



**Editor:**

**Dimitris Malliaropoulos:**  
*Economic Research Advisor*  
[dmalliaropoulos@eurobank.gr](mailto:dmalliaropoulos@eurobank.gr)

**Written By:**

**Vasilis Zarkos:**  
*Economic Analyst*  
[vzarkos@eurobank.gr](mailto:vzarkos@eurobank.gr)

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## Japan: Firm economic activity on reconstruction investment.

- Production and export activity has recovered since the March disaster. We expect the sharp economic rebound to peak in Q3 and recede to a more sustainable track thereafter. Reconstruction is anticipated to boost GDP growth in 2012, partially insulating the economy from global weaknesses.
- Fragile economic conditions in major developed countries and lower growth in emerging markets have made us lower our GDP growth projection for 2012 down to 2.3% from 2.8% a quarter earlier. Risks to the Japanese economy stem mainly from weakness in global demand and a rising yen.
- The BoJ is expected to keep its policy rate unchanged at least until the end of 2012. Further appreciation of the yen, most likely triggered by further erosion of global risk appetite and/or QE3 launched by the Fed, may prompt the BoJ to take additional action towards monetary easing.

As was broadly expected, a V-shaped recovery followed the abrupt halt caused by the massive earthquake in March (Figure 1). Supply chains have been broadly restored while, according to the Ministry of Economy, Trade and Industry, 93% of the manufacturing bases directly hit by the disaster and 83% of those indirectly hit have recovered their production level. As a result, industrial production and real exports in August have almost reached their February levels (95.7% and 97.6%, respectively). In addition, yearly vehicle production growth entered positive territory in August. Electricity supply conditions are gradually normalizing as is evident by the end in restrictions on the electricity use in early September.

The earthquake caused the Japanese economy to contract by 0.5% q-o-q in Q2, posting the third quarterly negative growth reading in a row. GDP shrunk mainly due to a slump in net exports and disappointing private capital expenditures. We expect GDP to post a sharp rebound in Q3, on the backdrop of fast restoration of the damages caused by the earthquake. The

economic activity will most likely peak in Q3 and recede to a more sustainable trajectory thereafter. In particular, the economy is anticipated to lose momentum towards the end of the year, as base effects fade away, extensive reconstruction is not expected to kick in earlier than Q2 2012 and exports will now be constrained by weaker global demand rather than by supply distortions. Later in 2012, we expect economic growth to accelerate, boosted by public reconstruction expenditures, higher export volumes, provided that global economic sentiment improves and fading burden due to energy imports, as nuclear stations are likely to resume operation (at the moment, about 35% of nuclear reactors operate).

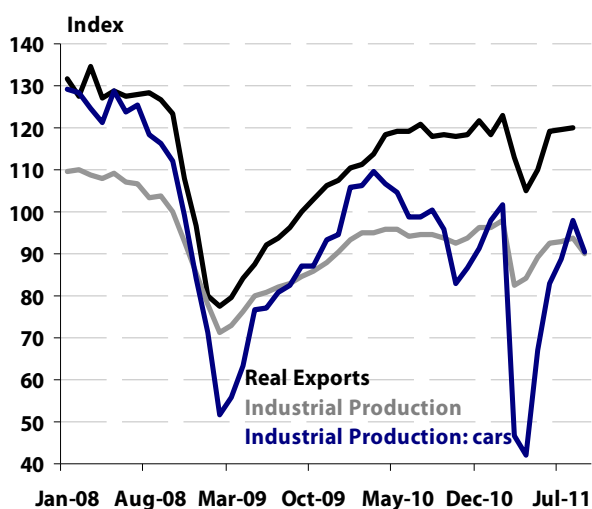
Consumption is expected to rebound in Q3 due to base effects and a resurgence in car sales. However, a plunge in TV sales is likely to have a negative impact, after Japanese rushed to buy new TV sets prior to transition to digital signal. Looking ahead, household expenditures are likely to take advantage from reconstruction, the eco car tax reduction program and a likely revival of the eco appliances point system financed by the third

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supplementary budget. That said, we anticipate subdued consumption growth in 2012 as business sentiment is expected to remain stressed, while labor market conditions remain relatively adverse. The September labor survey is the first since February to include disaster affected prefectures. The survey reveals that the nationwide unemployment rate declined to 4.1%, compared to 4.6% in February. Yet, one should read the figures with caution, as since February, the labor force declined by 970000, while employed persons are 560000 less. Persons not in labor force jumped by 1960000 compared to a month earlier (when disaster areas were not included), suggesting that employment conditions in the afflicted regions remain harsh.

Figure 1

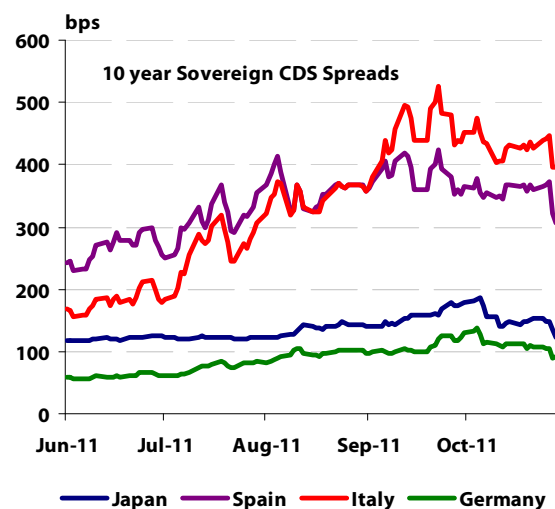


Source: Bloomberg

Unlike other major developed countries, where growth is forecast to stagnate or even contract, the Japanese economy will benefit from reconstruction expenditures that may partially insulate the country from global demand weaknesses. Prime Minister Noda has proposed a third supplementary budget for reconstruction worth ¥12tn, above the initially assumed figure of ¥10tn. This adds to the first and second supplementary budgets worth ¥6tn and the sum matches the government estimated damages of about ¥17tn. However, uncertainty remains about the final size and time of implementation of the plan, as the government needs opposition party cooperation for parliamentary approval. Besides issuing government bonds, large spending cuts, privatizations and higher taxes levied on individual incomes and corporations are proposed to finance the budget, implying that political disputes may delay the implementation of the reconstruction policies. That said, in our baseline scenario the budget is likely to start affecting economic growth from the beginning of the new fiscal year, i.e. Q2 2012.

Core inflation, i.e. inflation excluding fresh food, turned positive mainly due to soaring energy prices in the first half of the year. However, core inflation is expected to return to negative territory, most likely in October, as the cigarette tax hike and the one-off increase in casualty insurance premia come full circle. Looking ahead, core inflation is expected to remain negative throughout 2012, on the backdrop of lower energy prices, yen appreciation and weak domestic demand.

Figure 2



Source: Ameco

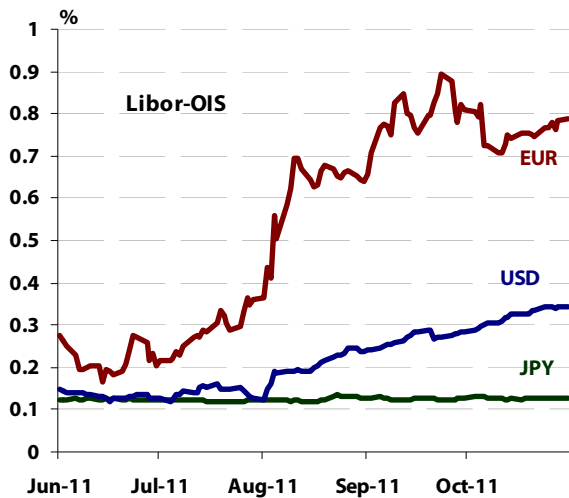
Risks to the Japanese economy stem mainly from weakness in global demand and a rising yen. Fragile economic conditions in major developed countries and lower growth in emerging markets have made us lower our Japanese growth projection for 2012 down to 2.3% from 2.8% a quarter earlier. Financial turbulence in the euro area has reached Japan, though at a muted extent. Some contagion is evident in sovereign CDS widening (Figure 2), however, markets do not seem to worry much about the country's stressed public finances. On the other hand, unaffected JPY Libor suggests that there is no significant stress in interbank lending (Figure 3). This does not come as a surprise, given the low exposure of Japanese banks to euro area debt. Nonetheless, further escalation of the sovereign debt crisis in the euro area would have negative repercussions for the economy, as Japanese exports are highly dependent on external demand (Figure 4). In addition mounting uncertainties in Europe keep the yen at persistently elevated levels, due to its safe heaven status. This erodes competitiveness of Japanese products, companies' repatriated profits and their stock valuations, thus offering firms incentives to move production overseas, to the detriment of employment and domestic demand.

The Bank of Japan acknowledged in its October meetings the rising risks to the economy due to the global slowdown and the

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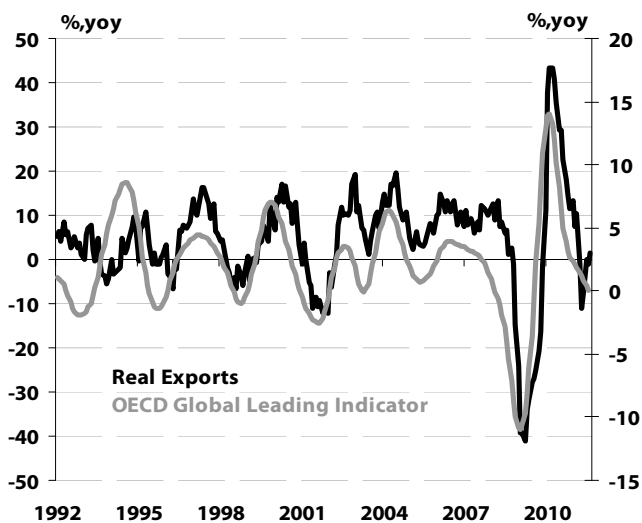
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Figure 3



Source: Bloomberg

Figure 4



Source: Bloomberg

appreciating yen. The bank has recently decided to enhance its monetary easing by increasing the total size of its asset purchases by ¥5tn. The additional easing came after the USDJPY cross dropped to new record lows, revealing the bank's increasing concern about the strengthening of the currency. After the recent expansion, the central banks' unconventional measures currently stand at ¥55tn, comprising of ¥35tn in liquidity provision and asset purchases worth ¥20tn. As of the end of September, fund supply stands at about ¥31.2tn while asset purchases sum up to slightly above ¥6tn. In our view, the BoJ will remain on a loose monetary policy mood due to the deflationary environment and the strong yen. Further appreciation of the yen, most likely triggered by further erosion of global risk appetite and/or QE3

launched by the Fed, may prompt the BoJ to take additional action. This could include additional scaling up of the asset purchases ceiling and the pace of purchases. With respect to the uncollateralized overnight call rate, the BoJ is expected to keep it unchanged at 0.1% until at least the end of 2012.

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Eurobank EFG, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333.7365, fax: +30.210.333.7687, contact email: Research@eurobank.gr

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