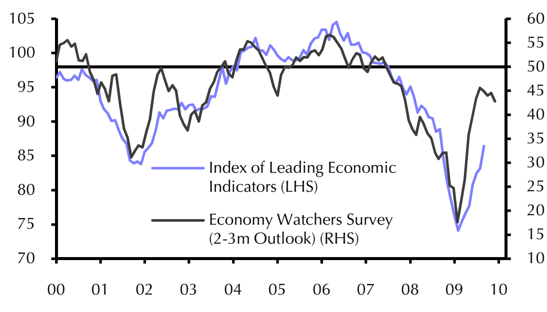
CAPITAL ECONOMICS

Is Japan's recovery already faltering?

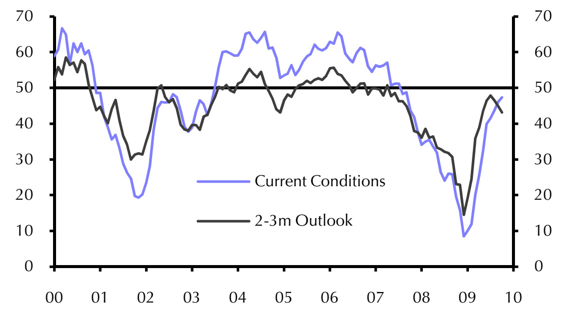
- **The falls in the main balances of Japan's Economy Watchers Survey in October suggest that the recovery lost a little momentum at the start of the fourth quarter. Nonetheless, growth was probably unsustainably strong in the third quarter and these balances remain at comfortably high levels.**
- The Economy Watchers Survey (EWS) polls around 2,000 people holding jobs that enable them to observe economic activity in three main areas: household spending, corporate activity and employment. Respondents are prompted to consider factors such as retail sales volumes, new orders received, and the number of job offers. Net percentage balances are then calculated in the usual way for current conditions ("good" minus "bad") and the outlook for the next two to three months ("better" minus "worse"). The survey is taken towards the end of the month and as such can be seen as a relatively timely composite indicator of consumer and business confidence.
- Today's report showed that the **current conditions index fell to 40.9 last month, from 43.1 in September. This is a relatively large monthly move and takes the index back to its lowest level since May**. The declines were broad-based, with particularly large falls in retail, services and manufacturing. The expectations index fell less sharply, to 42.8 from 44.5, but is now at its lowest since April.
- **Other survey evidence for October has been mixed at best**. The manufacturing PMI edged down from 54.5 to a still high 54.3, while the Shoko Chukin survey of small and medium sized business confidence also slipped one tick from 43.5 to 43.4. However, the Shoko Chukin survey included a 1.5 point fall in confidence among *non*-manufacturers. The October consumer confidence survey will be released this Friday and the EWS suggests that the risks here are on the downside too.
- Nonetheless, **while it would clearly be worrying if these falls developed into firm downward trends, it is premature to conclude that the recovery is over.** For a start, all these survey measures remain close to their recent highs. As Chart 1 shows, the EWS is still consistent with further gains in the index of leading economic indicators, and the recent declines have made only a small dent in the previous rebound.
- Nor was the EWS all bad news. In particular, **the assessment of current employment conditions continued to improve, suggesting that the second successive fall in the monthly unemployment rate reported in September was not just a statistical fluke**. Admittedly, the 2-3 month outlook for employment did fall back, but again remained well above its previous lows. (See Chart 2.)
- There are several reasons why the recovery may have lost some momentum at the start of the fourth quarter. We would give most weight to the diminishing impact of the previous government's stimulus measures and the uncertainty about the intentions of the new DPJ administration (whose honeymoon period may already be over). But the bigger picture is that growth was always likely to settle down to more sustainable levels at some point. **We expect to learn on Monday that GDP growth accelerated to an annualised rate of as much as 4% in the third quarter. The latest survey evidence is consistent with a slower but still decent pace of growth in the fourth quarter and beyond.**

Chart 1: Japan LEI & EWS



Source – Thomson Datastream

Chart 2: Japan EWS - Employment



Source – Thomson Datastream

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