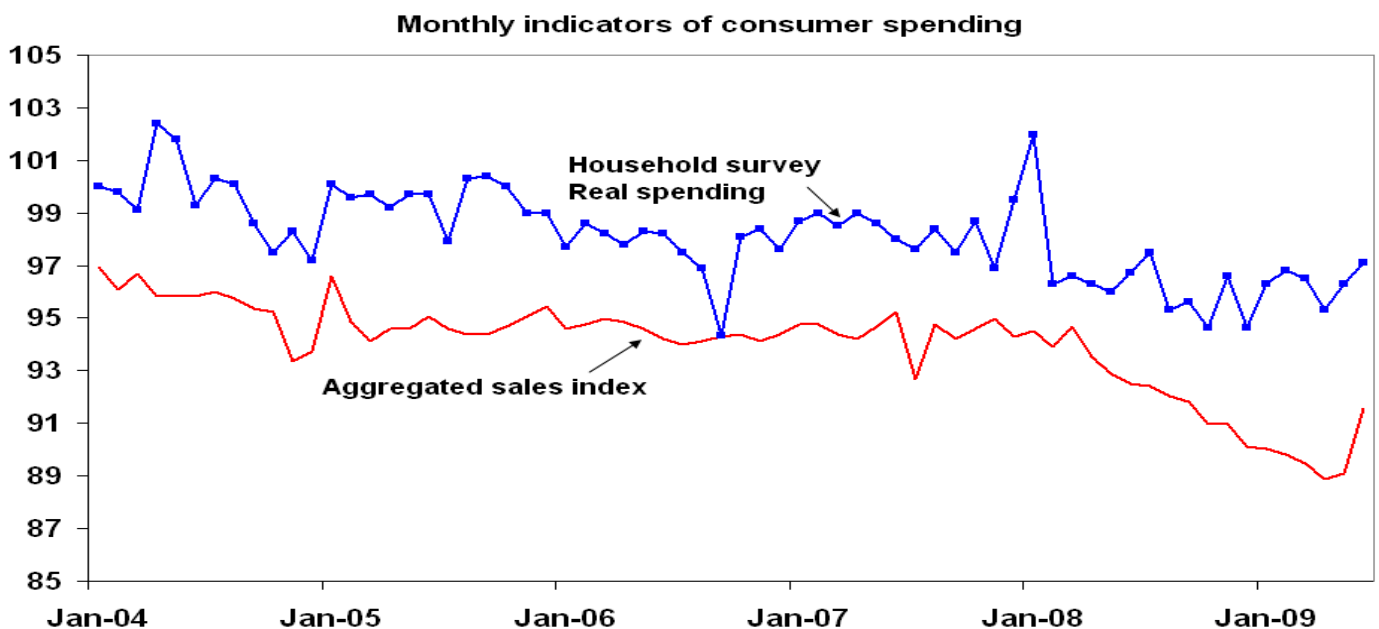
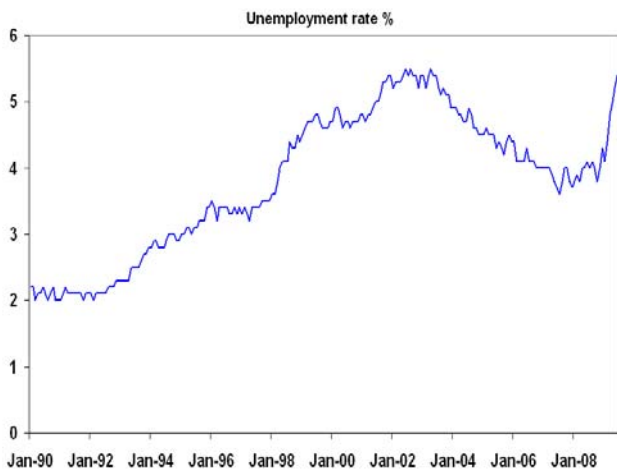
Profitability has been the other key driver of business investment and the MOF surveys of corporate finance show an exceptionally severe decline in earnings. Operating profits were down by almost 80% yoy in March quarter while current profits were almost 70% lower. The Shoko Chukin business survey showed easily the worst results on profitability for 30 years. Recently, however, things have looked less negative with the Shoko Chukin survey results improving slightly while the Tankan survey suggests that firms expect earnings and profit/sales ratios to improve in late 2009 and early 2010. The Tankan survey points to further weakness in the investment intentions of Japanese business and our forecasts are for a further decline in investment until year-end followed by a weak recovery.



Consumer spending up against weak background

Although the June quarter national accounts showed a rise of 0.8% in private consumption, the environment looks very unpromising for a sustained lift in household demand. The labour market is still weakening with employment falling steadily since late last year to result in a drop of around 2% in the employed workforce. At the same time the jobless rate has increased very rapidly - from around 3.8% last October to a near record 5.4% in June.

Household earned incomes have come under great pressure with the Labour Ministry monthly survey showing significant reductions in cash earnings, largely reflecting big reductions in overtime and other non-standard hours. Total cash earnings were down by 7% yoy in June month with a drop of around 1% yoy in scheduled wages and double-digit declines in non-scheduled and special cash earnings. The most comprehensive quarterly measure of real household incomes is the compensation of employees and this has fallen in real terms by around 2% between December quarter 2008 and June 2009. This points to the importance of Government efforts to stimulate demand with a clear lift in the aggregated measure of retail sales in the June quarter.



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