

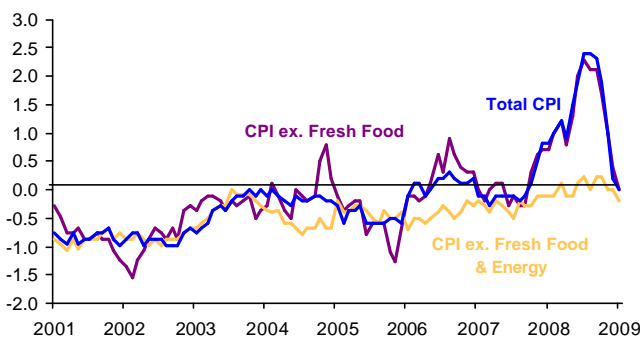
Japan

Japan on the verge of deflation

Japan's inflation slowed to zero, as signposted by PMI data

Official data released by the Ministry of Internal Affairs and Communications on 26 February indicated that Japan's core annual inflation was flat in January, dropping from 0.2% in December and against a forecast of a 0.1% fall. It was the lowest core inflation since September 2007, when core consumer prices fell by 0.1% on an annual basis.

Chart 1: Japan Consumer Prices A%C



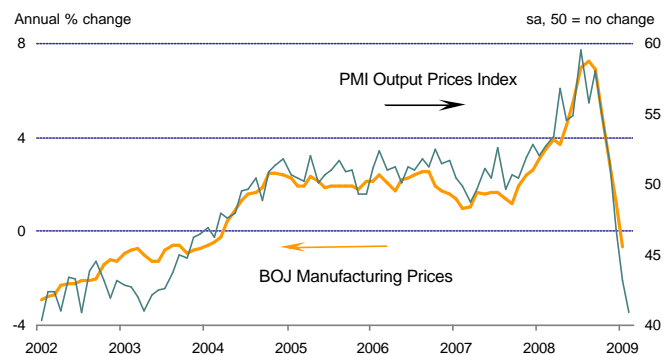
Stagnant price pressures suggest that Japan is teetering on the brink of deflation, a phenomenon that crippled its economy for the best part of decade. The failure of Japan's consumer prices to rise comes at a time when household spending is dwindling (a 5.9% annual drop was recorded for January) amid job uncertainty and weakening sentiment. This, combined with a severe drop in output and export demand in January, adds to Japan's woes and provides further evidence to suggest that Japan is slipping deeper into recession. It now appears that official prices data for February will show that the Japanese economy dropped back into deflation over the month.

The price components of the Nomura/JMMA Japan Manufacturing PMI, compiled by Markit and released on a monthly basis, signalled that deflationary pressure was on the horizon long before official data. In fact, the PMI indexes for both output and input prices signalled deflation back in December, with both components dropping below the crucial 50.0 no-change mark during

this month. Moreover, PMI data are released a full month in advance of official estimates.

The below chart plots the relationship between the PMI Output Index and BoJ manufacturing price estimates. It is clear that PMI data have accurately tracked the underlying trend in official figures since the start of the series in October 2001, with PMI data displaying a **correlation of 0.95** with official estimates.

Chart 2: PMI Output Prices Index vs. BoJ Manufacturing Prices



Deflation appears imminent

February PMI data signalled that the rate of input and output price deflation accelerated over the month, with both indexes posting their lowest levels since late 2002. High oil and energy prices – which shrouded Japan's deflationary problem for several years – are now tumbling, leading to suggestions that Japan in fact never escaped deflation.

The next Nomura/JMMA Japan Manufacturing PMI is released on 31 March. To find out how to receive data from the surveys or obtain copies of the reports, please contact economics@markit.com

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