



# Lombard Street Research

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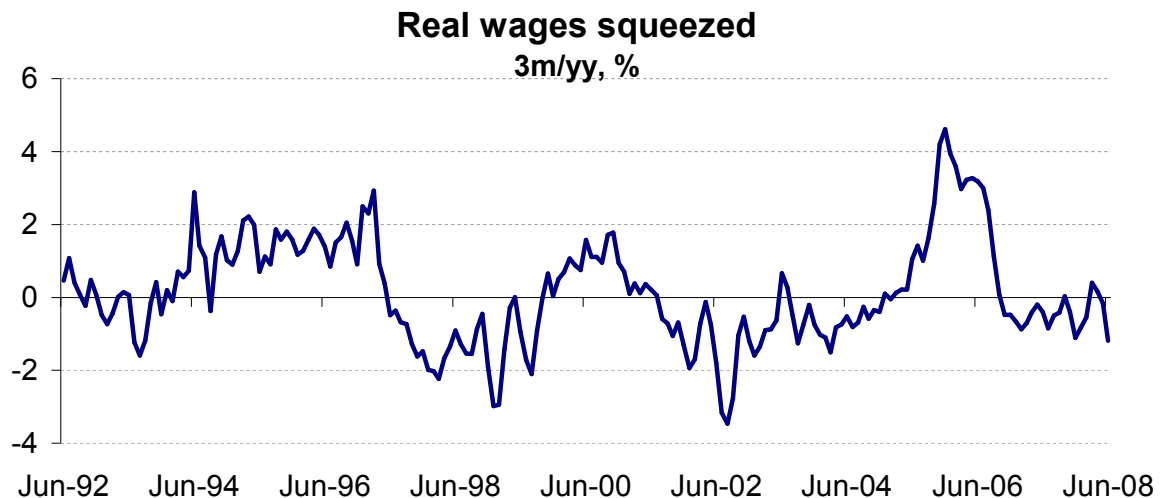
Daily Note: 31 July 2008

## The “R” word gains currency in Japan

**WE SUGGEST: Recession in Japan but equities look OK**

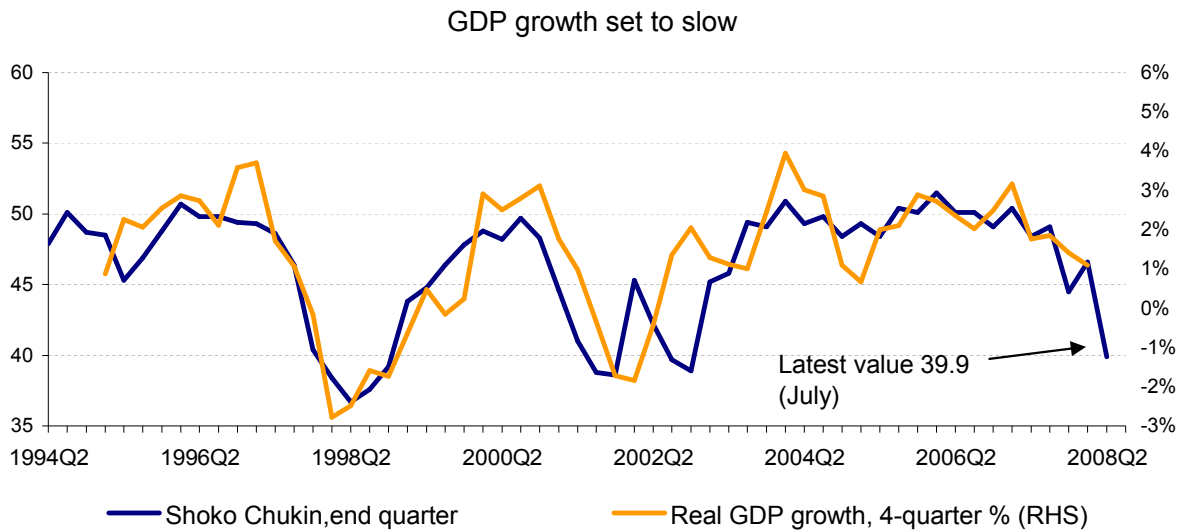
**SUMMARY:** Today’s labour earnings data show a fall in nominal earnings of 0.6% over the last year. But with inflation at a decade high of 2% the squeeze in real earnings is apparent. Other releases this week, including rising unemployment and falling business confidence, have been universally soft. GDP almost certainly contracted in Q2 and looks likely to do so again in Q3.

This morning’s data in Japan are the latest in a series of recent economic statistics that point to recession. Nominal cash earnings fell 0.6% in the 12 months to June - the first *nominal* decline this year. (Consensus expectations were for a 0.2% increase.) But of course inflation is now squeezing *real* incomes, with headline CPI up to 2% in June. The real wages index, also published by the Ministry of Labour, reported real wages down by 2.8% in the last year. June (and December) are the main bonus months and reduced bonus payments have exacerbated the drop in total annual earnings. But the underlying trend is clearly one of falling real wages with a fall of 1.2% in the latest three months compared with the same period a year ago.



This data comes on top of a rise in the unemployment rate to 4.1% in June and a further dip in the job-to-applicant ratio to 0.91, the seventh month in a row that it has been below unity. Rising unemployment will add to pressure on the consumer at the same time as

inflation eats into real disposable incomes. Consumer confidence and consumer spending are likely to remain weak for the rest of the year. (Consumer spending almost certainly contracted in Q2). Meanwhile also this week the *Shoko Chukin* measure of small business confidence fell to another six-year low of 39.9 in July from 40.7. This drop in confidence is also likely to be related to the externally driven rise in inflation that is squeezing corporate profit margins. As the chart below shows, this survey is now at a level that would be consistent with negative GDP growth.



Earlier this week Deputy Governor of the Bank of Japan Kiyohiko Nishimura became the second board member to openly mention the possibility of a technical recession this year. (Atsushi Mizuno made similar remarks last week.) We would agree, except that recession looks inevitable rather merely possible. Almost certainly GDP contracted in Q2 - we await confirmation of this with the GDP release in mid-August. The current parlous state of consumer and business confidence, plus the faltering export growth, suggest that GDP growth in the current quarter will also be negative.

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