

# Japan

## Japan shows heightened risk of double-dip recession

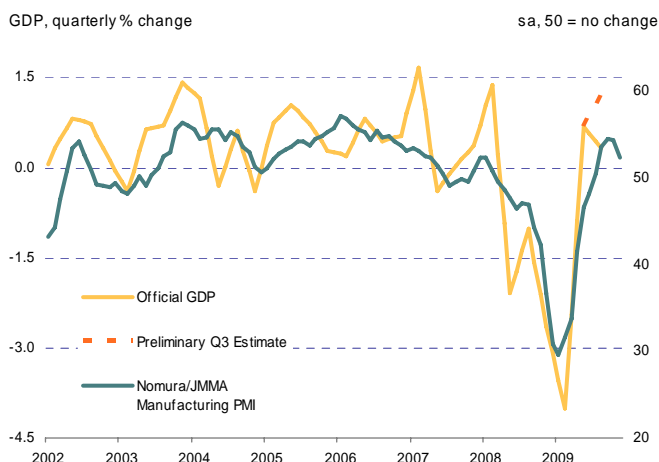
- **Manufacturing was the principal driver of growth in H2 2009.**
- **Services activity continues to fall, in line with PMI data.**
- **Reliance on exports leaves economy vulnerable to renewed weakening in 2010.**

### Japan's export-led recovery

Japan emerged from its deepest recession in modern history in the second quarter of 2009, growing at a quarterly rate of 0.7%. GDP continued to rise in the following quarter, although growth was revised down heavily from 1.2% to 0.3%. This was more in line with PMI data, which had pointed to a 0.5% expansion of the world's second-largest economy.

PMI data have a good track record against official GDP figures. Since the inception of the manufacturing series in November 2001, the headline Nomura/JMMA Manufacturing PMI has displayed a **correlation of 0.82** against both quarterly and annual rates of change in GDP.

**Chart 1: Japan Manufacturing PMI and GDP**

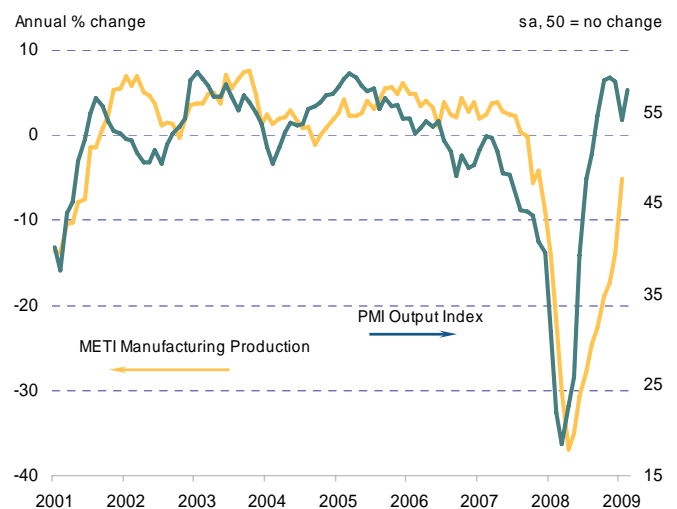


Sources: Markit, Cabinet Office.

Renewed GDP growth mainly reflected an improvement in demand from external sources, which rebounded in

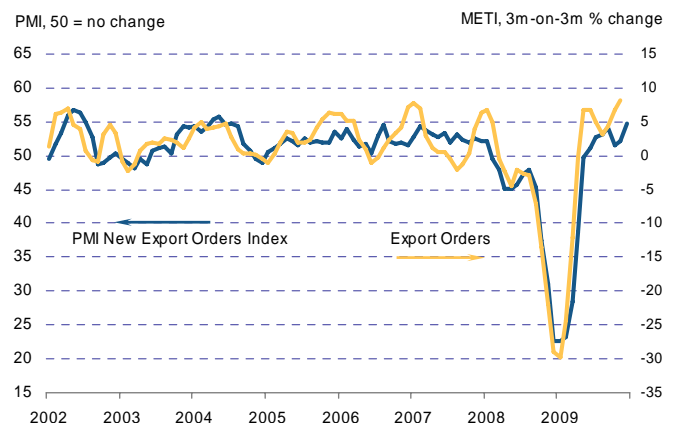
the second half of 2009 following the sharp deterioration seen at the start of the year. This was largely a result of improved economic conditions in many of Japan's key trading partners, with emerging Asia – in particular China – a key source of trade. The manufacturing sector, which initially felt the brunt of the economic downturn, showed robust signs of recovery in late-2009 and is responsible, alongside increased fiscal stimulus, for spearheading the sharp reversal of economic conditions in Japan.

**Chart 2: Japan Manufacturing Production**



Sources: Markit, METI.

**Chart 3: Japan Exports**



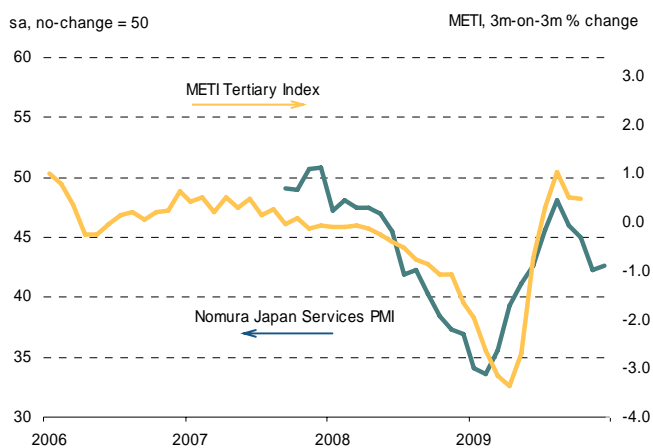
Sources: Markit, Customs Office.

## Lacklustre domestic demand shackles Japan's growth prospects

While manufacturers have led the economic fightback in Japan, service providers' fortunes have been distinctly different. Following some initial signs of improvement after the height of the downturn, the performance of the sector has remained lacklustre, with the headline Business Activity Index still below the neutral 50.0 threshold at the beginning of 2010. In fact, PMI data signalled that the contraction of services activity gained momentum towards the end of 2009, with the average for Q4 faster than that seen throughout Q3.

Mounting deflationary pressures are set to compound demand weakness in the months ahead as customers look to delay their purchasing decisions in an attempt to capitalise on reduced prices in the future.

**Chart 4: Japan Services PMI**



### Q4 prospects

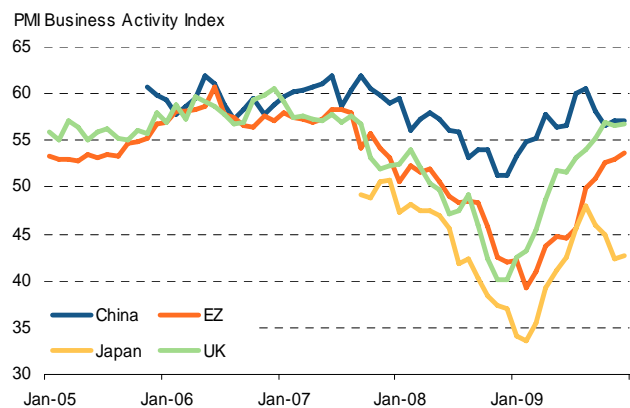
The PMI figures therefore suggest that GDP growth remained lacklustre in Q4. Export-led growth in manufacturing was likely offset by weak business conditions in the service sector. Meanwhile, reduced

fiscal stimulus and stubborn deflationary pressures are likely to have adversely affected economic activity in the final quarter.

### Double-dip recession?

The reliance on manufacturing exports as the principal driver of economic growth leaves Japan vulnerable to a renewed weakening of GDP, and even the risk of a 'double-dip' recession in 2010. Importantly, the surge in global manufacturing output in late-2009 was aided by the rebuilding of inventories, especially in emerging markets such as China. The inventory cycle is therefore a source of export growth that is likely to fade as we move into 2010. If services are unable to support economic growth, which looks to be a particular risk in Japan, slower growth looks inevitable.

**Chart 5: International services comparisons**



The fate of manufacturing will therefore once again depend on the economic health of Japan's key trading partners such as the US, Europe and China. Promising news for exporters is that Naoto Kan, the new finance minister, has called for a weaker yen. This view is a departure from the former minister, who considered a strong yen beneficial for the Japanese economy.

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