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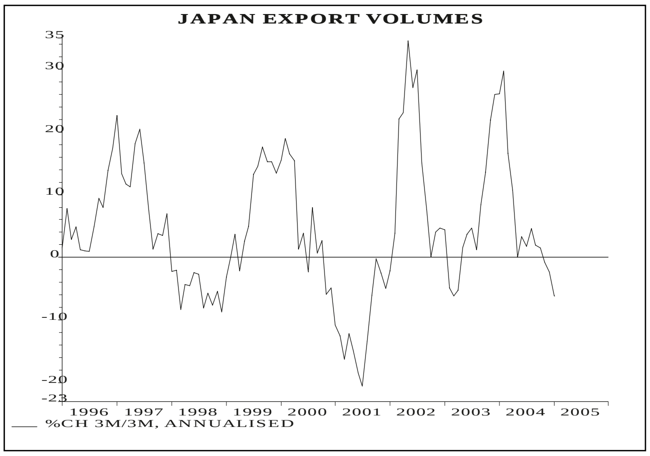
DAILY COMMENTARY

RECESSION NUMBER FIVE IN JAPAN

A poor set of GDP numbers for the final quarter of 2004 suggested Japan spent a significant part of the year in mild recession and has triggered renewed soul-searching over the country's long-term economic prospects. Yesterday's news of a sharp fall in export volumes during January has done little to lift the pall of gloom. The sense of angst has been compounded by the difficulties facing the Bank of Japan in executing its policy of quantitative easing. In truth, the two issues are slightly separate, since there is little the BoJ can do to reflate the economy. The Japanese authorities lost the ability to stimulate credit growth many years ago. All it can do now is to try and prevent a sudden and premature rise in JGB yields circumventing any potential economic recovery. From time to time, there may be bidding shortfalls in Ministry of Finance auctions, causing yields to spike. But that could be countered by an open-ended commitment to buy JGBs at ultra-low levels, to guard against the risk of an unintended tightening of monetary policy. Policy wise, that would make more sense than trying to maintain an artificially high reserves target, which does little to stimulate money supply growth. The BoJ should certainly start considering a wider menu of options, since the risks are rising that a renewed sell-off in the US$ will compound Japan's economic difficulties.



Weak Exports, Even Weaker Consumption

Last week's confirmation that Japan spent much of last year in recession comes as little surprise. The consumption indicators have been turning down since the early months of 2004, suggesting the pervasive impact of falling wages and stagnant employment were taking their toll. The industrial production numbers had also started to sag over the summer months, partly in response to a slowdown in technology demand and reflected by the dip in exports. The outlook for the early months of 2005 should in theory, be a little brighter. Japan's two key export markets - the US and China - are firing on all cylinders. Doubts, however, still linger over the high-tech sector, particularly given the level of price destruction that has emerged in consumer electronics during recent months, and following the poor export numbers for January. Export volumes fell 5.8% m/m, and while the monthly data has been somewhat volatile, the 3m/3m annualised rate still dropped to a new low of -6.2%. By rights, the export numbers ought to be turning up by now.

A more pressing issue and contributor to Japan's disappointing performance has unquestionably been the weakness of consumer demand. Real spending fell at an annualised rate of 1.0% in the second half of 2004, while nominal consumption contracted 0.8%. Various 'excuses' have been proffered for the downturn, with some suggesting that warmer weather in the run-up to Christmas may have hurt sales of clothing and perishable foods. There may be some credence to this view, since Tokyo department store sales did bounce in January. But the fact remains spending started to turn down early last year. The household survey peaked in February and slipped steadily over the summer. The decline then accelerated towards the end of the year, which may have been due to the unseasonably warm weather. The 2.4% m/m drop for December was quite extreme, since spending fell to its lowest level in nominal terms since April 1989, and was down a hefty 6.3% from its February peak.

It would certainly be wrong to make too many excuses for the poor spending numbers. It is quite clear that the destructive cycle of wage deflation and falling employment levels are tak-

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ing their toll. BoJ data shows that average monthly wages and salaries were down 3.8% y/y in December, and by 2.5% y/y in the second half of 2004. The level of employment did bounce in December, but it was still unchanged on the year and 0.6% below the June 2003 peak. It would be easy to put the cart before the horse and argue the weak labour market is a reflection of soft GDP growth. That allows politicians to blame the Bank of Japan for not doing enough to stimulate the economy, and some senior members of the LDP - and the Ministry of Finance - have certainly been doing that of late. In reality, creative destruction - so ardently favoured by Prime Minister Koizumi on taking power in April 2001 - is not compatible with a sustainable recovery when the economy is mired in a liquidity trap. The persistent fall in real wages has to be countered by a policy stimulus of some sort. Otherwise - as politicians discovered in many countries during the 1930s - the end result will be a prolonged downturn, with only brief interludes of hope. Since the bubble burst in 1990, Japan has experienced five recessions - arguably six depending on the precise definition used. The long-term prime rate has fluctuated within a tight range since Mr Koizumi took the helm. But it has proved difficult to provide any meaningful policy relief. The key lending rate was 1.55% last month - down just 30 basis points from the level of April 2001. It did fall to a low of 1.25% in 2003, but in the grander scheme of things, that is pretty insignificant. Once short rates had hit rock bottom, it became almost impossible to really get long-term rates measurably lower.

Of course, the Bank of Japan has been under pressure to try a range of other measures to stimulate money supply growth, but none of them were ever going to work. The primary transmission mechanism of monetary policy has to be lower borrowing costs, which is essentially not an option any more. The banks have long been awash with excess reserves, and raising the liquidity target progressively to a high of Y30-35tr was somewhat academic. It sent a clear message of the BoJ's intentions, but as a policy, it had limited effect. Bailing out the banks when they ran into trouble was important, since there was an obvious propensity for defaulting banks to severely magnify any credit crunch, as evident from the Hokkaido Takushoku debacle of 1997, and the LTCB and Nippon Credit failures a year later. But interestingly, there have been no major bank 'failures' since the collapse of Resona in 2003. And yet the monetary mechanism still remains essentially broke. Fixing the banking system is a necessary, but not sufficient, condition for bringing an end to the persistent economic under-performance.

All this puts the onus on the Government to accept the inherent flaw in a policy of encouraging wage deflation in the hope that it will eventually secure sustainable recovery. Mr Koizumi has gone some way to acknowledging the problem, but in some sense, the LDP's hands are tied. It is not just the heavy internal pressure on companies to deliver higher rates of return: Japan faces a unique challenge in dealing with the competitive threat posed by China. The trade deficit Japan runs vis a vis China is not enormous. Last year, it was a comparatively modest US$20.4bn, compared to a shortfall of US$162.0bn between the US and China. Until recently, Japan has offset higher import penetration of cheap consumer products with an acceleration in capital goods exports. But the recent data suggests that even Japan is starting to lose out to the competitive threat posed by China. The bi-lateral trade deficit has widened sharply in recent months (see chart). Chinese intransigence over its currency peg combined with a renewed sell-off in the US$ could squeeze Japan hard. The political pressure on the BoJ not to cut its reserves target is likely to intensify, but it is difficult to see that leading to a durable economic recovery in 2005.