Economic Research Department

BBVA

Japan

# GDP Observatory

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Ya-Lan Liu
yalan@grupobbva.com

## JAPAN: Q1 2009 real GDP contracted 4.0% qoq (-15.2% saar), its biggest drop ever

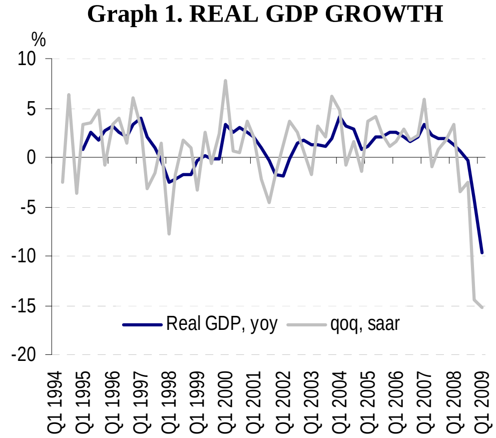
Japan's gross domestic product (GDP) for the quarter ending March 2009 came in at a historical record low of -4.0% quarter-on-quarter (qoq), seasonally adjusted, or an annualized -15.2%, according to the first preliminary estimate. This is better than market expectations (Bloomberg: -16.1% saar; Reuters: -15.7% saar), but worse than a revised -3.8% qoq in the previous quarter. For the fiscal year ending March 2009 (FY08), real GDP growth estimate came in at -3.5% year-on-year (yoy), the first negative growth since FY01 (-0.8% yoy) and below our -3.0% forecast.

This was the fourth straight quarter of negative growth, and the second straight quarter of double-digit negative growth, even outpacing the Asian financial crisis (Graph 1). Moreover, this reflects that the negative output gap sank further in Q1 09; according to Bank of Japan, Japan's potential growth rate has fallen to around 1% due to the effects of this financial crisis. Therefore, expectations of deflation will probably strengthen led by further stock adjustments and weaker growth expectations.

The debate about whether the next economic recovery is going to be L-shaped or V-shaped is inclining towards the latter, largely due to the growing consensus that a recovery will get underway in the second half of this year. Progress in inventory adjustments has fuelled expectations that industrial production will soon stop declining, and now market attention is shifting to the likely speed and extent of the recovery in manufacturing activity. Although the manufacturing sector capacity utilization rate rose for the first time in six months in March (0.8% mom), it ran at only 60% of its previous peak over the past year (Graph 2). An L-shaped recovery would reflect a bear scenario, where the economy remains stagnant for some time after a sharp drop. A V-shaped recovery would reflect the bull scenario, in which the economy quickly bounces back from its plunge.

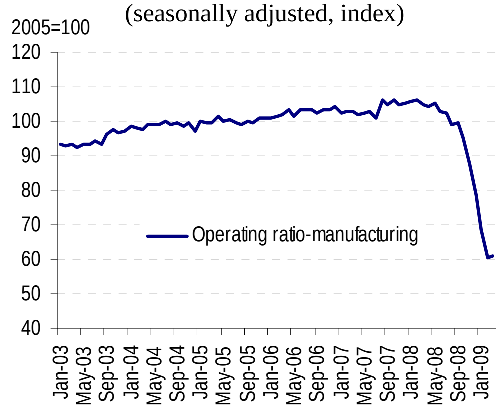
We currently forecast a contraction in real GDP growth of 6% yoy in calendar year 2009 followed by a 0.4% decline in 2010, albeit the balance of risks in 2009s lies heavily on the

**Graph 1. REAL GDP GROWTH**




Source: National statistics, ERD BBVA

**Graph 2. OPERATING RATIO**
(seasonally adjusted, index)




Source: National statistics, ERD BBVA

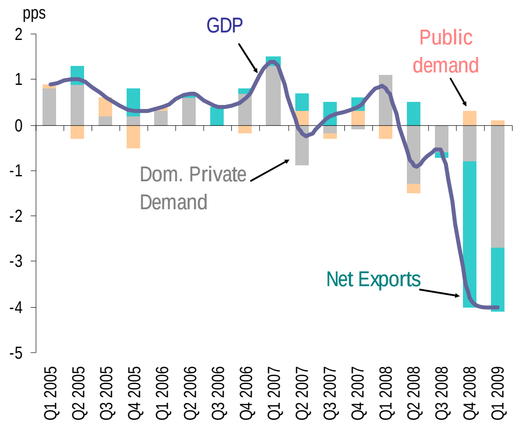
downside. Therefore, our forecast for real GDP is closer to an L-shaped economic recovery. Even though the Japan's fiscal stimulus packages unveiled seem sizeable, the impact on the real economy will be belated due to lack of parliamentary consensus on the face of the general elections in 2009. Also, because the effects of the government's economic stimulus package are likely to wear off in mid-2010, growth would dip into contraction again. The second round of negative growth will not be as pronounced as in 2009, but it does suggest that the recovery pace will be slow.

In the Q1 09 data released this week, real GDP fell 4% qoq, seasonally adjusted. Among GDP demand items, private demand made the largest negative contribution to qoq growth: 2.7 percentage points; a much wider drop than that in Oct-Dec 08. In particular, private non-residential investment was the largest drag on growth (-1.6 percentage points). Net exports made a negative contribution of 1.4 percentage points, less than in the previous quarter due to a positive contribution of imports (2.7 percentage points). Export contraction accelerated to 26% (-70% saar) from the previous quarter, while imports fell 15% qoq as private demand plunged. Public demand made a marginal positive contribution of 0.1 percentage points during the quarter, albeit lower than that of the previous quarter (Graph 3).

Nominal GDP shrank in Q1 09 by -2.9% qoq (-10.9% saar) from -1.6% in Q4 08. The GDP deflator was 1.1% yoy, widening from the previous quarter (0.7% yoy), which was the first positive deflator in roughly 11 years (Graph 4). However, this was mostly due to the import deflator (deducting from GDP) falling further to -23.2% yoy in Q1 09 from -11.7% yoy in the previous quarter, as oil and other commodities prices fell and the yen surged. Conversely, the domestic demand deflator fell for the first time in six quarters, to -0.9% yoy in Q1 09 from 0.3% yoy in the previous quarter, likely showing that Japan's economy is taking on a more deflationary note. Moreover, due to the import deflator´s drop more than that of exports, the terms of trades income losses shrank significantly for the second straight quarter. As a result, gross domestic income (GDI, real GDP plus trading gains) fell 1.9% qoq for the fourth straight quarter of decline, significantly less than real GDP (-4.0%) for the second straight quarter (Graph 5).

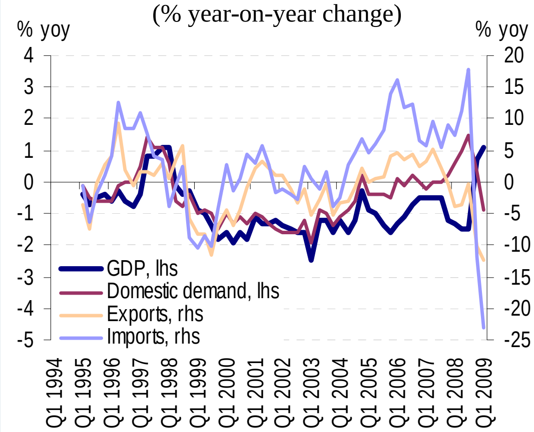
Going forward, inventory adjustments underway is expected to shrink the negative contribution from inventory, while both private consumption and government expenditure are expected to rise reflecting the results of the stimulus economic measures. The ratio of inventory to shipments declined for the first time in March (-0.4% month-on-month) after its rally in the last part of 2008 (Graph 6). However, even if the economy recovers briefly, bigger cuts in labor and capex lying ahead may slow the

**Graph 3. CONTRIBUTION TO QUARTERLY REAL GDP GROWTH**



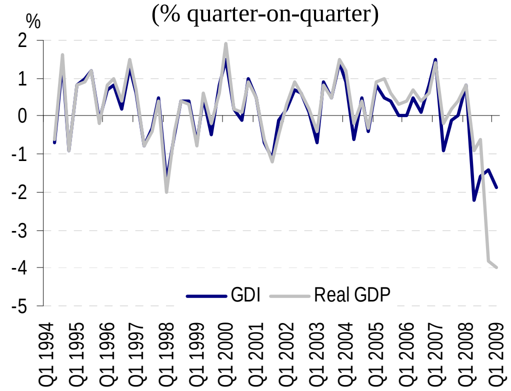

Source: National statistics, ERD BBVA

**Graph 4. GDP DEFLATORS**
(% year-on-year change)




Source: National statistics, ERD BBVA

**Graph 5. GDI vs GDP**
(% quarter-on-quarter)




Source: National statistics, ERD BBVA

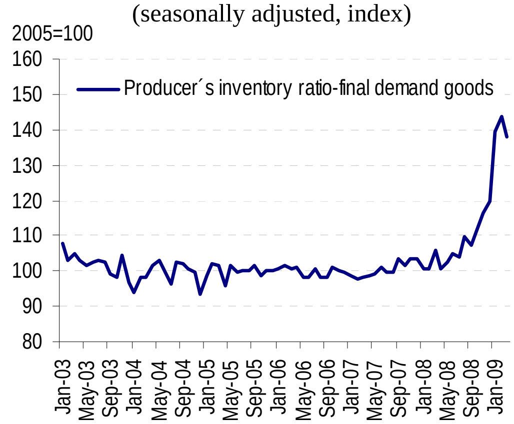
recovery again at the end of 2010, in the absence of new stimulus measures.

In sum, the major factors for an L-shape recovery call are:

1) Japan´s dependancy on the external sector for growth in the absence of signs of recovery in external demand.
2) On the domestic demand side, Japan´s widening output gap will lead to steeper adjustments ahead to capital and labor, which means that capex and private consumption will remain weak.
3) The government's stimulus package measures effect is likely wear off in the second half of 2010, unless an additional package is unveiled by then.

As for the economic outlook, the Bank of Japan (BoJ) expects Japan´s economy to recover by the end of this year, which is likely to be reflected on its economic assessment due for release on May 22. Nevertheless, the BoJ apparently believes that risks to the economic trend lie mostly on the downside, not the upside, as Japan´s economy has experienced brief recoveries in the past that failed to be sustained. Therefore, the BoJ also seems to anticipate an L-shaped rather than a V-shaped economic scenario.

**Graph 6. INVENTORY RATIO**
(seasonally adjusted, index)




Source: National statistics, ERD BBVA

**TABLE: REAL GDP BY COMPONENT** (% q-o-q, except where noted)

| Chained 2000 yen, % qoq, seasonally adjusted | 2008 Q1 | 2008 Q2 | 2008 Q3 | 2008 Q4 | 2009 Q1* | Q1* annualized |
|---|---|---|---|---|---|---|
| **Real GDP** | **0.8** | **-0.9** | **-0.6** | **-3.8** | **-4.0** | **-15.2** |
| I. Domestic Demand | 0.8 | -1.5 | -0.6 | -0.6 | -2.5 | -9.8 |
| *Domestic Demand (contribution, pp)* | *0.8* | *-1.4* | *-0.6* | *-0.6* | *-0.6* | -- |
| Private Demand | 1.4 | -1.7 | -0.8 | -1.1 | -3.4 | -12.8 |
| Private Consumption | 1.4 | -1 | 0.1 | -0.8 | -1.1 | -4.2 |
| Private Residential Investment | 4.8 | -2 | 3.1 | 5.5 | -5.4 | -20 |
| Private Non-Residential Investment | 1.7 | -2.9 | -4.4 | -6.7 | -10.4 | -35.5 |
| *Private Inventory (contribution, pp)* | *0.1* | *-0.1* | *0.1* | *0.2* | *-0.2* | -- |
| Public Demand | -1.3 | -0.7 | 0 | 1.3 | 0.2 | 1.0 |
| Government Consumption | -0.4 | -0.8 | -0.2 | 1.6 | 0.3 | 1.3 |
| Public Investment | -5.1 | -0.8 | 1 | -0.1 | 0 | -0.4 |
| *Public Inventory (contribution, pp)* | *0.0* | *0.0* | *0.0* | *0.0* | *0.0* | |
| GFCF | 0.9 | -2.5 | -2.5 | -3.9 | -7.7 | -27.5 |
| *II.Net Exports of Goods and Services (contribution, pp)* | *0* | *0.5* | *-0.1* | *-3.2* | *-1.4* | -- |
| Exports | 2.4 | -0.8 | 1 | -14.7 | -26 | -70.1 |
| Imports | 2.4 | -4.2 | 1.5 | 3.1 | -15 | -47.7 |
| Memo: | | | | | | |
| Nominal GDP | 1.3 | -2.1 | -1.5 | -1.6 | -1.6 | -10.9 |
| GDP deflator (% yoy) | -1.3 | -1.5 | -1.5 | 0.7 | 1.1 | -- |

* First preliminary estimate

Source: National statistics, ERD BBVA