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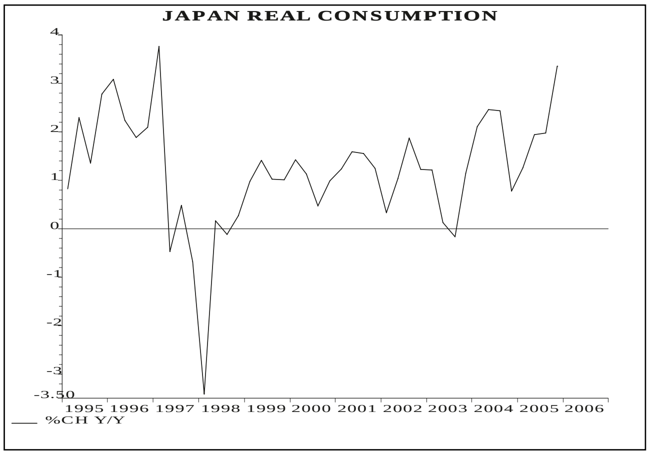
MR FUKUI IN THE DRIVING SEAT

Bank of Japan Governor Toshihiko Fukui has stood his ground well in recent weeks. In the face of considerable hostility from some senior officials within the LDP, Mr Fukui has stuck to his timetable, calling for an exit to quantitative easing by the spring. Nearly all of the economic data has vindicated the governor's stance, and now critics within the government are falling into line, including Prime Minister Koizumi. Indeed, the sheer strength of the Q4 GDP numbers, combined with the relative outperformance of longer-dated JGBs, has set the stage for a more aggressive tightening over the coming year or so. The critical factor will be the acceleration in core inflation indices. The sharp drop in the consumption deflator is worrying, but on balance, should not be enough to stop the BoJ from pushing short rates up in the second half of the year. The corporate services price index (CSPI) is nearly in positive territory too, the latest in a line of inflation indicators to suggest deflation pressures are in fact receding. Much depends on how well the long end of the JGB curve performs when quantitative easing is lifted, and any possible fallout from further rate hikes in the US. On the first score, the omens are certainly encouraging. JGB yields are likely to head higher, but the modest nature of any rise could, ironically, increase the BoJ's room for manoeuvre.



Long Term Yields The Key

Mr Fukui shows no sign of being deflected. Speaking to the Committee on Financial Affairs in the upper house of the Diet, he has reiterated the Bank of Japan's determination to exit quantitative easing. As we have argued before, that is still a world away from hiking short rates. The first priority must be to eliminate the excess liquidity, which is helping to drive real estate lending up so sharply. Latest estimates, based on results for the first nine months of FY2005, suggest the six major banks could see their combined net profits leap by nearly threefold this financial year, to around Y2.83tr. Of course, the banks still have nearly Y6.0tr in public funds to repay, but the scale of the improvement in their balance sheets is just one more reason why the BoJ needs to start bringing down the reserves target. As a policy tool, it is more than redundant: it is contributing to the speculative tendencies that have emerged in recent months. Even business leaders are starting to warn of the dangers, with the chair of the Japan Association of Corporate Executives pleading for an end to quantitative easing.

Of course, cutting the reserves target does not automatically imply short rates will start to go up. The two are still very distinct policies. But a successful reduction in the first target obviously increases the risks that the overnight rate will be neutralised. The first condition has to the be the performance of longer dated JGBs. The rationale behind quantitative easing was multi-layered. On a superficial basis, a higher reserves target was suppose to prod banks into accelerating the pace of lending. As a policy weapon, that never really worked. Lending has turned up, but only after land prices had stabilised in the big cities, and the pace of bankruptcies had slowed enough to help the banks recapitalise.

The second argument was more compelling, but less easily understood. The problem for any economy in a classic Keynesian liquidity curve is how to get long term rates down, and ensure they remain low enough for long enough to facilitate a recovery. In this sense, the policy has been a resounding success, although it was not a sufficient condition for recovery to take hold. The Government needed to change its tack with the banking crisis, which it duly did with the

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Resona bailout in May 2003, which was fundamentally different from previous failures, where the official response helped to create more bad debts. Nevertheless, by anchoring long rates at such low levels since the summer of 2001, the BoJ was able to provide a much looser monetary policy than hitherto had been possible. Throughout the 1980s, the JGB curve was much too steep, something that contributed in no small measure to the prolonged debt crisis.

Against this backdrop, the trajectory of longer-dated JGBs during any recovery becomes enormously significant. A premature and excessive rise in JGB yields has the potential to derail the recovery, and push the economy back into a deflation spiral. Quantitative easing is also an important anchor for fiscal policy. Low long-term rates have provided the government with more room for manoeuvre, to start bringing down its deficit. The BoJ has to tread carefully, to ensure that any policy tightening does not jeopardise the government's objective of a primary budget surplus by FY2011.

So far, the BoJ's timetable is going to plan. First and foremost, the real data has been very positive, not least the GDP numbers for Q4. Taking the second half of 2005, domestic demand growth was down somewhat from H1, falling from an annualised 5.0% to 1.6%. However, part of that reflected inventory accumulation. The slowdown in final domestic demand was more modest, from an annualised 4.6% to 2.9% between H1 and H2. And weaker government spending in Q4 - down by an annualised 0.6% - contributed too. Final private sector domestic demand was up by an annualised 3.6% in the second half of 2005. The important point was the rebound in consumer spending, after the Q3 lull. Consumption was up 3.4% last year, the best showing for any year since the collapse of Japan's bubble economy.

Of course, government critics will point to the deterioration in the deflator, which admittedly was somewhat surprising. The headline GDP deflator was down 1.7% y/y, but more worryingly, the consumption deflator accelerated too, and fell 0.9% y/y. It would be wrong to dismiss these numbers too lightly, since deflators generally have a good track record of pre-empting inflation trends, particularly where durables are concerned. They have regularly diverged from the CPI in many countries, with the sharp fall in prices for these goods picked up more accurately by the deflators.

In this case, however, there are clear signs that Japan is no longer seeing quite the same level of deflation within durables. According to the December nationwide CPI, the y/y rate of decline in durable prices has fallen to 2.0%, its lowest rate of decline since April 2000. Semi-durable goods prices are edging higher too, with the annual rate rising to 0.5%, its highest rate since August 1998. These trends have been mirrored in 'furniture and utensils' and in particular household durables. The 6-month rate of change in furniture and utensils has dropped to -0.8%, its smallest decline since October 1999. Household durables are also down at their lowest rate since July 1999, falling 1.2%. The upward pressure was reflected in recreational goods prices, which rose 0.1% y/y, the first annual increase since February 1999. There is also modest upward pressure on clothing, which is quite striking after the long period of falling prices. Service sector inflation is nudging higher, although it is not clear how much of this constitutes one-off factors. Higher utility prices have played a part, so too have rising rents and base effects in communications. Nevertheless, this morning's CSPI report was instructive. The annual rate of decline was just 0.1%, the lowest since late 1993 (consumption tax hike aside). Similar factors were in play - higher communications costs and rents, but also a rise in the transport component. Indeed, the CSPI was introduced by the Bank of Japan in the late-1980s at the height of concern about Japan's bubble economy and the acceleration in service sector inflation. The imminent return to positive territory is possibly one of the strongest signals yet, that deflation pressures are receding.