TD Bank Financial Group

TD Economics

Special Report

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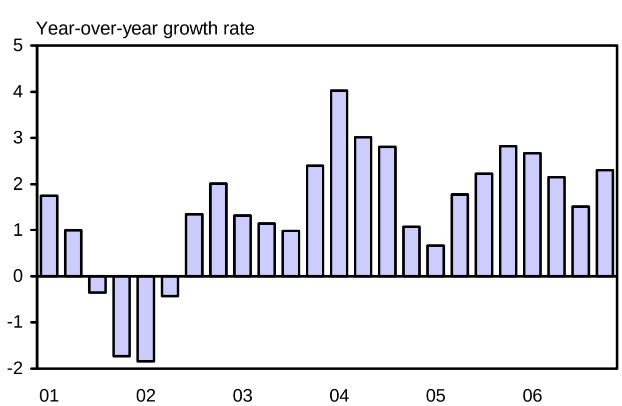
JAPANESE GDP FLIES, MAKING A RATE HIKE NEXT WEEK MORE LIKELY

After decelerating through the first nine months of 2006, Japanese gross domestic product (GDP) rocketed ahead by an annualized 4.8% over the final three months of the year. The only drag on economic growth in the quarter was a slight liquidation of inventories, setting the stage for the Bank of Japan's (BOJ) Monetary Policy Meeting next week. Financial market expectations of a rate hike tipped above 50 per cent after the GDP figures were released based upon the greater likelihood of a rate hike next week being priced into Japanese interest rate swap contracts. The most substantial wild card remains the possible verbal intervention by Japanese cabinet ministers who appeared to derail a hike in January. While weak wage and price trends mean the BOJ must act with a delicate hand, the economy appears ready for its first interest rate increase since July 2006.

JAPANESE GROSS DOMESTIC PRODUCT



Source: Japan Cabinet Office and Haver Analytics.

HIGHLIGHTS

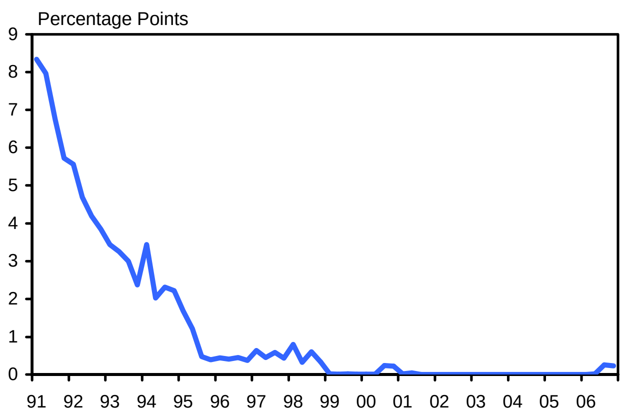
- **Real GDP grew by 4.8% in the final quarter of 2006**
- **Significantly increases the odds of a Bank of Japan rate hike next week**

Fourth quarter real GDP growth was nothing short of phenomenal, though it comes on the heels of a downwardly revised 0.3% rate of growth in the third quarter. This means the economy averaged an annualized pace of 2.5% in the second half of 2006 – strong but not nearly as shocking – but still in excess of the economy's long-run potential pace, which is estimated to be in the range of 1.5-2.0%. This suggests that economic activity will put upward pressure on prices in 2007.

Public investment was a contributor to growth for the first time since the third quarter of 2005, while private non-residential investment expanded once again, growing by 10% since the end of 2005. The weakness of the yen has also held some sway over trade flows as exports grew strongly and imports contracted for the second straight quarter. We acknowledge the Japanese economy cannot sustain 4-plus per cent growth rates and recent revisions to GDP have tended to be downwardly biased. Moreover, the economy will face near-term headwinds with tax increases coming in 2007. Nevertheless, Japanese real GDP growth will continue to trend at, or just below, 2% through 2007, and a forward-looking BOJ should be able to take that into account when they meet next week.

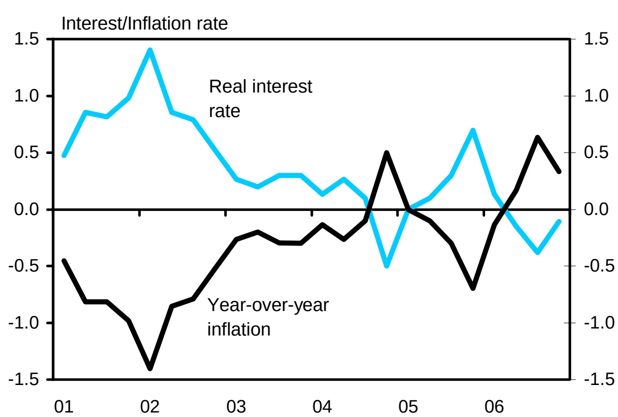
Government officials have focused on weak consumer spending, which grew by just 0.6% over the course of 2006. There is also a palpable fear of deflation, given personal consumer prices declined by 0.3% in 2006, while hourly wages grew by just 0.2%. On a real basis, however, this represents an increase in purchasing power of 0.5% for consumers. A further downward trend in prices and wages would certainly not be helpful for sustaining Japanese economic growth. Counterintuitively though, a higher nominal interest rate might even be expansionary if it convinces consumers and businesses that deflation is dead and economic fundamentals have returned to normal. Falling prices and a zero interest rate meant real interest rates actually rose in Japan – slowing the economy – when economic growth was already poor. If domestic inflation can be coaxed out of its hole, a quarter-point increase in interest rates by the BOJ could be more than offset in real terms with higher inflation, and a pace of real GDP growth above trend points to just this. This may bring some near-term strength to the yen, but given the BOJ is unlikely to signal any intention to begin a steady campaign of rate hikes, this will likely have little impact on the yen and associated carry-trade over the longer horizon.

JAPANESE OFFICIAL INTEREST RATE



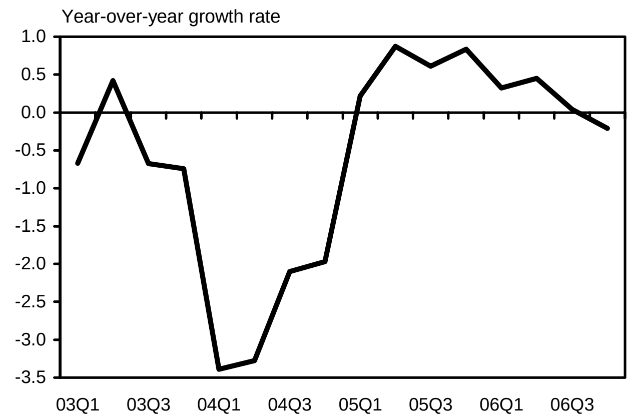
Source: Japan Cabinet Office and Haver Analytics.

JAPANESE REAL INTEREST RATE



Source: Japan Cabinet Office and Haver Analytics.

AVERAGE MONTHLY EARNINGS



Source: Ministry of Health, Labor, and Welfare and Haver Analytics.

The issue for the BOJ remains how to normalize interest rates when the spectre of deflation is firmly fixed over the economy. The case is not nearly a slam dunk. Weak consumer prices and wages suggest the economy has yet to permanently slay the deflationary dragon. Moreover, cabinet officials enjoy a non-negligible influence over the BOJ and have continued to exert pressure to keep interest rates unchanged. Nevertheless, a forward-looking BOJ will likely raise interest rates by a quarter-point to 0.50 percentage points when they announce their decision February 21st. The BOJ needs to convince the economy that prices and wages should consistently rise year after year and ensure a return to normalcy. There is nothing normal about the third-largest economy on the planet growing by 4.8% in the fourth quarter and leaving interest rates just a hair above zero.

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