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With No End to Deflation in Sight, Bank of Japan May Lower Price Outlook

Ongoing deflationary pressure, apparent in corporate final goods prices and consumer prices, is succeeding in keeping the Bank of Japan (BOJ) from changing its zero-rate policy in the near term. Moreover, we expect the central bank's fiscal 2005 price outlook, due out later this month, to be downgraded from 0.1% to around -0.1% to -0.2%.

In the BOJ's corporate goods price index (CGPI), domestic CGPI rose 0.3% month-over-month in March, up for the second month in a row and the largest increase in eight months, mainly because of higher oil and coal product prices, which were up 2.8% month-over-month.

But growth in the corporate CGPI on a year-over-year basis appears to have passed its peak and may moderate further. To be sure, in year-over-year terms, acceleration in domestic CGPI was just marginal at 1.4% following February's 1.3%, and much lower than the local peak of 2.1% seen in October and November last year.

Recent sluggishness in industrial production, which, as a leading indicator, has a close correlation with the domestic CGPI, supports this view (**Display 1**). In February, industrial production rose only 0.5% year-over-year, the lowest reading in 18 months, barring -0.8% growth in October. Furthermore, the recent sharp fall in the diffusion index of leading indicators, which hit a three-year low at 20% in February, implies that industrial production could fall into a negative growth trend in the near future (**Display 2**).

Broken down by stage of processing, year-over-year growth in raw materials prices (index weight: 2%) was only 0.7%, after a decline of 1.3% in February. This represents a significant slowing compared with the 24-year peak of 8.4% recorded last July, and a big contrast with import prices of raw materials, which were still surging at 19.7% year-over-year in March (**Display 3**). Intermediate product prices

(index weight: 55%) rose a substantial 3.4% in the month, although this also represents a moderation compared with a 24-year peak of 4.5% seen last December.

Meanwhile, growth in final goods prices (index weight: 43%) was down by 1.7% year-over-year in March. Within this, consumer goods prices were still falling, by 1.0%, albeit some easing when compared with February's -1.5% and January's -2.0% (**Display 4**). Thus, consumer price deflation, which is of paramount importance to policymakers, is still continuing. In fact, after falling 0.3% in January, core nationwide CPI (excluding fresh food prices) fell 0.4% year-over-year in February, the largest drop in 21 months. Total nationwide CPI also fell by 0.3% year-over-year in the month, a larger drop than January's -0.1% (**Display 5**).

Sluggish private consumption probably will keep consumer goods prices from rising. Salaried-workers' household spending declined 4.1% year-over-year in February, registering the largest fall in 19 months (**Display 6**).

JGB Market Awaits BOJ Price Outlook

If downward price pressure intensifies further, the BOJ could find itself in a position where it becomes more and more difficult to change policy.

No doubt, the JGB market will pay close attention to the central bank's upcoming semi-annual report on the economy and price outlook, due on April 28. Given current trends, we think the majority mean forecast for core CPI for this fiscal year probably will be downgraded from the 0.1% announced six months ago to around -0.1% to -0.2%. This would send an implicitly positive message to the JGB market that the central bank believes it won't see a pronounced rise in the CPI for another year or more, and therefore will not be able to start the exit process from its ultra-loose monetary policy for at least that long.

Of note, the central bank plans to announce its CPI outlook for fiscal 2006 in the report. As we

understand it, the purpose of this exceptional and premature announcement is to encourage an upbeat view on the economic recovery and to keep face. With this in mind, we wouldn't be surprised if the

bank reported a positive CPI for fiscal 2006 of more than 0.1%.

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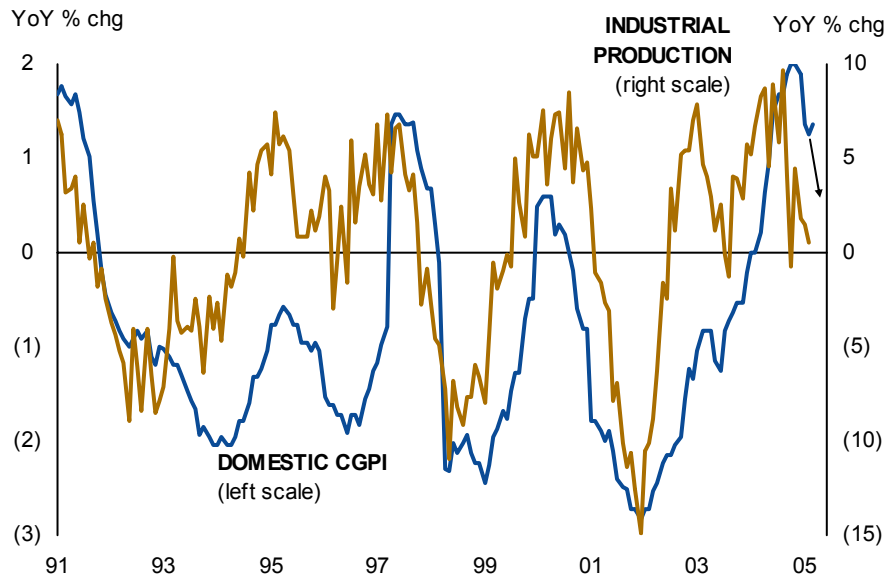
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Display 1: Slowing Industrial Production Implies Further Moderation Ahead in Corporate Goods Prices

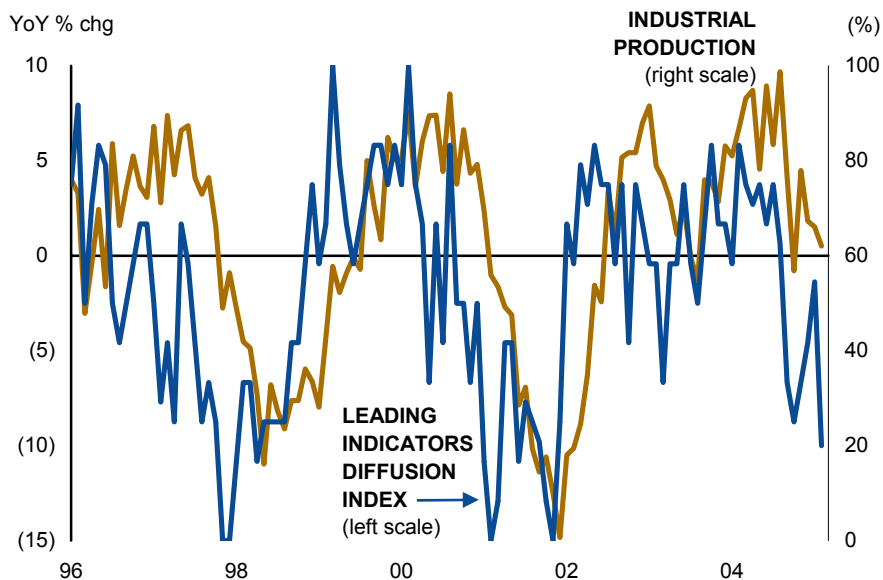
Domestic Corporate Goods Price Index and Industrial Production



Source: Bank of Japan, Ministry of Economy, Trade and Industry, April 20, 2005

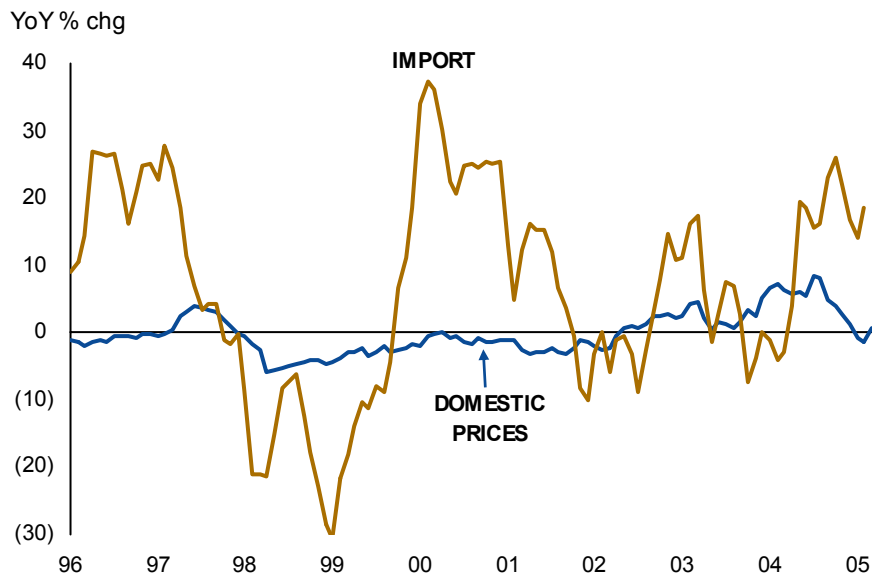
Display 2: Diffusion Index of Leading Indicators Points to Further Weakness in Industrial Production

Industrial Production and the Diffusion Index of Leading Indicators



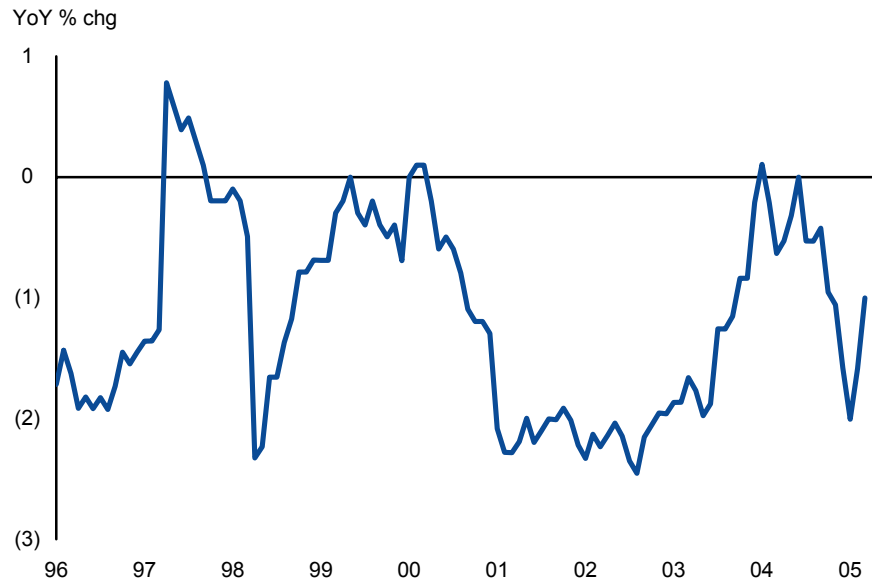
Source: Ministry of Economy, Trade and Industry, Cabinet Office, April 20, 2005

Display 3: Although Domestic Raw Material Prices Have Slowed, Import Prices Are Hitting a Plateau
Corporate Goods Price Index (Raw Materials)



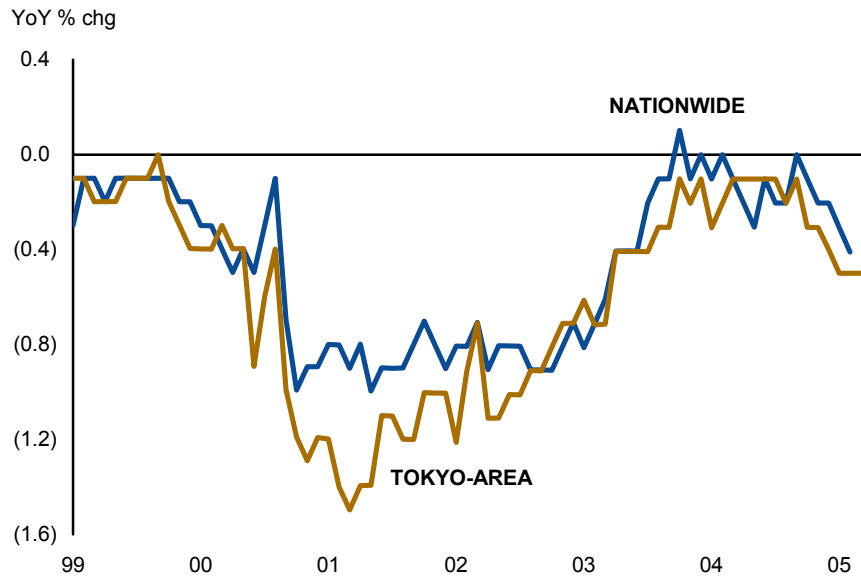
Source: Bank of Japan, April 20, 2005

Display 4: Consumer Goods Prices Still Falling
Domestic Corporate Goods Price Index (Consumer Goods)



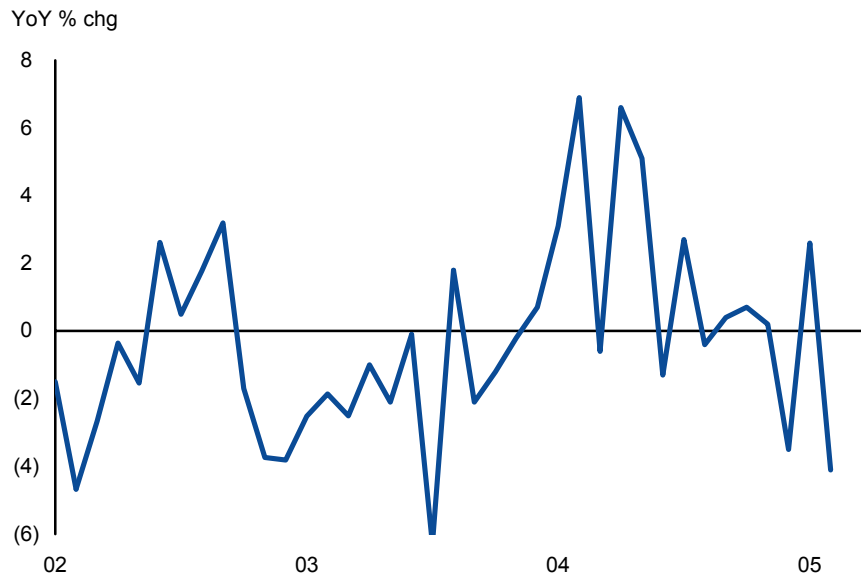
Source: Bank of Japan, April 20, 2005

Display 5: CPI Deflation Is Deepening
 Core Consumer Price Index (Excluding Fresh Foods)



Source: Ministry of Internal Affairs and Communication, April 20, 2005

Display 6: Sluggish Consumer Spending Is Putting Downward Pressure on Consumer Prices
 Salaried-Workers Household Spending



Source: Ministry of Internal Affairs and Communication, April 20, 2005