

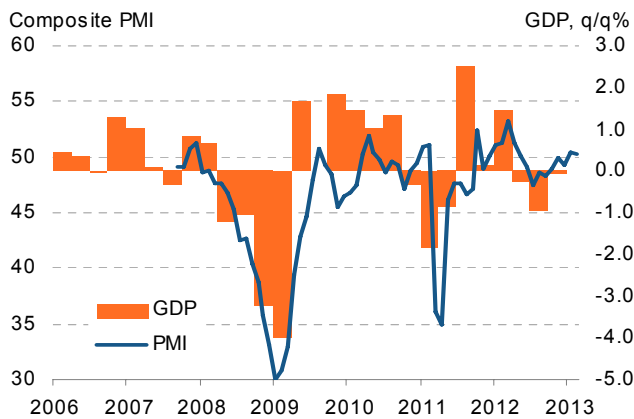
# Japan

## PMIs point to “Abenomics”-fuelled growth upturn

- **Business confidence hits five-and-a-half year high in February**
- **PMIs point to revival of economic growth in first quarter**
- **Policymakers face challenge to sustain improvement in business optimism**

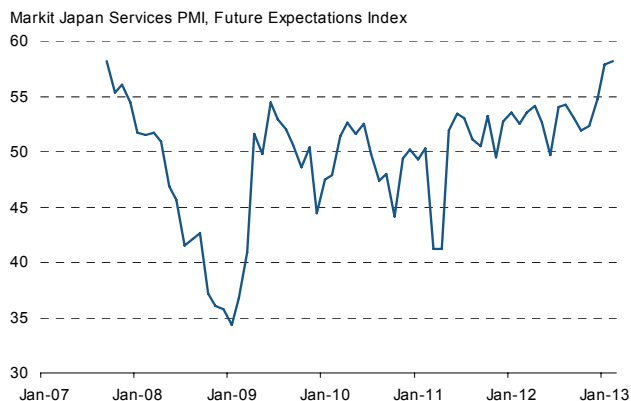
Business confidence in Japan has surged to a five-and-a-half year high, fuelled by expectations of economic recovery following the government’s pledge to defeat deflation. PMI data suggest that the country could pull out of its recession in the first quarter, but the rate of expansion is likely to be only modest and the government faces huge challenges to sustain the recent improvement in business sentiment.

### Markit/JMMA Japan ‘all-sector’ PMI and GDP



Sources: Markit, Cabinet Office (via Ecwin).

### Business confidence



Source: Markit.

### Confidence at five-and-a-half year high

The term ‘Abenomics’ has been used to describe the ‘three-arrowed’ approach advocated by Shinzō Abe since his appointment as Japan’s Prime Minister at the end of last year. The three arrows are fiscal stimulus, including a \$100bn infrastructure spending plan, more aggressive monetary easing, including the doubling of the inflation target to 2%, and growth-enhancing structural reforms.

The pursuit of these policies, designed to tackle the deflation that has plagued Japan since the 1990s, has already been linked to the yen losing roughly one-fifth of its value against the euro and the US dollar and Japanese equity prices rising by around one-third since last October.

The optimism in the financial markets is also becoming increasingly shared by firms in the real economy. Markit’s service sector PMI survey showed confidence about the year ahead hitting a joint survey record high in February, with firms reporting the greatest optimism since September 2007. Many companies directly referred to “Abenomics” when explaining their improved sentiment about the year ahead.

This improvement in confidence helped drive actual levels of service sector business activity higher for a fourth successive month in February, with inflows of new business growing at the fastest rate since last April.

### Export lift

Exporters are also starting to benefit from the weakened yen, which has made goods more competitively priced in overseas markets. Trade data showed goods exports rose for the first time in eight months in January, helping to drive an increase in industrial production for the second successive month. The manufacturing PMI had signalled that upturn in production in advance, and also indicates that the improving trend continued into February, with the PMI hitting an eight-month high.

## First quarter GDP increase

The PMI surveys provide the most comprehensive and up-to-date guide to business activity and therefore economic growth, and the two surveys sent a combined signal that activity rose for a second successive month in February. Although only marginal (the composite index slipped from 50.4 to 50.2 but importantly remained above the no-change level of 50).

The increase in activity signalled by the PMI surveys so far this year suggests that the Japanese economy could return to growth for the first time in a year in the first quarter (gross domestic product fell by 0.2%, 1.0% and 0.1% in the second, third and fourth quarters of last year respectively). Growth looks likely to be modest, perhaps 0.1%-0.2%, but the revival could further help to boost business and consumer confidence, putting Japan on a firm footing for further expansion in the second quarter.

## Policy challenges

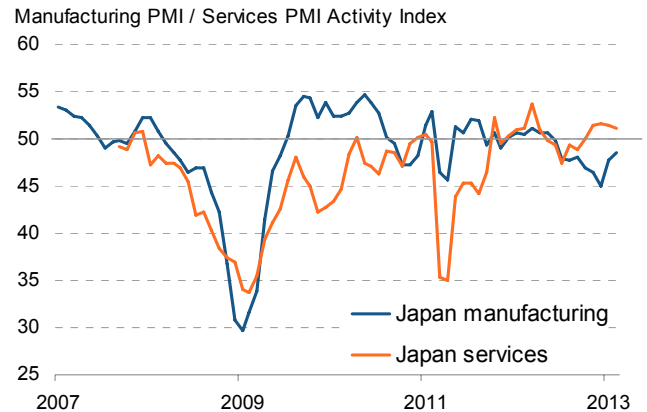
The outlook depends to a large extent on whether new Bank of Japan governor Haruhiko Kuroda will be able to deliver on the promises of more aggressive monetary policy. The raising of the inflation target to 2.0% brings with it the difficult challenge of actually getting prices to rise to meet that target. Despite the stimulus that has already been put in place, the Bank of Japan's Policy Board is still currently forecasting inflation of just 0.9% in the 2014 fiscal year.

This tells us that current policy is therefore insufficient to break the deflationary trend. Interest rates have been close to zero since the late 1990s, which also effectively rules out forward guidance, and quantitative easing via the buying of government debt has made little impact. Even the prospect of the Bank of Japan buying longer-dated debt would be unlikely to have much effect, given the low interest rates that already exist throughout the yield curve.

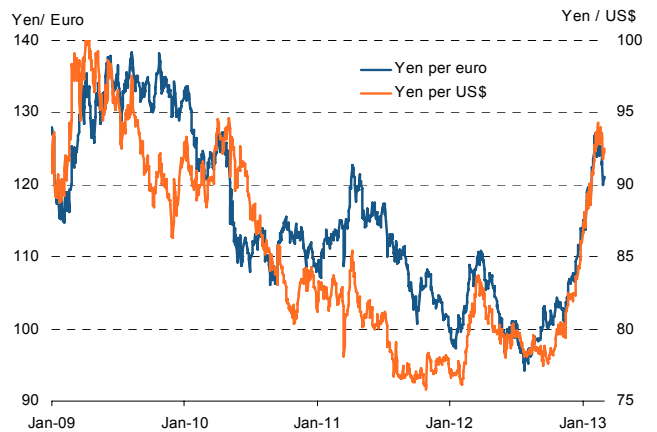
New stimulus could take the form of the Bank of Japan buying corporate bonds or other similar riskier assets, or even buying foreign government bonds in an attempt to pull the exchange rate down further. Both are controversial, and the latter in particular due to the current focus on "currency wars".

The danger is therefore that the current wave of "Abenomics"-fuelled optimism could quickly fade if words are not followed by prompt action.

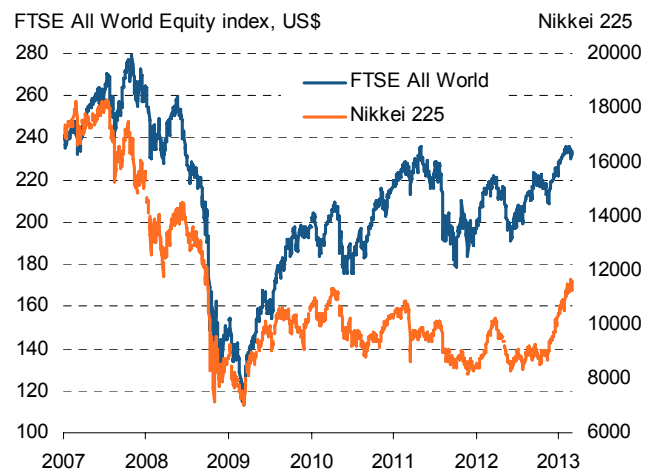
## PMI Business Activity Indicators



## Exchange rate



## Equity prices



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