

# ■ Japan

UOB Economics Projections	2007	2008	2009F	2010F
GDP	2.3	-0.7	-5.8	1.8
CPI (average, y/y)	0.0	1.4	-1.4	-2.0
Unemployment (4Q avg)	3.9	4.0	5.2	5.8
Current account (% of GDP)	4.4	2.9	-	-
Fiscal balance (% of GDP)	-2.8	-4.0	-	-

*Monumental political leadership change lifts sentiment and boosts the JPY even as uncertainties persist.*

*The USD/JPY has tested new lows recently even as Japan's economic recovery is projected to be tepid and the BoJ to remain on-hold in 2010.*

*Despite growth peeking into positive territory in 2q09, key drivers remain soft.*

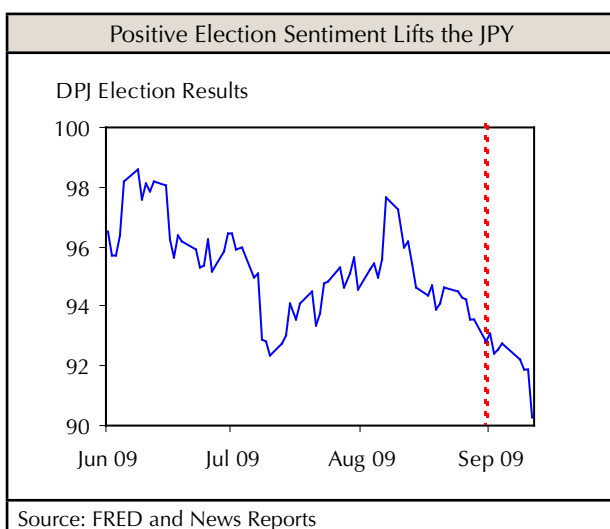
*The significant economic slack in Japan continues to raise the risk of more severe deflation.*

## Politics Lift Sentiment but Fundamentals Remain Challenging

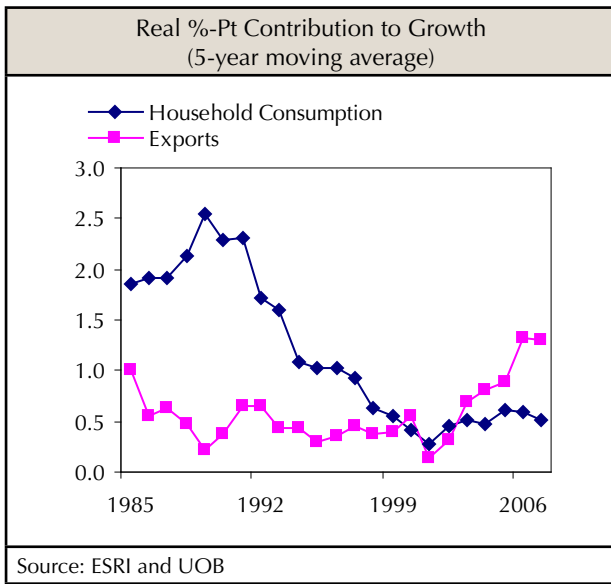
Although Japan economic growth nudged into positive territory in 2q09, up slightly more than 0.5% sequentially, after plunging more than 3% in the prior two quarters, that occurrence was not the watershed event for the country. The limelight was on the landslide victory of the Democratic Party of Japan (DPJ) in the lower house elections (reportedly securing 327 votes out of the 480-seat Diet) at the end of August, which removed the Liberal Democratic Party (LDP) from roughly half a cen-

tury of political power (reportedly, except for the interruption in 1993, the LDP has essentially governed Japan continuously since the 1950s). The leader of DPJ, Yukio Hatoyama, officially took office as the new Prime Minister of Japan on September 16. At the news conference, reportedly, the new Prime Minister emphasizes that he is obligated to “change history” and that “the battle begins now”.

Indeed, when the euphoric dust settles, there is much work to be done in Japan. The details and timing of the budget amendments favored by the DPJ remain actively debated at this time. It is widely recognized, however, that Hatoyama tends to support policies that promote household consumption as the main driver of economic growth. And in order to manage the burgeoning fiscal debt situation, the DPJ has pledged to reduce “administrative costs” and revamp the “bureaucratic” system of Japan. The ambitious Hatoyama administration, reportedly, is expected to firm up a new budget proposal over the next few months, to be submitted by the end of this year. But with the highest debt-to-GDP ratio among the major economies, Japan's fiscal management and discipline will remain an important topic for many years to come. To say the least, the structural shift envisioned by Hatoyama, following years of inefficiencies in the economy and government, would be highly challenging.



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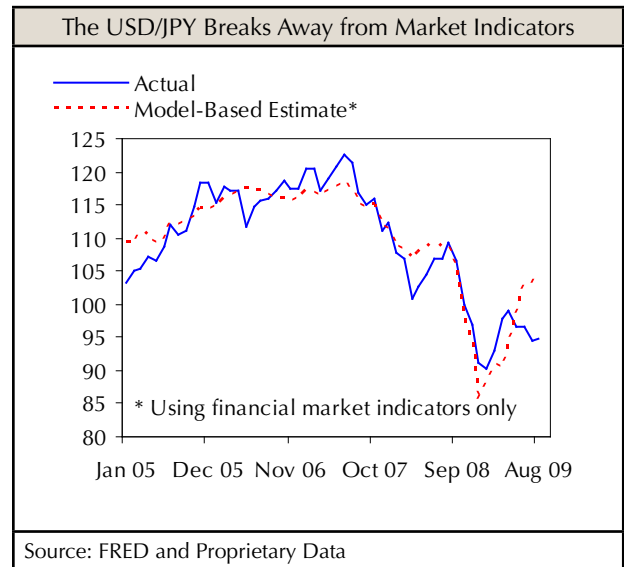


While the DPJ has overtly stressed that it values the independence of the Bank of Japan (BoJ), it is unclear whether the ongoing deflation environment in Japan, which could be aggravated by household-friendly fiscal measures, would add another dimension of complexity to monetary policy. Separately, the subject of international relations, especially between Japan and US, could potentially be another thorny area going forward.

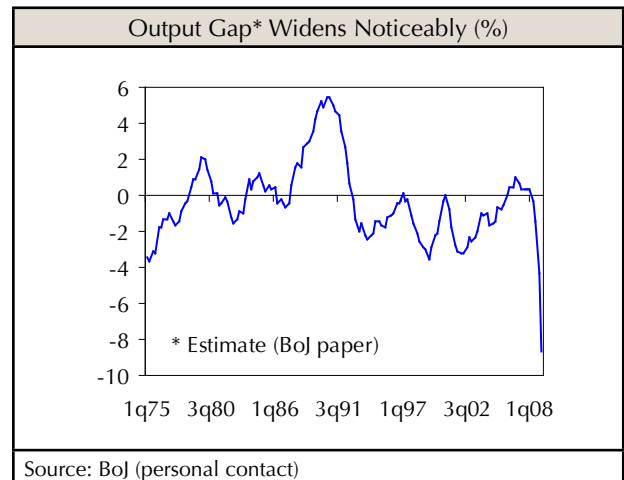
Nonetheless, the monumental change in political leadership in Japan was clearly positive for the JPY. The USD/JPY initially broke the 93.00 support level following the election results, and technical momentum over the subsequent few sessions probably instigated the push towards the 90.00 level. Most recently, the currency pair abruptly broke the 90.00 support level reportedly after comments from the new Finance Minister, Hirohisa Fujii, fuelled speculation that risks of official intervention are off the table despite the recent appreciation of the JPY. After smoothing out the daily fluctuations, the monthly average in the USD/JPY has been largely hovering under the 95.00 level since June. The apparent JPY strength, against the backdrop of appreciation in higher-yielding major currencies like the AUD and NZD, has nevertheless been confounding (even after taking into account the political effect).

After all, among the advanced economies, Japan's current economic downturn has been the sharpest; and among the major central banks, the BoJ maintains one of the lowest, if not the lowest, policy rates; and financial market conditions globally have improved. Therefore, the usual fundamental and market-risk drivers of USD/

JPY seem more consistent with a general backdrop of JPY weakness. Furthermore, although one could contend that the preference for household-friendly measures by the DPJ might imply a stronger JPY, policymakers probably favor a weaker JPY to partially combat the continued deflation backdrop in Japan. And our simple USD/JPY equation, using only financial market indicators, also implies an upward bias in the USD/JPY in the coming months. Hence, while we lowered our near-term forecast level for the USD/JPY to fluctuate around 95.00, we maintain the directional view that the currency pair might eventually push higher towards 100.00 in 2010 after the JPY reverts to its prior status of becoming the dominant funding currency.



Although the Japan economy witnessed a positive bounce in 2q09, we anticipate the subsequent growth figures to be more subdued. Indeed, our annual real GDP growth forecast still assumes a sizable average contraction in



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2009 of more than 5% primarily because of the nose-dive in economic activity earlier in the year. Despite the positive lift from fiscal policy, Japan's export-oriented economy still relies heavily on the global economy for support. Our tepid global recovery outlook and the fragile domestic labor market conditions suggest a more cautious recovery path in Japan. In light of the foregoing assumptions, we expect real GDP growth to average less than 2% in 2010.

The plunge in growth has obviously widened the output gap and enlarged the degree of economic slack in Japan.

According to the BoJ proprietary data on output gap, the 1q09 level was the most negative on record (going as far back as 1975). The sizable output gap should push up the unemployment rate further from an average of 5.2% in 2009 to 5.8% on balance in 2010. And standard relationships between unemployment and inflation would imply a more intense underlying deflation environment in 2010. The recent downward creep in the core CPI might be an early indication of this phenomenon. All in all, the foregoing backdrop seems consistent with the notion that the BoJ should be the least likely major central bank to tighten policy in 2010.