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Kazuhiko Ogata*

Japan Economist
Global Economic Research

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Japan Economic Perspectives

Japan's Strong First-Quarter GDP Growth Exaggerated By Deepening Deflation

After three consecutive quarters of zero or negative growth, first-quarter real GDP growth in Japan was amazingly strong, up 1.3% quarter-over-quarter (5.3% annualized), much better than the market expectation of 0.6% (2.5% annualized).

But there is evidence to suggest that this stronger-than-expected growth was largely the result of deepening deflation. In fact, rising inventories, declining exports and a worsening consumer environment tell us that the economic picture is not nearly as bright as the headline figure suggests, not to mention that the outlook for coming quarters is bleak, at best.

The central bank seems to agree. In a recent meeting, the Bank of Japan (BOJ) policy board decided to maintain the liquidity target at 30 to 35 trillion yen, with some amendment in their directive.

Headline Numbers Belie Underlying Trends

Broken down by component, private consumption rebounded sharply by 1.2% after two straight quarters of decline, and accounted for more than half (0.7% point) of GDP growth. Private capex, up 2.0%, also contributed a positive 0.3% point to growth.

But trends in inventories and exports are worrisome. Accumulation of private inventories boosted growth by 0.4% point, and exports declined for the first time in more than three years, implying that external factors are no longer a driver of growth. Importantly, net exports (exports minus imports) were a negative contributor to real GDP for the third consecutive quarter, pushing growth down by 0.1% point.

Furthermore, on a year-over-year basis real GDP growth was a mediocre 1.2% in the quarter, a small rebound from the two-and-a-half-year low of 0.6% in the previous quarter, while private consumption remained weak, up only 0.8% and just 0.3% in nominal terms after the fourth quarter's 0.1%. At the same time, employee compensation declined 0.5% year-over-year, a significant deterioration from fourth quarter's 0.6% (**Display 1**).

Artificially Enhanced Growth

Importantly, deflationary pressure intensified in the quarter, which significantly exaggerated real growth. Nominal GDP grew only 0.6% quarter-over-quarter (less than half of real GDP growth) and was flat year-over-year, the worst showing since the third quarter of 2003. Meanwhile, the GDP deflator, a broad measure of price changes, dropped a larger-than-expected 1.2% year-over-year, a significant worsening from –0.4% in the prior quarter (**Display 2**).

Further evidence of deepening deflationary pressure is seen when the GDP deflator is broken down by component. For example, private consumption dropped from –0.2% year-over-year in the fourth quarter to –0.5% in the first; private capex from –0.8% to –1.6%; government consumption from 0.8% to –0.7%; exports from 1.6% to –0.4%; public investment from 1.4% to 0.1%; housing investment from 0.8% to 0.1%; and imports from 5.6% to 3.3% (**Display 3**).

Liquidity Target Unchanged

Given the environment of deepening deflation, we would think the central bank less inclined to tighten monetary policy. And, in the monetary policy board meeting held on May 12 and 13, policymakers agreed to maintain the liquidity target at 30 to 35 trillion yen, despite market concerns that they might lower the target.

Although this decision was basically in line with our expectations, the board took one more step that we find confusing, amending its policy directive to permit the current account balance to temporarily fall below the target range. This may sound like a technical issue but in our understanding, allowing the current account balance to fall below the target while acknowledging that liquidity demand is extremely weak effectively causes the target to become meaningless—in other words, it is virtually equal to removing the target, in our view.

Nonetheless, we imagine that the BOJ feels happier now that it has obtained a freer hand over money market operations. And, though we fear the potentially negative long-term impact on the equity market of this reduced commitment, virtually removing the target when deflation is deepening might become a positive factor for the JGB market, particularly in the long end of the curve.

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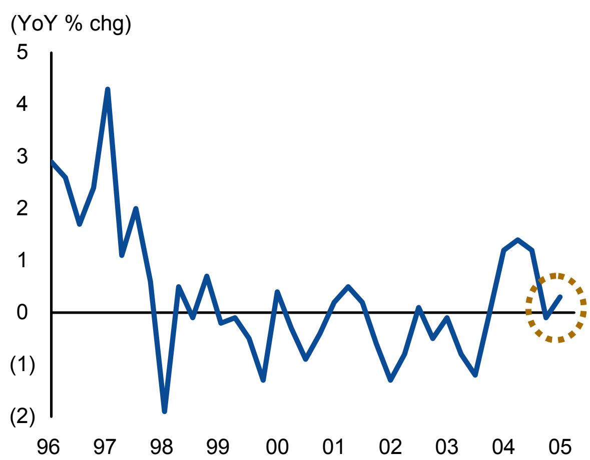
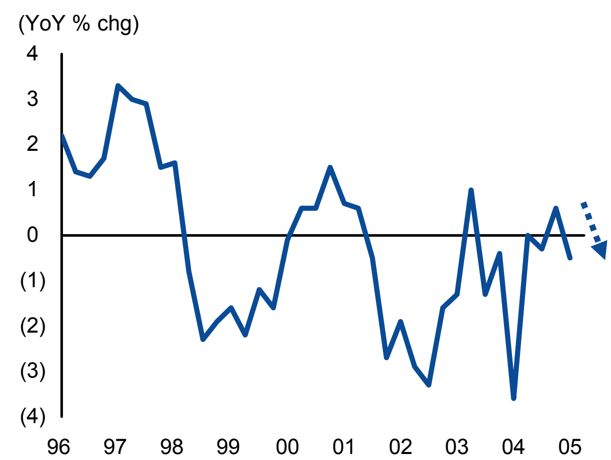
Display 1: Consumption Saw a Weak Rebound While Employee Compensation Worsened in the First Quarter

Nominal Growth in Private Consumption



Source: Cabinet Office

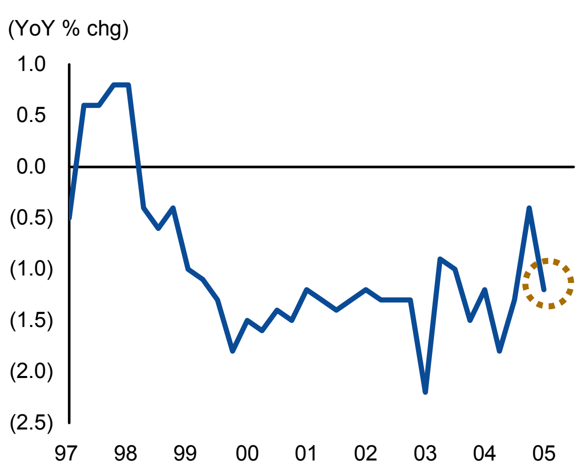
Growth of Employee Compensation



Source: Cabinet Office

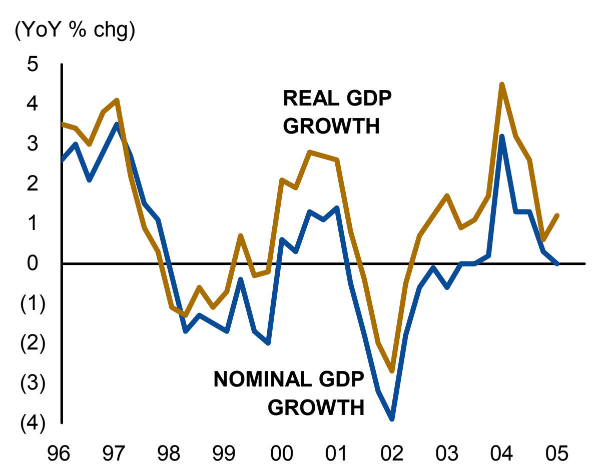
Display 2: First-Quarter GDP Growth Was Significantly Exaggerated By Intensifying Deflationary Pressure

Growth in the GDP Deflator



Source: Cabinet Office

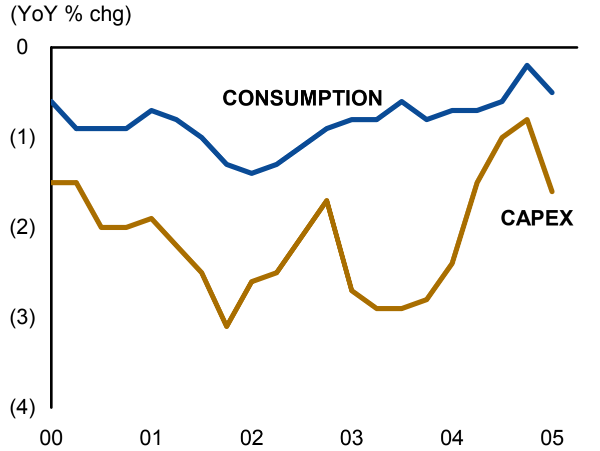
Real and Nominal GDP Growth



Source: Cabinet Office

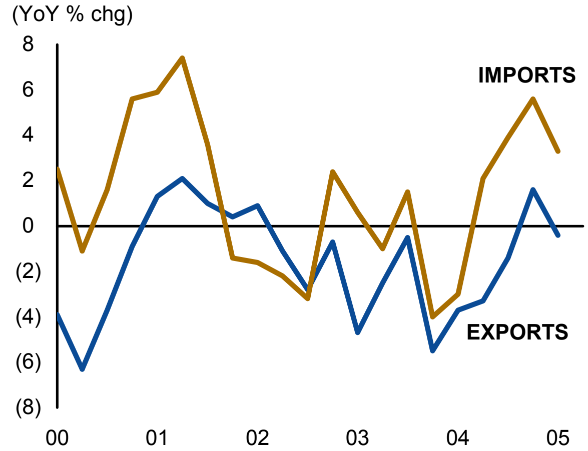
Display 3: All GDP Deflator Components Showed a Downturn in Growth For the First Quarter

GDP Deflator: Consumption and Capex



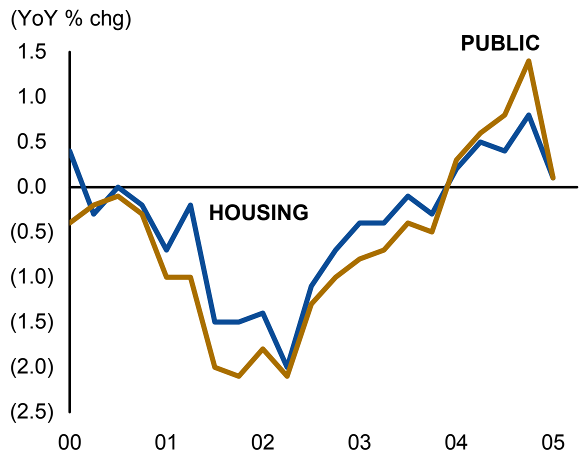
Source: Cabinet Office

GDP Deflator: Imports and Exports



Source: Cabinet Office

GDP Deflator: Housing and Public Investment



Source: Cabinet Office