

# Flash Comment

January 22, 2009

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## Japan: BoJ fears a return to deflation

**Overview:** Bank of Japan (BoJ) today, as expected, left its leading O/N target rate unchanged at 0.1% in a unanimous board decision. In addition, BoJ revised its GDP forecasts sharply lower for both FY 2008 and FY 2009. Although BoJ still avoids using the D-word, it appears that it is becoming increasingly concerned about the possibility of a return to deflation in Japan. With the O/N target rate close to zero, the O/N target rate is no longer the main monetary instrument. As we stressed in our recent paper, BoJ has effectively turned to some kind of quantitative easing with the main focus on maintaining credit flows and boosting BoJ's balance sheet. Moving in this direction, BoJ today announced the final detail in its plans to purchase commercial paper and will possibly soon start to purchase corporate bonds outright in the market.

### Details:

- In connection with today's monetary meeting, BoJ released revised forecasts for GDP growth and inflation (see table below). Compared to the board members' previous forecasts from October 2008, GDP growth for FY 2008 and FY 2009 was revised sharply lower to -1.8% (previous: 0.1%) and -2.0% (previous: 0.6%), respectively. As seen in table below, BoJ's GDP forecasts are now more negative than our latest GDP forecast. While we do not know the details behind the bank's GDP forecasts, we reckon that the board members assume that GDP growth will continue to contract in H1 09 on the back of an extraordinarily sharp contraction in GDP in Q4 08 (-1.7% q/q according to our latest estimates).
- The inflation forecast for FY 2009 was cut to -1.1% from 0.0%, and more importantly the longer term FY 2010 inflation forecast was cut to -0.4% from 0.3%. In today's policy statement, it appears that BoJ is becoming increasingly concerned about Japan possibly returning to deflationary territory: "Turning to prices, there is a possibility that the inflation rate will decline further if downside risks to economic activity materialize or commodity prices fall. In this case, the risk of a decline in medium- to long-term inflation expectations of firms and households warrants attention."
- BoJ today announced the final details in its plans to purchase commercial paper. The CP purchasing program will last until March 31 2009 and the limit on BoJ's total purchase will be JPY 3 trn. Commercial paper with maturities less than three months and a1-ratings will be eligible. In addition BoJ will examine direct purchase of corporate bonds, and eligible collateral for BoJ lending was broadened further by including commercial paper and corporate bonds issued by real estate investment corporations.

**Implications:** The latest BoJ forecasts paint a very bleak picture of the Japanese economy: despite a sharp contraction in Q4 08, the economy will most likely continue to contract in H1 09 and there are increasing risks of a deflation scenario. However, we are unlikely to see another (small) interest rate cut, as most BoJ board members believe slightly positive interest rate are preferably to zero rates, to improve the efficiency of the money market. Hence, the leading O/N target rate is likely to remain unchanged at 0.1% well into 2010. The very bleak outlook will increasingly force BoJ to consider "unorthodox" easing measures. BoJ is already moving in this direction, albeit reluctantly. The initiatives announced today are modest and the

growth in the BoJ monetary base and balance sheet has still been modest compared to the Fed, Bank of England and ECB. That said, we should not expect short term miracles from the BoJ's efforts to increase credit availability for the private sector. The current weakness in the Japanese economy has primarily been driven by an external demand shock, and not a domestic credit crunch as in the US and most of Europe.

### Bank of Japan board members' forecasts for the Japanese economy, January 2009

% y/y		GDP	DB	CPI	DB
Fiscal 2008	Median	-1.8 (0.1)	<b>-1.4</b>	1.2 (1.6)	<b>1.3</b>
	Range	-2.0 to -1.7		1.1 to 1.2	
Fiscal 2009	Median	-2.0 (0.6)	<b>-1.1</b>	-1.1 (0.0)	<b>-0.8</b>
	Range	-2.5 to -1.9		-1.2 to -0.9	
Fiscal 2010	Median	1.7 (1.7)	<b>1.2</b>	-0.4 (0.3)	<b>0.3</b>
	Range	1.5 to 1.9		-0.6 to 0.0	

Note: Numbers in brackets are previous BoJ forecast from October 2008. DB figures are the latest forecast from Danske Bank. Note that the forecasts covers fiscal years starting in April 1 and finishing March 31.

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