

# BANK OF JAPAN WATCH

18<sup>th</sup> Feb. 2009



## What more can the BoJ do?

- *Final rate cut still on the cards, but at these levels would only be symbolic*
- *Next steps include extension of CP purchases and new plan to buy corporate bonds*
- *Unfortunately, policy-makers will probably continue to do too little, too late*

The Bank of Japan could yet cut interest rates all the way to zero, but the focus has already shifted towards a more ambitious programme of asset purchases. There is plenty of room to extend the size and duration of existing schemes, as well as to add new assets to the list. However, Japanese policy-makers' natural caution means that they will probably continue to do too little, too late.

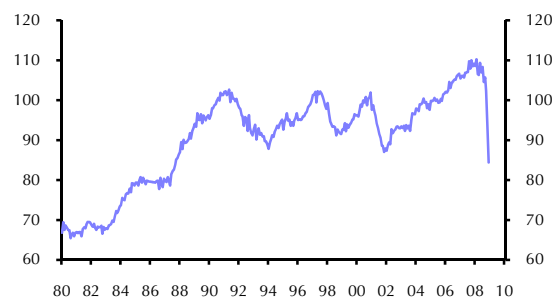
### Enough to drive a man to drink

The Policy Board's two-day meeting, which concludes tomorrow, will be overshadowed by the awful GDP figures released on Monday. The economy shrank by 3.3% q/q in the final quarter of 2008 (or 12.7% at an annualised rate), as exports collapsed by 13.9% q/q. (For more details see our *Asian Data Response*, 16<sup>th</sup> February.) The upshot is that **the Board's own GDP forecasts, updated as recently as January, are already looking too optimistic.**

The median forecast for the current fiscal year 2008-09 (ending in March) was for a decline of 1.8%. But for this to be achieved, GDP would now have to rebound by at least 2% q/q in the January-March quarter, which is clearly not going to happen. In contrast, we have pencilled in a further decline of around 1% q/q, which would translate into a fall of 2.5% for the current fiscal year as a whole. However, the risks are skewed to the downside and an even worse outcome is definitely on the cards.

In particular, there is growing pressure on the Bank to do more to help the export-oriented manufacturing sector, where output appears to be in free-fall. (See Chart 1.)

CHART 1: JAPAN INDUSTRIAL OUTPUT (2005 = 100)



Source – Thomson Datastream

What's more, **the Bank of Japan's own Senior Loan Officer Survey shows that financial conditions, although still better than in most Western economies, are deteriorating rapidly.**

Commercial banks are reporting a marked increase in the demand for loans from firms, reflecting difficulties in raising funds from other sources (bond and equity markets) and a decline in internally-generated funds (primarily profits). At the same time, banks are expecting to tighten lending criteria and raise margins.

### What more can the Bank do?

The key official rate could still be trimmed all the way to zero, where it was for most of the period between 1999 and 2006. This would mean that the policy of paying interest on reserve balances held at the central bank, only introduced last November, would effectively be abandoned. However, this would not necessarily be a bad thing: the payment of interest on reserves has encouraged financial institutions to park spare cash at the central bank rather than use it to increase lending or buy assets.

But there are two further reasons why the Bank might be reluctant to cut to zero. First, another small move (which would be the third in five months) might simply open the Bank to criticism that it has been indecisive. Secondly, with the key rate already at just 0.1%, it is hard to see what another 10bp reduction would achieve. So while we would not rule out a final cut, it would essentially be symbolic.

The bigger picture is that the focus of monetary policy has already shifted to outright asset purchases. The Bank of Japan is reluctant to describe this as “quantitative easing”, which in the Japanese context has the specific meaning of a target for the reserve balances held at the central bank. But the underlying principles and the impact are much the same as the unconventional tools of monetary policy now being adopted elsewhere, notably in the US and the UK.

**So far the scale of asset purchases has been fairly modest, but at least a framework has been established that could be developed into a more ambitious programme.**

Attention has focused on the plan to buy a total of up to ¥3 trillion of commercial paper (CP) by the end of the fiscal year. The programme has been limited to CP (including asset-backed CP) rated at least A-1 with a residual maturity of up to 3 months. In addition, the Bank has stepped up its purchases of government bonds (JGBs) and extended the scope of these purchases to include floating rate and inflation index-linked bonds. It now also accepts corporate bonds issued by REITs as collateral in its money market operations.

Finally (and with rather less fanfare) the Bank has reintroduced the stock purchase programme operated between 2002 and 2004, under which just over ¥2 trillion worth of equities were bought from financial institutions. (The Bank started to sell these shares in October 2007 but suspended these sales in October 2008, with more than ¥1 trillion worth still on the central bank’s books.) The new programme is initially capped at ¥1 trillion.

Next, **the Bank will almost certainly extend the programme of CP purchases well into the next financial year, increasing the total amount to be bought in the process. We also expect the Bank to introduce a new programme to purchase corporate bonds, perhaps starting at ¥1 trillion.** The Bank already accepts bonds rated as low as BBB in its regular repo operations. The hurdle for outright purchases would presumably be set higher, say A or above.

However, for now at least there is a great deal of reluctance to go any further, with the Bank sticking to a piecemeal approach. **There does not appear to be any serious discussion of a quantum leap in the amount of bonds and equities being purchased, let alone the possibilities of cooperating with the government in a major fiscal expansion financed by central bank purchases of JGBs.** In that respect, the weakness of the government itself clearly does not help.

Indeed, for most observers, ourselves included, the main lesson from Japan’s “lost decade” was the need for policy-makers to act sooner and do more than rather than less. In contrast, the Bank appears to look back at that experience and conclude that the limited impact of the measures that were taken at the time means that there is little point in being more aggressive now.

**The Bank also seems to be wary of taking on too much risk from the private sector, which to our mind seems short-sighted.** If the policy of private sector asset purchases succeeds in rescuing the economy, the Bank should be able to exit at a profit. If it does not, and the economy continues to weaken, it is surely better that any losses sit on the broader shoulders of the Bank rather than undermine confidence further. However, we fear that Japanese policy-makers will continue to do too little, too late.

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**TABLE 1: BANK OF JAPAN BACKGROUND INFORMATION**

Interest Rate Meetings	Policy Board meets every month, with additional meetings at the end of April and October to coincide with the publication of the twice-yearly “Outlook for Economic Activity and Prices”. Meetings are usually two days, with the rate announcement at the end of the second day. There is a press conference after each meeting.	
Release of Minutes	Yes, minutes are published about a week after the next meeting (therefore typically about 6 weeks after the meeting concerned).	
Disclosure of Voting	Yes, at time of announcement.	
Inflation Target	No formal target, but Bank of Japan’s objective is to maintain price stability, and Board members have said that this is consistent with a range of 0-2% for reported inflation. Policy is set with reference to a time horizon of “about two years ahead”.	
Policy Guidance	Press conferences and publication of “Monthly Report of Recent Economic and Financial Developments” after each regular meeting. Minutes follow about 6 weeks later. Growth and inflation forecasts published in twice-yearly “Outlook for Economic Activity and Prices” in April and October, with interim updates in January and July.	
Official Interest Rates	Policy is now specified in terms of a target for the uncollateralised overnight call rate. This target is currently set at 0.1%. The Bank also sets a “basic loan rate” and a “basic discount rate”, which have essentially the same function as the old “discount rate”. These rates are both currently set at 0.3%.	
Membership of Policy Board	Monetary policy decisions are made by a majority vote of the nine members of the Policy Board: the Governor, two Deputy Governors, and six other members.	
Governor	Mr. Masaaki Shirakawa (most recently an academic but previously a BoJ official)	
Deputy Governors	Mr. Kiyohiko G. Nishimura (previously an economics professor) Mr. Hirohide Yamaguchi (previously a senior BoJ official)	
The other six members of the Policy Board.	Ms. Miyako Suda (previously an economics professor, “hawk”) Mr. Seiji Nakamura (previously at MOL Ferry Co.) Mr. Hidetoshi Kamezaki (previously at Mitsubishi Corp.) Mr. Atsushi Mizuno (previously strategist at various international banks, “ultra-hawk”) Mr. Tadao Noda (previously at Mizuho finance group, “hawk”) One vacancy	
Meetings	<b>Date</b>	<b>Outcome / Capital Economics Forecast</b>
* Publication of half-yearly “Outlook for Economic Activity and Prices”	31 October*	20bp cut to 0.3%
	20 – 21 November	No change
	18 – 19 December	20bp cut to 0.1%
** Interim update	21 – 22 January 2009 **	No change
	<b>18 – 19 February</b>	<b>No change</b>
	17 – 18 March	No change
	6 - 7 April	No change
	30 April *	No change
	21 – 22 May	No change
	15 – 16 June	No change
	14 – 15 July**	No change
	10 -11 August	No change
	16 – 17 September	No change
	13 – 14 October	No change (rates end 2009 at 0.1%)

Sources – Bank of Japan, Capital Economics