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Japan

03:30 GMT 22 July 2009

- Deflation threat is deepening despite a stabilisation of the output plunge
- Macroeconomic policy is likely to remain expansionary despite talk of an exit strategy
- Possibility of the first change of ruling party in half a century adds to political risks

Macroeconomy

Q1 GDP plunged by a record 4% q/q (9.7% y/y). The steep decline was led by exports (-26% q/q) and capital investments (-10.4%), which more than overwhelmed positive contributions from falling imports (-15% q/q) and a slight gain in government spending (+0.2% q/q). Data released in Q2 so far points to a stabilisation of sentiment but still-steep declines in real sectors, from housing to exports. We expect output to continue to fall by a severe 8% in Q2 before narrowing to a 3% decline in H2, bringing the full-year contraction to 5.8%. While Q1 may have seen the worst of the headline GDP plunge, the current negative GDP gap of more than 8% is putting heavy downward pressure on prices. All inflation measures are venturing deeper into negative territory, a trend that we expect will last until year-end.

Exchange rate

USD-JPY failed to rebound above 100 in early April and has since been trending downwards, hitting a five-month low of 92.5 in early July. We think that USD-JPY will be limited by broad-based USD weakness and that JPY overvaluation will have to be expressed through the crosses rather than against the USD. We expect broad-based USD weakness in H2 to prompt a break below 90 in Q4.

Interest rates

The Bank of Japan (BoJ) has kept its policy rate near zero (at 0.10%), and decided at its latest meeting in July to extend its various liquidity measures until year-end. While official forecasts have been revised upwards to take into account an expected stabilisation in the global economy in the near term, heavy deflationary pressure at home likely means the bank will maintain its current ultra-loose monetary policy despite talk of an 'exit strategy'. We expect CPI declines to continue steepening in H2, putting renewed pressure on the BoJ to ease policy towards year-end.

Fiscal policy

The government unveiled a new fiscal stimulus package totalling JPY 15.4trn on 10 April, which it said would create 400,000-500,000 jobs and push up GDP by 2ppt in FY10 (ends 31 March 2010). The JPY 15.4trn headline figure amounts to 3% of GDP, making this the largest stimulus package in Japan's history. The upcoming general election on 30 August could lead to a change in government (see 'Politics' section below), yet whichever party wins the election is expected to maintain the current expansionary fiscal policy.

Important disclosures can be found in the Disclosures Appendix.



Politics

Prime Minister Taro Aso called a general election for 30 August following the stunning defeat suffered by his Liberal Democratic Party (LDP) in the Tokyo assembly election in mid-July. The latest opinion polls point strongly to a victory for the opposition Democratic Party of Japan (DPJ), which, if it materialised, would put an end to over 50 years of LDP leadership. We expect that a DPJ-led government would shift the focus of fiscal spending to boosting household income and pursue deeper regional cooperation, especially with China. Key near-term concerns are the potential failure of a single party to win a strong mandate, and the risk of market dissatisfaction with the 'missing pieces' in DPJ's economic strategy.

Structural issues and business conditions

The ageing of Japan's population is set to accelerate in the coming years, with the working-age population (15-65) now declining by 0.8% a year on average and the 65+ population set to rise to 26% of the total population by 2020 from 21.5% currently. The household sector remains extremely conservative, holding massive amounts of cash savings that earn no returns, which explains the lack of domestic growth even during the latest recovery cycle. Business conditions will likely remain cyclically depressed in the near term, but the demographic shift may create opportunities for some sectors.

External sector

Japan has relied increasingly on externally driven growth in recent years. Exports now account for 18% of GDP, up from 10% in 1999, and until recently contributed more than half of GDP growth. Japan is a major exporter of top-end manufactured products and capital goods. Its top export destinations are the US (20.4%), China (15.3%), South Korea (7.6%), Taiwan (6.3%), and Hong Kong (5.4%).

Table 1: Economic forecasts for Japan

	2007	2008	2009F	2010F	2011F	2012F
GDP growth (%)	2.4	-0.7	-5.8	0.6	0.8	1.0
Inflation (%)	0.1	1.4	-1.6	-2.5	-2.0	-1.5
USD-JPY (year-end)	111.7	90.6	88.0	105.0	103.0	100.0
Policy rate (overnight call rate %, year-end), %	0.50	0.10	0.0	0.0	0.25	0.25

*Note: 2007-2008 actual, 2009-2012 SCB estimates;
Source: SCB Global Research*



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Data available as of 03:30 GMT 22 July 2009. This document is released at 03:30 GMT 22 July 2009.

Document approved by: Nicholas Kwan, Regional Head of Research, Asia