

Japan

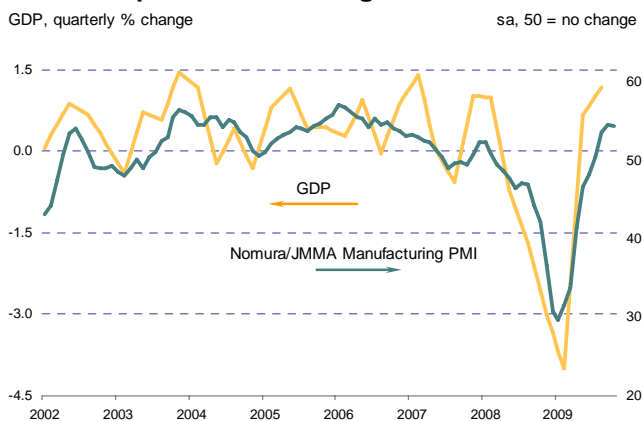
Japan's economy expanded at the strongest rate for two years in Q3

- **Japan GDP up 1.2% in Q3.**
- **Growth supported by rising exports and government stimulus measures...**
- **...although outlook remains subdued due to deflationary fears.**

Better-than-expected GDP growth

Official data released on 16 November showed that Japan's economy expanded for the second successive quarter in Q3, growing at a quarterly rate of 1.2% following 0.7% growth in Q2. The rise was comfortably faster than the 0.6% increase economists had been expecting, spurred by a bottoming-out of private sector capital investment, which increased by 1.6% in Q3, rising export sales and stimulus measures aimed at boosting demand from domestic sources.

Chart 1: Japan Manufacturing PMI and GDP



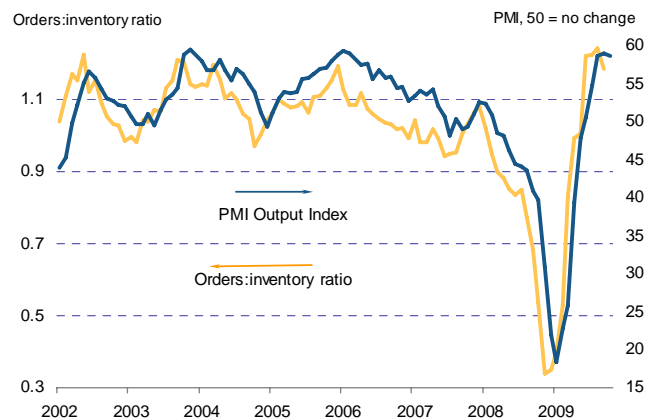
Sources: Markit, Japan's Cabinet Office.

The Japanese Manufacturing PMI survey, compiled by Markit on behalf of JMMA/Nomura, has tracked the downturn and subsequent upturn in official growth estimates, displaying a **correlation of 0.83**. In comparison, the closely-watched Bank of Japan Tankan survey exhibits **correlations of only 0.37 and 0.70** against quarterly and annual rates of change in GDP. The more timely nature of the PMI surveys, released monthly instead of quarterly, also helps the

PMI act as an advance indicator of economic activity in Japan.

Although data for Q3 were promising, and above the average seen for leading industrialised economies, commentators remain wary about the outlook as deflationary fears persist amid lacklustre domestic demand. The PMIs also provide the first tentative suggestion that the initial phase of the recovery in manufacturing – in which the rebuilding of inventories has boosted demand – may be waning. The orders:inventory ratio, which acts as a guide to the extent to which any imbalances between stock levels and demand will affect production, reached a record high of 1.24 in September but subsequently fell to 1.18 in October – a four-month low – pointing to weaker growth of manufacturing output in the coming months.

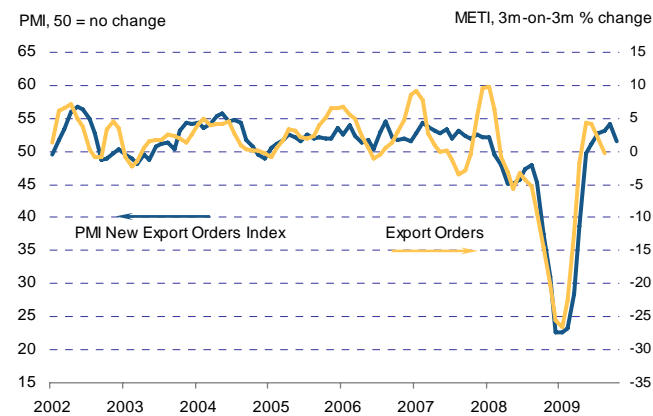
Chart 2: Orders to inventory ratio



Sources: Markit.

The export component of the manufacturing PMI survey also fell to a four-month low in October, signalling that export demand appears to be losing some momentum (the series displays a **correlation of 0.88** with official export figures), partly reflecting the strength of the yen against the dollar and uncertainty surrounding the recoveries in the US and Western Europe.

Chart 3: Japan Exports



Sources: Markit, Japan's Customs Office.

Prospects for Q4 and 2010

Although GDP growth was the strongest for two years in Q3, prospects for Japan's economy remain

uncertain as deflationary fears mount and stimulus measures start to wane. Structural problems in the services economy, weak domestic demand and fragile labour market conditions are also concerns that the ruling party must address if Japan's economy is to emerge from a prolonged period in which it has underperformed.

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