

Economics

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Materializing pains from the European crisis

- **October real exports fell for the first time since April** — The real export index as calculated by the Bank of Japan decreased 4.8% MoM in October, for the first drop since disaster-ridden April. Lackluster economic developments for Japan's major trading partners have translated directly into Japan's export situation, in our view.
- **Exports to the EU fell particularly sharply** — By destination, real exports to the EU plunged nearly 9% MoM in October, for the first drop since April. This sharp fall is consistent with a 6.4% MoM drop in manufacturing new orders in the Euro area in September and strongly suggests that dysfunctional financial intermediation, eroding business sentiment and fiscal austerity measures have started to exert strong downward pressure on economic activity.
- **Why are exports to China so weak?** — China-bound real exports have remained range-bound in recent months despite relatively high growth in China. By item, exports of capital goods stopped rising completely this year after strong growth in 2009 and 2010. This probably reflects tighter financial conditions, especially towards small businesses, and the resultant slowdown in activity, in our view. Furthermore, due to the yen appreciation against other Asian currencies and the euro, the price competitiveness of Japanese products may have eroded relative to Korean or European goods.

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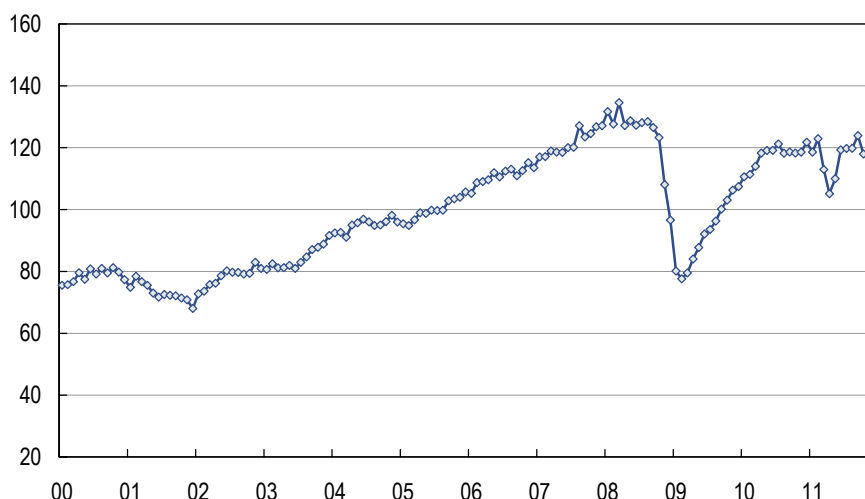
Materializing pains from the European crisis

Kiichi Murashima

Japan's export growth has lost steam in recent months after a brief period of sharply higher growth driven by a normalization period following the March 11 earthquake and tsunami, jeopardizing the budding economic recovery. Most notably, real exports to the EU fell nearly 9% MoM in October, which appears to be an indication that a negative feedback loop between worsening financial conditions and faltering economic activity is under way in the Euro area. In addition, exports to the U.S. and China also dropped in October. Renewed weakness in external demand is largely in line with our expectations but the October data suggests a downside risk to our growth forecasts.

The real export index, as calculated by the Bank of Japan, decreased 4.8% MoM in October, for the first drop since disaster-ridden April (see Figure 1). Lackluster economic developments for Japan's major trading partners have translated directly into Japan's export situation, in our view. The October level was 2.7% below the third-quarter average, suggesting that negative growth in exports is possible in Q4.

Figure 1. Real Export Index as Calculated by Bank of Japan (CY2005=100)

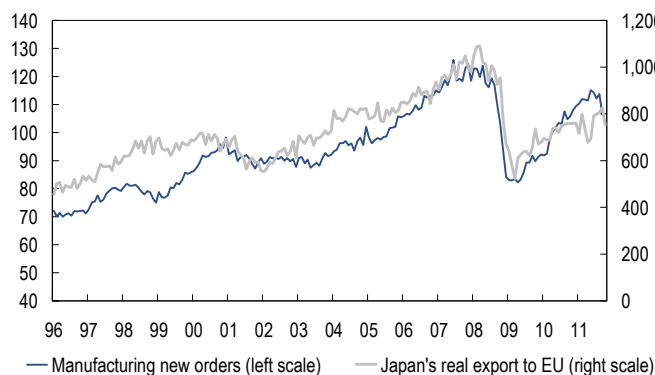


Source: Ministry of Finance, Bank of Japan, Citi Investment Research and Analysis.

By destination, most notably, real exports to the EU plunged 8.8% MoM in October (our own estimates), for the first drop since April. This sharp fall is consistent with a 6.4% MoM drop in manufacturing new orders in the Euro area in September (see Figure 2) and strongly suggests that dysfunctional financial intermediation, eroding business sentiment and fiscal austerity measures have started to exert strong downward pressure on economic activity. By item, while auto exports to the EU have been rebounding, exports of other items now appear to be moving sideways or even weakening in recent months (see Figure 3). From here, exports of capital goods, which accounts for the largest portion of exports to EU, likely will fall in an outright manner amid tighter financial conditions in the euro area.

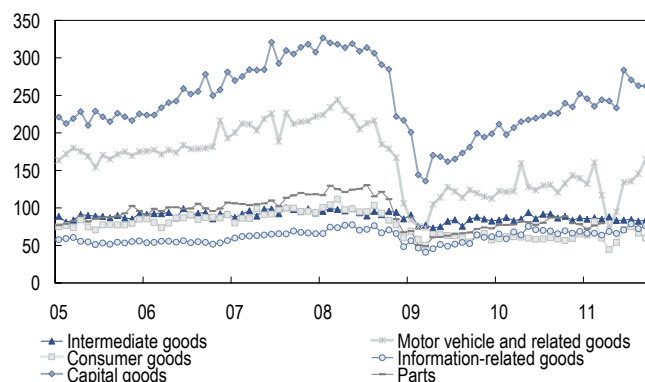
Meanwhile, real exports to the U.S. dropped a more moderate 1.9% MoM in October, for the first fall since April. A sharp rebound in auto exports, driven by the normalization in supply chains, appears to be already behind us.

Figure 2. Manufacturing New Orders in the Euro Area and Japan's Real Exports to EU (Left Scale: CY2005=100, Right Scale: ¥bn)



Source: Eurostat, Ministry of Finance, Bank of Japan, Citi Investment Research and Analysis.

Figure 3. Real Exports to EU by Item (¥bn)

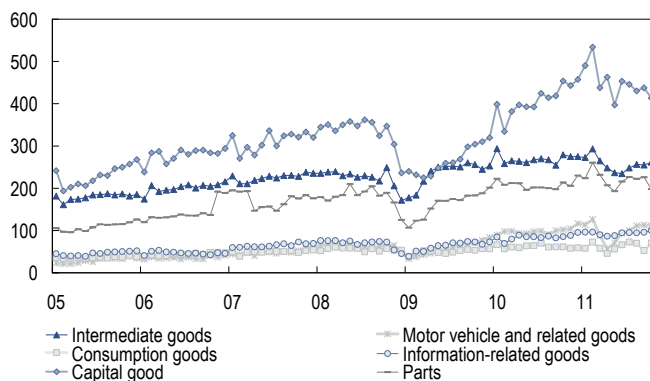


Source: Ministry of Finance, Bank of Japan, Citi Investment Research and Analysis.

For Asia, China-bound real exports declined 2.5% MoM in October, remaining range-bound in recent months despite relatively high growth in China. By item, exports of capital goods stopped rising completely this year after strong growth in 2009 and 2010 (see Figure 4). This probably reflects tighter financial conditions, especially towards small businesses, and the resultant slowdown in activity, in our view. Furthermore, due to the yen appreciation against other Asian currencies and the euro, the price competitiveness of Japanese products may have eroded relative to Korean or European goods (see Figure 5).

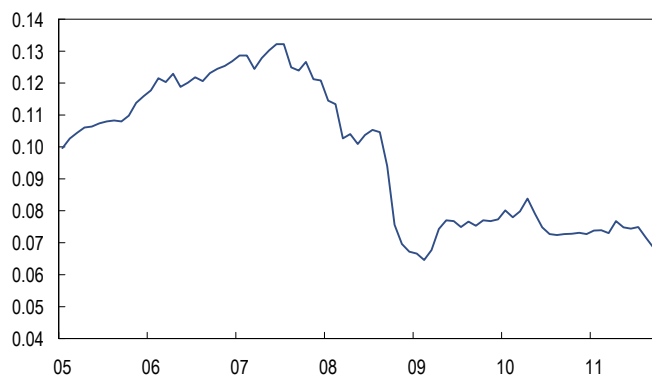
Meanwhile, real exports to Asia ex-China also posted the first decline since July with a 3.9% MoM fall in October. Given still resilient domestic demand in Asian nations, we believe Japan's exports catered to local demand have remained relatively healthy but exports of goods which are processed for re-export to industrialized countries may have started to slow. The export value to Thailand plunged 5.1% YoY in October after a 16.1% YoY rise in September, highlighting the adverse impact of the flooding.

Figure 4. Real Exports to China by Item (¥bn)



Source: Ministry of Finance, Bank of Japan, Citi Investment Research and Analysis.

Figure 5. JPY's value against Korean Won (JPY/KRW)



Source: Haver, Citi Investment Research and Analysis.

Given our view of lackluster economic growth by Japan's major trading partners, Japan's exports are likely to stall until the first half of 2012. Although the Chinese

economy has continued to grow at a relatively strong pace, Japan's China-bound exports have reflected mildly moderating business activities in China since the start of 2011, in our view. As noted above, we also see the possibility that Japanese products may have lost some of their competitive edge in the Chinese market. With the Chinese economy expected to moderate through the first quarter of 2012 (GDP expected to grow 8.1% YoY), exports to China are unlikely to gain momentum for the time being. We believe exports will be difficult to achieve in the Euro zone as well based on our forecast of an economic recession there from the fourth quarter of 2011 through the third quarter of 2012. On the other hand, the U.S. economy has gained momentum again, mainly from consumer spending. This bodes well for a sustained moderate uptrend in Japan's exports to the country, in our view.

Economic Indicators

Economic Indicators

Nov. 29 (Tue) 8:30 a.m. Tokyo Time	Nominal Household Spending, All Households (Oct)	Forecast: -1.6% Yr.-Yr.; 0.1% SA Mo.-Mo. Previous: -1.9% Yr.-Yr.; 1.3% SA Mo.-Mo.
	Real Household Spending, All Households (Oct)	Forecast: -1.4% Yr.-Yr.; 0.0% SA Mo.-Mo. Previous: -1.9% Yr.-Yr.; 0.9% SA Mo.-Mo.
	Nominal spending for all households in October likely declined by 1.6% YoY after -1.9% YoY in September, which corresponds to increasing 0.1% MoM after +1.3% MoM in September. On the other hand, general CPI excluding imputed rents declined by 0.2% YoY in October. Therefore, real spending for all households likely declined by 1.4% YoY after -1.9% YoY in September, which corresponds to remaining at the same level from one month ago after +0.9% MoM in September. Our forecast would place the October level of seasonally adjusted real spending 0.6% higher than the third-quarter average, following +1.4% QoQ in the third quarter.	
Nov. 29 (Tue) 8:30 a.m. Tokyo Time	Labor Data, Job Offers-to-Seekers Ratio (Oct)	Forecast: 0.68 Previous: 0.67
	Total Employment (Oct)	Forecast: -0.2% Yr.-Yr. Previous: -0.5% Yr.-Yr.
	Unemployment Rate (Oct)	Forecast: 4.1% of Workforce Previous: 4.1% of Workforce
	We expect the nationwide unemployment rate in October will be 4.1% for the second consecutive month. The improvement of unemployment rate has continued but we expect the labor market to improve at a gradually slower pace amid the slowdown of industrial production and consumption. Total employment likely rose by 0.2% MoM in October, while the number of unemployed probably decreased by 0.2% MoM and the non-labor force likely remained at the same level from one month ago. On the other hand, the effective job offers-to-seekers ratio was probably 0.68 following 0.67. In the background, effective job offers, which indicate labor demand, likely rose 19.5% YoY, while effective job seekers, which indicates labor supply, probably declined 2.7% YoY in October.	
Nov. 29 (Tue) 8:50 a.m. Tokyo Time	Retail Sales, Overall (Oct)	Forecast: 1.0% Yr.-Yr.; 0.6% SA Mo.-Mo. Previous: -1.2% Yr.-Yr.; -1.5% SA Mo.-Mo.
	We expect retail sales in October to rise by 1.0% YoY after a drop for the second consecutive month. This gain stems from motor vehicles sales which turned around to a gain from a drop for the first time since September 2010 amid the base effect that these sales in October 2010 substantially fell by the end of government stimulus package. Motor vehicles sales likely surged to 12.0% YoY from -0.4% YoY in September. Food & beverages sales probably increased by 1.5% YoY after -0.7% YoY in September. On the other hand, machinery and equipment sales likely declined by 23.3% YoY after -21.4% YoY in September amid disappearing positive effects from some of the one-off factors including front-loaded TV purchases ahead of the shift to terrestrial digital broadcasting and increased demand for energy-saving-related goods amid an electricity usage cap. General merchandise sales probably decreased by 1.0% YoY after -4.0% YoY in September. That said, the October level of retail sales would be 0.9% lower than the third-quarter average, after +0.8% QoQ in the third quarter.	
Nov. 30 (Wed) 8:50 a.m. Tokyo Time	Industrial Production (Oct)	Forecast: 0.8% Mo.-Mo.; -1.3% Yr.-Yr. Previous: -3.3% Mo.-Mo.; -3.3% Yr.-Yr.
	We expect industrial production to increase by 0.8% MoM after -1.3% MoM in September. We believe that industrial production will be heavily dependent on carmakers with other sectors likely subject to adverse effects from weak external demand. According to METI's production forecast survey, the manufacturing industry plans to increase production by 2.3% MoM in October. However, actual number tends to be below this forecast. By industry, transport equipment makers plan to increase output in October. They are increasing production so that they can recoup lost production due to the disaster and prop up overseas (mainly in the U.S.) inventory to a proper level. However, the deluge-driven supply chain distortions in Thailand will likely depress production. On the other hand, production at electronic parts and device firms will be lackluster and general machinery production is leveling off, showing headwinds from slower overseas economies. The information and communication electronic equipment sector lacks momentum as well. Our forecast would place the October level of industrial production 1.3% lower than the third-quarter average, after +4.3% QoQ in the third quarter.	
Nov. 30 (Wed) 2:00 p.m. Tokyo Time	Housing Starts (Oct)	Forecast: -6.4% Yr.-Yr.; 0.77 Million Units SAAR Previous: -10.8% Yr.-Yr.; 0.75 Million Units SAAR
	October housing starts likely declined by 6.4% YoY after -10.8% YoY in September. On the other hand, seasonally adjusted annual rate of housing starts will increase by 3.2% MoM to 0.77 million units in October, after -20.2% MoM in September, because the rebound from the rush demand before the end of housing demand stimulus package takes a round. However, our forecast would place the October level of housing starts 12.4% lower than the third-quarter average after +8.4% QoQ in the third quarter. By owner occupant relation, owned houses will likely rise by 2.6% MoM after -14.3% MoM in September; rented houses will probably increase by 4.0% MoM after -29.6% MoM in September; houses built for sale will likely rise by 2.5% MoM following a 18.6% month-on-month drop in September.	

Source: MIC, MHLW, METI, MLIT, Citi Investment Research and Analysis.

Main Forecasts

Currency and interest rate forecasts

	Current	Q4 11 Forecast	Q1 12 Forecast	Q2 12 Forecast	Q3 12 Forecast	Q4 12 Forecast
Japan: Yen/US\$	76	75	75	76	76	76
Call money	0.10	0.10	0.10	0.10	0.10	0.10
Long-term benchmark JGB	1.01	1.10	1.20	1.05	1.10	1.30

Source: 'Global Economic Outlook and Strategy', Citi Investment Research and Analysis (October 26, 2011).

Macroeconomic and GDP data for FY2010-2012E (YoY %)

	2010	2011 E	2012 E
Real Gross Domestic Product	2.4 %	0.3 %	1.8 %
Domestic Demand	1.6 %	1.0 %	2.0 %
•Private Domestic Final Sales	1.5	0.3	1.6
••Private Consumption	1.0	0.1	0.8
••Business Investment	4.2	0.4	3.6
••Residential Investment	-0.2	4.9	9.4
•Government Consumption	2.3	2.3	1.6
•Public Investment	-9.8	-1.0	7.7
•Inventories (Contribution) ^a	0.5	0.3	0.2
Net Exports (Contribution) ^a	0.9 %	-0.6 %	-0.2 %
•Exports of Goods & Services	17.1	-0.3	2.4
•Imports of Goods & Services	10.9	4.9	4.7
Nominal GDP	0.4	-1.6	1.1
Consumer Prices ex. Fresh Food	-0.9 %	-0.1 %	-0.3 %
GDP Deflator	-1.9	-1.9	-0.7
Current Balance (Yen in Trillions)	15.9	10.3	11.9
•Pct. of GDP	3.3 %	2.2 %	2.5 %
Trade Balance (Yen in Trillions)	6.5	-1.0	1.1
Corporate Profits (Fiscal Year)	50.0	2.0	13.5
General Govt. Balance (Fiscal Year)	-9.8 %	-10.3 %	-9.2 %

^a Contribution to GDP growth in percentage points. GDP: Gross Domestic Product.

E: Citi Investment Research and Analysis forecasts as of November 16, 2011.

Source: Economic and Social Research Institute; Ministry of Finance; Ministry of Public Management, Home Affairs, Posts and Telecommunications; Bank of Japan; *Nihon Keizai Shimbun*; Citi Investment Research and Analysis.

Major economy GDP growth forecasts, CY2010-2012E (YoY %)

	2010	2011 E	2012 E
United States	3.0 %	1.8 %	1.9 %
Japan	4.1	-0.4	1.8
Euro Area	1.8 %	1.6 %	-0.3 %
United Kingdom	1.8	0.9	0.7
Asia	9.2 %	7.4 %	7.2 %
•People's Republic of China	10.4	9.1	8.7

E: Citi Investment Research and Analysis estimates.

Sources: 'Global Economic Outlook and Strategy', Citi Investment Research and Analysis (October 26, 2011) and 'Japan Macroeconomic Forecast', Citi Investment Research and Analysis (November 16, 2011).

Recent economic indicators (YoY % or units as indicated, ¥bn)

	Jul	Aug	Sep	Oct
PRODUCTION				
Industrial Production	-3.0 %	0.4 %	-4.0 %	
Shipments	-3.0	0.2	-2.6	
Inventories	4.1	5.8	5.6	
Private Machinery Orders, Excl. Ships and Power	4.0	2.1	9.8	
Contracted Public Works Orders	-15.9	3.5	3.3	
CONSUMPTION				
Retail Sales (METI)	0.6 %	-2.6 %	-1.2 %	
All Household Consumption, Nominal	-1.8	-3.9	-1.9	
New Motor Vehicle Registrations	-23.3 %	-22.4 %	-2.1 %	25.2
New Housing Starts	21.2	14.0	-10.8	
LABOR MARKET				
Employment	-0.3 %	-0.5 %	-0.5 %	
Unemployment Rate (Level)	4.7	4.3	4.1	
Job Offers/Seekers Ratio (Level)	0.64	0.66	0.67	
New Job Offers	12.2	18.4	12.5	
Cash Earnings (5 Workers or More)	-0.2	-0.6	0.0	
PRICES				
Nationwide Consumer Prices	0.2 %	0.2 %	0.0 %	-0.2
•Excl. Fresh Food	0.1	0.2	0.2	-0.1
Domestic Corporate Goods Prices	2.8	2.6	2.5	1.7
MONEY AND CREDIT				
Monetary Base	15.0 %	15.9 %	16.7 %	17.0 %
M2	3.0	2.7	2.7	2.7
M3	2.4	2.2	2.3	2.3
L (Broadly-defined Liquidity)	0.7	0.4	0.2	-0.1
Bank Lending	-0.6	-0.5	-0.3	0.0
TRADE, CAPITAL FLOWS, AND CURRENCIES				
Trade Balance, Customs Clearance Basis, SA	¥-1602	¥-265.2	¥-96.7	¥-457.9
Export Value Growth (Yen Basis)	-3.4	2.8	2.3	-3.7
•Volume	-5.2	0.9	1.7	-4.0
Import Value Growth (Yen Basis)	9.9	19.2	12.1	17.9
•Volume	-2.6	6.0	0.9	6.0
Current Account, (SA, Billion yen)	752.5	652.6	1186.6	
Yen/US Dollar Spot Rate	¥77.59	¥76.58	¥76.69	¥78.80

Source: Bank of Japan, government and industry association statistics, Citi Investment Research and Analysis.

Net buying/selling of Japanese stocks on three main exchanges by all 58 incorporated securities firms (¥bn)

	Individual			Corporate		Investment		Securities	
	Cash	Margin	Total	Financial	Nonfinancial	Trusts	Foreign	Firms	
July	-176.9	128.1	-48.8	-192.8	53.4	-72.0	169.5	110.8	
August	390.3	218.4	608.8	759.7	153.0	66.9	-1065.6	-564.8	
September	-54.8	-62.6	-117.4	518.0	60.1	5.4	-752.6	298.2	
October	-165.4	-13.7	-179.1	52.2	33.1	-66.5	165.5	15.2	
10/17~10/21	-0.9	37.2	36.3	-32.8	12.4	-23.7	-48.7	56.7	
10/24~10/28	-106.6	-52.1	-158.7	-8.1	12.8	6.6	158.4	1.8	
10/31~11/04	15.0	63.6	78.6	17.0	11.0	9.6	-71.2	-51.8	
11/07~11/11	10.5	33.6	44.1	25.0	30.8	-8.0	-25.2	-63.6	

Note: Data based on net buying by 58 major securities firms with seats on the exchanges.

Source: Tokyo Stock Exchange, Citi Investment Research and Analysis.

Appendix A-1

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