GFC ECONOMICS

DAILY COMMENTARY

SOME BREATHING SPACE FOR THE BOJ

As the Bank of Japan convenes for its monthly policy board meeting, the monetary authorities appear to have secured some breathing space. Upward revisions to the GDP and industrial production data, a recovery in the leading indicators and better consumption numbers for January paint a more optimistic outlook for the Japanese economy. The BoJ is also enjoying rather more success in hitting the reserves target. The monetary authorities are no longer faced with the difficult choice of cutting its reserves target when the economy is still technically in recession - at least for now. At the same time, the political pressure to water down the proposed consumption tax increases is mounting. Some members of the LDP certainly seem keen not to repeat the policy mistakes of 1997 and 2000. Even the spectre of a US$ crisis appears to have been held at bay. The mere threat of intervention is proving quite effective at holding the Y/US$ rate at the 104 line or thereabouts. But the case for a substantial realignment in the yen against the US$ remains. Japan's recovery since the spring of 2003 has been too dependent on net exports. A record current account surplus in 2004 suggests it may only be a matter of time before the Ministry of Finance is forced to acquiesce to a weaker US$.

GDP Data Still Weak

When the Cabinet Office switched to US-style national accounts last summer, it was expected that bewildering revisions to the Japanese GDP numbers would become a thing of the past. That remains a forlorn hope. This week's changes to the Q4 data now show the economy was not in recession during the latter stages of 2004 afterall. An annualised contraction of 0.5% q/q was suddenly turned into a similar increase. In truth, the revisions have been over-hyped. Nearly all of the change can be traced to updated figures on inventories. Unsurprisingly, the Cabinet Office put a positive spin on these numbers, suggesting the rise in inventories reflected a "future increase in shipments". That may or may not be the case. But the boost to inventories disguises some important *downward* revisions to the data. Most significantly, the rise in capital spending has been cut back to 0.1% q/q, compared with a previous estimate of 0.7% q/q. Consumption was still down by an annualised rate of 1.0% too. Private sector domestic demand continued to contract, despite the upward revision to inventories. In short, the revisions still leave a weak set of numbers and provide little reason to believe a genuine recovery is close to hand.

The downward revision to the capital spending numbers was unsurprising in light of the recent MoF survey, which suggested that investment had contracted sharply in Q4. These figures tend to be a little more volatile than the national accounts data. Nevertheless, last week's news that capital expenditure had shrunk by an annualised rate of 11.1% was eye-catching. It also seemed quite improbable, given the tremendous improvement in corporate profitability witnessed since the second half of 2002. But intriguingly, the MoF survey also showed why Japanese companies have become more cautious, after corporate profits fell back during the final three months of 2004. Total profits were down 8.6% q/q, equivalent to an annualised fall of 30.3%. The manufacturing sector led the way, with profits falling 9.7% q/q, but non-manufacturing profits were down too, by 8.5% q/q.

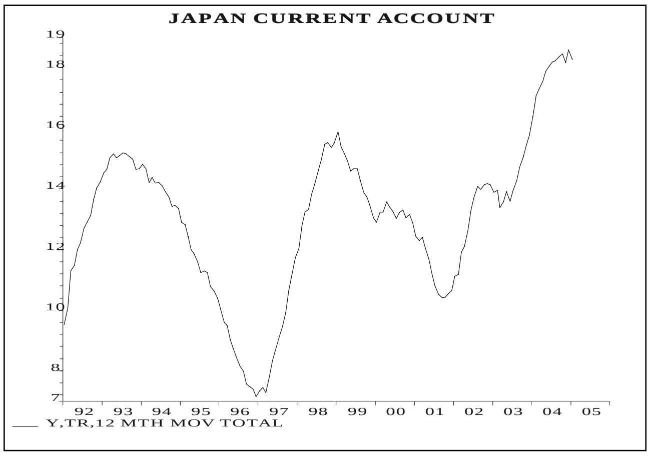
The sudden downturn in corporate profitability should hardly come as a surprise. Two of the key drivers of demand - consumer spending and exports - came under sustained pressure as

GFC Economics
Coborn House, 3 Coborn Road, London E3 2DA
Tel. 020 8981 8085 Fax. 0870 056 1693
graham.turner@gfceconomics.com - rupert.thompson@gfceconomics.com - ben.combes@gfceconomics.com

2004 wore on. By January of this year, export volumes were falling by a 3m/3m annualised rate of 6.1%. Consumer spending contracted by an annualised 0.9% during the second half of 2004. By contrast, the cutbacks in government expenditure were a little less pronounced than hithterto, with Q4 showing a decline of 0.3% y/y. Residential investment also accelerated, with the annual rate rising to a more respectable 3.3%. But neither of these sectors could make up for the weakness in consumption and exports.

These numbers show the limits once again of relying on cost cutting to drive economic growth, a point that the Koizumi coalition is belatedly beginning to recognise. The unrelenting squeeze on wages finally left its mark on consumer demand during the second half of 2004. As that took its toll on corporate margins, the pressure on companies to cut their capex plans intensified. The latest machinery orders data suggest Japanese companies remain more than a little circumspect. Private domestic machinery orders fell by 3.6% m/m, the second monthly decline. The annual rate was a meagre 1.6%.

Against this backdrop, the Japanese authorities are likely to come under more pressure than usual to defy the currency markets. The record non-oil trade deficit reported in the US on Friday briefly sent the US$ down, but the Ministry of Finance's determination to 'hold the line' has stemmed any immediate selling. Memories of the Bank of Japan's last concerted campaign of intervention - during 2003 and the early months of 2004 - remain all too vivid. During this fourteen month period, the Bank of Japan spent an estimated US$348.0bn trying to support the US$. The Finance Minister, Sadakazu Tanigaki, reiterated this morning "We are ready to take action in the foreign exchange market against undesirable, excessive or speculative moves". It would seem the Japanese government has no intention of letting any recovery in 2005 be derailed by the looming US$ crisis.



Such a position, however, will ultimately prove untenable. Politically, the Japanese authorities will come under pressure to accept their share in the burden of adjustment. The euro has - so far - come under the most sustained upward pressure from the devaluation of the US$. Other Asian countries also recognise that fighting currency markets may prove more problematic in the long run, after their experience of 1997. An appreciating currency brings potential short run problems, including a loss of export market share. But excessive intervention threatens to stoke up asset bubbles, and after the last Asian crisis, a number of countries - S.Korea and Thailand included - are unwilling to go down that route again. Ultimately, Japan will be left isolated with China, as one of two countries resisting the US$ selling - but in doing so - potentially accentuating the pressure on the floaters.

The Finance Minister is fundamentally incorrect when he suggests there is no case for a revaluation of the yen. As last Friday's US trade numbers showed, the bi-lateral deficit with Japan is widening steadily, reaching US$76.2bn in the year to January. The bi-lateral imbalance is less than the US runs with Euroland and China. Nevertheless, yesterday's current account numbers in Japan underlined the fundamental reason why the yen will eventually have to go up. Higher oil prices pulled the visible balance down compared with a year earlier. But the 2004 current account surplus of Y18.6tr was still a record for any year. A strong underlying trend in the incomes balance has compounded the rise in the non-oil trade surplus. Contrart to Mr Tanigaki's assertion, there are plenty of reasons why the yen will be forced during 2005.

This document is for your private information only. In publishing research, GFC Economics is not soliciting any action based upon it. GFC Economics' publications contain material based upon publicly available information, obtained from sources that we consider reliable. However, GFC Economics does not represent that it is accurate and it should not be relied on as such. Opinions expressed are current opinions as of the date appearing on GFC Economics' publications only. GFC Economics is not liable for any loss or damage resulting from the use of its products.