

JAPAN ECONOMICS UPDATE

15th Dec. 2011



Global weakness prompts downgrade of GDP forecast

- **Worse than expected results from the Tankan survey and deteriorating global conditions have prompted us to revise down our Japan GDP forecasts for 2012 and beyond.** We continue to expect a full-year recession in 2011 and a rebound in growth in 2012, but the strength of this rebound is likely to be much weaker than previously anticipated. We are now forecasting GDP growth of just 1.0% next year (down from 2.0% previously), and 0.5% in 2013 (down from 1.0%). This is below the Bloomberg consensus of 1.7% in both 2012 and 2013.
- **The results of the Bank of Japan's Tankan survey of business conditions, published today, show a sharp fall in Q4.** The headline index for large manufacturers fell from +2 in Q3 to -4 in Q4. In contrast, conditions for large non-manufacturing businesses improved somewhat in Q4, rising from +1 to +4. (See Chart 1.) The Tankan asks whether business conditions are favourable or unfavourable (i.e. their level). If we plot the *change* in the Tankan's index for large manufacturers against the change in GDP, the Q4 survey indicates GDP will contract by around 0.5% q/q in Q4, and fall a further 0.1% in Q1 2012. (See Chart 2.) Small and medium sized manufacturers and non-manufacturers reported conditions remained "unfavourable" in Q4, albeit slightly less so than in Q3.
- **The multiple headwinds that firms have faced in Q4 are unlikely to abate and will depress business conditions further next year.** The outlook components of the Tankan show manufacturing and non-manufacturing businesses of all sizes expect conditions to deteriorate in Q1 2012. It's not hard to see why: the global economy has slowed in 2011 and is set to slow further in 2012. Today's flash euro-zone PMIs confirmed output in the region is already contracting, while the on-going sovereign debt crisis is likely to lead the euro-zone into a fairly deep recession. According to the HSBC/Markit flash PMI for China, manufacturing output in Japan's largest trading partner is also falling.
- **According to the Tankan, business investment has been an early casualty of the deteriorating outlook.** Firms have reined in their plans for capital expenditure as the year has gone on. In Q2, businesses had planned to increase investment by 4.2% in FY2011 compared to FY2012, but this fell to 3.0% in Q3 and just 1.4% in Q4. No doubt the strong yen will have played its part, reducing the competitiveness of Japanese exporters, and is further reducing the yen-value of overseas profits. If the yen strengthens to 70 against the dollar by the end of 2012 as we expect, this will further weigh on investment spending.
- **On a less gloomy note, government spending should provide some support to domestic demand in 2012.** The bulk of earthquake-related reconstruction spending is expected to kick in next year, while the increases in taxation that will form a dedicated income stream to pay for reconstruction bonds won't come into effect until FY2013. Admittedly, we don't expect the government to get much bang for its buck, but without this additional fiscal support the risks of Japan being dragged into a third recession since 2008 are very high.
- Overall, **Japan will be one of the better performing developed economies next year.** But beyond 2012, we expect growth to drop to 0.5%, close to its low trend rate, as the additional stimulus fades and the government starts to cut other spending and raise taxes.

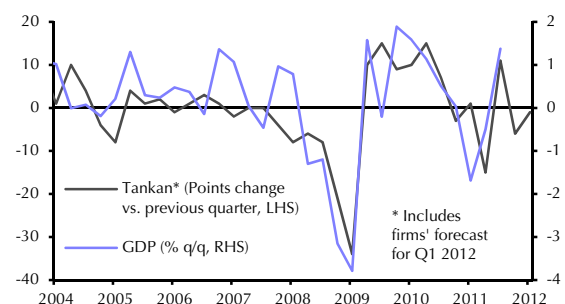
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Chart 1: Tankan Business Conditions



Source – Thomson Datastream

Chart 2: Tankan (Large Manufacturers) & GDP



Sources – Thomson Datastream, Capital Economics