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GLOBAL ECONOMIC & MARKET OUTLOOK

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Eurobank EFG

FOCUS NOTES

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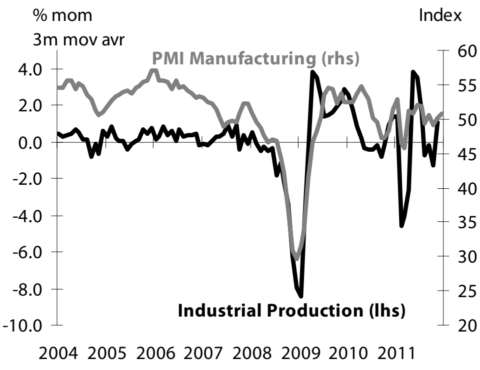
Japan should avoid a technical recession, supported by reconstruction-related activity and inventory restocking

- Although the Japanese economy marked in Q4 2011 the fourth GDP contraction in five quarters, recent economic data suggest that economic conditions are slowly improving.
- In our view, Japan should avoid a technical recession, with reconstruction-related activity and inventory restocking offsetting any further weakness in net trade.
- The risk of a slowdown may appear again in FY2013, when reconstruction demand would have run its course and tax hikes would have to take effect in order to finance the increased government consumption and investment.
- The Bank of Japan surprised markets at its February policy meeting with a decision to increase long-term JGB purchases and turn its "understanding" of medium/long-term price stability into an inflation target of 1%.
- Although the recent monetary easing was warranted to support the fragile Japanese economy, additional support from fiscal policy is needed to help the economy return to a sustainable growth path.

Overview

Although the Japanese economy contracted in the final quarter of 2011 mainly due to particularly weak external demand, recent economic data suggest that economic conditions are slowly improving. Private domestic demand sustains growth, with the manufacturing PMI index hovering above the 50-threshold that signals expansion (Figure 1). In our view, Japan should avoid a technical recession, with real economic activity regaining momentum in 2012 and, particularly in the second quarter of the year as reconstruction-related activity and inventory restocking should start exerting an influence on GDP growth. However, we have further downgraded our Japanese growth projection for 2012 to 1.6% from 2.3% a quarter earlier, as the recovery is starting from a very low base and gloomy global economic conditions should take their toll on the Japanese economy.

Figure 1



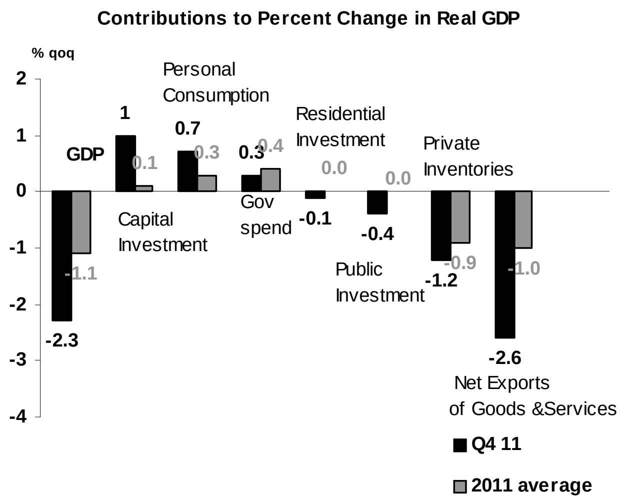
Source: Bloomberg

Although we do not expect net trade to rebound quickly given persisting global economic stagnation in H1 2012, export volumes should be supported by a rebound from Thailand flooding. The timing of the implementation of the third supplementary budget, which includes the bulk of post-earthquake reconstruction plans, as well as the fourth supplementary budget[1] which is a key factor for the consumption outlook, will be crucial for the recovery of the Japanese economy. The risk of a slowdown may appear again in FY2013, when reconstruction demand would have run its course and tax hikes would have to take effect in order to finance the increased government consumption and investment.

GDP plunged in Q4 2011 due to external slowdown and a huge decline in inventories

Real GDP was much weaker than expected in Q4 2011, reporting a contraction of 2.3% q-o-q annualized versus the market forecast of -1.4% (Figure 2). Although the negative growth was partly attributed to unfavorable base effects, as Q3 growth was revised upwardly from 5.6% to 7.0%, the key factor for the economic plunge was a sharp slowdown for external demand. Exports declined significantly by -11.9% q-o-q annualized due to the global economic slowdown, the appreciation of the yen and the impact of Thailand flooding. Given that imports sustained growth (+4.1% q-o-q annualized), boosted by fossil fuel imports for power generation, net trade had a large negative contribution to real economic activity of -2.6%.

Figure 2



Source: Cabinet Office

[1] The FY2011 fourth supplementary budget passed at the beginning of 2012 amounts to JPY2.5trn and includes JPY300bn for eco car subsidies (for environment-friendly vehicles), JPY493.9bn for medical treatment for the elderly, child raising and welfare, and JPY133.9bn for welfare benefits. The budget also includes JPY740 bn for cash flow assistance for small businesses hit by last March's earthquake and tsunami.

Private domestic demand had a positive contribution of 0.5% to real GDP growth, with consumer spending increasing for a third quarter by 1.2% q-o-q annualized and private capex rebounding to 7.9% growth after four quarters of decline. In contrast, housing investment declined by -3.1% q-o-q annualized, reversing its upward momentum in the previous quarter due to the eco-point program[2] and the Flat 35S mortgages[3]. In addition, private inventory investment contributed negatively to real GDP, subtracting -1.2% from the annualized quarterly growth. As far as the public sector is concerned, public domestic demand declined for a second quarter, subtracting 0.2% from real economic activity. The contraction in the public sector was entirely attributed to public fixed investment, which contracted by 9.5% q-o-q annualized. This marked a second consecutive decline and reinforced our view that the implementation of the JPY12.1trn third supplementary budget which contains the bulk of post-earthquake reconstruction will not spur renewed growth earlier than Q2 2012.

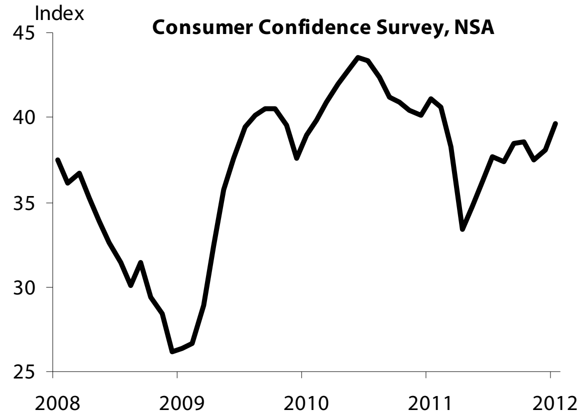
Private consumption to sustain positive momentum in the coming quarters

According to our estimates, real economic activity will most likely rebound in Q1 2012 towards 1.5% q-o-q ann, avoiding a technical recession, i.e. a second consecutive quarter of GDP contraction. Personal consumption is expected to sustain positive momentum in the coming quarters, supported by reconstruction and the eco-car subsidies revived as part of the fourth supplementary budget. In particular, the eco-car subsidies should underpin consumption in 2012, offsetting the fall in sales of flat-panel TVs due to the end of earlier policy supports. Indeed, recent economic data suggest that personal outlays should continue to support real economic activity. Retail sales rose sharply in January (4.1% m-o-m versus market expectations of 1.0%), reversing its recent downward trend. Much of the increase was attributed to a surge in auto sales, which increased to their highest level since August 2010 due to the reintroduction of the subsidy for purchases of fuel efficient cars. In addition, according to the Cabinet Office's Household Survey, the headline index of consumer confidence continued to edge up at the beginning of 2012, increasing to 39.6 in January from 38.1 in the previous month (Figure 3). However, we anticipate a rather moderate acceleration of personal expenditures, to an annual average of 1.2% from 0.0% in 2011, as unfavorable labor market conditions continue to weigh on wage growth (Figure 4).

[1] The eco-point program was designed to promote energy-efficient home appliances in an effort to cope with power shortages caused due to the earthquake and tsunami in March.

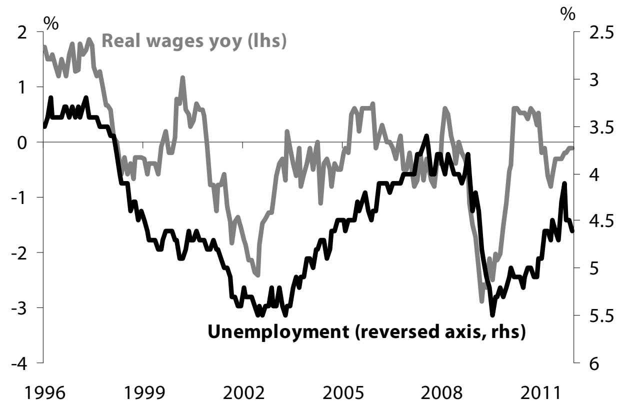
[2] The Flat 35S mortgages are loans with duration of 35 years maximum, offering preferential lending rates for the purchase of high-quality residences.

Figure 3



Source: Cabinet Office

Figure 4



Source: Bloomberg

Public fixed investment to be the major source of growth in 2012

In line with the January's EWS's optimism on the reconstruction outlook, we believe that public fixed investment will be the major source of growth in 2012, starting to boost real GDP in the second quarter of the year. According to Cabinet Office estimates, the third supplementary budget passed on November 21, 2011 will provide a real GDP boost of about 1.7%, i.e. about JPY8.6trn, with JPY4.3trn in public investment and the rest JPY4.3trn in private capex (JPY1.9trn), government consumption (JPY1.4trn) and private consumption/housing investment (JPY1.0trn).

Trade deficit to continue through 2012, albeit at a lower level

Export growth continued to trend down at the beginning of 2012, with the trade balance reporting the largest deficit Japan has ever posted in a single month (-JPY1.48trn). Exports declined for the fourth consecutive month (-9.3% yoy after a decline of -8.0% in December), while imports maintained their upward trend, increasing by 9.8%. However, much of this deficit is due to special factors, i.e. seasonality[4] and China's Lunar New Year which was in January[5]. Therefore, although Japan's trade deficit will likely continue through 2012 as import growth will probably outweigh export growth due to continuing demand for energy and support from post-quake reconstruction, we do not expect a larger deficit in the following months. The global manufacturing cycle is showing signs of recovery, contributing positively to Japan's export volumes. Meanwhile, the negative impact of the above-mentioned special factors should fade, and the rebound from Thailand flooding should soon materialize.

Additional monetary easing by the BOJ surprised markets

The Bank of Japan (BOJ) surprised markets at its February 13-14 monetary policy meeting with a decision to increase long-term (with maturities of 1-2 years) JGB purchases JPY10trn under the Asset Purchase Program, from JPY55trn to JPY65trn (Table 1), and turn its "understanding" of medium/long-term price stability (median 1%) into a price stability goal of 1% "for the time being". The BOJ will complete its planned purchases by the end of 2012, as was scheduled before the increase, suggesting that the monthly pace of JGB purchases should accelerate towards JPY1.4trn/month. We believe that the central bank's move came amid heavy political pressure, as fiscal policy intervention has not yet moved forward with a decision on consumption tax hikes. Although the Bank of Japan's governor has highlighted central bank's independence when it implements monetary policy, recent calls in Japan's parliament to move to a more accommodative policy -given that other major central banks[6] have enhanced their monetary easing measures- have urged the BOJ to go along with additional monetary easing and change its language in order to increase its transparency and credibility.

The last time the BOJ increased the size of its long-term purchases was in October 2011, as a result of yen appreciation. That said, the recent move of the central bank partly reflects exchange rate considerations. Indeed, the recent monetary easing has led to a further depreciation of the yen, mainly against the dollar (about 3%), while equity prices have extended recent gains since the latest Bank of Japan's actions (about +7.5%). We remain cautious about the longer term impact of the recent monetary easing, given that central banks overseas move toward additional easing, posing upward pressure on the yen. While the BoJ has made steps toward easing since 2010, it has a long way to go before it catches up with the easing already done by its G10

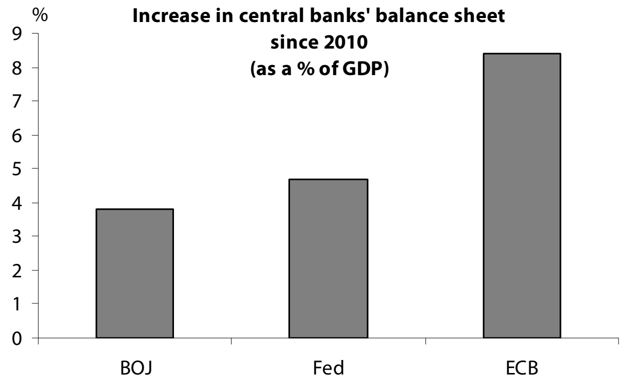
[4] *January is prone to deficits due to seasonality.*

[5] *In contrast to last year's Lunar New Year, which was in February 2011.*

[6] *The Bank of England, the European Central Bank, the US Federal Reserve.*

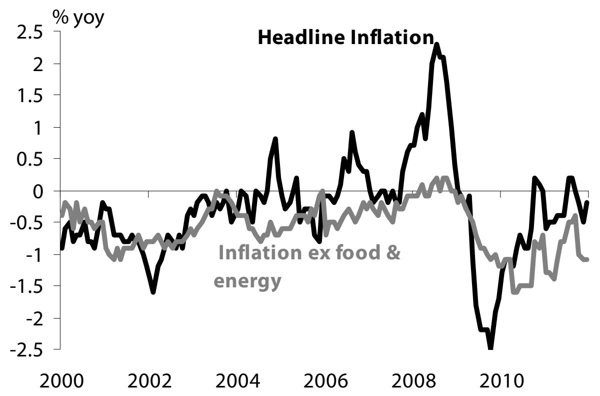
counterparts (Figure 5). Should the Fed move forward with a third round of quantitative easing, then additional easing by the BoJ will be inevitable to deter a further strengthening of the yen. Meanwhile, the recent expansion of JGBs purchases focuses on bonds with remaining maturities of two years or less, whose yields are now hovering at very low levels (around 0.1%). Given that there is little room for the new purchases to depress the above-mentioned yields further, the BoJ should go ahead with an expansion of its asset purchase program, extending the duration of JGBs purchased. The monetary policy effort to help Japan escape from deflation (Figure 6) and return to sustainable growth should be underpinned by fiscal policy, so as to reform the tax system and introduce a credible plan to improve public finances and, therefore, increase the momentum of the economy.

Figure 5



Source: Bloomberg, Eurobank EFG Research

Figure 6



Source: Bloomberg

Table 1: BOJ’s Asset Purchase Program

(JPY bn)	Initial program (Oct 2010)	1st expansion (Mar 2011)	2nd expansion (Aug 2011)	3rd expansion (Oct 2011)	4th expansion (Feb 2012)	Maximum Amount Outstanding	Amount Outstanding as of Feb 10, 2012
Asset purchases	**5,000**	**+5,000**	**+5,010**	**+5,000**	**+10,000**	**30,010**	**10,316**
Long-term JGBs	1,500	+500	+2,000	+5,000	+10,000	19,000	3,816
Treasury bills	2,000	+1,000	+1,500			4,500	2,367
CP	500	+1,500	+100			2,100	1,539
Corporate Bonds	500	+1,500	+900			2,900	1,679
ETFs	450	+450	+500			1,400	848
JREITs	50	+50	+10			110	67
Collateral fund supply	**30,000**		**+5,000**			**35,000**	**32,825**
Total	**35,000**	**+5,000**	**+10,010**	**+5,000**	**+10,000**	**65,010**	**43,140**

Source: Bank of Japan (BOJ)

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