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Treasury & FX Group

Quid Pro Quo

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Economic report

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End of Days? BoJ Does it Again

Controversy-

The Bank of Japan, after seven years, ended the era of the zero interest rate policy in Japan. Was the move warranted? Or is it the case of too much too soon given that quantitative easing (covered in one of our earlier issues) had been done with only some time back.

Contention-

Indications are plenty that Japan's economic recovery is once again building momentum. In our opinion, abandoning the 'Zero Interest Rate Policy' is more a step towards normalization of monetary policy instead of cyclical policy tightening. With the expanding economy supported by increased consumer spending, solid corporate activity and continued improvements in exports, such a move seemed justified.

Market impact-

With the economy already in momentum and the consumer and business sentiment strong, an end to Zero Interest Rate Policy will not have much effect. However, a close eye on inflation, consumer sentiment surveys and subsequent BOJ moves with regards to monetary policy should provide useful insights.


Risk-

Previously, bad decisions from the BoJ, have had long lasting impacts on the Japanese economy and have been the topic of many discussions. This could be another feather in their much-decorated cap.

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As widely expected, the Bank of Japan decided, on Friday 14 of July 2006, to end the zero interest rate policy. As our readers might remember our issue on the end of Quantitative Easing some time back, we feel that a discourse on this latest development will be a complement to that issue.

BOJ's official statement

Change in the Guideline for Money Market Operations

July 14, 2006


1. At the Monetary Policy Meeting held today, the Bank of Japan decided, by a unanimous vote, to change the guideline for money market operations for the inter meeting period, effective immediately from the announcement of the decision.


The Bank of Japan will encourage the uncollateralized overnight call rate to remain at around 0.25 percent.

2. With respect to the complementary lending facility, the Bank decided, by a 6-3 majority vote, to change the basic loan rate[Note] applicable under the facility to 0.4 percent, effective immediately from the announcement of the decision, and maintain the temporary waiver of add-on rates for frequent users of the facility.

With respect to the outright purchases of long-term interest-bearing Japanese government bonds, purchases will continue at the current amounts and frequency for some time, with due regard for future conditions of the balance sheet of the Bank.

3. Japan's economy continues to expand moderately, with domestic and external demand and also the corporate and household sectors well in balance. The economy is likely to expand for a sustained period. Developments are broadly in line with the projection in





the Outlook for Economic Activity and Prices (hereafter the Outlook Report) released on April 28, 2006. The year-on-year rate of change in consumer prices is projected to continue to follow a positive trend.


4. The Bank has maintained zero interest rates for an extended period, and the stimulus from monetary policy has been gradually amplified against the backdrop of steady improvements in economic activity and prices. In this environment, maintaining the previous level of the policy interest rate may result in large swings in economic activity and prices in the future.

Taking account of the current assessment of economic activity and prices from the two perspectives outlined in the New Framework for the Conduct of Monetary Policy (March 2006), the Bank judged it appropriate to adjust the level of the policy interest rate at this juncture so that a desirable course of economic activity and prices was to be maintained. Today's policy decision will contribute to ensuring price stability and achieving sustainable growth in the medium to long term.

5. On the future path of monetary policy, the Bank will conduct monetary policy by carefully assessing economic activity and prices. The Bank will adjust the level of the policy interest rate gradually in the light of developments in economic activity and prices if they follow the projection presented in the Outlook Report. In this process, an accommodative monetary environment ensuing from very low interest rates will probably be maintained for some time.

[Note] The basic loan rate is stipulated in Article 15, Paragraph 1, Clause 2 of the Bank of Japan Law. The basic discount rate in Clause 1 in the same paragraph is also set at 0.4 percent (Discounting bills has been suspended).





The Policy Board of BOJ made the decision at the end of its two-day meeting. It is the first interest rate hike since the central bank raised the key short-term rate to 0.25 percent from near zero in August 2000.

Along with the policy shift, the BOJ also raised the official discount rate to 0.40 percent from the current 0.1 percent. The discount rate serves as the ceiling for the overnight call rate.

The markets had expected the board would approve the rate rise. BOJ policymakers had been warning that under the current monetary policy, overheated capital investment could make economic activity more volatile.

Rationale


Business Sentiment


The June BoJ *Tankan* revealed solid business sentiment readings, sharp growth in planned capital spending and gradual diminishing of spare capacity, justifying a scaling-back of monetary stimulus with zero interest rates. The business conditions improved, as measured by the judgment diffusion index (DI) for large manufacturers, which rose to a level, close to the high of post-bubble history.

Moreover, large non-financials' FY2006 capital spending plans were revised up from 2.7% to 11.6%, the highest since June FY1990.

Inflation

Moreover, policymakers had been indicating that they may be too becoming too complacent about prospects for subdued inflation for an extended period of time. The pickup of core inflation excluding fresh food to 0.6% yoy in May from 0.5% yoy in April reflected not only higher energy costs, which were no longer considered to be temporary, but also price hikes in wage-sensitive private services.






Moreover, the BoJ's 2Q 2006 consumer survey revealed a pickup in the median one-year inflation expectation to 2.0% after remaining at 0.0% for more than two years. As Japanese consumers are not used to a positive inflation environment, the absolute forecast level may not be very reliable. Still, the fact that inflation expectations had finally turned up was notable.


Labor and wages

Monthly Labor Survey figures released on July 3 showed the first decrease in average monthly total cash earnings per regular employee (-0.5% yoy) in four months. The number of employees remained in a moderate uptrend, but the per-employee real wage has averaged a 0.2% yoy decline since the start of 2006 after averaging +1.2% yoy in the second half of 2005, which suggests that firms are focusing on relatively low-cost part-time workers in their efforts to address growing personnel shortages. That said, the number of full-time employees rose 1.1% yoy in May, while the number of part-timers increased by just 0.1%. In particular, the pace of year-on-year growth in regular employee numbers had been steadily building within the manufacturing sector.

More Glory

The Bank of Japan noted in April that the output gap “seems to have closed.” This was followed soon after by an S&P upgrade of Japan's credit rating outlook to positive from stable, a sign that the country had, at long last, turned a corner. As well, after years of shedding the “triple excesses” of capacity, employment and debt, Japan's corporate sector is finally in reasonable health again. Banks had slashed their non-performing loan ratio from 8.4% of total loans in 2002 to 2.4% in 2005. A sickly balance sheet for the banking sector had been a major stumbling block for the Japanese economy for years. The improved condition of corporations is reflected in increased corporate borrowing.






After steadily declining for almost a decade, bank lending has finally started to increase on a year-on-year basis

All of the above indicated that Japan's economic recovery is once again building momentum. Hence, the time seemed right after seven years, for the era of the zero interest rate policy in Japan to end; a declaration of victory over the 1990s collapse of the property bubble that had shackled the Japanese economy and sent the country into a deflationary spiral.

Future Prospects

Already the 5-year experiment with quantitative easing had been discarded, and following it up with abandoning the 'Zero Interest Rate Policy' is more a step towards normalization of monetary policy instead of cyclical policy tightening. As regards to its future conduct of monetary policy, the BOJ said that any adjustment in the level of policy rates would likely to be gradual, depending upon developments of economic activities and prices. In this regard, all economic indicators along with asset prices have to be closely watched. An eye also needs to be kept on all surveys that measure consumer and business sentiment as well as any comments from the BOJ members.



Economic Snapshot

		Fiscal year 06												
	Units	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April	May	June	July-June
<u>Inflation</u>														
Headline Inflation	%	8.99	8.41	8.53	8.27	7.89	8.51	8.76	8.05	6.91	6.16	7.12	7.65	7.92
Core inflation	%	7.62	7.55	7.58	7.81	7.59	7.36	7.34	7.00	6.67	6.43	6.58	6.29	7.11
Food inflation	%	9.73	7.82	7.52	6.41	5.84	8.1	8.17	7.48	5.42	3.64	5.59	7.78	6.92
Non-food inflation	%	8.47	8.83	8.25	9.61	9.38	8.8	9.18	8.44	7.98	8.01	8.21	7.55	8.63
<u>T-bill (Wgt Avg)</u>														
3 month	%	7.69	7.99	8.10	8.10 id rejected		8.09	8.10	8.10	8.10	8.10	8.10	8.33	n/a
6 month	%	7.97	8.12	8.14	8.14 id rejected		8.25	8.29	8.29	8.29	8.29	8.29	8.49	n/a
12 month	%	8.69	8.78	8.79	8.77	8.79	8.77	8.75	8.78	8.79	8.79	8.79	8.79	n/a
<u>External Sector</u>														
Export	Mln US\$	1,269	1,401	1,483	1,325	1,114	1,455	1225	1229	1513	1450.9	1488.9	1515	16,469
Import	Mln US\$	1,997	2,235	2,322	2,325	2,300	2,475	2145	2210	2682	2258.9	2648.5	2986	28,584
Trade balance	Mln US\$	(728)	(834)	(839)	(1,000)	(1,186)	(1,020)	(920)	(953)	(1169)	(808)	(1160)	(1471)	(12,087)
Remittances	Mln US\$	313	348	341	373	309	371	391	358	424	401	507	464	4600
Forex reserves	Mln US\$	12613.2	12123.9	12000.3	11714.8	11341	11669	11504.7	11516	12487	13021	13003	13137	n/a
<u>Key</u>														
n.a		not available												
n/a		not applicable												



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