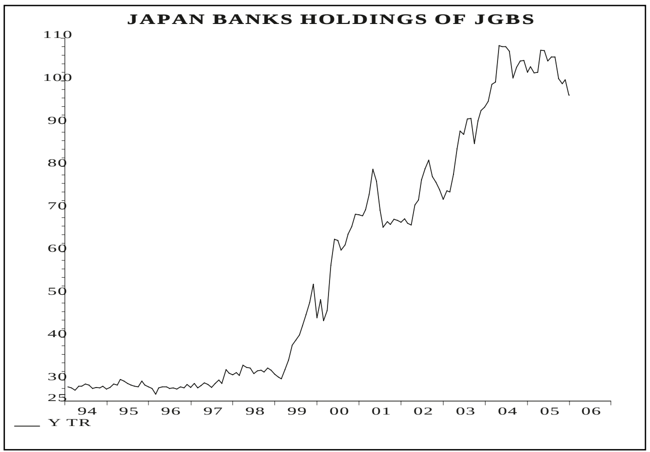
February 8th 2006

GFC ECONOMICS

DAILY COMMENTARY

BoJ's Balancing Act

The current gyrations of the Nikkei 225 have inevitably raised question marks over the durability of last year's impressive rally. Speculation as to when the Bank of Japan will announce an end to quantitative easing is clearly taking its toll. If nothing else, the hesitancy of Japanese stocks underlines the case for caution. Removing excess liquidity within the banking system is one thing, neutralising short rates is quite another. Whether the equity market can sustain new highs in the coming months will depend critically on how the BoJ communicates its strategy. The risks are huge. Banks are already paring down their holdings of JGBs in anticipation of a policy reversal. JGB yields may climb further from here, but the BoJ will have to guard against an erratic jump in 10-year yields. There is a strong case for removing the current levels of excess liquidity, which are fuelling a return of speculative tendencies in the property market. But equally, a sudden rise in borrowing costs could jeopardise Japan's recovery. The economy is strong, a point likely to be borne out by next week's GDP numbers. However, the reform agenda has suffered a number of setbacks this year. The BoJ's stance will need to remain accommodating, or this morning's sell-off in the Nikkei 225 could be a foretaste of more a serious reversal.



Reform Agenda Tarnished

If a week in politics is a long time, a month must seem like an eternity. It has certainly been a less than auspicious year so far for Prime Minister Koizumi. The numerous scandals that have caused his poll ratings to fall sharply have been well documented. The shady stock transactions at Livedoor, the reinstatement of the import ban on US beef, the falsification of earthquake resistance data for buildings and bid-rigging at the Defence Facilities Administration Agency have all been damaging. But Tuesday's announcement from the Ministry of Land, Infrastructure and Transport is particularly worrying. The government's advisory panel on national road development has approved the construction of nearly all of the remaining 1,276km of expressways proposed in its blueprint developing a nationwide network of high-speed road tolls. Reform of the Highways Commission was meant to be an integral part of the Koizumi agenda for change.

Of course, it is the arrest of Livedoor chairman Takafumi Horie that will cast the biggest shadow over the remaining months of Mr Kozimui's tenure as LDP leader. Crucially, the unequivocal support shown for Mr Horie when he stood in last year's Diet elections has created a media and public backlash against the reform agenda. Shinzo Abe may be the leading contender to replace Mr Koizumi in September, with one recent poll giving the Chief Cabinet Secretary 38% of the public's support, well ahead of his nearest rival, Yasuo Fukuda on 13%. However, one leading newspaper has claimed it will only 'back' Mr Abe if he distances himself from the 'pro-market agenda'. Therein lies the biggest risk from the recent spate of scandals. The FY2006 budget has been set in stone, but a number of difficult challenges on social security and medical care reform still lie ahead. If Mr Koizumi cannot even deal with the rather more straightforward task of curbing unnecessary highway construction, then hopes for a stabilisation of the public sector debt burden by FY2011 must be in some doubt.

It should be said, none of these scandals compare even remotely to the corruption unearthed during the 1990s as Japan's property bubble started to deflate. Livedoor still pales in comparison to the arrests, suicides and public humiliation faced by scores if not hundreds of company

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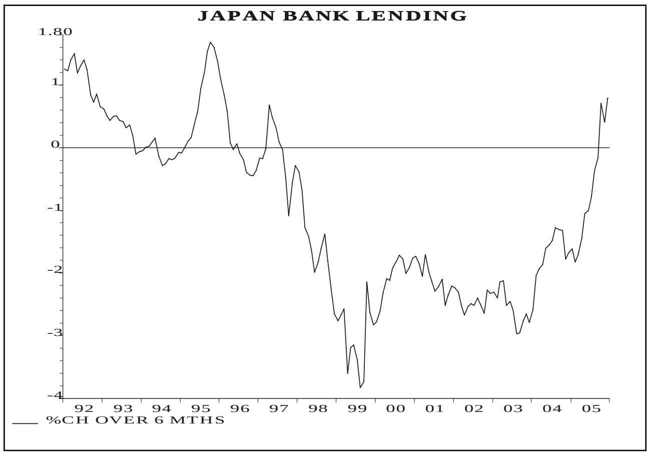
executives as one bank after another defaulted. The problems started in late 1990, with the arrest of executives at Sumitomo Bank, Mitsui Trust & Banking and property company Itoman, before reaching a climax in 1997 and 1998. Yamaichi Securities, Dai-Ichi Kangyo Bank, Daiwa Securities, Nikko Securities, Asahi Bank, Hokkaido Takushoku Bank, Hokkoku Bank, Orange Kyosai Kumiai and Nomura Securities were some of the household names implicated in 1997 alone. The list for 1998 is just as long. Livedoor's Mr Horie may yet be convicted of securities fraud. But some of the executives arrested in 1997 were involved in money laundering with Japan's murky underworld and most notorious gangsters. In the context of the last 15 years, Livedoor needs to be kept in perspective.

That said, political momentum is crucial if the reform agenda is not to be derailed. In Mr Koizumi's defence, the economic data should allow the Prime Minister to regain some initiative, with the prospect of strong consumer spending in Q4 giving the GDP numbers due next week a significant lift. Whether the stock market can sustain new highs will, however, depend in part on how tough the Bank of Japan decides to be in withdrawing quantitative easing. As this morning's bank lending numbers showed, the case for removing the excess liquidity is becoming hard to refute. In seasonally adjusted terms, bank lending has risen by 0.8% over the past six months. Historically, this is still far below the double-digit growth rates witnessed during the late-1980s. The annual rate is still only 0.0%. M2+CDs growth slipped back again to a miserable 1.9% y/y. Broad liquidity growth slowed again to 2.3% y/y, its lowest rate since March 2004.



Nevertheless, the speed of the turnaround in lending has been quite dramatic, and also belies some worrying developments. Bank lending rates have fallen to record lows. Data for November shows that the average loan rate dropped below 1.3% for the first time on record. Competition between banks is intensifying and driving borrowing costs down. The authorities may be pleased that the major banks have been successfully re-capitalised, and are continuing to pare their bad debt ratios. But the unseemly return to aggressive loan tactics reminiscent of the late-1980s is clearly playing a part in the emergence of speculative forces within the Tokyo and Osaka property markets. It would be stretching the comparison to suggest we are witnessing a flashback to the heady days of 1989. Land prices are still falling in many of the regions, particularly where the improvement in the labour market has been less evident.

However, the Bank of Japan faces a delicate balancing act. The reserves target of Y30-35tr provides an enormous incentive for banks to lend at any cost, since they earn no return on current account balances held at the central bank. With real estate lending by banks rising 44.0% y/y in Q3 last year, there is a clear need to start lowering this target. But of course, banks have been one of the biggest buyers of JGBs, and with lending turning up, the temptation to cut their holdings is self-evident. JGB holdings by banks peaked at Y108.3tr in April 2004, and fell to Y96.6tr in December. At this stage, the shift away from bonds is not being driven by the growth in lending, which is still below that of deposits. Banks are merely shifting their assets away from JGBs to other securities, possibly in anticipation that quantitative easing will soon have to end. Either way, there is a risk that as lending continues to firm, its growth will eclipse that of deposits - up 1.5% y/y in January - triggering a more forceful adjustment of the banks' balance sheets. To guard against the risk of a wrenching adjustment in JGB yields, the BoJ will have to communicate its intention to keep short rates on hold loud and clear.