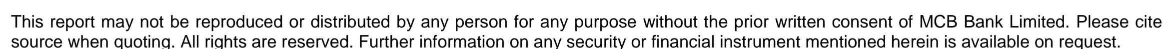
MCB Bank Limited
Formerly Muslim Commercial Bank limited

Treasury & FX Group

Quid Pro Quo

Issue 8 **Economic report** *March 15th 2006*

End of Quantitative Easing- is BoJ Taking the Punch bowl Away?



Controversy-
Does the end of quantitative easing (QE) by BoJ represent the formal end to the era of cheap finance and will it result in the end of the global liquidity glut?

Contention-
The end of QE is indicative of a return to health of the Japanese banking system, and does not on its own signify any real tightening by the Bank of Japan (BoJ). With zero interest rate policy (ZIRP) still in place, and inflation leading to positive real rates of interest, Japan's monetary policy remains more accommodative than ever.

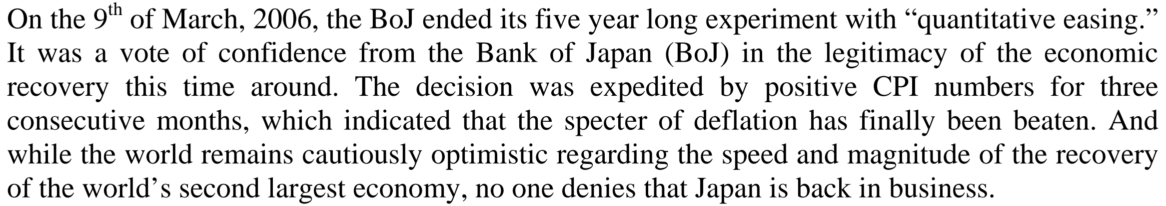
Market impact-
QE matters little on a here and now basis. Its end should have little impact on global currency and financial markets. However, when BoJ terminates ZIRP and raises interest rates, expect the unwinding of carry trades and an appreciation of the Yen/US$ exchange parity.

Risk-
With a torrid seven year experience with deflation, BoJ will not raise interest rates in a hurry. Japan may yet, for some time, remain the largest creditor country in the world.

The information contained in this publication is for information purposes only. The information contained herein has been obtained or derived from public sources believed by us to be reliable, but we do not represent that it is accurate or complete and it should not be relied upon as such. Any opinions or predictions constitute our judgment as of the date of this publication and are subject to change without notice. The information contained herein is not meant to be, nor shall it be construed as, an offer by MCB Bank Limited or any of its affiliates to offer to buy or sell any financial product. Readers are expected to make their own investment decisions without undue reliance on this report and the company accepts no responsibility whatsoever for any direct or indirect consequential loss arising from any use of this report or its contents. The Bank may from time to time hold positions in, and may effect transactions in, the currencies and securities mentioned herein.

Generally, this report may only be distributed to professional and institutional investors.

This report may not be reproduced or distributed by any person for any purpose without the prior written consent of MCB Bank Limited. Please cite source when quoting. All rights are reserved. Further information on any security or financial instrument mentioned herein is available on request.



On the 9th of March, 2006, the BoJ ended its five year long experiment with "quantitative easing." It was a vote of confidence from the Bank of Japan (BoJ) in the legitimacy of the economic recovery this time around. The decision was expedited by positive CPI numbers for three consecutive months, which indicated that the specter of deflation has finally been beaten. And while the world remains cautiously optimistic regarding the speed and magnitude of the recovery of the world's second largest economy, no one denies that Japan is back in business.

Key economic indicators are flashing green across the board, and generically speaking, the Japanese recovery should be good news for everyone. Long the laggard, Japan can finally hope to provide new momentum to already robust economic growth. This sounds a little hard to believe in the face of more than a decade of economic decadence; however, one need only look back to the 1980s to remember the fear and veneration that the Japanese miracle inspired. Japan is back, once again with a point to prove.

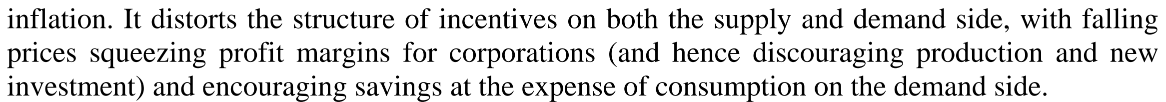
However, one can argue that the road to heaven is paved with bad intentions. International finance is often a zero-sum game, and Japan's recovery is no blanket for hope. In a financial world dependent on a stagnant Japan as a premier source of cheap liquidity, Japanese inflation, and expected tightening is not good news. True to script, conspiracy theories regarding the potential destabilizing impact of BoJ's end to QE came in thick and fast. However, as we explain below, most of the concerns are unwarranted for the moment.

QE- Much Ado about Nothing

The end to quantitative easing is significant, but primarily as a historical event. It heralds the formal recognition of the Japanese recovery, and ends a five-year long experiment in central banking. It also signals the beginning of the end of Japan's ultra-loose monetary policy, and indicates that tightening shall ensue in due course. For all practical purposes, however, it does not mean much on a here and now basis. Global currency and financial markets should remain largely unaffected.

Here is why. Essentially, quantitative easing flooded the commercial banks with excess liquidity by crediting the reserves they hold with the BoJ. The required balance for these reserves is 6 trillion yen; that much the commercial banks have to keep deposited with the central bank. However, under quantitative easing, the BoJ has steadily increased these reserves to a target range of 30-35 trillion Yen. The excess reserves were intended to enhance the credit creation power of the banks, and provide a source of additional funds to a crumbling financial system. In the high-flying days of Japan's dominance, banks had lent like there would be no tomorrow. With the bursting of the asset price bubbles, and the subsequent collapse of the economy, many of the highly leveraged companies could not repay their debt. Banks kept bogus loans on their books for fear of triggering a financial collapse, but as NPLs spiraled and the economy kept receding, it become clear that these loans would never be repaid. It was in the back-drop of these testing times that BoJ instituted QE.

QE should not be confused with ZIRP (zero interest rate policy). Under ZIRP, the BoJ has held short-term interest rates at zero since 1999, in its bid to fight deflation. However, even zero interest rates could not stimulate the economy and Japan continued to be plagued with the dreaded specter of falling prices. While we in Pakistan would find that hard to believe in the present circumstances, expectations of deflation are actually more harmful to the economy than



inflation. It distorts the structure of incentives on both the supply and demand side, with falling prices squeezing profit margins for corporations (and hence discouraging production and new investment) and encouraging savings at the expense of consumption on the demand side.

Desperate Times Called for Desperate Measures

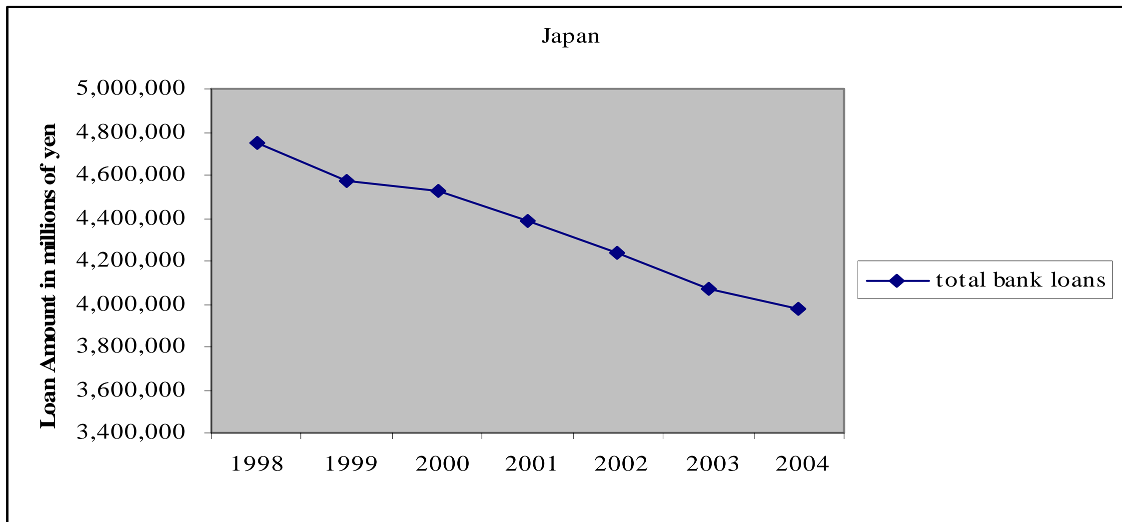
Deflation meant that ZIRP did not work. Even at zero nominal rates of interest, falling prices resulted in the real rates of interest (which are inflation adjusted) remaining positive. At positive real rates of interest, credit demand in a fragile economy did not pick up. From a central bank's perspective, that leads to a policy paralysis. BoJ could do no better than set interest rates at zero, and in a time of falling prices, even zero interest rates were not accommodative enough to stimulate the economy.

What then was the reason of introducing quantitative easing? Essentially, it gave banks more lending power at a time when there was no demand for loans. From the regulatory point of view, the long-term goal of quantitative easing was to help shore up the Japanese banking system. Burdened with huge Non- performing loans (NPLs), a legacy of the crash of the 1990's stock and asset price bubbles, Japanese banks were unwilling to burn their fingers by lending again. Quantitative easing was institutionalized as a means of providing moral support to a banking system so that it resumed its primary role as an extender of credit. In macro-economic jargon, it sought to transmit the BoJ's loose monetary policy through the banking lending channel at a time when the interest rate channel was not working.

The March 9th announcement of terminating QE was trumpeted in the financial press as being BoJ's first move in the start of a tightening cycle. Many expressed surprise at the BoJ's bold move; expecting that the torrid affair with deflation would keep the BoJ from tightening so soon into the recovery. They pointed to the fact that even though core CPI numbers have been positive for three consecutive months, that was significantly owing to higher oil prices. Japan's core price index, unlike, those of most other developed countries, includes energy prices. If energy prices were removed from the calculation, CPI numbers in November and December would become negative, while January core CPI number would be bumped down from 0.5% to 0.1%. An end to easing, when the fight against deflation has not been won decisively, seemed inappropriately hasty to many.

The BoJ's take on the matter is slightly different. They do not see the end to QE as a tightening move, claiming that the purpose of QE was never to fight deflation. QE was only inducted to provide back-up support to a collapsing financial system. As the banking system has recovered, the need for QE no more exists. It is hard to say whether BoJ's claim with regards to the intent behind QE is a policy decision which they were fully aware of five years back, or something that has become clearer with the luxury of hindsight. However, that is not the bone of contention. Whatever the intention behind instituting QE, one cannot deny that it did not work. For five long years, BoJ kept pumping money worth trillion of yen into the financial system. Banks, however, did not pass on the extra credit, via loans, to the general economy. As Figure 1 below highlights, despite the presence of both QE and ZIRP, banking sector loans kept decreasing since 1999 upto 2004.

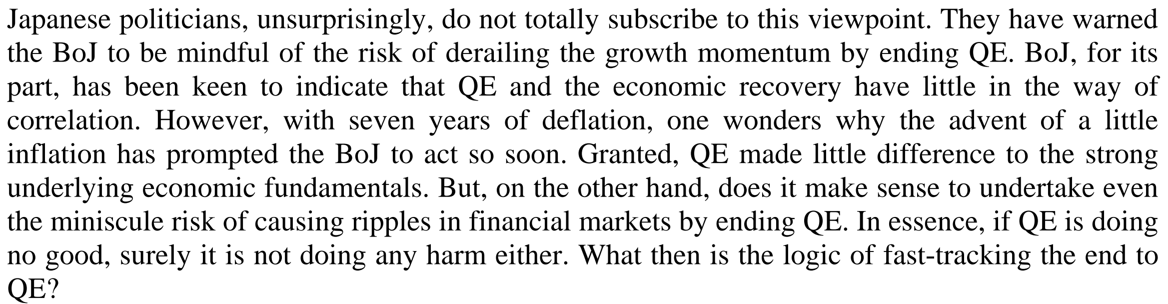
Figure 1



With NPLs of more than 8.5% of their advances portfolio, trying to force-feed banks into make additional loans in an uncertain economy just could not work. As they say, you can take a horse to drink, but you cannot make it drink! Despite the BoJ's best efforts, banks remained hesitant to lend to companies with dwindling balance sheets. Deflation persisted, depressing both domestic consumption and investment. The in-house consensus was that the catharsis needed to be internal, in the form of reforms. To a great extent, that line of reasoning proved to be correct. A broad range of painful but piecemeal political and economic reforms were undertaken. And while the process is by no means complete, Japanese banks have come a long way since hitting rock-bottom.

And as the economy rebounded, both demand for loans picked up in 2005. Businesses are looking to invest in capacity enhancement as consumer demand has picked up. The banking sector, long on the sidelines, has cleaned up its act and is now in a position to take advantage of the new growth momentum by re-opening their advances portfolio. QE, per se, made little difference to either the economy or the banking system. Both recovered the conventional, hard way. QE only parked a few trillion yen on the banks' balance sheets, and made no other tangible difference.

The question arises, if QE could not help fight deflation, why should it be considered instrumental in now sustaining inflation? Surely the recovering economy, with rising employment, wages, and most importantly, new-found consumer spending shall be enough to keep the inflationary momentum going. And make no mistake; BoJ's monetary policy even in the absence of QE is actually more expansionary than before. The welcome re-emergence of inflation has meant that real rates of interest have turned negative for the first time since 1997. By definition, it means that only now is the Japanese monetary policy actually accommodative. And that should provide much needed stimulus to both economic growth and the price level. The BoJ seems justified in assuming that ZIRP alone can serve the purpose in terms of conducting an expansionary monetary policy. Going along with QE is simply superfluous to the central bank's objectives.



Japanese politicians, unsurprisingly, do not totally subscribe to this viewpoint. They have warned the BoJ to be mindful of the risk of derailing the growth momentum by ending QE. BoJ, for its part, has been keen to indicate that QE and the economic recovery have little in the way of correlation. However, with seven years of deflation, one wonders why the advent of a little inflation has prompted the BoJ to act so soon. Granted, QE made little difference to the strong underlying economic fundamentals. But, on the other hand, does it make sense to undertake even the miniscule risk of causing ripples in financial markets by ending QE. In essence, if QE is doing no good, surely it is not doing any harm either. What then is the logic of fast-tracking the end to QE?

Some observers have put it down to BoJ's keenness to assert its independence in the face of mounting political pressure. We do not agree. After a torrid experience with bursting asset price bubbles, negative economic growth, falling prices, and many false alarms of recovery, egos at the BoJ have been consigned to the back burner. After all, it will be their head on the line if the Japanese economy sinks back into a recession. The reason why BoJ ended QE prematurely is not because it was overlooking the historical tussle with deflation, but that it was mindful of what caused deflation in the first place; the bursting of the stock and real estate bubbles back in 1990. The Nikkei has already shown impressive gains of around 40% in 2005, while real estate prices in Tokyo have started rising for the first time in a decade. BoJ feels that to continue pumping excess liquidity through QE in a time of widespread optimism regarding the future of the economy might provide impetus to another speculative bubble. That idea of allowing the foundations of yet another asset price bubble to be laid by continuing an ultra-loose monetary policy when there is a general consensus that the economy is recovering smacks of misguided complacency.

Regardless, in our view, QE on its own shall change little in the financial world. To say that this spells the end of the Yen carry trade and the end of the global liquidity glut is not only premature, but inaccurate. For now, BoJ has claimed that short-term interest rates shall remain at zero for some time yet. The Lombard rate (basically the discount rate) is at 0.1% and would act as a ceiling to the overnight rate in case it starts rising. Long-term rates are also not expected to rise by much. Thus, for all practical purposes, Japan shall continue being a source of cheap finance. In effect, while quantitative easing has been sidelined, ZIRP shall continue to be in place. With BoJ's commitment to keeping short-term interest rates at virtually zero in the short to medium term, borrowing in Yen shall continue being an attractive option.

ZIRP Matters

To our mind, it shall be the ending of ZIRP that will be the real gutsy move, the one that should really matter from a global perspective. What would that mean for the future of global liquidity and the Yen? Japan is the largest creditor country in the world. When interest rates go up in Japan, they would go up all over the world.

And a string of positive CPI numbers would force the BoJ to start raising rates at some point in the future. At the moment, financial markets expect the rate hikes to start towards the end of CY2006. That represents a particularly difficult situation as it would mean that most major central banks around the world would all have assumed a tightening course. Global liquidity, and subsequently, international growth shall certainly be affected. With Japan and the Euro zone tightening simultaneously, two important sources of cheap finance shall not remain that cheap anymore. Asset prices across the world, and specially north of the Atlantic, may head southwards.

Currency Markets- a Return to Economics

The greatest impact however, shall be on the currency markets. The Japanese and Euro zone recoveries having received official recognition by their respective central banks, and currency strengthening is only a matter of time. Since last year, currency markets have been increasingly driven by yield; interest rates have mattered more than anything else. It is no coincidence that the dollar's bull-run in 2005 coincided with continuous Fed hikes throughout the year while the ECB and BoJ were not raising rates. For a graphical representation of this assertion, look at Figure 2 and Figure 3 below. The US$ strengthened against both the Euro and the JPY as the Fed continuously raised rate while the ECB and the BoJ kept rates at very low levels.

Figure 2

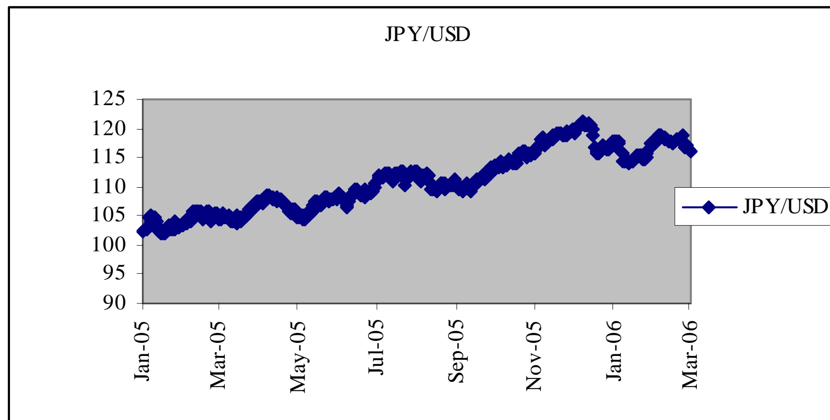
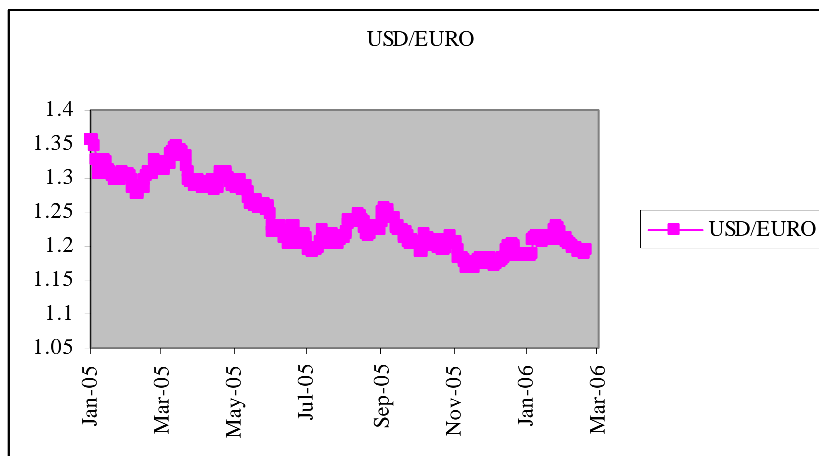


Figure 3



That is no more the case. Not only are future Fed hikes data dependant, the ECB has also started tightening. And the BoJ shall follow suit in a few months.

Changing interest rate dynamics have interesting implications for the much-talked- about Euro and Yen carry trades. The European Central Bank (ECB) is already on a tightening course, and has raised rates by 50 basis points in the last two months. Depending on the direction of daily fluctuations, anyone undertaking the Euro/Dollar carry trade will be alternating in the money, and out of the money. In other words, at current interest rate and exchange rate levels, borrowing in Euro and investing in US$ is no longer a sure-shot way of making money.

With yield differentials having topped out, the USD/Euro parity movement shall now be primarily data dependant. Both ECB and Fed are expected to raise rates a little further, but unlike 2005, the yield differential is not expected to rise. Thus, in our view, future direction shall be determined by the strength of the underlying economies.

Yen Dollar Carry Trade; A Case of Penny Wise and Pound Foolish?

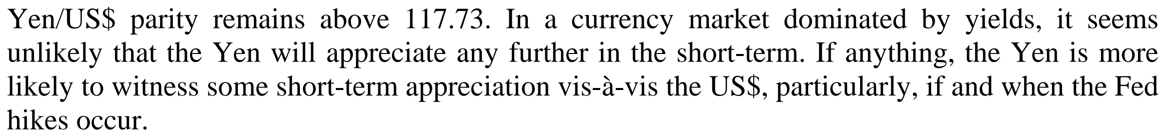
The Yen carry trade is more controversial. Investors, and in particular hedge funds, have made a killing through borrowing in Yen (and paying next to nothing in interest), and investing in higher yielding assets abroad. The only risk they carry is of the yen appreciating vis-à-vis other currencies, which would result in capital losses. Many analysts have attributed the strength of emerging market currencies to this phenomenon. Hedge funds, and risk taking investors in general, have sought to make handsome returns using this strategy. And in 2005, as the Fed tightened, carry trade aficionados began exploiting the cash yield differentials between the US$ and the Yen. Hardly surprising, the returns on these carry trades were fabulous. In 2005, not only did hedge funds who borrowed in Yen and invested in US$ denominated assets earn the difference in interest yields, but they also made capital gains as the dollar appreciated against the yen.

But as they say, all good things come to an end. News of QE ending resulted in sudden unwinding of some of the more risky carry trades. The New Zealand dollar and the Icelandic Krona are both very high yielding currencies, and by dint of offering near double-digit interest rates, are havens for carry-trade engaging hedge funds. On expectations of BoJ terminating QE, both currencies experienced a sharp sell-off. The logic- if cheap finance becomes scarce, emerging market trades might no more be worth the risk.

Yield Still Matters…

That has led markets calling into question the future of the Yen/US$ parity as well. There are two sides to this issue. Economic fundamentals dictate that the yen-dollar parity should trade in the range of 100-105. Currently it is around 117. Interest rate differentials (both present and expected), on the other hand, indicate that the yen could depreciate further to 125. Thus, while no one debates the long-term appreciation of the Yen, its short-term course is less certain.

With a couple more Fed hikes likely, carry trade aficionados will be keen to cash in on the rising interest differential between the US and Japan. At current interest rates, our calculations indicate that borrowing in Yen and investing in three month US$ CD's makes money as long as the



Yen/US$ parity remains above 117.73. In a currency market dominated by yields, it seems unlikely that the Yen will appreciate any further in the short-term. If anything, the Yen is more likely to witness some short-term appreciation vis-à-vis the US$, particularly, if and when the Fed hikes occur.

However, as the BoJ moves closer towards the termination of ZIRP and raising domestic rates, carry trades will start unwinding. It is then, and not now, that the Yen is expected to appreciate sharply towards its long-term target of close to 100.

A delayed adjustment of the Yen is good news for Asia's second largest economy. The Japanese recovery would suffer from an abrupt appreciation of the yen. With the economy at the threshold of a long-awaited recovery, an appreciation of the yen is worrying on two counts. Firstly, it would hamper export growth, which accounts for more than 10% of Japanese GDP. Secondly, and more importantly, it shall reduce and possibly reverse the inflationary pressures that have recently built up, by making imports less expensive.

…However, a Return to Sanity lies Ahead

In recent times, making currency predictions based on economics has been likened to carrying owl to Athens; it's just not been the way to go. However, a return to sanity seems likely in the not-to-distant future. More specifically, it would be interesting to observe the market reaction when the Fed ends its measured interest rate hikes. Since Greenspan initiated monetary tightening, the Fed was quick to indicate the future path of monetary tightening. Every FOMC meeting resulted in a 25 basis point hike, and markets were privy to the Fed's intentions. However, with the Fed Funds rate now close or above the neutral level, markets are no longer so sure. Two hikes are still expected, but surely the Fed cannot continue jacking up rates indefinitely. And once the attractive and cash differentials between the dollar and the Yen and Euro top out, economic fundamentals will come to the forefront. In the interim, in the foreign currency market, the next few months will offer much in the way of volatility and little in the way of direction.

On a macro-economic level, once Japan starts tightening, a global growth slowdown is in the offing, there is no denying that. However, we are not of the view that Japanese and Euro zone tightening shall result in a global meltdown. Both BoJ and ECB will be keen to convey the future paths of monetary policy well in advance. That should provide financial markets with ample time to make the necessary re-alignments.

Economic Snapshot

		Fiscal year 06								
	Units	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	July-Feb
Inflation										
Headline Inflation	%	8.99	8.41	8.53	8.27	7.89	8.51	8.76	8.05	8.43
Core inflation	%	7.62	7.55	7.58	7.81	7.59	7.36	7.34	7.00	7.48
Food inflation	%	9.73	7.82	7.52	6.41	5.84	8.1	8.17	7.48	7.63
Non-food inflation	%	8.47	8.83	8.25	9.61	9.38	8.8	9.18	8.44	8.87
T-bill (Wgt Avg)										
3 month	%	7.69	7.99	8.10	8.10	bid rejected	8.09	8.10	8.10	n/a
6 month	%	7.97	8.12	8.14	8.14	bid rejected	8.25	8.29	8.29	n/a
12 month	%	8.69	8.78	8.79	8.77	8.79	8.77	8.75	8.78	n/a
External Sector										
Export	Mln US$	1,272	1,408	1,499	1,329	1,120	1,421	1229	1300	10,578
Import	Mln US$	1,997	2,235	2,322	2,328	2,300	2,420	2145	2253	18,000
Trade balance	Mln US$	(725)	(827)	(823)	(999)	(1,180)	(999)	(916)	(953)	(7,422)
Remittances	Mln US$	313	348	341	373	309	336	391	n.a	n/a
Total Foreign Investment	Mln US$	130	161	183	208	323	458	164.6	n.a	n/a
Forex reserves	Mln US$	12,613	12,124	12,000	11,715	11,321	11,211	11,505	n.a	n/a

Key
n.a not available
n/a not applicable

MCB BANK LIMITED

(Formerly known as Muslim Commercial Bank Limited)

20th Floor

MCB Tower

I.I Chundrigar Road

Karachi

Contact

Farrukh Karim Khan

Kamran Parekh

Telephone: **92-21-2270024**

Fax: **92-21-2270094**
92-21-2270109

Email: farrukh.karim@mcb.com.pk
kamran.parekh@mcb.com.pk

Website: www.mcb.com.pk