

15 June 2009

Flash Comment

Japan: Bank of Japan preview

- With signs that the economy is stabilising and financial stress easing, we do not expect BoJ to announce new quantitative easing measures in connection with the close of its monetary meeting tomorrow.
- BoJ's view of the economy is expected to be marginally more positive. However, a substantial change in its view of the economy is more likely to happen at the July meeting.
- We expect BoJ to start tightening in Q3 10. However, a 'technical' rate hike to improve the functionality of the money market before Q3 10 cannot be completely ruled out.

Assessment

The Bank of Japan (BoJ) today starts its two-day monetary meeting. The bank is expected to announce its decision at around 06:00 CET tomorrow morning. We expect BoJ to leave its leading O/N target rate unchanged at 0.1%. Anything else will be a big surprise. All 23 economists surveyed by Bloomberg expect BoJ to leave its leading interest rate unchanged.

In addition, we do not expect BoJ to announce any new non-conventional monetary easing initiatives. At the moment, it appears that BoJ's recent initiatives including purchase of commercial paper and short-term corporate bonds have worked as intended as both commercial paper and corporate bond yields have declined substantially from their peaks in early 2009 (see chart). We do not expect BoJ to step up its purchases further. While government bond yields have increased recently in line with the global trend, the increase in government bond yields in Japan so far has been modest compared with the US.

Finally there are signs that the economy has started to stabilise and in the past week there has been some speculation that BoJ will upgrade its view of the economy further. At its previous meeting in May, BoJ upgraded its view of the economy by saying that it believed that the economy is 'bottoming out'. We only expect BoJ to be marginally more positive about the Japanese economy tomorrow. It is still too early for BoJ to make the big jump and say that the economy is 'expanding'. A major change in BoJ's view of the economy is more likely to happen at its next meeting on 14-15 July, when BoJ will provide new board member forecasts for the Japanese economy.

With signs that financial stress is subsiding and the global economy stabilising, central bank focus globally will increasingly turn to how to unwind the massive quantitative easing. However, compared with other countries, this will be a minor issue in Japan as the size of quantitative easing (measured by the increase in central bank's assets) in Japan has been modest compared with other countries (see chart).

Outlook

While we believe Japanese growth will outperform in H2 09, we do not expect BoJ to be among the first major central banks to tighten monetary policy. The output gap remains substantial and headline and core inflation will remain negative well into 2010. We currently expect BoJ to start tightening monetary policy in Q3 10. That said, the discussion about ultra-low-interest-rate policy and its dysfunctional impact on money markets has rekindled in recent weeks in Japan. Hence, a 'technical' interest hike before Q3 10 to improve the functionality of the money market cannot be completely ruled out.

One-year forward O/N call rate is currently trading at 0.13% (mid-price), suggesting the markets see very little likelihood of a rate hike within the next year. 18-month forward O/N call is trading at 0.16%.

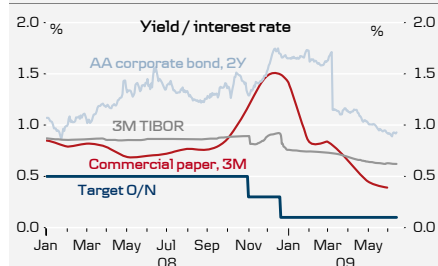
Expected outcome

	DB	Con	Previous
O/N Target	0.1%	0.1%	0.1%
Treasury purch.*	1.8trn	na	1.8 trn

*Target for monthly purchase of treasury bonds

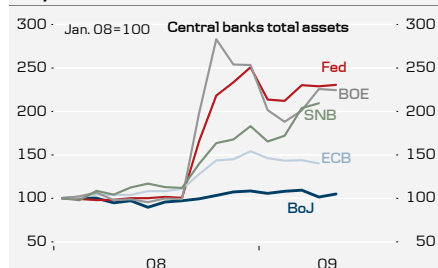
Source: Bloomberg, Danske Bank

Monetary transmission has started working



Source: EcoWin, Markit

Quantitative easing so far modest in Japan



Source: EcoWin, Markit

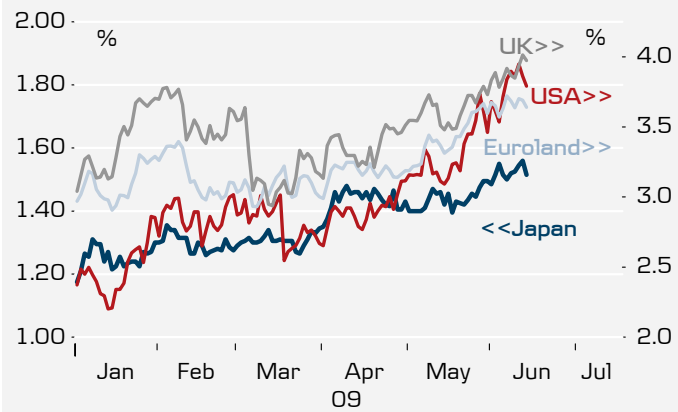
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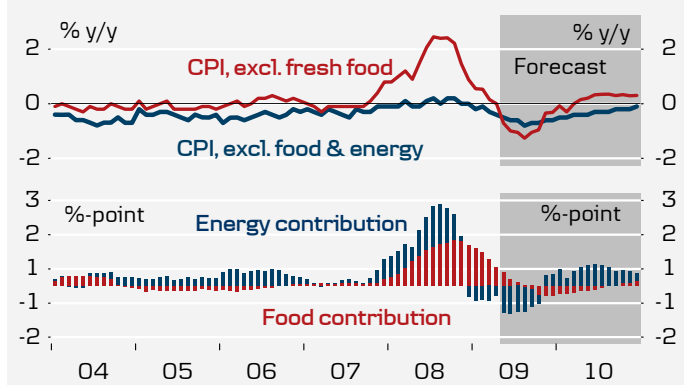
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Benchmark 10-year treasury bond yields



Source: EcoWin, Danske Bank, Markit

CPI inflation will remain negative for most of 2009



Source: EcoWin, Danske Bank, Markit

Disclosure

This report has been prepared by Danske Research, which is part of Danske Markets, a division of Danske Bank. Danske Bank is under supervision by the Danish Financial Supervisory Authority. The author of this report is Flemming J. Nielsen, Senior Analyst.

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First date of publication

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