



Daily Note: 13 June 2008

Bank of Japan prepares to do nothing

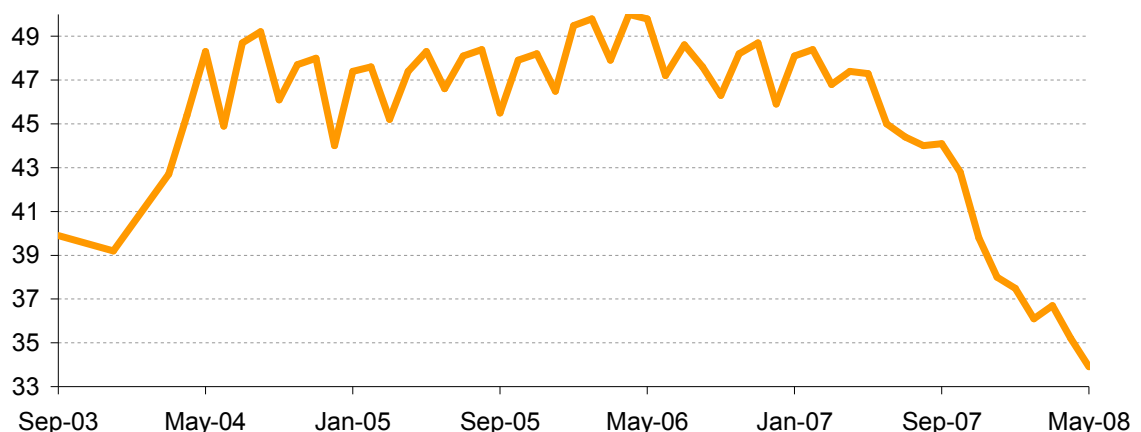
WE SUGGEST: Japanese equities may do OK, the economy won't

SUMMARY: The Bank of Japan left interest rates on hold at 0.5% today, as expected. But also today consumer confidence slipped to another six year low amid rising inflation expectations. Soft business and consumer confidence point to gloomy prospects for Japan for the rest of the year, despite strong growth in Q1.

As expected the Bank of Japan kept interest rates on hold at 0.5% this morning. Their assessment of the economy also remains the same – that the Japanese economy is slowing due to the effects of higher food and energy prices. Earlier this week revised Q1 GDP data showed growth to be estimated at 1.0% in the quarter, rather than the 0.8% previously. An increased estimate for capital spending was the main reason for the upward revision. But there can be little doubt that this was a spike in growth that will not last for the rest of the year.

Consumption increased by 0.8% in Q1, the first time in a year that consumer spending has been anything other than anaemic. But the prospects are poor, as underlined by today's consumer confidence release, which showed a further fall in confidence in May to 33.9, the lowest since December 2001.

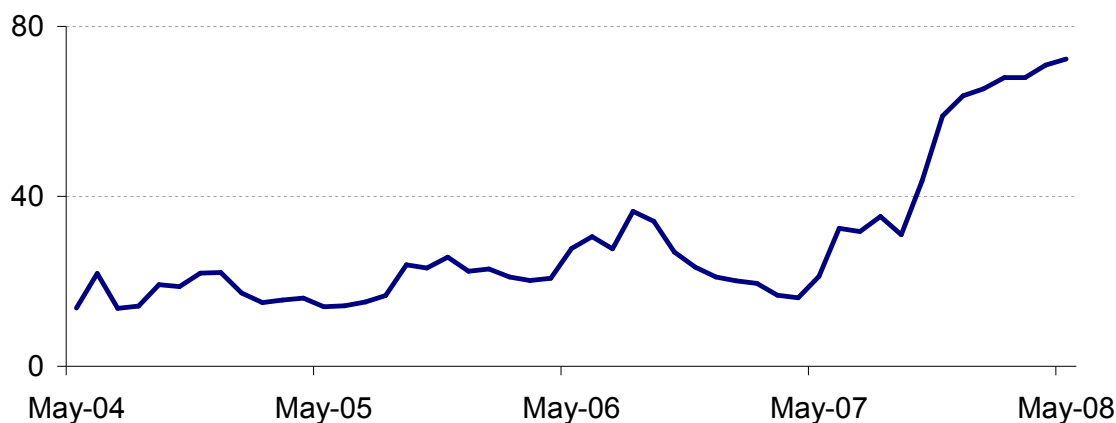
Japanese household consumer confidence



A factor in the recent sharp drop in confidence has been the rise in Japanese inflation and inflation expectations. Over 70% of households now expect inflation to be above 2% in 12 months' time, compared with around 20% a year ago. Higher food and energy prices have pushed headline inflation decisively above zero in recent months with CPI inflation at 0.8% in April (-0.1% excluding food and energy). Nominal labour earnings

growth is set to remain meagre at best (it was 0.6% in the 12 months to April). A slackening labour market suggests that the outlook for employment is turning negative. The job to applicant ratio fell to 0.93 in April, the fifth consecutive month that it has been below one. Negligible labour earnings growth with positive inflation - and expectations of higher inflation - points to an ongoing squeeze on real disposable incomes. Consumption growth will be weak for the rest of the year. Most of the recent monthly indicators of retail spending are currently recording negative year on year growth rates, suggesting a slowdown is already under way.

Percentage of Japanese households expecting Inflation to be over 2% in a year's time



Meanwhile today's industrial production data recorded a 0.2% fall in the month of April, the second consecutive monthly fall. For now export growth is reasonable in Japan as the rest of Asia enjoys strong domestic demand. But as these economies slow as they deal with inflation, demand for Japanese exports will fade too. Small business confidence fell to a six-year low in May. (See *Daily Note* "Japan in recession, but equities hot?" by Maya Bhandari, published on 6th June, for a full discussion of the outlook for the Japanese corporate sector.)

Japanese growth will peter out to zero or less this year, although any recession should be short-lived. For now it seems as if the BoJ will do little in the way of policy action this year, as it focuses more on inflation than on growth.

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