

Research

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Japan: BoJ on hold for some time yet

- During our Asian round trip we visited Tokyo talking to policymakers and local analysts. Everyone told us that it was only due to political pressure that the BoJ left interest rates on holds at the January meeting.
- In our view, the policy board of the BoJ seems to be split into (at least) two groups. One group believes that the BoJ should normalise monetary policy. This group believes that the BoJ should take the opportunity now, when the economy is undergoing a long-term economic expansion, to raise interest rates. The second group is much more concerned about the downside risk. Hence, they believe that the BoJ should be very data-dependent and that the bank should be very cautious in raising interest rates.
- Many local analysts still maintain that if Q4 GDP data, due on 15 February, come out on the strong side, the BoJ will hike interest rates. And the market currently sees a 75% chance that the bank will hike at the February meeting. We disagree, though. In our view, the weak private consumption and inflation indicators since the January meeting point to the BoJ leaving interest rates on hold at the meeting in February.
- Going forward, the likelihood that the BoJ will raise interest rates ultimately hinges on whether private consumption and inflation will begin to trend upwards. We note that the Japanese labour market may not yet be tight enough to create significant wage pressures stimulating consumption. Contrary to market expectations we see a significant risk that the BoJ will be forced to remain on hold for another couple of months, as it will have to wait for an uptrend in private consumption and inflation to develop.
- Our dovish view on the BoJ is in line with our bearish view on the yen (see *FX Crossroads: Yen to fall, dollar to rise*, 31 January). Moreover, we are convinced that a sudden unwinding of carry trades due to a forceful strengthening of the yen will not be triggered by a more hawkish BoJ.

Waiting for the Japanese consumer

Moving slowly

During our Asian roundtrip we spent four days in Tokyo talking to policymakers and local analysts. In *FX Crossroads: Yen to fall, dollar to rise*, 31 January, we outlined our view on the yen following our

trip. In this paper we dip deeper into the economic story unfolding in Japan and assess how it will likely affect monetary policy going forward.

The general perception among economists is that the Japanese economy experienced a soft patch in Q2-Q3 of 2006 – especially in private consumption.

At the root of the weakness in private consumption lies the slow feedback from strong corporate performance to wage growth. However, most observers see the weakness in private consumption as a temporary phenomenon that is primarily due to bad weather and reluctance to buy ahead of new product launches, etc. Most observers, including the Bank of Japan, believe that the Q4 GDP figures due on 15 February will show private consumption bouncing back strongly.

Going forward, there is some disagreement about how strong private consumption will be in 2007. All agree that the strong corporate performance and labour market tightness will eventually translate into rising wage pressures that will support private consumption – but the timing is disputed. Some argue that the tightness of the labour market will soon translate into wage pressures that will boost consumption. Others believe that the sluggish wage growth is due to deeply entrenched structural elements in the Japanese labour market that will not change overnight. These observers argue that wage growth is likely to be a weak supporter of private consumption for some time yet.

Bank of Japan credibility under fire

We arrived in Tokyo in the midst of some stormy weather for the Bank of Japan after it decided to leave interest rates on hold at the January meeting. Everyone told us that the BoJ had lost all credibility after this decision. Apart from the ever hawkish Mr Mizuno, it was most likely only board members Ms Suda and Mr Noda who voted for a rate hike at the January meeting. Rumours suggested a few board members had bowed to political pressure not to raise interest rates.

In our view, the policy board of the BoJ seems to be split into (at least) two groups. One group believes that the BoJ should normalise monetary policy, mainly so as to be capable of reacting to negative shocks in an accommodative way in the future. This group believes that the BoJ should take the opportunity now, when the economy is undergoing a long-term economic expansion, to raise interest rates. Furthermore, they would argue that even if current data is relatively weak, one should be looking at the trend and focusing on a forward-looking approach to monetary policy. This group comprises Mr Mizuno, Ms Suda and Mr Noda, and is probably also the group that Governor Fukui leans most towards.

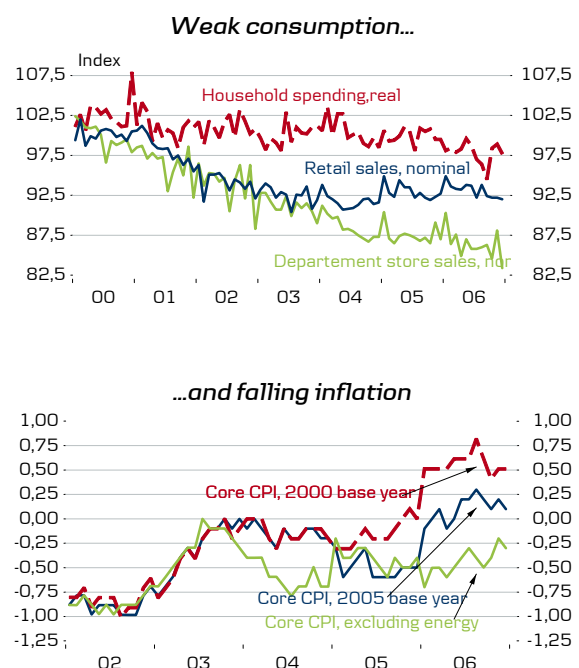
The second group is much more concerned about the risk of deflation in Japan. Hence, they believe

that the BoJ should be very data-dependent and that monetary policy has to be accommodative for some time yet. Therefore, in their view, the BoJ has to balance the forward-looking approach to monetary policy with current data flows. Deputy Governor Iwata obviously belongs to this group. The deciding factor at coming monetary policy meetings will ultimately be whether some of the more neutral members, e.g. Deputy Governor Muto, shift their position.

In our view, it is very likely that the BoJ will change its view on the economy in the half-yearly outlook report due at the end of April. The bank will stress that the corporate sector will remain a driving force for the economy for a longer period than initially expected. And, further, that the expected positive fallout from the corporate sector on the household sector is likely to be slower in coming than initially thought.

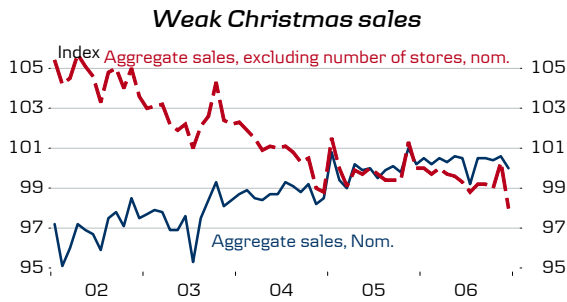
Bank of Japan on hold again in February

What then is our take on future monetary policy decisions by the BoJ? There has been a string of weak economic indicators since the January policy meeting. Most importantly, private consumption and inflation figures disappointed, but wage data, too, surprised on the downside. The only bright point was industrial production figures. Therefore, we believe the cautious stance the BoJ took at the January meeting has proven correct.



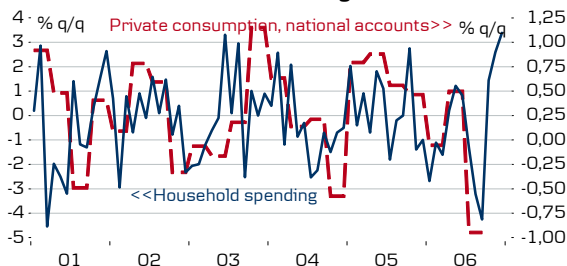
Furthermore, if one looks at a series such as aggregate sales, which are comprised of major sales

indicators of goods and services, the December data were also weak.



In our view, the weak private consumption indicators point to the BoJ leaving interest rates on hold at the meeting in February. The main reason the bank kept interest rates on hold at the January meeting was because of concerns about private consumption. The data since that meeting has not confirmed that the weakness in private consumption in H2 2006 was temporary. Many local analysts still maintain that if Q4 GDP data, due on 15 February, come out on the strong side, the BoJ will hike interest rates. And indeed the rebound in the monthly household spending indicator suggests that private consumption will jump to around 4% annualised. But our bet is that this will still not be enough for the doves in the BoJ to vote for a hike. Our view is contrary to current market pricing, which sees a 75% chance that the bank will hike at the February meeting

Private consumption rebounded in Q4 – but it will not be enough

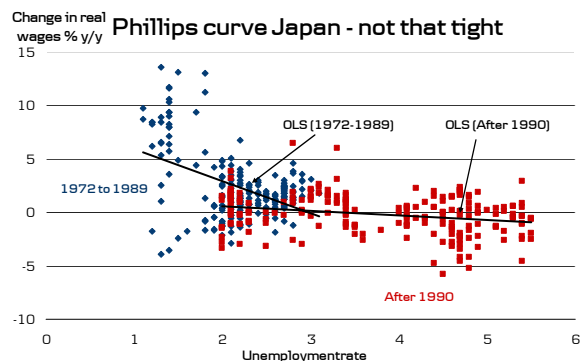


So, what about all the political noise? Obviously, there was political pressure on the BoJ in the run-up to the meeting in January. But, in reality, this is no different to what has been seen over the past couple of years. The BoJ is obliged by law (passed in 1998) to take into account the stance of the government. We don't buy the story that the only reason the bank did not hike in January was political pressure. As we wrote in *Flash Comment – Japan: BoJ on hold – and no hint of a near term rate hike*, 19 December, Fukui expressed concerns about the development of private consumption af-

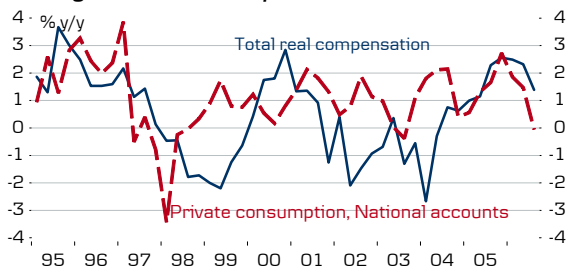
ter the meeting in December: this was the reason most board members wished to postpone a hike.

Moving beyond the February meeting, what the bank needs to see before raising interest rates is a confirmation that their basic story of the strong corporate performance spilling over to the household sector is in place. We do not buy the story on the streets that if the bank does not hike in February or March it will have lost its window of opportunity to hike before the Upper House election in July. The argument goes that the unpopular Prime Minister, Shinzo Abe, wants to show the public that the government has succeeded in overcoming deflation and the BoJ will not be obliged to destroy such a victory. In our view, if the data turns out to the better, the bank will raise interest rates without a second thought – that was what it demonstrated when it removed quantitative easing in March last year and raised the interest rate in July. Hence, the likelihood that the BoJ will raise interest rates ultimately hinges on whether private consumption and inflation will begin to trend upwards in the coming months. Below, we note a few points on this.

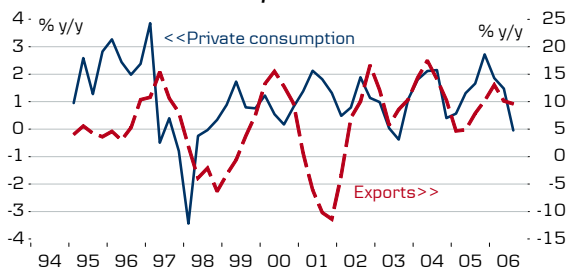
First, the Japanese labour market may not yet be tight enough to create significant wage pressures. As the graph below illustrates, historically, the unemployment rate may have to fall to fall below 3% before significant wage pressures build. Moreover, there may be some truth to the structural explanations behind sluggish wage growth. The large generations of baby boomers born right after the Second World War are now beginning to retire. These highly paid employees are being replaced by young people who struggled to find a job in the 1990's. Both their work experience and their wage demands are relatively low.



Second, the transmission mechanism from rising wages to rising private consumption is not that strong in Japan.

Wages and consumption – weak connection

Instead, private consumption in Japan is often driven by exports.

Still export driven

And with global industry still at relatively low levels Japanese exports/industry are likely to feel slight downward pressure in the coming months.

Pointing downwards

What about all the discussion on carry trades and the weakness of the yen? Could this lead the BoJ to act? The BoJ is definitely concerned about the extent of carry trades because a sudden unwinding of the trades would create very considerable volatility in the financial markets. But we do not see the BoJ raising interest rates to dampen carry trades. The BoJ is focused on economic activity and prices, and this will not change. Further, the dovish Japanese government will not put pressure on the BoJ to raise interest rates in order to strengthen the yen.

Where does this leave us in terms of the BoJ? As mentioned above, we don't see the BoJ hiking at the meeting in February – in contrast to current market pricing, which sees a 75 % chance that the BoJ will hike in February. Moreover, we see a significant risk that the BoJ will be forced to remain on hold for

another couple of months, as it will have to wait for an uptrend in private consumption and inflation to develop. This is also contrary to current market pricing, which is convinced that the BoJ will hike during the spring.

Our dovish view on the BoJ is in line with our bearish view on the yen (see *FX Crossroads: Yen to fall, dollar to rise*, 31 January). Finally, we are convinced that a sudden unwinding of carry trades due to a forceful strengthening of the yen will not be triggered by a more hawkish BoJ.

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