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Japan – Not quite the Christmas present

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- The lending facility announced today by the BoJ will bring only brief relief to the central bank and the economy; we expect the government to push for more
- We argue that this monetary policy debate has its roots in fiscal policy
- What the government really wants from the BoJ is more JGB purchases in 2010

BoJ ends one easing cycle with... another

The Bank of Japan (BoJ), in an unscheduled meeting today, announced yet another JPY 10trn lending facility for financial institutions, which it hopes will lower longer-term money market rates. This comes barely one month after the central bank's decision at its 30 October meeting not to extend its credit market programmes beyond their scheduled expiry dates. The proximate trigger of this new round of easing is more home-grown than the global credit crunch of a year ago. The government formally declared in its 20 November monthly economic report that the economy is now in "mild deflation". This was followed by major officials stepping up their calls for the central bank to "combat deflation". Today's announcement was the latest effort by the central bank to reinforce its easing stance. The key question is: did the government get what it wanted today?

It is interesting to note that, when it comes to assessing the economy, the central bank and the government actually differ very little. Both forecast falling prices in years ahead. Both have noted that the economy is "picking up", driven by private consumption and exports, but recognise the fragility of the current rebound. And while the decline in headline CPI widened to another record of 2.5% y/y in October, there has been no notable widening in core price deflation that would explain the government's suddenly toughened stance.

The fiscal aspect of the monetary policy debate

We suspect that the government is pushing the BoJ to avert a potential fiscal blow-out, not deflation. Specifically, with the market increasingly fretting over a record JPY 44trn (or more) of Japanese Government Bond (JGB) issuance next year, there is now a more urgent need for the government to assuage fears of a supply glut. In this context, the BoJ's previous quantitative easing (QE) regime clearly demonstrated the central bank's ability to absorb massive JGB purchases through balance-sheet expansion.

As a brief recap, the BoJ has experienced two episodes of quantitative easing over the past decade. The first, which began in February 1999 and lasted until August 2000, was a response to the fallout from the Asian financial crisis; it ended as the technology boom fostered hopes of a recovery. The bursting of the IT bubble proved these hopes false within months, forcing the central bank to enter another period of quantitative easing in March 2001. This period would last five years. Table 1 highlights the key measures taken during the two QE eras, and shows that JGB purchases were a major policy tool used by the BoJ during both.

Important disclosures can be found in the Disclosures Appendix



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**Table 1: Timeline of unconventional BoJ monetary policy measures**

	Details
1998 – the run-up to the first QE regime	<ul style="list-style-type: none"> • Range of eligible collateral broadened to include corporate bonds, loans on deeds, asset-backed commercial paper (ABCP), and other forms of asset-backed securities (ABS) • Liquidity provided at longer terms by extending the maturity of bill purchases and Japanese Government Bond (JGB) repos from 6M to 1Y • Number of counterparties for JGB purchases and commercial paper repo operations increased • OCR lowered 25bps to 0.25% in Sep-1998
The first QE regime from Feb-1999 to Aug-2000	<ul style="list-style-type: none"> • Shift to ZIRP – policy rate encouraged to move “as low as possible” • Actual rates as low as 0.02% • Tools used: JGB repos and JGB outright purchases • BoJ issued statement to clarify its policy in Sep-1999 • BoJ issued statement to pave way for exit in Jul-2000 • ZIRP I ended Aug 2000; OCR raised to 0.25%
The intermission between Sep-2000 and Feb-2001	<ul style="list-style-type: none"> • Lombard-type standby lending introduced 09-Feb-01 • Discount rate cut by 15bps to 0.35% • Outright purchases of ST govt securities increased • Bill purchases broadened in Jul-2001
The second QE regime from Mar-2001 to Mar-2006	<ul style="list-style-type: none"> • Discount rate cut by 10bps to 0.25% on 01-Mar-01 • Operating target changed from Overnight Call Rate (OCR) to banking-sector Current Account (CA) on 19-Mar-01; target CA at JPY 5trn • Positive CPI target made explicit 19-Mar-01 • More JGB purchases pledged on 19-Mar-01, capped by outstanding bank notes • Further expansion of JGB purchases in Aug-2001; target CA at JPY 6trn • Further expansion of JGB purchases in Sep-2001; target CA at JPY 8trn; discount rate lowered to 0.1% • Further expansion of JGB purchases in Dec-2001; target CA at JPY 10-15trn • Active CP repo/ABS repo/bill purchases in Dec-2001 • Further expansion of JGB purchases in Feb-2002; further relaxation of Lombard access; further relaxation of collateral • Further expansion of JGB purchases in Oct-2002; target CA at JPY 15-20trn; maturity for bill purchases extended from 6M to 1Y • CA target set at to JPY 17-22trn in Mar-2003 • CA target raised to JPY 22-27trn in Apr-2003 • CA target raised to JPY 27-30trn in May-2003 • CA target raised to JPY 27-32trn in Oct-2003; maturity cap for govt securities repo extended from 6M to 1Y • CA target raised to JPY 30-35trn in Jan-2004
Second QE regime ended Mar-2006	<ul style="list-style-type: none"> • Operating target changed from CA to OCR Mar 2006; OCR effectively at 0% • OCR raised to 0.25% Jul 2006; discount rate at 0.4% • OCR raised to 0.5% Feb 2007; Discount rate 0.75%
Credit crisis measures Sep-2008 to Nov-2009	<ul style="list-style-type: none"> • Coordinated USD facility introduced on 18 and 29-Sep-08 (both unscheduled) • Further strengthening of USD facility 13-Oct -08 • Broad JGB purchase programme on 14-Oct-08; access to securities lending facility relaxed; CP repo expanded; collateral expanded • OCR lowered by 20bps to 0.3% on 31-Oct-08; discount rate at 0.5%; interest of 0.1% paid on excess reserves • BoJ commits to conduct CP repo “more flexibly” in Nov-2008 • Outright purchases of corporate bonds introduced 02-Dec-08 (unscheduled) • OCR lowered by 20bps to 0.1% on 19-Dec-08; discount rate at 0.3%; interest of 0.1% paid on excess reserves • Details of CP purchase programme released Jan-2009 • Special funds-supplying operation, outright corporate bond purchase in Feb-2009 • Further expansion of JGB purchases in Mar-2009 • Collateral expanded in Apr-2009 • Measures to Dec-2009 or Mar-2010 • Pledge in Nov-2009 of no extension of measures when they expire • New JPY 10trn lending facility announced at unscheduled meeting on 01-Dec-09

Sources: BoJ, IMF, Standard Chartered Research

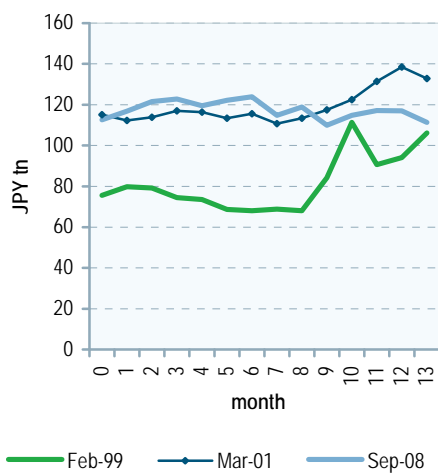


The 2009 easing – all bark and no bite

An interesting question is how the BoJ's response to the current crisis compares to previous responses. The inconvenient fact is that, notwithstanding all the liquidity measures announced, what the BoJ has done since last year's credit crisis falls short of monetary easing from a balance-sheet perspective. Specifically, these unconventional measures started as co-ordinated moves to address the global need for USD liquidity, and were followed by measures that allowed the central bank to directly intervene in the corporate credit markets. On the other hand, JGB purchases, which played an important role during previous QE periods, were not emphasised, and the operating target never shifted away from the OCR as it did during the 2001-06 episode.

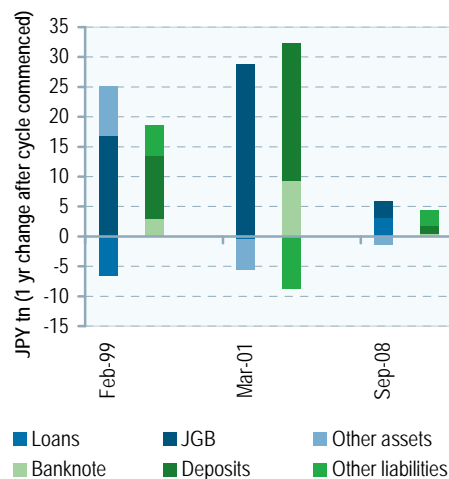
The result is a far tamer balance-sheet expansion in the current easing cycle (see Chart 1). During the 12-month period that ended in Q3-2009, the BoJ managed to increase its balance sheet by only JPY 4.4trn. This pales in comparison to gains of JPY 18.5trn and JPY 23.5trn during the 1999 and 2001 QE periods, respectively.

Chart 1: BoJ balance sheet in previous easing cycles



Sources: BoJ, Standard Chartered Research

Chart 2: Change in asset/liability components



Sources: BoJ, Standard Chartered Research

The contrast is also evident when we examine the key components of these balance-sheet changes (see Chart 2). The two previous QE cycles left strong footprints on the BoJ's balance sheet in the form of JGB holdings on the asset side and assumed deposits on the liabilities side – the latter a reflection of the current account balance of the financial sector, which was an explicit operating target under the 2001 QE regime. In contrast, direct lending is now the main source of asset growth, while the impact on assumed deposits has been negligible. In short, the very essence of QE – namely, the expansion of the central bank's balance sheet for the purpose of base money creation – has been largely absent during the current easing cycle.

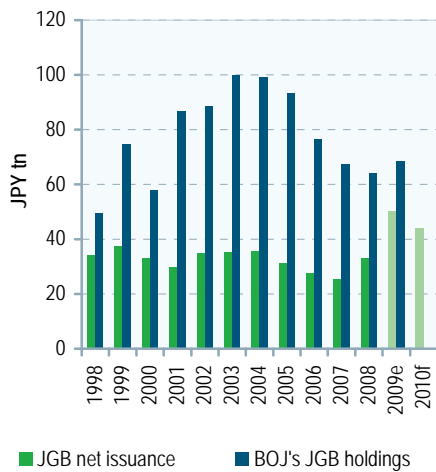
As such, we are inclined to view the BoJ's credit-market measures over the past year as stop-gap attempts to boost confidence at a time of extreme market fear, rather than a systemic injection of 'quantitative' liquidity from a monetary policy perspective. While the bank's pledge to purchase commercial paper and corporate bonds does constitute a potential channel for QE, in reality, related holdings of these securities totalled only JPY 350bn as of September, which does not even put a dent in the overall picture. The expansion of credit facilities, as announced today, does help the financial sector cope with unforeseen liquidity tightening to some extent. Yet the passive nature of these facilities works in much milder ways than active JGB purchases by the central bank from a balance-sheet perspective, as the introduction of various lending facilities in recent years demonstrates.



We expect more JGB purchases by the BoJ next year

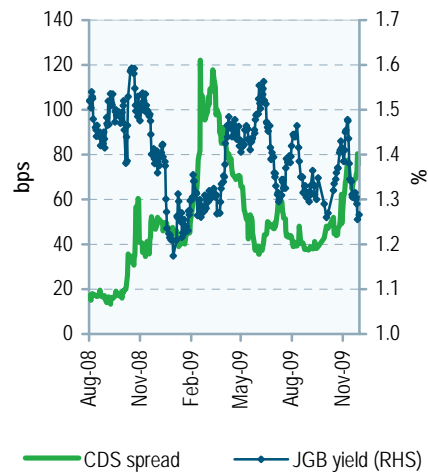
Thus, we do not see today's BoJ measures as providing true relief to a government that is about to embark on the biggest fiscal funding exercise in the country's history. The near-term risk is that, without BoJ purchases, the sheer supply of new JGBs could push up real yields and tighten monetary conditions in general (see Chart 3). JGB yields and sovereign CDS have diverged in recent weeks as the former benefited from the recent flare-up of deflation fears, while the latter were supported by concerns over the coming JGB supply glut (see Chart 4). We believe these developments warn of a renewed deterioration in the credit market which the BoJ cannot ignore. We therefore expect the central bank to eventually expand its JGB purchases next year, albeit in a reluctant and gradual fashion. Throughout most of this year, we have called on the BoJ to restart QE to avert deflation (see **OTG, 7 April 2009, 'Japan – Relapse into deflation'**) – a call that the central bank has steadfastly resisted. The irony is that current fears of fiscal fallout at home may achieve what the deflation threat has failed to, giving the central bank the final push it needs into a true QE regime.

Chart 3: Net JGB issuance and BoJ's JGB holdings



* FY basis; JGB issuance for FY09 is an estimate, and that for FY10 a target, based on latest official comments; BOJ's JGB holdings for FY09 are as of Sep-09;
Sources: BoJ, Standard Chartered Research

Chart 4: JGB yields and CDS



Sources: Bloomberg, Standard Chartered Research



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