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FINANCIAL ANALYSIS & COMMENTARY

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A double dip for Japan's economy?

Double dips: Good when it comes to ice cream, not when it comes to economics. Japan, unfortunately, isn't known for its ice cream.

There is good news on the economic front. Third-quarter gross domestic product figures show that stimulus measures had their desired effect, luring shoppers into car dealerships and electronics stores. Capital investment rebounded after last year's demand shock, and exports to Asia were strong. Growth also was more balanced than in the prior quarter.

All told, GDP expanded 1.2% in the July-September period from the prior quarter, twice what economists expected and the second consecutive period of growth for the world's second-largest economy. With that, though, the caveats begin.

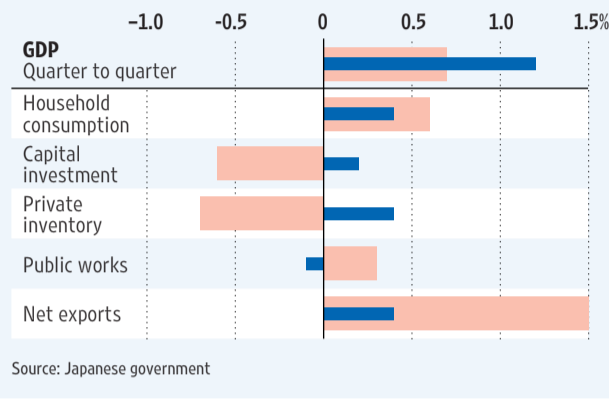
Government incentives were a key driver of growth, and as they fade, household



Bloomberg News

Balancing act

Japan's third-quarter real GDP and selected contributors to growth



spending on fuel-efficient autos and energy-saving electronics are likely to slump. Auto sales could drop 10% without the eco-car breaks, the Japan Research Institute estimates, knocking 0.16 percentage point off of GDP growth. A further discouragement

to consumers? An annual company survey by the Nikkei newspaper reveals that winter bonuses will drop at double-digit rates this year—the first such fall in the history of the survey.

Counting on sustained foreign demand is equally tricky,

with South Korean and Chinese firms increasingly competitive and government stimulus—like Beijing's auto tax cut—also possibly fleeting. In the key U.S. market, a recovery in demand remains tenuous with unemployment still rising and consumer senti-

ment down sharply.

Meanwhile, another large contributor to GDP growth in the latest period, a sharp inventory increase, is part a recovery from plunging rates earlier, and part a reflection of hopes that things will pick up at home and abroad. Either way, inventory building isn't a sustainable driver of economic growth.

Perhaps uniquely Japanese among the risks, though, is deflation. The domestic-demand deflator plunged 2.6%—the largest drop since 1958—indicating that companies are losing their ability to price goods and services.

Continued government support will, most likely, offset some of this. With another election expected next year, Tokyo has already begun discussing another pump-priming package.

But with the other engines of Japan's growth still shaky, it might not be their last.

Safety net for banks quietly frays

The U.S. banking sector has enjoyed immense government support for more than a year. But a little-noticed action by Standard & Poor's has put a small, but potentially important, dent in the wall that protects the banks.

Bank ratings clearly illustrate the high level of government backing for the industry. For instance, S&P gives **CitiGroup** a single-A rating, but adds that it would be rated triple-B-minus, four notches lower, with no assistance. **Morgan Stanley** and **Bank of America** get a three-notch lift. Even **Goldman Sachs Group** enjoys a two-notch benefit.

But S&P recently downgraded a Citibank subsidiary, **Citibank Korea Inc.**, to its stand-alone rating, even though it theoretically enjoys the backing of its parent. S&P did so because it feels there is "uncertainty" about whether the U.S. government wants Citi to provide additional support to "noncore" overseas affiliates.

This is interesting because Citi hasn't talked about the unit as noncore. More importantly, it shows S&P is starting to tweak how it thinks about government backing. At some point, all banks will return to stand-alone ratings. S&P declined to detail a road map for that process. Citi may fare fine, since it's better capitalized than it was pre-crisis.

But the longer the enhanced ratings remain, the longer it will take for investors to know the true strength of the banking sector.

—Peter Eavis

A new U.S.-China trade: pointed niceties

Welcome to China, Mr. President. By the way, why is your country becoming so protectionist?

This is the message greeting President Barack Obama as he and members of his administration head off for talks in Beijing with top Chinese leaders.

In unusually blunt comments, a Chinese Ministry of Commerce spokesman accused the U.S. of showing a

hitherto unseen "protectionist side," adding that China hoped the U.S. wasn't abandoning free-trade principles.

The irony of China lecturing the U.S. on free trade, while large parts of the Chinese economy remain restricted to foreign trade and investment, should be left aside for now. Rather, the question concerning many is whether such rhetoric shows there's a real danger of an

imminent breakdown in Sino-U.S. trade relations.

Such concerns still look overblown. But the high tide of issues between the two countries hasn't passed yet.

Certainly Gary Locke, the U.S. commerce secretary, is keen to put things in perspective. Rising disputes between China and the U.S., he said, are a good sign of a maturing, rules-based trade relationship. With antidumping peti-

tions against China this year representing just 1.3% of the value of its exports to the U.S., any problems are still relatively small.

This is a fair point. But given that antidumping cases take some time to put together—12 months of evidence needs to be gathered first—there's potential for more complaints against China to emerge in the coming year.

That's something Beijing is aware of. It also knows U.S. unemployment is at unusually high levels, and that Mr. Obama owes much to his union supporters. So with the U.S. still accounting for 14% of its exports, it senses some danger, and is upping the rhetoric.

The real test of the trade relationship will come after the Obama team is safely back in Washington.

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