

JAPAN ECONOMICS WEEKLY

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Editor: David Rea

Still in the grip of deflation

- **The revision to the CPI base-year resulted in a marked downward revision to inflation, showing clearly that Japan is still in the grip of deflation.** Although the Bank of Japan has only recently expanded its asset-purchase scheme, we would not rule out further monetary easing, particularly in combination with government action to reduce the value of the yen.
- The week ahead will be dominated by the publication of Q2 GDP on Monday. Although activity has recovered much more quickly than was expected at the start of Q2, GDP will almost certainly contract for a third consecutive quarter. We think our earlier forecast of a 2.0% decline is now a little too pessimistic given the rapid restoration of supply chains, but believe the consensus forecast of a 0.6% fall is far too bullish with risks stacked to the downside.

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North America

2 Bloor Street West, Suite 1740
Toronto, ON
M4W 3E2
Canada
Tel: +1 416 413 0428

Managing Director
Chief International Economist
Japan Economist
Asia Economist (based in Singapore)

Europe

150 Buckingham Palace Road
London
SW1W 9TR
United Kingdom
Tel: + 44 (0)20 7823 5000

Roger Bootle (roger.bootle@capitaleconomics.com)
Julian Jessop (julian.jessop@capitaleconomics.com)
David Rea (david.rea@capitaleconomics.com)
Vishnu Varathan (vishnu.varathan@capitaleconomics.com)

Asia

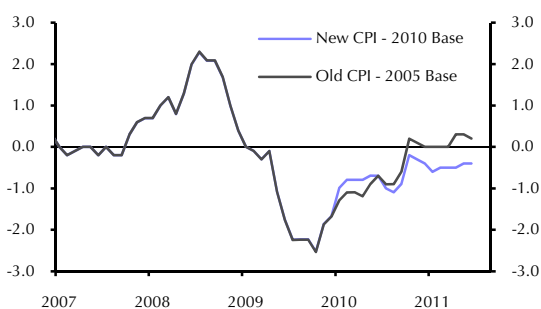
#26-03
16 Collyer Quay
Singapore 049318
Tel: +65 6595 5190

Still in the grip of deflation

On Friday, the Statistics Bureau released a revised consumer price index rebased from 2005 to 2010. Changing the base year has two effects: first, the weights of the components of the index are revised to reflect the current basket of goods as purchased by the consumer, including any changes in quality and any new products that have entered the market. Second, the index is reset to 2010 = 100, with historical rates of change recalculated from the rebased index.

The new index better reflects changes in the prices of goods from the perspective of consumers, and is better able to reflect changes in relative prices. **The result of the adjustment was a marked downward revision to CPI inflation.** The latest data for June 2011 showed all items inflation revised down from 0.2% under the 2005-base, to -0.4% under the new 2010-base. (See Chart 1.) Core inflation, which excludes the prices of fresh food, saw a similar downward revision from +0.4% in June to -0.3%.

CHART 1: ALL ITEMS CPI INFLATION (% Y/Y)



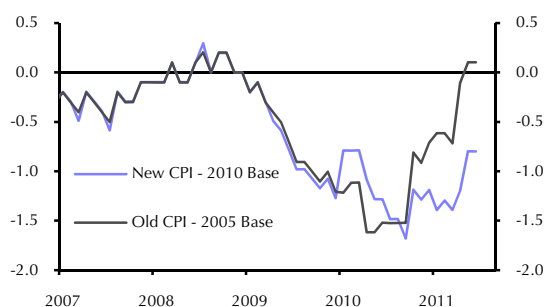
Source – Thomson Datastream

With CPI inflation below zero, it is clear that Japan has not escaped deflation. Reports earlier in the year that the economy had, were premature to say the least, and, more importantly, inaccurate. For a start, the jump in inflation in April (on the old base) was the result of a cut in tuition fees at the start of the academic year in April 2010 dropping out of the annual comparison. Secondly, one swallow does not make a summer. A few months of inflation are no more a sign the economy had escaped deflation than they were in 2008 when rising global commodity prices pushed the all items and core

measures of CPI inflation towards 3%. At the time, the core-core measure, which excludes all food and energy prices, reached a peak of only 0.2%.

Under the 2010-base index, core-core inflation has also been revised down, but by an even larger amount. The revision of core-core inflation in June from +0.1% to -0.8% leaves the economy firmly in deflationary territory. (See Chart 2.)

CHART 2: CORE-CORE INFLATION (% Y/Y)



Source – Thomson Datastream

What is clear from the revised figures is that **inflation in Japan remains a long way from the Bank of Japan's definition of price stability.** The Bank's forecasts for FY2011 and FY2012 were for core inflation of 0.7% in both years under the 2005-base measure. This would be roughly equivalent to a 0.0% rate under the new base, well below the Bank's target of +1% for core price inflation. On the surface, this would suggest the Bank needs to do more to support the economy and should loosen monetary policy further. However, these forecasts were made before the recent intervention in foreign exchange markets and before the Bank expanded the size of its asset purchase programme from ¥40 trillion to ¥50 trillion. We will have to wait till October for the Bank to produce its updated inflation forecasts.

Nonetheless, **we would not rule out further monetary easing from the Bank of Japan, particularly in relation to a coordinated response with the Japanese government to the continued strength of the yen.** The yen has been trading firmly in the 76-77 yen-dollar band for several days, a

level which twice previously brought about intervention to weaken the currency. The business lobby is vocal about its displeasure at the high level of the yen, but it is clear from recent currency movements that intervention alone, or even combined with a moderate increase in Bank's asset purchase scheme, is not sufficient to discourage investors from holding yen. If the authorities embark on another course of action involving some form of monetary easing to weaken the yen, this would probably have been positive for inflation and support the Bank's objective of achieving price stability.

The week ahead

The main event this week will be the publication of **Q2 GDP** on Monday. Output in Q2 has recovered much more quickly than was expected at the start of the quarter, with businesses restoring supply chains and restarting production earlier than even they expected to be able to. Government spending has also increased, as the initial outlays to finance the clean-up operation before rebuilding begins proper have supported activity. However, net trade at least will be a drag on overall activity as exports were 5.6% lower q/q while imports were 2.1% higher. This alone would be enough to knock around 1% from GDP.

Overall, GDP will almost certainly fall for a third consecutive quarter in Q2 due to the low starting point in April. We think our earlier forecast of a 2.0% decline is now a little too pessimistic, as the economy has been quicker getting back to its feet than we initially thought. Nonetheless, we still believe the consensus forecast of a 0.6% fall is too bullish and the risks to the consensus are strongly on the downside. We would look for Q2 GDP to be in the region of 1.3% to 1.5% below Q1 GDP.

The **all industry activity index** for June on Friday will augment the GDP release by providing a monthly breakdown of expenditure, so we can see whether spending accelerated or fell-away across the quarter. We expect the all industry activity index as a whole to pick up by around 2.2% m/m, thanks to increases of 1.9%, 3.9% and 0.8% in tertiary, industrial and government activity respectively. The only unknown is construction activity, which we expect probably expanded by around 5%.

At the time of writing, the y/y consensus forecast for **merchandise trade** in July is consistent with a decline in both exports and imports on a seasonally-adjusted monthly basis. We disagree. At worst, shipments may level out, but exports should expand as they continue to overcome the disruption caused by the Great East Japan Earthquake. Indicators such as the manufacturing PMI point to a further expansion in production in July, and manufacturers' forecast for industrial production in July, surveyed in mid-July, were for an expansion of 2.2% m/m. It is hard to see how exports would contract if output is increasing and they remain below pre-disaster levels. Admittedly, we expect the outlook for export growth to weaken as the global economy slows and a strong yen is felt in either fewer sales or lower profits. But for now we have pencilled in a rise of 2.0% and 0.5% m/m for exports and imports respectively in July, which would cause the seasonally-adjusted trade deficit to fall to ¥78bn from ¥191bn in June.

David Rea

Tel: +44 (0)20 7808 4699

Latest Data & Main Forecasts

JAPAN ECONOMIC INDICATORS

Monthly Indicators	m/m(y/y) unless stated	Mar	Apr	May	June	July
Consumer Prices	Headline	-0.1%(0.0%)	0.0%(+0.3%)	0.0%(+0.3%)	-0.2%(+0.2%)	-
	Excl. Fresh Food	+0.2%(-0.1%)	+0.2%(+0.6%)	0.0%(+0.6%)	-0.3%(+0.4%)	-
	Excl. Food & Energy	-0.2%(-0.7%)	0.0%(-0.1%)	+0.1%(+0.1%)	0.0%(+0.1%)	-
M2 Money Supply		(+2.6%)	(+2.7%)	(+2.7%)	(+2.9%)	(+2.9%)
Bank Lending (Excl. Shinkin)		(-1.8%)	(-1.0%)	(-0.8%)	(-0.6%)	(-0.6%)
Unemployment Rate		4.6%	4.7%	4.5%	4.6%	-
Retail Sales		-7.6%(-8.3%)	+4.1%(-4.8%)	+2.4%(-1.3%)	+2.9%(+1.1%)	-
Industrial Production		-15.5%(-13.1%)	+1.6%(-13.6%)	+6.2%(-5.5%)	+3.9%(+1.6%)	-
Manufacturing PMI		46.4	45.7	51.3	50.7	52.1
Economy Watchers Survey (Outlook)		26.6	38.4	44.9	49.0	48.5
Consumer Conf. (Excl. One Person Households)		38.6	33.1	34.2	35.3	37.0

Quarterly Indicators	%q/q(%y/y) unless stated	Q2 2010	Q3 2010	Q4 2010	Q1 2011	Q2 2011
GDP		0.0%(+3.1%)	+0.9%(+5.0%)	-0.7%(+2.2%)	-0.9%(-1.0%)	-
Private Consumption		-0.2%(+1.3%)	+0.8%(+2.5%)	-1.0%(+0.6%)	-0.6%(-1.0%)	-
Tankan Business Conditions (Large Manufacturers)		+1	+8	+5	+6	-9
Tankan Business Conditions (Large Man. Outlook)		+3	-1	-2	+2	+2

LATEST MARKET DATA

Instrument/rate		1 mth ago	1 week ago	Latest*	Instrument/rate	1 mth ago	1 week ago	Latest*	
Official rates	Japan O/n	0-0.10	0-0.10	0-0.10	Global yields	US 10 year	2.91	2.56	2.26
	US Fed funds	0-0.25	0-0.25	0-0.25		Ger 10 year	2.50	2.15	2.07
	ECB Refi	1.50	1.50	1.50		UK 10 year	2.94	2.54	2.34
	UK Repo	0.50	0.50	0.50		Equity indices	Nikkei 225	9,974	9,300
Market rates	3m LIBOR	0.20	0.20	0.19	Topix	859	801	768	
	12m OIS	0.08	0.07	0.07	US S&P 500	1,316	1,199	1,173	
JGB yields	2 year	0.13	0.12	0.13	Exchange rates	Yen index **	174.1	174.8	178.6
	5 year	0.31	0.28	0.30		¥/\$	79.0	78.5	76.7
	10 year	0.99	0.91	0.96		¥/Euro	112	112	109
	20 year	1.87	1.75	1.84		¥/£	128	129	125
Yield curve (10 – 2yr, bp)		86	79	83	Crude Oil	WTI, \$ pb	98	87	85











* Latest as at 09.30 BST, 12th Aug. 2011. ** Trade-weighted index where 1990 = 100

MAIN ECONOMIC & MARKET FORECASTS

%q/q(%y/y)unless stated	Latest	Q2 2011	Q3 2011	2010	2011	2012
GDP	-0.9%(-1.0%)	-1.4%(-2.1%)	+2.0%(-1.7%)	(+3.9%)	(-1.2%)	(+3.0%)
Private Consumption	-0.6%(-1.0%)	-1.0%(-1.7%)	+1.0%(-1.6%)	(+1.9%)	(-1.1%)	(+1.2%)
Consumer Prices	-0.1%(0.0%)	(+0.3%)	(-0.2%)	(-0.6%)	(0.0%)	(0.0%)
Unemployment Rate	4.6%	4.9%	5.2%	5.1%	5.2%	4.0%
Overnight Rate, end period (%)	0-0.10	0-0.10	0-0.10	0-0.10	0-0.10	0-0.10
10 yr JGB, end period (%)	0.96	1.04	1.00	1.11	1.00	1.25
Nikkei 225, end period	8964	9,816	9,000	10,229	9,000	9,250
¥/\$, end period	76.7	80	80	81	85	90
¥/Euro, end period	109	117	112	109	119	117
¥/£, end period	125	129	128	127	136	140

Japan Diary & Forecasts

JAPAN

Date	Release/indicator/event		Time (BST)	Time (Tokyo)	Previous*	Median*	CE Forecast*
Mon 15 th	 Jpn GDP (Q2 Prov.)	q/q(y/y)	00.50	08.50	-0.9%(-1.0%)	-0.6%	-1.4%(-2.1%)
Tues 16 th	 Jpn No Significant Data Released		-	-	-	-	-
Wed 17 th	 Jpn No Significant Data Released		-	-	-	-	-
Thu 18 th	 Jpn Merchandise Trade Balance (Jul)		00.50	08.50	+¥68.6bn	+¥69.3bn	+¥78.0bn
	 Jpn Adjusted Merchandise Trade Balance (Jul)		00.50	08.50	-¥191.2bn	-¥131.9bn	-¥136bn
	 Jpn Merchandise Exports (Jul)		00.50	08.50	(-1.6%)	(-2.6%)	+2.0%(0.0%)
	 Jpn Merchandise Imports (Jul)		00.50	08.50	(+9.8%)	(+11.0%)	+0.5%(+13.6%)
	 Jpn Coincident Index (Jun Final.)		06.00	14.00	108.6p	-	-
	 Jpn Leading Index (Jun Final.)		06.00	14.00	103.0p	-	-
Fri 19 th	 Jpn All Industry Activity Index (Jun)		05.30	13.30	+2.0%	+2.2%	+2.2%

Japan is 8 hours ahead of BST *m/m(y/y) unless otherwise stated; p = provisional estimate

KEY FORTHCOMING EVENTS/DATA

Date	Event	Date	Event
24 th Aug	Corporate Service Price Index (Jul)	31 st Aug	Manufacturing PMI (Aug)
26 th Aug	National & Tokyo CPI (Jul/Aug)	2 nd Sept	Capital Spending (Q2)
30 th Aug	Unemployment Rate (Jul)	7 th Sept	BoJ Interest Rate Announcement
30 th Aug	Household Spending (Jul)	8 th Sept	Bank Lending (Aug)
31 st Aug	Industrial Production (Jul Prov.)	8 th Sept	Current Account (Jul)
31 st Aug	Vehicle Production (Jul)	8 th Sept	Machinery Orders (Jul)
31 st Aug	Construction Orders & Housing Starts (Jul)	8 th Sept	Economy Watcher's Survey (Current and Outlook) (Aug)

Selected Recent Publications

Date	Publication	
Mon 8 th	Capital Daily	Has the rot stopped?
	Global Economics Update	Are emerging markets immune?
	European Economics Update	ECB purchases may have little lasting impact
	UK Economics Update	Stock market turmoil increases double dip risks
Tue 9 th	Capital Daily	ECB's latest steps unlikely to save the day
	UK Commercial Property Focus	How much further can the Central London office boom run?
	Japan Economics Data Response	Consumer Confidence (Jul.)
	European Economics Update	Italy's fiscal measures will need to be seen to be believed
	UK Ind. Prod. (Jun.), Trade (Jun.) & BRC Retail Sales (Jul.)	Recovery in weak position to deal with market turmoil
	Global Markets Update	How much further could the US stock market fall?
	Latin America Economics Update	Market mayhem underlines downside risks to growth
	China Economics Update	Inflation rises, but economic activity is weak
	US Economics Update	Fed's longer low rate pledge won't change much
	Japan Economics Update	What next for the Bank of Japan?
Wed 10 th	Capital Daily	What next for the US stock market?
	Emerging Asia Economics Update	How quickly would Asia recover from another global downturn?
	Middle East Economics Update	Can the Gulf economies withstand an oil price shock?
	Global Markets Update	US Treasury yields could fall even further
	European Economics Update	Plunging equity markets exacerbate growth risks
	China Foreign Trade (July)	Surplus widens
	Japan Economics Update	Q2 GDP likely fell less than expected
	UK Economics Update	Report confirms rates to stay low for a long time
	UK Economics Update	Bounce in UK equities unlikely to continue
	European Economics Update	Could German courts block the bail-outs?
Global Markets Update	Prospects for the other major developed stock markets	
Canada Chart Book	Financial turmoil may undermine economic recovery	
Thu 11 th	Capital Daily	Will US Treasury yields drop further?
	UK Commercial Property Update	Prime retail property not immune to further consumer spending falls
	Latin America Economics Update	Mexico: Interest rates on hold until 2013?
	UK Mortgage Arrears and Possessions (Q2)	Mortgage payment problems little changed
	Japan Economics Update	Machinery orders jump but outlook appears weak
	UK CML Buy-To-Let Lending (Q2)	BTL lending bounces back, for now.
	Global Markets Update	What next for emerging market markets?
	European Economics Update	What more can the SNB do?
US International Trade (Jun.)	Economy cannot rely on boost from overseas	
UK Markets Chart Book	Recovery fears spread from bonds to equities	
Fri 12 th	Capital Daily	New forecasts for emerging market equities and bonds
	Euro-zone Industrial Prod. (Jun.) & French & Greek GDP (Q2)	Recovery slowed sharply in Q2
	UK Economics Weekly	Is the UK on the ratings hit-list?
	European Economics Weekly	French fears deepen crisis
	Emerging Asia Economics Weekly	Asia would benefit from a further fall in oil prices
	Japan Economics Weekly	Still in the grip of deflation

For copies of any of these reports, please call +44 (0)20 7823 5000 or e-mail publications@capitaleconomics.com