

Japan logs record deflation as demand slides

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By Leika Kihara

TOKYO (Reuters) - Japanese core consumer prices fell a record 1.7 percent in the year to June with weakening household demand for goods playing an increasing part in pushing the nation deeper into deflation, raising some doubts about the Bank of Japan's recovery forecast.

It was the fourth straight month of decline, matching a median market forecast and accelerating from a 1.1 percent drop in May in another sign the world's No. 2 economy is stuck in the doldrums with rising job losses hurting spending.

Price falls are expected to moderate when the effect of sharp rises in energy costs last summer fade. But deflation may persist longer than the BOJ expects and threaten its forecast for a gradual economic recovery toward early next year, putting any exit from its ultra-easy monetary policy on hold, analysts say.

"It's turning into a home-made deflation. Instead of falling energy costs, weakness in the economy is becoming the main culprit of price falls," said Kyohei Morita, chief Japan economist at Barclays Capital.

"That kind of deflation tends to last for a very long time. Prices won't start rising again until late 2011, which means an exit from the BOJ's easy policy won't come for another two years."

Roughly 70 percent of the drop in the core consumer price index (CPI), which excludes food prices but includes energy costs, was due to falling energy prices, data showed on Friday.

But the so-called core-core CPI, which cuts out the sliding energy bill, fell 0.7 percent from a year earlier and the decline has gathered steam for four straight months, suggesting deflation may persist unless household demand picks up.

It was the biggest fall since December 2004 in this index, which is similar to underlying inflation indicators used in Europe and North America.

BOJ VIEW IN DOUBT

The BOJ is already forecasting two years of deflation, so price falls alone are unlikely to push it back into full-blown quantitative easing, which in Japan involved flooding the banking system with cash to meet a specific monetary target.

Many BOJ officials believe no further policy action is needed unless Japan risks slipping into a deflationary spiral, in which falling prices and a weak economy feed into each other.

The central bank believes the risk of this happening is small because the economy will likely pick up later this year with support from reviving global demand.

But uncertainty looms over that forecast. The unemployment rate hit a six-year high and job availability sank to a record low, suggesting consumers are unlikely to loosen their purse strings any time soon.

"Japan's economy, despite some upbeat assessments from the government and the BOJ, is in a deflation cycle," said Simon Wong, an economist at Standard Chartered Bank in Hong Kong.

"The current economy is operating way below capacity and that's putting downward pressure on prices. The main challenge for the BOJ remains deflation."

Japanese government bond futures were down on the day, focusing on gains in the stock market as the data was in line with market expectations.

MORE GOODS PRICES FALLING

Prices fell for goods ranging from flat-screen television sets and cellphone bills to overseas package tours.

Of the range of items that make up core CPI, 47 percent saw price falls in June from a year earlier, up from 39 percent in May. It was also the first time in three years that the number of goods whose prices fell exceeded the number logging price gains, adding to evidence that deflation was broadening.

Core consumer prices for Tokyo, available a month before the nationwide data, also fell a record 1.7 percent in July from a year earlier.

Analysts expect annual CPI falls to exceed 2 percent in the coming months before narrowing to around 1 percent by year-end.

Having just emerged from almost a decade of deflation after the collapse of a property bubble in the 1990s, Japan's economy has been sideswiped by the global financial crisis that started in 2007 with a U.S. mortgage market meltdown.

While the economy is expected to have bounced back in April-June after five straight quarters of contraction, analysts say any recovery will be fragile as companies slash jobs and cut capital spending, weakening domestic demand.

(Additional reporting by Hideyuki Sano, Tetsushi Kajimoto; Editing by Hugh Lawson)

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