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Asia Pacific Executive Brief

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CONTENTS

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Japan

Political & policy issues to watch

A rise in political risk

... PM Kan loses control of the upper house

… & legislation may stall

Political risk is rising in Japan following the ruling DPJ's weak performance in the July upper house election. The DPJ now holds just 106 seats in the 242 seat chamber or 110 including their existing coalition partners the People's New Party (PNP) and the New Party Nippon. The opposition LDP lifted their share to 84 seats with the remaining 48 now held by minor parties. This leaves the current DPJ-led coalition short of an upper house majority, making it very difficult to pass legislation. Various coalition options have been proposed. The DPJ may try to bring the centrist Your Party (11 seats) into the coalition, although this still leaves it one seat shy of a majority. Japan could be facing legislative gridlock, a change of prime minister, and an early election as a result.

Policy impact

… no increase in the consumption tax

… privatisation of Japan Post Office proceeds

The upper house polls have two big policy outcomes. First, voters rejected PM Kan's proposal to lift the 5% consumption tax in an effort to curb soaring public debt. This will make it hard for future governments to lift this tax. Second, the bill to halt the privatisation of Japan Post and double the cap on deposits at Japan Post to Yen 20m (US$225,000) is now in trouble. The bill was pushed by the PNP but having lost two of their five upper house seats in July their influence has waned. Your Party has expressed strong opposition to the bill and it could become a deciding factor in any future coalition. The bill may be revised or withdrawn, which is probably the best outcome for Japan.

Outlook for the market

Surging exports push up 2010 GDP

Japan's outlook has improved in the last few months as exports have soared. The IMF has just lifted its 2010 GDP forecast for Japan to 2.4% from 1.9% previously. We've lifted our own forecast to 1.8% from 1.6% as we have two concerns about the outlook. First, rising political risk is likely to undermine the current lift in sentiment. Second, the 1H'10 upturn is mainly in export manufacturing, which is exposed to a double dip recession in the West as well as an overly strong Yen.

… driven by China and Asean demand

Strong global demand pushed exports up 39%yoy in May and by 47%ytd. The export rebound lifted industrial production 20%yoy in May, although the May index reading of 87.4 is barely at the average 2003 level suggesting lots of excess capacity. Sales to the US have slowed (+18%yoy in May) but growth is still being driven by China (+25%yoy) and ASEAN (+47%yoy).

Bringing a lift in business confidence

Business confidence lifted in Q2'10 with the Tankan headline index for large manufacturers hitting +1 from -14 in Q1'10 as firms expect the current expansion to continue in 2H'10. The survey also showed manufacturers planning to boost capital spending by 4.4% in FY2010-11 (beginning April 1). Machinery orders have recovered a bit in recent months (+17%yoy in May) but are still 35% below their peak in 2007. We may lift our 2010 fixed investment forecast from its current 0.3% growth as local production nears capacity.

But consumer demand remains weak

Doubts remain over Japan's consumer recovery. Consumer confidence ticked up to 42.8 in May, a two and a half year high, but unemployment also rose to 5.2% after being below 5% earlier in the year. As noted above, despite the sharp rebound in manufacturing, production volumes remain below the level of the last seven years. Retail sales growth eased to 2.8%yoy in May, although new car sales grew 18%yoy in June. We might see a small improvement in 2H'10 consumer demand but it is difficult to see anything above 1% or 2% growth. Our 2010 forecast is for 0.2% spending growth.

Watch for a switch in policy on deflation

Persistent deflation weighs on consumer demand. The government may force the Bank of Japan to restart quantitative easing soon, flooding the market with yen and depressing the currency. Your Party has made a 2% core inflation target a condition for joining the DPJ coalition. Under this scenario, CPI growth would turn positive in 2011 as the yen weakens.

	2007	2008	2009	2010	2011
GDP, real growth, %	2.4	-1.2	-5.2		
CPI, year average, %	0.0	1.4	-1.4		
Overnight call rate, year end, %	0.50	0.21	0.10		
Yen to US$1, year average	118	103	94		

Sources: 2007-2009 data from the BOJ and government sources; 2010-2011 forecasts by IMA Asia.