

# JAPAN ECONOMICS WEEKLY

16<sup>th</sup> Nov. 2009



Editor: Julian Jessop

## Is Japan facing a sovereign debt crisis?

- The markets are increasingly worried about the sustainability of Japan's fiscal position. We share some of these concerns, and they could lead to further small increases in government bond yields in the coming weeks. Nonetheless, **the chances of a full-blown sovereign debt crisis are still very small. A gradual depreciation of the yen seems much more likely than a sharp sell-off in JGBs.**
- The crucial point is that **the sustainability of the fiscal position depends on many other factors than just the gross debt/GDP ratio.** These include the level of interest rates, the maturity profile of debt, the prospects for economic activity and inflation, the size of the structural deficit, the scope for tax increases and expenditure savings, and (a key factor that is almost always overlooked) the ability of a very rich country like Japan to sell assets to repay debt.
- This week's data highlight comes early with the release on Monday of the first estimate of Q3 GDP. The usual caveats apply to this preliminary data. But **Japan recorded the fastest growth of any G7 economy in the second quarter and we believe it will be near the top of the league in the third as well.** (Pages 2 and 3.)

## Data Previews (page 4)

Q3 GDP (Mon. 16<sup>th</sup> Nov.) – *Recovery still led by net trade, but domestic demand may now be rising too*

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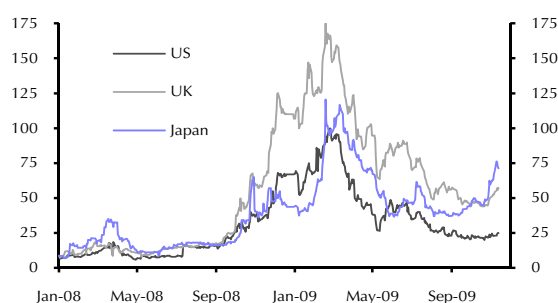
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## Is Japan facing a sovereign debt crisis?

The increase in Japanese government bond (JGB) yields in recent weeks largely reflects the global trend, as expectations of both economic growth and inflation have been marked higher. However, an additional factor has been concern that the new DPJ government will fail to tackle the growing debt mountain. As a result the costs of insuring against a Japanese sovereign default have jumped too, although they remain below the peaks seen in the depths of the global financial crisis. (See Chart 1.)

CHART 1: 5-YEAR CREDIT DEFAULT SWAP PREMIUMS (BPS)



Source – Thomson Datastream

Given the extraordinary events of the last year or so it would be foolish to rule anything out. Nonetheless, we think **the chances of a full-blown sovereign debt crisis in Japan are still very small**. For a start, the fiscal position is not as dire as the headline numbers suggest. The ratio of gross government debt to GDP is clearly frightening: the OECD estimates that it will climb to 200% of GDP in 2010. In the meantime, the DPJ government is struggling to gain credibility. We therefore share some of the markets' concerns, and they could lead to further (but small) increases in government bond yields in the coming weeks.

However, the sustainability of the fiscal position depends on many other factors than just the gross debt/GDP ratio. These include the level of interest rates, the maturity profile of debt, the prospects for economic activity and inflation, the size of the structural deficit, the scope for tax increases and expenditure savings, and (a key factor that is almost always overlooked) the ability of a very rich country like Japan to sell assets to repay debt.

We will look at all these factors in more detail in a *Japan Economics Focus* shortly. But on the last point, it is worth stressing that **Japan's net government debt (financial liabilities minus financial assets) is a less alarming 100% of GDP**. Admittedly, the difference between gross and net debt is mainly accounted for by assets held by the social security fund, which will soon be needed to support an ageing population in retirement. But there are plenty of non-financial assets that could be sold if required, including some of the publicly-owned infrastructure accumulated under the many fiscal packages during the "Lost Decade".

What's more, the prospects for the economy over the next year or so are brighter than most observers give credit for, which will make it easier to put in place a credible medium-term programme of fiscal consolidation. The upshot is that there is nothing magical about the 200% debt/GDP figure and it would be wrong to conclude from this alone that the fiscal position is past the point of no return.

In the meantime, **aside from the mountain of supply (and Japan is hardly alone here), the fundamentals for JGBs remain positive**: overnight rates will be held near-zero for the foreseeable future, persistent price deflation means that even nominal yields as low as 1.0-1.5% are attractive, and the Bank of Japan will continue to support the market with large outright purchases. We expect these factors to cap 10-year yields at around 1.5%.

However, while a sharp sell-off in JGBs is unlikely, we have become more concerned about the outlook for the currency. (See our *Global Markets Update*, "Turning bearish on the yen", 11<sup>th</sup> November.) The fiscal stimulus will have to be at least partially reversed in the next few years, requiring an even longer period of ultra-loose monetary policy and continued support from net exports if Japan's economic recovery is to be sustained. **With the world economy also likely to slow again through 2010 and into 2011, it is hard to see how Japan can continue to grow and eventually escape deflation without a weaker yen.**

For this and other reasons, we are revising our forecast for the yen/dollar exchange rate to 100 (from 90) for end-2010 and 110 for end-2011.

### Review of the past week

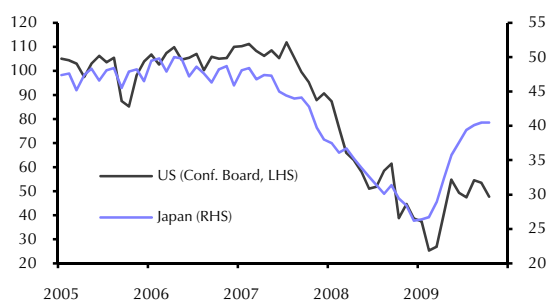
The latest survey data, notably the falls in the main balances of the Economy Watchers Survey (EWS) in October, suggest that **the recovery lost a little momentum at the start of the fourth quarter**. Consumer confidence, the manufacturing PMI, and the Shoko Chukin survey of small and medium sized businesses, were all flat or slightly lower last month after a run of decent gains. Nonetheless, while it would clearly be worrying if these falls developed into firm downward trends, the key survey indicators remain close to their cyclical highs. As Chart 2 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.

CHART 2: LEI & EWS



Source – Thomson Datastream

CHART 3: CONSUMER CONFIDENCE



Source – Thomson Datastream

Similarly, the rebound in consumer confidence remains impressive - much more so than in the US in particular. (See Chart 3.) The relatively large fiscal stimulus and early signs of a recovery in the labour market are clearly helping.

Finally, any signs of faltering at the start of the fourth quarter need to be seen in the context of the likely strength in the third. The latest survey evidence is consistent with a slower but still rapid pace of growth in the fourth quarter and beyond.

### The week ahead

The highlight comes early with the release on Monday of the first estimate of **Q3 GDP**. The usual caveats apply to this preliminary data. But Japan recorded the fastest growth of any G7 economy in the second quarter and we believe it will be near the top of the league in the third as well. Our forecast that GDP rose by around 1.0% q/q in Q3 would translate into an annualised rate of just over 4.0%, compared to the 3.5% already reported in the US. Net trade should again have made the biggest single contribution to growth, but domestic demand may finally have begun to recover too. (See full data preview on page 4.)

Otherwise the only item of note is the **Bank of Japan Policy Board meeting**, which concludes on Friday. This should be a non-event as the last meeting was held as recently as the end of October and left no loose ends. At that meeting the Bank confirmed a timetable for the withdrawal of some emergency facilities, including the outright purchases of commercial paper and corporate bonds, which have become increasingly redundant as financial conditions have improved. But the Bank's own forecasts of persistent price deflation confirmed that the most important forms of monetary stimulus (near-zero official interest rates, generous liquidity provision and large outright purchases of government bonds) are likely to continue for the foreseeable future.

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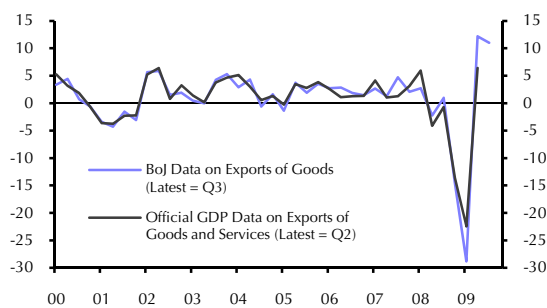
| Forecasts         | Previous     | Median       | Capital Economics |
|-------------------|--------------|--------------|-------------------|
| GDP % q/q (% y/y) | +0.6%(-7.2%) | +0.7%(-5.3%) | +1.0%(-5.0%)      |

**Recovery still led by net trade, but domestic demand may now be rising too**

We already know from the monthly data published by the Bank of Japan that exports jumped again in Q3. (See Chart 1.) Imports also picked up as the domestic economy recovered, which will dampen the overall boost from net trade, but the external sector should still have made the largest single contribution to growth.

That actually seems a pretty good bet. The monthly data suggest that consumer spending rose again, and the ongoing fiscal stimulus means that government spending probably did so too. The main negative in Q2 was a massive 0.8 percentage point (pp) drag from inventories, which should have been at least partially reversed in Q3 as the pace of destocking slowed.

CHART 1: EXPORTS (% Q/Q, REAL SEAS. ADJ.)



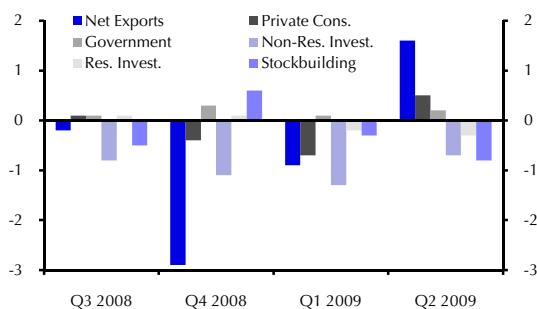
Source – Thomson Datastream

This apparent dependency on net exports is not necessarily a cause for concern. After all, it was a collapse in exports that dragged the Japanese economy into a deep recession into the first place, so it is not so surprising that it is exports that have been leading the recovery. (See Chart 2.) Nonetheless, it would clearly be encouraging if domestic demand managed to make a positive contribution in Q3 too, after falling 1.1% in Q2.

Otherwise, residential investment (housebuilding) was exceptionally weak in Q2, falling by 9.5% q/q (subtracting 0.3pp from growth). Spending on the biggest of big ticket items was always likely to be relatively slow to recover. However, after such a sharp decline there is scope for a small bounce in Q3 as financial conditions improved.

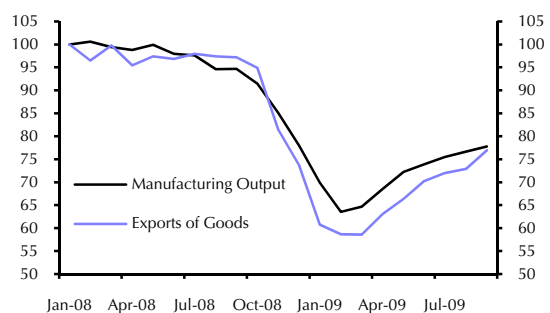
The biggest unknown is non-residential investment, which fell by 4.8% q/q in Q2 (subtracting 0.7pp from growth). The huge spare capacity created by the recession means there is little incentive to ramp up investment just yet. But output and confidence in the manufacturing sector has been recovering. (See Chart 3).

CHART 2: CONTRIBUTIONS TO GDP GROWTH (% POINTS)



Source – Thomson Datastream

CHART 3: EXPORTS & MANUFACTURING (JAN. 08 = 100)



Source – Thomson Datastream

Overall, we expect Q3 GDP to rise by 1.0% or so, which would be comfortably above consensus, including a decent contribution from domestic demand as the headwind from weak investment begins to fade.

## Latest Data & Main Forecasts

### JAPAN ECONOMIC INDICATORS

| Monthly Indicators                           | m/m(y/y) unless stated | Jun           | Jul           | Aug           | Sep           | Oct     |
|--|------------------------|---------------|---------------|---------------|---------------|---------|
| Consumer Prices                              | Headline               | -0.2%(-1.8%)  | -0.1%(-2.2%)  | -0.1%(-2.2%)  | -0.1%(-2.2%)  | -       |
|  | Excl. Fresh Food       | -0.2%(-1.7%)  | -0.1%(-2.2%)  | -0.2%(-2.4%)  | +0.1%(-2.3%)  | -       |
|  | Excl. Food & Energy    | -0.1%(-0.7%)  | -0.2%(-0.9%)  | 0.0%(-0.9%)   | 0.0%(-1.0%)   | -       |
| M2 Money Supply                              |                        | (+2.5%)       | (+2.7%)       | (+2.8%)       | (+3.0%)       | (+3.3%) |
| Unemployment Rate (%)                        |                        | 5.4           | 5.7           | 5.5           | 5.3           | -       |
| Household Spending                           |                        | -0.3%(+0.2%)  | -1.3%(-2.0%)  | +1.9%(+2.6%)  | +0.1%(+1.0%)  | -       |
| Industrial Production                        |                        | +2.3%(-23.5%) | +2.1%(-22.7%) | +1.6%(-19.0%) | +1.4%(-18.9%) | -       |
| Goods Exports (Value, BoP Basis)             |                        | +6.4%(-37.0%) | +1.4%(-37.6%) | +3.2%(-37.1%) | +2.5%(-32.1%) | -       |
| Visible Trade                                |                        | +¥740bn       | +¥475bn       | +¥547bn       | +¥428bn       | -       |
| Current Account                              |                        | +¥1,928bn     | +¥1,159bn     | +¥1,234bn     | +¥1,338bn     | -       |
| Manufacturing PMI                            |                        | 48.2          | 50.4          | 53.6          | 54.5          | 54.3    |
| Economy Watchers Survey (Outlook)            |                        | 45.6          | 44.9          | 44.0          | 44.5          | 42.8    |
| Consumer Conf. (Excl. One Person Households) |                        | 37.6          | 39.4          | 40.1          | 40.5          | 40.5    |

| Quarterly Indicators                             | %q/q(%y/y) unless stated | Q3 2008      | Q4 2008      | Q1 2009      | Q2 2009      | Q3 2009 |
|--|--------------------------|--------------|--------------|--------------|--------------|---------|
| GDP  |                          | -1.3%(-0.3%) | -3.4%(-4.3%) | -3.3%(-8.7%) | +0.6%(-7.2%) | -       |
| Private Consumption                              |                          | +0.1%(+0.7%) | -0.7%(-0.3%) | -1.2%(-2.8%) | +0.7%(-1.0%) | -       |
| Tankan Business Conditions (Large Manufacturers) |                          | -3           | -24          | -58          | -48          | -33     |

### LATEST MARKET DATA

| Instrument/rate            | 1 mth ago    | 1 week ago | Latest* | Instrument/rate | 1 mth ago     | 1 week ago     | Latest*    |        |       |
|----------------------------|--------------|------------|---------|-----------------|---------------|----------------|------------|--------|-------|
| Official rates             | Japan O/n    | 0.10       | 0.10    | 0.10            | Global yields | US 10 year     | 3.41       | 3.50   | 3.43  |
|                            | US Fed funds | 0-0.25     | 0-0.25  | 0-0.25          |               | Ger 10 year    | 3.29       | 3.36   | 3.34  |
|                            | ECB Refi     | 1.00       | 1.00    | 1.00            |               | UK 10 year     | 3.60       | 3.89   | 3.74  |
|                            | UK Repo      | 0.50       | 0.50    | 0.50            |               | Equity indices | Nikkei 225 | 10,257 | 9,789 |
| Market rates               | 3m LIBOR     | 0.33       | 0.32    | 0.32            | Topix         | 900            | 874        | 867    |       |
|                            | 12m OIS      | 0.13       | 0.14    | 0.14            | US S&P 500    | 1087           | 1069       | 1087   |       |
|                            | JGB yields   | 2 year     | 0.25    | 0.28            | 0.27          | Exchange rates | Yen index  | 151    | 152   |
| 5 year                     | 0.62         | 0.71       | 0.66    | ¥/\$            | 91            |                | 90         | 90     |       |
| 10 year                    | 1.33         | 1.45       | 1.35    | ¥//Euro         | 135           |                | 133        | 134    |       |
| 20 year                    | 2.11         | 2.16       | 2.13    | ¥/£             | 149           |                | 149        | 150    |       |
| Yield curve (10 – 2yr, bp) | 108          | 117        | 108     | Crude Oil       | WTI, \$ pb    | 79             | 77         | 77     |       |







\* Latest as at 08.30 GMT, 13<sup>th</sup> Nov. 2009

### MAIN ECONOMIC & MARKET FORECASTS

| %q/q(%y/y)unless stated        | Latest            | Q3 2009      | Q4 2009      | 2009    | 2010    | 2011    |
|--------------------------------|-------------------|--------------|--------------|---------|---------|---------|
| GDP                            | +0.6%(-7.2%) (Q2) | +1.0%(-5.0%) | +0.8%(-1.0%) | (-5.5%) | (+3.0%) | (+1.0%) |
| Household Spending             | +0.7%(-1.0%) (Q2) | +0.5%(-0.7%) | +0.3%(+0.4%) | (-1.0%) | (+1.3%) | (+0.8%) |
| Consumer Prices                | (-2.2%)           | (-2.2%)      | (-1.8%)      | (-1.2%) | (-1.0%) | (-0.5%) |
| Unemployment Rate (%)          | 5.3%              | 5.5%         | 5.3%         | 5.1%    | 5.0%    | 4.8%    |
| Overnight Rate, end period (%) | 0.10              | 0.10         | 0.10         | 0.10    | 0.10    | 0.10    |
| 10 yr JGB, end period (%)      | 1.35              | 1.30         | 1.25         | 1.25    | 1.25    | 1.25    |
| Nikkei 225, end period         | 9,770             | 10,133       | 10,500       | 10,500  | 10,250  | 10,000  |
| ¥/\$, end period               | 90                | 90           | 90           | 90      | 100     | 110     |
| ¥//Euro, end period            | 134               | 131          | 126          | 126     | 130     | 143     |
| ¥/£, end period                | 150               | 143          | 140          | 140     | 150     | 165     |

## Japan Diary & Forecasts

### JAPAN

| Date                 | Country  | Release/indicator/event                | Time (GMT)      | Previous*    | Median*      | CE Forecast* |
|----------------------|--|--|-----------------|--------------|--------------|--------------|
| Sun 15 <sup>th</sup> |  <b>Jpn</b> | GDP (Q3 Prov.)                         | q/q (y/y) 23.50 | +0.6%(-7.2%) | +0.7%(-5.3%) | +1.0%(-5.0%) |
| Mon 16 <sup>th</sup> |  <b>Jpn</b> | Tertiary Industry Activity Index (Sep) | 23.50           | +0.3%        | +0.1%        | +0.3%        |
| Tue 17 <sup>th</sup> | -  | No Significant Data Released           | -               | -            | -            | -            |
| Wed 18 <sup>th</sup> | -  | No Significant Data Released           | -               | -            | -            | -            |
| Thu 19 <sup>th</sup> |  <b>Jpn</b> | All Industry Activity Index (Sep)      | 04.30           | +0.9%        | -0.1%        | +0.1%        |
|                      |  <b>Jpn</b> | Leading Economic Index (Sep Final)     | 05.00           | 86.4p        | -            | -            |
|                      |  <b>Jpn</b> | Coincident Index (Sep Final)           | 05.00           | 92.5p        | -            | -            |
| Fri 20 <sup>th</sup> |  <b>Jpn</b> | BoJ Interest Rate Announcement         | -               | 0.10%        | 0.10%        | 0.10%        |

\*m/m(y/y) unless otherwise stated; p = provisional estimate

### KEY FORTHCOMING EVENTS/DATA

| Date                                   | Event  | Date                 | Event   |
|--|--|----------------------|---|
| 24 <sup>th</sup> Nov                   | BoJ Monthly Report (Nov)                       | 26 <sup>th</sup> Nov | Unemployment Rate, Job-to-Applicant Ratio (Oct) |
| 24 <sup>th</sup> -29 <sup>th</sup> Nov | Manufacturing PMI (Nov)                        | 26 <sup>th</sup> Nov | Household Spending (Oct)                        |
| 24 <sup>th</sup> Nov                   | External Trade (Oct)                           | 26 <sup>th</sup> Nov | National, Tokyo CPI (Oct/Nov)                   |
| 25 <sup>th</sup> Nov                   | BoJ MPC Minutes (30 <sup>th</sup> Oct Meeting) | 26 <sup>th</sup> Nov | Retail Sales (Oct)                              |

## Selected Recent Publications

| Date                 | Publication  |  |
|----------------------|--|--|
| Mon 9 <sup>th</sup>  | Capital Daily  | Markets shrug off rise in US unemployment.                               |
|                      | Germany Industrial Production & Trade (Sep.)           | Industrial data point to strong growth in Q3.                            |
|                      | Global Economics Update                                | Are we any closer to a global Tobin tax?                                 |
|                      | Latin America Economics Update                         | Mexico: disinflation process has further to run.                         |
|                      | Emerging Europe Update                                 | Latvia: Still no sign of growth.   |
|                      | US Economics Update                                    | Extended tax credit is a shot in the arm for housing.                    |
|                      | UK Treasury Monthly                                    | Bounce in gilt yields may not last.                                      |
| Tue 10 <sup>th</sup> | Capital Daily  | Fed survey suggests credit crunch fading fast.                           |
|                      | UK RICS Housing Sur. (Oct.) & CLG House Prices (Sep.)  | Bank costs to rise, regardless of Tobin tax.                             |
|                      | Asian Economics Update                                 | Slow rebalancing of the housing market continues.                        |
|                      | UK Trade (Sep.) & BRC Retail Sales (Oct.)              | Is Japan's recovery already faltering?                                   |
|                      | Asian Economics Update                                 | Trade boost still in doubt.  |
|                      | German ZEW (Nov.)/ French & Italian Ind. Prod'n (Sep.) | Indonesia's impressive upswing to stay on track.                         |
|                      | Global Markets Update                                  | Expectations deteriorate, but level still high.                          |
|                      | UK Commercial Property Update                          | Bond yields to drop back in 2010 as inflation fears fade.                |
|                      | Asian Economics Focus                                  | Why have leisure and hotels held up relativ. well during downturns?      |
|                      | US Economics Focus                                     | New Zealand facing a long hard slog.                                     |
| Wed 11 <sup>th</sup> | Capital Daily  | The macroeconomic implications of the lower dollar.                      |
|                      | Global Markets Update                                  | Inflation expectations may not have much further to rise.                |
|                      | UK Labour Data (Sep./Oct.)                             | A tough six months ahead for Indian stocks.                              |
|                      | Asian Economics Update                                 | Employment unlikely to keep rising.                                      |
|                      | UK Bank of England Inflation Report (Nov.)             | China's commodity imports slow.  |
|                      | Emerging Europe Update                                 | Dovish Report leaves door to further policy action open.                 |
|                      | Global Markets Update                                  | Price pressures continue to fade.  |
| Thu 12 <sup>th</sup> | Capital Daily  | Turning bearish on the yen.  |
|                      | UK Mortgage Arrears and Possessions (Q3)               | Office development cut, but not enough to prevent rental declines.       |
|                      | Euro-zone Industrial Prod. (Sep.) & Spanish GDP (Q3)   | A darker outlook for the yen.  |
|                      | UK CML Buy-to-let Lending (Q3)                         | Labour market flexibility helps keep possessions low.                    |
|                      | Latin America Economics Update                         | Industrial output surges in Q3.  |
|                      | Asian Economics Update                                 | Buy-to-let lags the wider upturn in the mortgage market.                 |
|                      | European Commercial Property Update                    | Mexico: Industry drives economic recovery.                               |
| Fri 13 <sup>th</sup> | Capital Daily  | Markets too aggressive on Korean rate hikes to come.                     |
|                      | China Hong Kong GDP (Q3)                               | Office vs. industrial rents: why have Italy and Portugal been different? |
|                      | Japan Economics Weekly                                 | UK faces a decade of high unemployment.                                  |
|                      | Euro-zone Flash GDP (Q3)                               | UK faces a decade of high unemployment.                                  |
|                      | Emerging Asia Economics Weekly                         | Bonds and equities are not breaking up just yet.                         |
|                      | US External Trade (Sep.)                               | Disappointment as consumption stalls.                                    |
|                      | UK Economics Weekly                                    | Is Japan facing a sovereign debt crisis?                                 |
|                      | US Economics Weekly                                    | Out of recession, but domestic demand disappoints.                       |
|                      | European Economics Weekly                              | -  |
|                      |  | -  |

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