November 25th 2011

Global Watch

November 2011

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§Japanese Economy

1. Overview of the economy

Conditions Continue to Improve, but There Are Uncertainties Going Forward.

By Shinichiro Kobayashi, Senior Economist

After deteriorating sharply following the Great East Japan Earthquake, the economy has begun to show improvement. The movement toward recovery in supply capacity, which has accompanied the reconstruction of the infrastructure, is beginning to run its course, and economic indicators announced so far are showing a mixed picture of strengths and weaknesses. The trend toward improvement, however, continues unabated. Data on real GDP for the July-September period showed real growth running at an annualized rate of +6.0% for the quarter, thus confirming the rapid comeback in the economy following the earthquake. However, the yen has appreciated further, and the pace of economic growth in overseas economies has slowed, thus causing deterioration in the export environment and creating uncertainties about future trends.

Industrial production in September was down 3.3% from the previous month, the first decrease in six months. This was because of the effects of the pause in the trend toward the recovery of automobile production and a decline in general machinery output, including semiconductor manufacturing equipment. Trends in basic materials industries, including steel and chemicals, as well as in the electronic parts and devices industries continue to be lackluster. The forecast index for production calls for an increase of 2.3% in October and another rise of 1.8% in November, indicating that the trend toward an increase in output is continuing. In the automobile industry, domestic and overseas demand that was postponed still remains, and it is expected to be a factor boosting production for the time being.

Japan's exports, which had shown signs of weakening in previous months, recovered their momentum in September, as real exports rose a healthy 3.4% over the previous month. There is a possibility that the slowing of recovery in overseas economies is having an adverse impact not only on exports of basic materials and electronic parts but also on exports of general machinery. Nevertheless, exports of automobiles are holding firm and giving a boost to exports as a whole. In the United States, automobile sales in October were running above 13 million on an annualized basis, the highest level since February 2011, suggesting that the external environment for car exports is not bad.

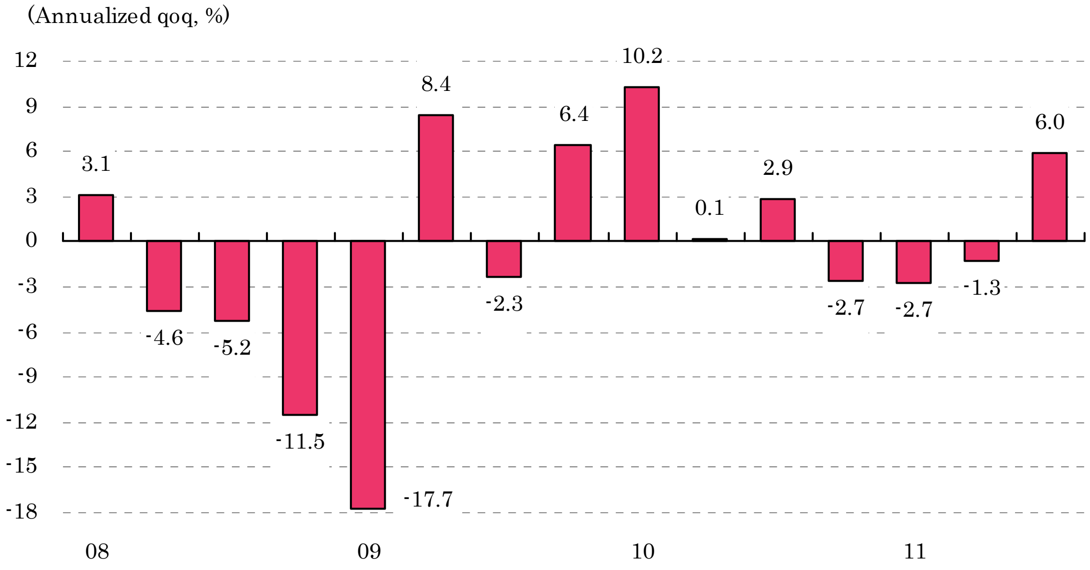
The improvement in personal consumption is continuing. According to the survey of household expenditures, in September, real consumer spending (of households with two-or-more persons) rose 0.9% from the previous month. Real consumption also rose in the July-September period by 1.4% over the previous quarter, the first increase in four quarters. In addition, at the real GDP level, spending, mainly on consumer durables, rose a high 1.0% over the previous quarter. Although sales of flat panel display (FPD) TVs have slumped on the one hand, sales of automobiles continue to be robust.

There are signs of improvement in household incomes. Total monthly cash earnings per worker in September rose 0.2% over the prior month, the second consecutive month-to-month increase, and scheduled earnings returned to the level of the same month of the previous year. However, summer bonuses were below the level of a year ago, and there is a strong possibility that winter bonuses may also remain below their levels of the prior year, suggesting that further time will be needed before the effects of the Great East Japan Earthquake fully run their course. On the other hand, unemployment in September stood at 4.1%, 0.5 percentage point below the level in February 2011, the month prior to the earthquake and the lowest level since November 2008. The ratio of effective job offers to job seekers is also improving.

Looking ahead, demand related to recovery from the disaster, principally public investment, is expected to boost the economy, and production as well as sales of automobiles are forecast to continue to be robust. Therefore, it appears the economy will avoid losing momentum. In addition, the movement toward restocking inventories overseas will be a factor boosting exports. If the improvement in employment conditions brings improvement in incomes, it is likely that consumer spending will become firmer. On the other hand, deterioration in the export environment is a cause for concern. If the slump in demand in overseas economies spreads, there is a risk that a resulting decline in Japan's exports may lead to adjustments in production.

(2011.11.15)

Chart1: Real GDP growth rate



Source: Cabinet Office

2. Topic of the month

Correlation between Domestic and Overseas Interest Rates and Foreign Exchange Rates

By Miki Ohata, Economist

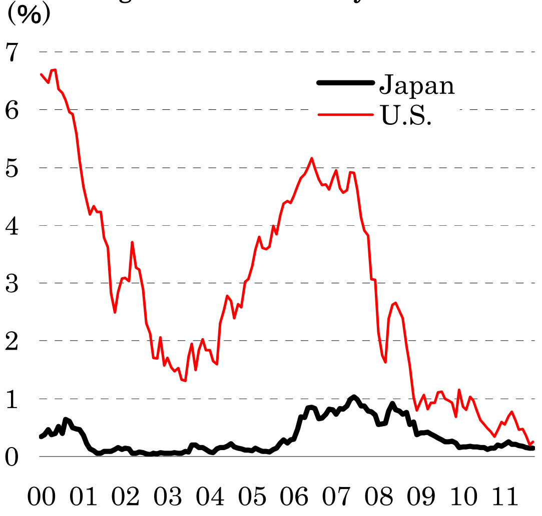
At present, we are in a "low interest rate era" with rates at historically low levels. However, in Japan, the decline in long- and short-term interest rates had already been in progress since the bursting of the economic bubble, and interest rates have been maintained at low levels for an extended period (Chart 2). On the other hand, after the collapse of Lehman Brothers and the serious deterioration in economic conditions, central banks in many of the industrialized countries have implemented easy monetary policies. As a result, interest rates in overseas economies have declined, thus narrowing the differential between rates in Japan and the United States as well as other countries. Turning to foreign exchange markets, since the middle of the first decade of the 21st century, the yen has appreciated and the dollar has depreciated in value. On October 31, 2011, the value of the dollar fell in Oceanian foreign exchange markets to 75.32 yen, the lowest level in the post-World War II era. Since the beginning of 2011, although the Japanese government and the Bank of Japan (BOJ) have intervened in the market on three occasions, the yen has remained at a high level.

The differential between domestic and overseas interest rates, along with the current account of the balance of payments and the rate of price increases, receives considerable attention as one of the factors determining foreign exchange rates. Recently, attention among market participants has focused especially on the correlation between the differential between interest rates on Japanese and U.S. two-year government bonds on the one hand and the exchange rate on the other hand. This past summer, the governor of BOJ, Masaaki Shirakawa, stated "foreign exchanges are not determined solely by the interest rate differential." However, he has also mentioned that there is a strong correlation between the interest rate differential on Japanese and U.S. two-year government bonds and the exchange rate. In fact, daily data on the Japanese-U.S. two-year bond rate differential and the yen-dollar rate indicate that the correlation is increasing. To cite specific data, the correlation coefficient from the year 2000 through the end of 2004 was –0.28, but calculations based on data between 2005 and the present (through the end of October 2011) show that the correlation has risen to 0.91.

However, a high correlation coefficient does not necessarily prove that there is a causal relationship between these two variables. Under uncertain economic and monetary conditions, such as those we are experiencing today, it is difficult to imagine why investors would emphasize the medium-term interest rate differential between Japanese and U.S. two-year government bonds and move their funds directly from dollars to yen. At the end of the day, the strength of the correlation between the interest rate differential between two-year Japanese and U.S. government bonds and the yen-dollar exchange rate in today's market—where there is virtually no movement in yen interest rates—may show nothing more than that the easing of monetary policy in the United States has triggered a sell-off of dollars, and, as a result, there is a strong linear relationship between the two variables.

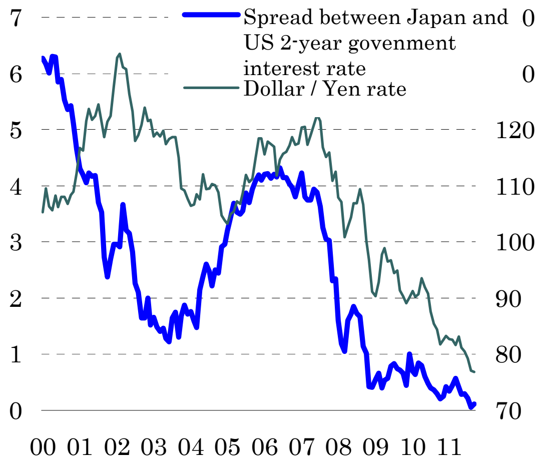
(2011.11.15)

Chart2: Japan and the US 2-year government bond yield



Source: Bloomberg

Chart3: Spread between Japan and the US 2year bond yields and US dollar / Yen rate



Source: Bloomberg

§Chinese Economy

Even if Inflation Has Peaked Out, Caution Is Still Needed.

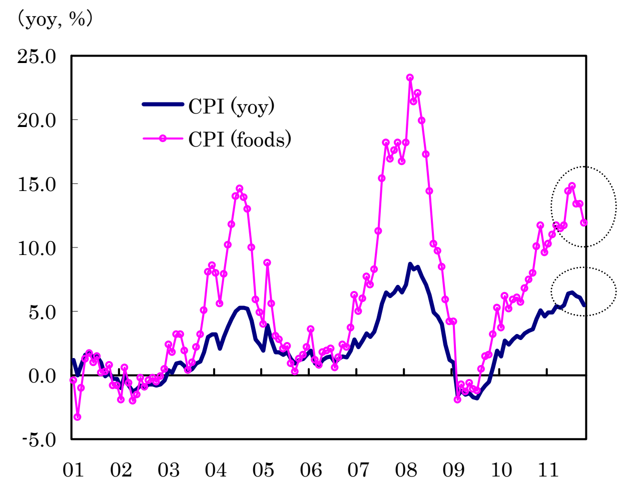
By Mariko Noda, Economist

The October year-on-year increase in the consumer price index (CPI) in China slowed to 5.5%, and the rise in food prices, which account for about 30% of the CPI, fell significantly to 11.9% (Chart 4). In addition, even compared with the previous month (data not on a seasonally adjusted basis), the rates of price increases have fallen. The CPI for all items and that for food products, which were up 0.5% and 1.1% from the previous month, respectively, in September, also slowed to +0.1% and –0.2%, respectively, in October. However, if we regard 2010 as an exceptional year, in normal years, the month-on-month rate of price increases shows a declining trend in October; so, these developments should not be considered as a sign of an easing in inflationary pressures (Chart 5). In fact, while the prices of pork, eggs, and certain other products have clearly peaked out, partly because of the government's stabilization measures (Chart 6), there are other products, such as mutton, beef, and soybean oil, whose prices are either continuing to rise or are stable at high levels (Chart 7). Therefore, inflationary pressures and expectations are no longer rising substantially, but they stubbornly persist.

As the inflation rate has declined significantly, expectations of an easing of monetary policy are mounting. However, judging at least from trends in food prices, it will take some time for the government to change the policy..

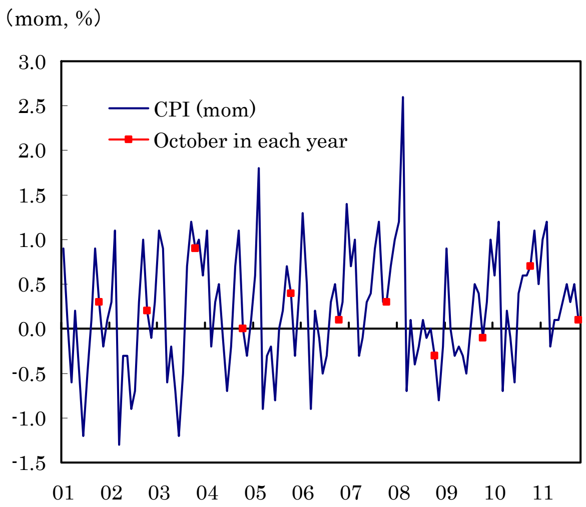
(2011.11.11)

Chart4: Rise in consumer prices (yoy)



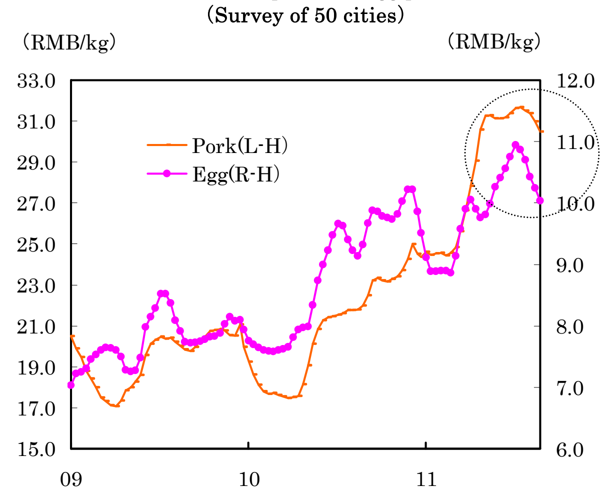
Source: CEIC

Chart5: Rise in consumer prices (mom)



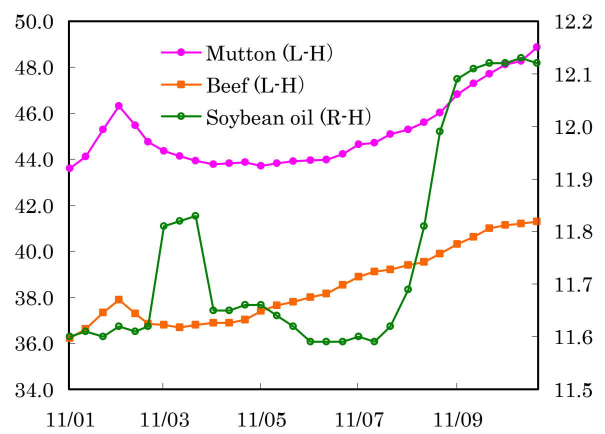
Source: CEIC

Chart6: Prices of pork and egg peaked out (Survey of 50 cities)



Note:Data are the average of every ten days of each month.
Source: CEIC

Chart7: Prices of Mutton, Beef and Soybean oil continue to rise (Survey of 50 cities)



Note:Data are the average of every ten days of each month.
Source: CEIC