

3 March 2009 (No. of pages: 6)

Scenario of 8% Growth in China Inducing Recovery in Japan Incorrect

Exports from Japan to China moving in line with China's electric power generation rather than its GDP growth

Japanese report: 2 Mar 09

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Summary

- Japan's economy is contracting sharply, but there are growing expectations that China's economy will help induce recovery—in response to a slowdown, the Chinese government has announced a series of large economic stimulus measures (4 trillion yuan in aggregate by end-CY10; 13% of GDP), leading Japan's markets to anticipate that Japan's economy will begin to recover should China's economy attain 8% growth.
- However, it is mistaken to believe that such economic growth in China will induce Japan's recovery. The key in this report is that exports from Japan to China have moved in line with China's electric power generation rather than its GDP growth. In China, electric power generation has plunged while real GDP has grown steadily, widening the gap between them. We believe electric power generation better represents the real situation with respect to China's economy. Thus, even should China attain 8% economic growth, Japan's economy will not necessarily begin to recover.
- The possibility of China's economic growth grinding to a halt is limited. Considering that (1) China's economy is not a pure market economy but a socialist market economy, (2) inflationary pressure has greatly waned and a greater margin exists for lowering interest rates, and (3) the ratio of government bonds outstanding to GDP is only around 20%, should China forcefully implement stimulus measures the possibility of economic growth coming to a halt is small. Dividing the economies of the world into four in terms of the US economy and resource prices, for China with an economic structure that is highly dependent on the US and vulnerable to high resource prices, lower commodity prices greatly easing inflationary pressure is the best possible news.
- In conclusion, while there appears to be only limited possibility of China's economic growth halting, we cannot place excessive expectations on the scenario that the expansion of China's economy will trigger a bottoming out of Japan's economy.

***Growing expectations
China's economy will
induce Japan's economic
recovery***

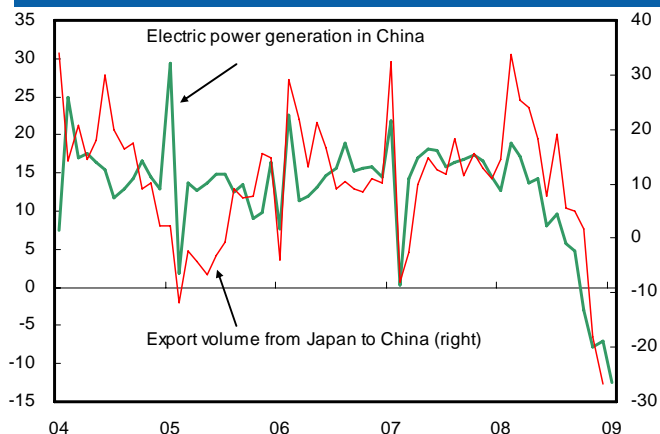
Japan's economy is contracting sharply, but there are growing expectations that China's economy will help induce recovery—in response to a slowdown the Chinese government has announced a series of large economic stimulus measures (4 trillion yuan in aggregate by end-CY10; 13% of GDP), leading Japan's markets to anticipate that Japan's economy will begin to recover should China's economy attain 8% growth. This report analyzes the validity of the scenario of 8% economic growth in China driving economic recovery in Japan.

***Exports from Japan to
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However, it is mistaken to believe that such economic growth in China will induce Japan's recovery. The key in this report is, as shown in charts 1 and 2, that exports from Japan to China have moved in line with China's electric power generation rather than its GDP growth. In China, electric power generation has plunged while real GDP has grown steadily, widening the gap between them. We believe electric power generation better represents the real situation with respect to China's economy. Thus, even should China attain 8% economic growth, Japan's economy will not necessarily begin to recover. To determine economic conditions in China going forward, electric power generation warrants monitoring.

Chart 1

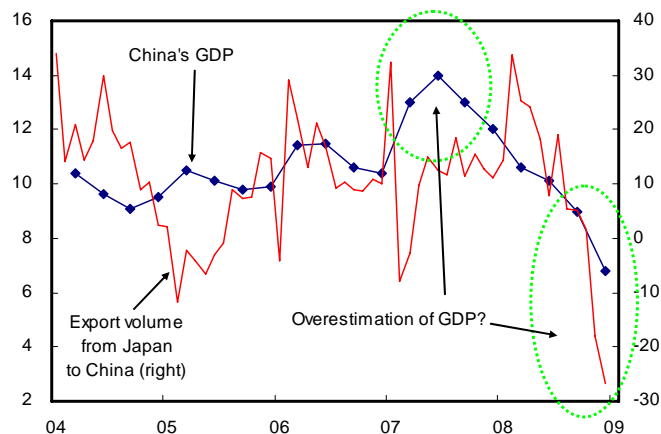
China's Electric Power Generation and Exports from Japan to China (Y/y %)



Source: CEIC Data; MOF.

Chart 2

China's GDP and Exports from Japan to China (Y/y %)



Source: CEIC Data; MOF.

***Limited possibility of
China's economic
growth halting***

The possibility of China's economic growth grinding to a halt is limited. Considering that (1) China's economy is not a pure market economy but a socialist market economy, (2) inflationary pressure has greatly waned and a greater margin exists for lowering interest rates, and (3) the ratio of government bonds outstanding to GDP is only around 20%, should China forcefully implement stimulus measures the possibility of economic growth coming to a halt is small. As China's purchases of iron ore rebound, the Baltic Exchange Dry Index is showing signs of bottoming out (Chart 3).

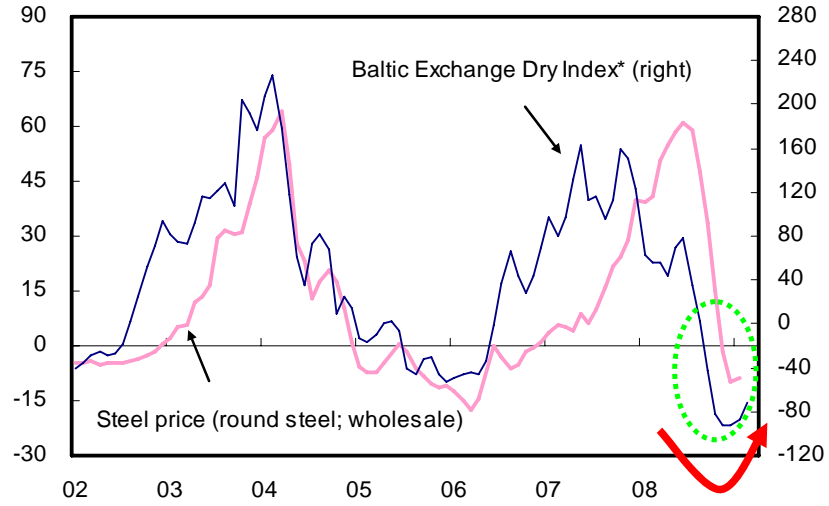
***Decline in commodity
prices easing inflationary
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news for China***

The decline in commodity prices greatly easing inflationary pressure is the best possible news for China. Chart 4 divides the economies of the world into four along the axes of the US economy and resource prices. The vertical axis depicts the percentage share of exports to the US in respective countries' GDP. It offers a measure of the degree to which the slowing of the US economy affects domestic economies through lower exports to the US. The horizontal axis portrays the ratio of net exports of mineral resources (crude oil, iron ore, etc.) to GDP. This axis provides a measure of the degree to which domestic economies are influenced by surging resource prices. Economies positioned high in the chart are highly dependent on exports to the US and are vulnerable to the slowing of the US economy. Also, economies positioned on the left of the chart are highly dependent

on the net import of resources. Their terms of trade can readily worsen, and they are vulnerable to surging resource prices.

Chart 3

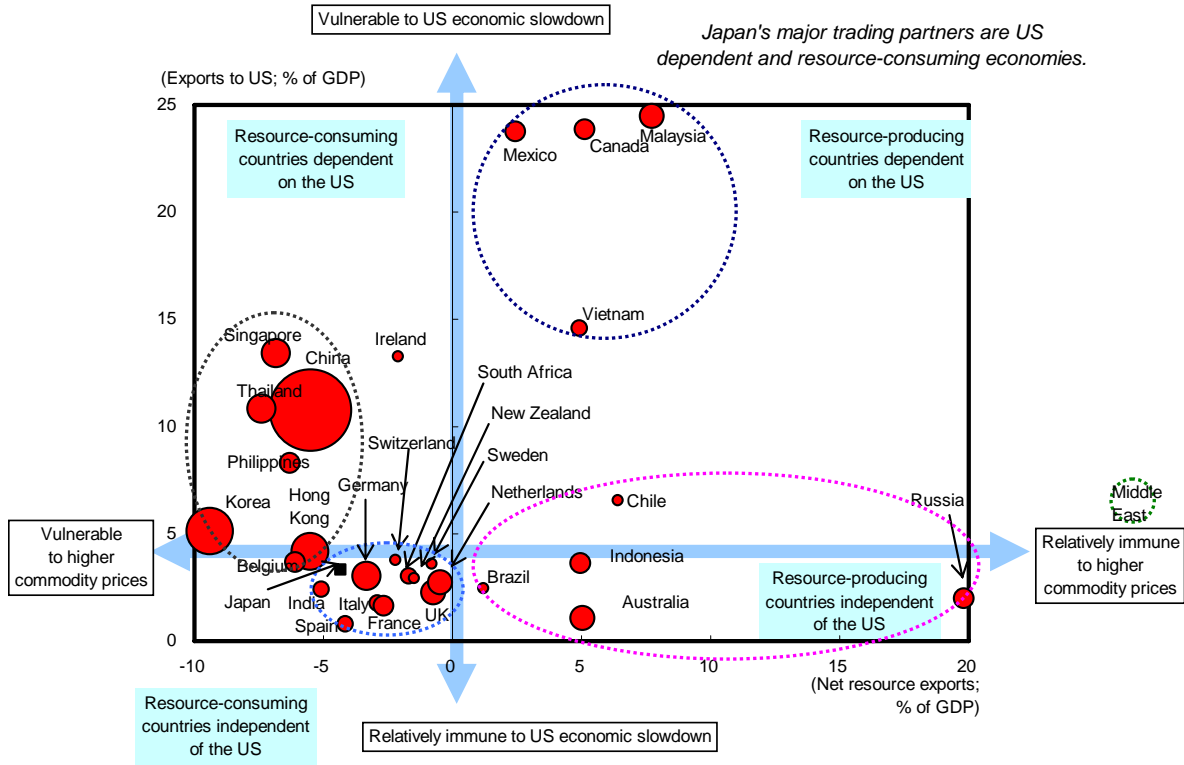
Steel Price in China and Shipping Market (Y/y %)



Source: Datastream, CEIC Data; compiled by DIR.
* monthly avg; Feb 2009: as of 17 Feb.

Chart 4

Sorting of Countries in Terms of Sensitivity to US Economy and Resource Prices



Source: UN, US Census Bureau; compiled by DIR.
Resources: Mineral fuels (oil, etc.,) and non-food materials (iron ore, etc.,).
To see the impact on respective countries in a simple way, exports to the US and net resource exports are shown as % of GDP.
Size of red circles indicates the value of exports from Japan.
Major countries outside the graph are Saudi Arabia (exports to US: 53% of GDP; net resource exports: 9% of GDP), Kuwait (39%; 4%), and Venezuela (31%; 20%). Export shares to these countries are below 1% of Japan's exports, which are shown by the smallest red dots.

China's economic structure highly dependent on the US and vulnerable to high resource prices

It should be evident that a steep rise in commodity prices is disadvantageous for nations positioned in the upper left quadrant of the chart, which includes China and other East Asian nations. The size of the circles in the chart indicates the value of exports from Japan, confirming again the close ties between the Japanese economy and the nations in the upper left. The implication of Chart 4 can be summarized as follows. For China with an economic structure that is highly dependent on the US and vulnerable to high resource prices, lower commodity prices greatly easing inflationary pressure is the best possible news. Should inflationary pressure subside, the Chinese authorities will be able to fully pursue financial and monetary policies.

Excessive expectations that expansion of China's economy will trigger bottoming out of Japan's economy

In conclusion, it is mistaken to think that likely 8% economic growth in China will drive Japan's recovery. While the possibility should be limited of China's economic growth coming to a halt, we cannot place excessive expectations on the scenario that the expansion of China's economy will trigger a bottoming out of Japan's economy.

Abbreviations in sources (alphabetical order): MOF: Ministry of Finance; UN: United Nations.