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Japan – A fragile rebound

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- Q2-09 GDP improvement reflects less distressed exports; domestic demand weakness is still evident
- GDP should improve further in H2, but wage and price deflation will hurt
- We revise our monetary policy forecast – we now see the BoJ keeping the policy rate at 0.1% through 2010 and considering inflation targets to anchor expectations

Q2 rebound driven by a smaller export decline

Japan's Q2-2009 real GDP growth of 0.9% q/q (-6.4% y/y), reported this morning, marks the end of the technical recession that began in Q2-2008 (for details, see Table 2 and Chart 1). The rebound was driven mainly by external demand, which added 1.6ppt to the q/q headline figure. Domestic private demand remained very weak. On the investment side, both capital formation and inventory build-up continued to suffer steep declines, resulting in a 1.3ppt drag on growth. This more than offset slight rebounds in consumption (+0.5ppt) and public spending (+0.3ppt).

Lingering weakness

The GDP rebound, which was widely expected, falls short of pointing to a sustainable recovery. The positive contribution of net exports was the result of a more moderate decline in exports (which still fell by 22.5% on a y/y basis) and a continued drop in imports, which reflects weak domestic demand. We are disappointed that investment spending remained on a downtrend, failing to reflect improvements in financial-market sentiment and Bank of Japan (BoJ) efforts earlier this year to alleviate corporate funding distress. We are also underwhelmed by the rebound in consumption, which, despite the government's stepped-up subsidy programmes (part of its latest stimulus package), reflects the negative impact of rising unemployment and the spread of the swine flu during the quarter.

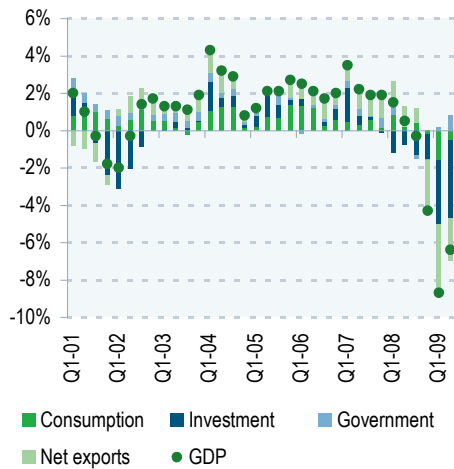
Table 1: SCB Japan forecasts

| | Q2-09 | Q3-09 | Q4-09 | Q1-10 | Q2-10 | 2009 | 2010 |
|--------------------------------|-------|----------------|----------------|----------------|----------------|----------------|----------------|
| Real GDP growth (y/y %) | -6.40 | -4.50 | -3.40 | 2.50 | 0.00 | -5.80 | 0.60 |
| Inflation (y/y %) | -1.20 | -2.40 | -2.70 | -2.50 | -2.50 | -1.60 | -2.50 |
| Policy rate (%) | 0.10 | 0.10 (0.00) | 0.10 (0.00) | 0.10 (0.00) | 0.10 (0.00) | 0.10 (0.00) | 0.10 (0.00) |

Note: Data in brackets denotes previous forecasts; Source: SCB Global Research

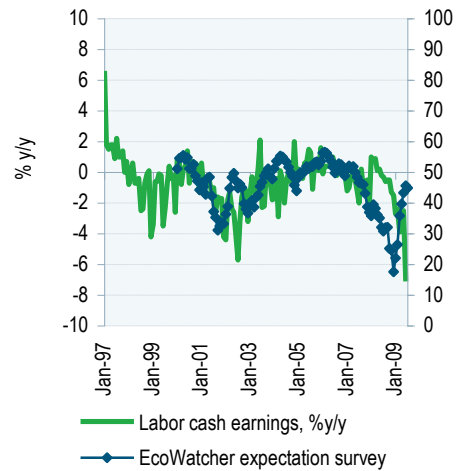


Chart 1: GDP growth contributors, y/y %



Sources: Bloomberg, SBC Global Research

Chart 2: Wage and sentiment trends



Sources: Bloomberg, SCB Global Research

Rebounding sentiment, collapsing income

We maintain our expectation of a weak recovery ahead. On a positive note, recent improvements in the global growth outlook and regional trade flows should bring a more substantial export recovery in the coming quarters. Local demand should also receive marginal support from continued fiscal pump-priming and the receding swine flu threat. Yet the biggest menaces, namely falling prices and rising joblessness, will continue to weigh on domestic demand. We note in particular the continued broad deceleration in the GDP deflator, which declined to a -1.1% q/q (0.5% y/y) pace in Q2, as another sign of the deflationary pressure facing the economy. The record 7.1% y/y plunge in June labour cash earnings (see Chart 2), reported earlier this month, is also a harsh reminder that the second-round impact of the H1-2009 output plunge could well linger, even though the initial shock has passed.

Anchoring price expectations to remain BoJ's top job

While we earlier warned of the rising deflation threat and called on the BoJ to ease policy further, the latest improvement in the headline growth figure – along with the Fed's latest position on its own quantitative easing measures – makes the BoJ more likely to avoid further drastic action, even at the risk of prolonging the deflation spell. Accordingly, we have revised our forecast and now expect no change to the BoJ policy rate for the remainder of 2009 and 2010, as shown in Table 1. This is premised on the view that continued deflation will justify using more explicit measures, e.g. an inflation target, as a policy goalpost to anchor price expectations at some point.

**Table 2: Japan real GDP growth by component**

| | Q2-2009 q/q% | Q2-2009 SAAR% | Q2-2009 y/y% | Contribution to GDP | Q1-2009 q/q% |
|-----------------------------|-----------------|------------------|-----------------|------------------------|-----------------|
| GDP | 0.9% | 3.7% | -6.4% | -- | -3.1% |
| Domestic demand | -0.7% | -2.7% | -4.2% | -0.7% | -2.2% |
| Private demand | -1.3% | -5.0% | -6.1% | -1.0% | -3.0% |
| Private consumption | 0.8% | 3.1% | -0.9% | 0.5% | -1.2% |
| Residential investment | -9.5% | -33.0% | -10.1% | -0.3% | -5.7% |
| Capital investment | -4.3% | -16.1% | -22.8% | -0.6% | -8.5% |
| Private inventories | -- | -- | -- | -0.5% | -- |
| Public demand | 1.2% | 4.7% | 2.8% | 0.3% | 0.6% |
| Fixed capital formation | -2.6% | -10.2% | -15.5% | -0.6% | -6.0% |
| Net exports | -- | -- | -- | 1.6% | -- |
| Exports of goods/services | 6.3% | 27.9% | -29.3% | 0.8% | -22.5% |
| Imports of goods/services | -5.1% | -18.9% | -17.3% | 0.8% | -14.9% |
| GDP deflator (y/y %) | 0.5% | | | | 0.9% |

Sources: Cabinet Office, Bloomberg, SCB Global Research



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