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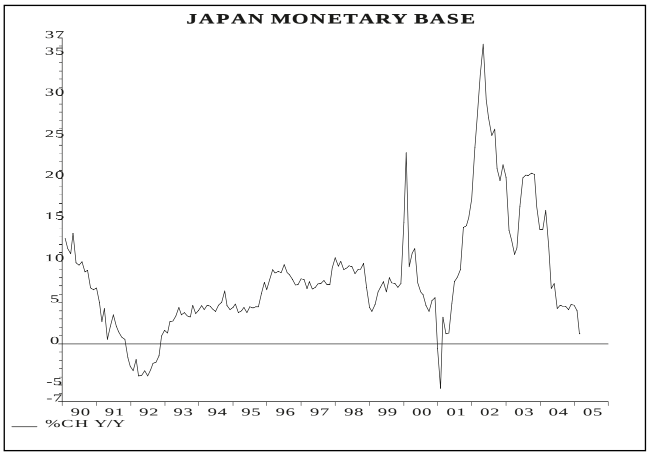
GFC ECONOMICS

DAILY COMMENTARY

JGB YIELDS HEADING HIGHER

JGBs are under pressure. The prospect of a stronger payroll report in the US and an acceleration in cost pressures - flagged unequivocally by Monday's jump in the consumption deflator - are not helping. Ten-year Treasury yields could well top 4.5% by the end of this week, dragging JGBs down further. But the economic data has shown a marked improvement in Japan too. The steady deterioration in the final months of 2004 was clearly exacerbated by a number of extenuating factors, which are now being unwound. Critically, the strength of Japan's two biggest export markets made it difficult to see why the industrial production numbers should remain so weak. January's bounce could well be the start of a modest up-trend in the coming months. The Nikkei 225 may finally breach the 12,000 mark for the first time since the end of last April. A test of 13,000 cannot be ruled out. But any such gains are unlikely to be sustained. Many of the deep-seated problems that precipitated Japan's prolonged battle with debt deflation have not gone away. That was underlined by this week's news that SMFG had been forced to add Y420bn to its bad-loan provision. The very fact Treasury yields are climbing in the US should also act as a warning. Too many of Japan's 'recoveries' have been predicated on a short-term upswing in exports. This one is liable to peter out all too quickly, as rising inflation pressures in the US force the Fed to act more aggressively.



Output Bounces

Government claims that the GDP report for Q4 represented the tail end of a soft patch would appear to have been vindicated by the January industrial production figures. The 2.1% m/m rise in output comfortably exceeded expectations, and while the February and March numbers are expected to register small declines, the quarter-on-quarter data should show a modest gain. The report was not unequivocally strong, since inventories were up 2.0% m/m, but that followed a similar drop in December. Indeed, the inventories to shipments ratio in January was 2.5% down from its 2004 high in September. Significantly, the ratio for electrical machinery fell to a new secular low in January, suggesting that some of the problems regarding persistent oversupply - although not pricing power - may have abated.

It was certainly hard to see why output should carry on contracting when both US and Chinese demand is quite so robust. The output cycle has always had a much closer correlation with exports than consumer demand. But the recent export numbers have been unambiguously weak, with January's 5.7% m/m drop in volumes pushing the 3m/3m annualised rate down to a new low of 6.1%. While there may be problems with the adjustment between the real and nominal data, exports also contracted on a comparable basis by 3.3% m/m in yen terms. The breakdown of the bi-lateral data do offer a glimmer of hope, since exports to the US were up by 3.8% on a 3m/3m annualised basis. But equally, exports to China were down 11.8%. Just how quickly this recovers - if at all - will be quite critical. Exports of capital goods to China have turned down significantly of late. It is possible that a maturing Chinese economy will have less need for capital imports from Japan, as it eventually moves away from being just a low-cost producer. Certainly the recent and dramatic widening of the trade imbalance between these two countries is a warning that this relationship may have rather more downside for the Japanese economy than hitherto assumed.

But a more pressing issue for the authorities in Tokyo has been the role of monetary policy in

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fostering a sustained upturn in Japanese domestic demand. The BoJ will be encouraged by the reports on January retail sales, housing starts and construction orders, which showed annual gains of 2.2%, 6.9% and 15.8% respectively. However, that is not why speculation over the current ultra-easy policy stance has intensified - quite the reverse. The present framework is simply not working, a point borne out by recent market moves, and more importantly, by the drop in monetary base growth. The policy of quantitative easing has essentially involved a series of step-changes in the reserve target, from its original low-point of Y4tr to today's Y30-35tr. During that time monetary base growth has repeatedly surged, but the impetus from every increase in the reserves target has always been essentially one-off. Unsurprisingly, monetary base growth has slowed dramatically, from a peak of 36.2% y/y in April 2003 to 1.2% y/y last month. That was the lowest growth rate since March 2001, when the policy of quantitative easing was introduced. This is not a coincidence. It merely confirms that, as a policy, raising the reserves target had a limited life span. If it did not work - and four years is more than a reasonable time frame to assess the impact - then the experiment with quantitative easing can be classed as a qualified failure. The one important caveat is that, without the incessant liquidity injections, JGB yields might have been significantly higher, and Japan's battle with deflation even more forlorn. It was better to have tried, but it was never going to be the complete answer.

The side effects are becoming increasingly hard to ignore. As Mr Fukui remarked on Monday, there is an unhealthy dichotomy opening up between regional and metropolitan land prices. There is no evidence that the strong pick for commercial property prices within Tokyo and other major cities is spilling over into the regions. We may be witnessing another speculative bubble, one reminiscent of the dotcom mania. The collapse of high-tech share prices proved quite debilitating for sentiment, and the recession in 2001 was the deepest yet since the long downturn began fifteen years ago. The authorities have every reason to be worried of a recurring pattern.

But of course, mere hints of any policy shift are apt to send bond yields significantly higher, and precipitate the very reversal the authorities are trying to avoid in the first place. Managing policy in a liquidity trap is a classic catch 22, but that is largely because too much emphasis is put on money supply and other targets, when the focus should be elsewhere. As we have argued before, regional land prices have continued to slide because banks are still writing off their bad debts at an unprecedented pace. It has always been assumed this would eventually lead to a resolution of Japan's banking crisis, and a stabilisation of land prices. Some of the banks are undoubtedly in much better shape. But the level of corporate bankruptcies still remains historically far too high. Corporate bankruptcies in 2004 were still Y7.8tr, equal to 1.6% of GDP. They are still broadly comparable to the levels witnessed during the first six years after the bubble burst (1991 to 1996), when they averaged Y7.6tr per annum. And in the last two months, defaults have actually risen, by 87.4% y/y and 35.3% y/y in December and January respectively. In this regard, the news from SMFG is quite significant. The upward revision to its bad debt provision may have been anticipated. But Japan is in a classic Keynsian liquidity trap. So long as banks continue to write down debts, the risk is that Japan will remain mired in a cycle of falling land prices, persistently high defaults and over-dependence on exports. Arguably, it would have been far better if the Japanese government had taken a different tack, nationalising the banks much earlier in the downturn and freezing debt write-offs. That would have proved more effective in stabilising land prices across the whole country, and allowed the pace of bankruptcies to subside to levels consistent with a durable economic recovery. Instead, we are left with yet another asset bubble - one in commercial property - and a central bank that wants to tighten, but is hamstrung by the risks that such a move may precipitate the very crisis it seeks to avoid. It is a lesson for other G7 countries as they seek to navigate the fallout from their own respective property bubbles.