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Japan – Flow-of-funds wraps up a bad FY09

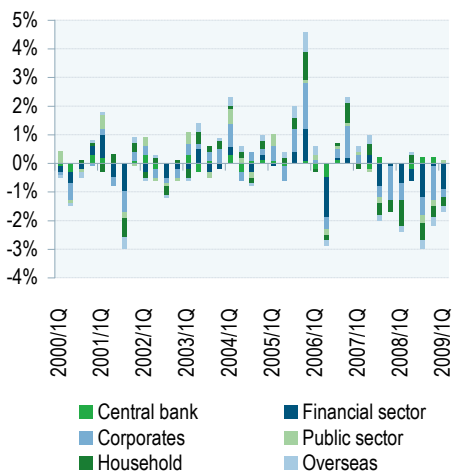
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- Flow-of-funds data shows record financial shrinkage in FY09
- We expect a rebound in Q2 as asset prices recover, but real economy is still a drag
- Data also points to rising capitalisation pressure in the financial sector

Record pullback in FY09

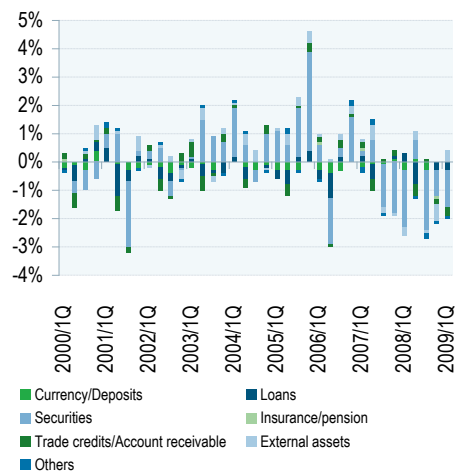
The latest flow-of-funds (FoF) data suggests that Japan’s economy suffered its seventh straight quarter of balance-sheet contraction in Q1-2009. Total financial assets ended the quarter at JPY 5,709trn, down by 1.6% q/q and by 6.4%, or JPY 393trn, y/y. This makes FY09 (ended 31 March 2009) the worst year since 1997 in terms of the shrinkage in financial claims, surpassing both FY08 (a decline of JPY 336trn) and FY02 (JPY 154trn). All sectors but the public sector continued to register declines in their financial assets, with financial sector leading the decline in the quarter. By asset class, securities suffered another quarter of heavy contraction due to the continued fall in stock prices in the period, which, combined with a decline in the stock of loans and other credit arrangements, more than offset a rebound in external assets (see Charts 1 and 2).

Chart 1: Balance-sheet changes by sector (ppt contribution to q/q growth)



Sources: BoJ, SBC Global Research

Chart 2: Balance-sheet changes by asset class (ppt contribution to q/q growth)



Sources: BoJ, SCB Global Research



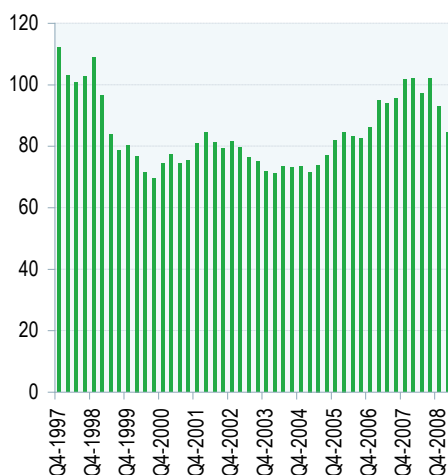
Both real and financial developments drove the contraction

In particular, we observe that:

- On top of the continued decline in loans, there was a sharp decline in trade credit in the quarter, echoing the unprecedented plunge in trade flows.
- There were some signs of stronger public-sector contribution to financial asset growth as the government stepped up its lending and credit programmes, but the overall impact was muted. Moreover, the central bank's balance sheet grew by only JPY 1.3trn after jumping by more than JPY 10trn the two previous quarters. The slowdown in growth came as lower loan placements offset increased securities holdings.
- Household cash holdings fell to JPY 787trn from a peak of JPY 791trn in Q4-2008, though corporate cash holdings climbed to JPY 208trn, the highest since Q1-2006, from JPY 201trn.
- Outward investment was surprisingly buoyant. Nearly all economic sectors registered rebounds in their holdings of foreign assets, whether direct or securities/debt investments.
- Loan liabilities assumed by the external sector fell further to JPY 84.4trn as of end-Q1-2009 from JPY 93trn at end-Q4-2008 and a peak of JPY 102trn a year earlier. This points to ongoing deleveraging of yen carry trades (see Chart 3).
- Depository institutions' capital liabilities dropped for a third year, by JPY 22trn, to end FY09 at JPY 56.4trn. This amounted to 3.8% of these institutions' total assets, the lowest since FY03 (see Chart 4).

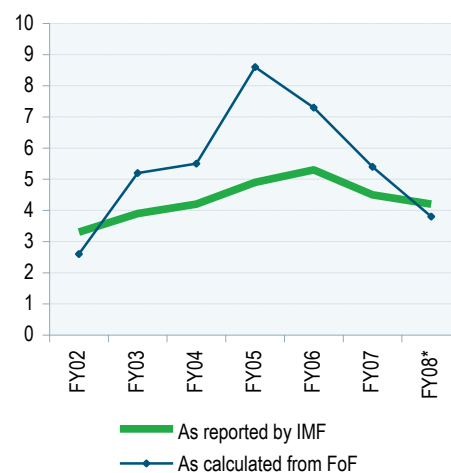
These developments broadly reflect what we already know: that despite aggressive policy actions in Q4-2008, Q1-2009 remained a period of deep financial-sector distress and severe economic contraction. The central bank's failure to expand its balance sheet further, despite the various outright purchase programmes introduced during this period, was a further setback. Yet even in this gloomiest of moments, the relative strength of outward investments does hint at some resilience in local sentiment, a development that has likely extended into Q2.

Chart 3: Loan liabilities assumed by the overseas sector (JPY trn)



Sources: BoJ, SBC Global Research

Chart 4: Capital ratio* (%)



* IMF figures are based on financial statements of all banks published by the Japanese Bankers' Association, whereas FoF data covers all depository institutions. IMF data for FY08 was estimated as of Sep-08;
Sources: BoJ, IMF, SCB Global Research



Rebound likely in Q2, but risks remain

Indeed, the broad rebound in asset markets in Q2 should provide a respite from the year-long contraction in the nation's balance sheet. Yet, while the nearly 20% rebound in stock prices since April should support a rebound in financial holdings, still-poor readings for demand indicators like housing starts and exports probably suggest that financial claims which are more linked to the real economy (such as loans, trade credit, and accounts receivable) will remain under pressure. The continued drop in financial-sector capital in Q1, to the tune of JPY 4trn, also casts doubt on the effectiveness of various 'carve-out' measures announced by the authorities in recent months to relieve banks' capital distress in the face of their large losses in FY09. The risk is that, despite the potential for some near-term valuation relief, operating losses will continue to mount. This would put continued capitalisation pressure on banks and drag on the re-leveraging process when real demand finally picks up.



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