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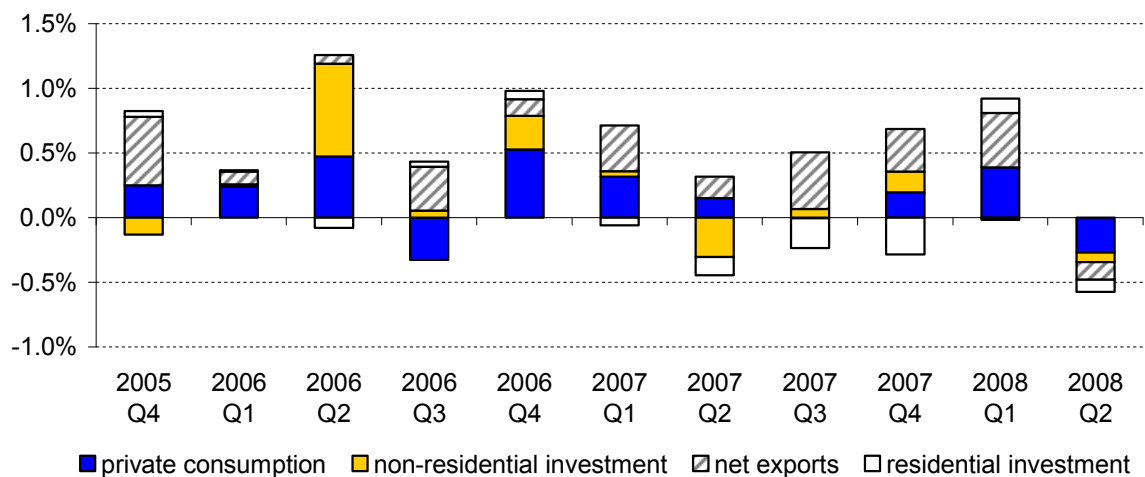
Japan's Q2 contraction grows larger

WE SUGGEST: Short-lived recession in Japan but equities OK

SUMMARY: The Japanese economy contracted by 0.7% in Q2 according to today's second estimate. Weaker investment and exports contributed to a downward revision. Near term prospects remain very poor but there will be recovery in 2009, especially if oil prices continue to fall. Looser fiscal policy may also help.

Japanese GDP contracted by 0.7% in the second quarter of this year, slightly more than the original 0.6% first estimate. The downward revision to growth was due to a greater fall in private non-residential investment now put at -0.5% compared with -0.2% previously. The recent Ministry of Finance quarterly survey had suggested a bigger drop in capital spending and market expectations had been for a bigger downward revision to -0.8% for quarterly GDP. Exports were also revised down (to -2.5% from -2.3%) and net exports were a 0.1% drag on GDP in the quarter having been flat on the first estimate. One of the main sources of negative growth, private consumption, was unrevised at -0.5% in the quarter. The contraction in GDP was the biggest since 2001.

Contributions to quarterly Japanese GDP growth



Given the current very weak state of business and consumer confidence the outlook is for further contraction or stagnation in the Japanese economy for the rest of the year. Consumer spending will continue to be dragged lower by the squeeze on real incomes from inflation and by a softening labour market. In addition, the outlook for exports is jeopardised by prospects of a slowdown elsewhere in Asia (destination for around half of Japanese exports).

But the recession this year should be shallow and short-lived. Japan is not directly exposed to the credit crunch and does not have significant sectoral financial imbalances. Moreover, Japan will benefit from lower oil and other commodity prices that reduce its externally driven inflation. The 0.1% monthly fall in wholesale prices in August reported earlier this week was the first monthly drop in almost a year. Lower inflation is likely to be more of a boost to the Japanese economy than any policy measures. Nevertheless, the switch from a contractionary to an expansionary fiscal policy will help and adds to the case for a short-lived Japanese recession.

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