BOJ meets as economy in worst slump since 1970s

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Board of Japan's central bank likely to discuss extending loan scheme

HONG KONG (MarketWatch) -- The Bank of Japan's policy board will meet this week under pressure to come up with creative answers to the nation's deepening economic gloom, after the latest data revealed the country suffered its biggest quarterly contraction since 1974.

With most economists forecasting more deterioration ahead, the central bank is left with a dearth of conventional options.

"Effectively all the Bank of Japan can do is accelerate measures that have already been announced," said Glenn Maguire, SocGen's chief Asia economist in Hong Kong.

Preliminary data released Monday by the Cabinet Office showed Japanese gross domestic product shrank 12.7% on an annualized basis in the October-December period, or 3.3% from the previous quarter. The decline was the biggest since a 13.1% annualized contraction in the January-to-March period in 1974.

The contraction followed a 2.3% annualized drop in the July-September quarter, bringing the fall in activity to three quarters. That's the longest since the recession that ended in December 2001, which followed the collapse of the technology bubble. See full story on Japan's GDP contraction.

The BOJ's two-day policy board meeting is slated to begin Wednesday, and is expected to focus on actions geared towards easing corporate finance conditions.

At its January meeting, bank Governor Masaaki Shirakawa instructed staff to look into ways to purchase corporate bonds maturing within a year.

UBS says the BOJ is unlikely to cut interest rates from already low levels, but will instead consider extending the duration of its commercial-paper buying program.

Late last week Shirakawa indicated the BOJ would seek to consider extending the "extraordinary" measures it has take to help loose up credit conditions for Japanese companies.
About 3 trillion yen ($33 billion) has already been drawn down via the BOJ's special lending program which allows financial institutions to obtain low-interest loans by using bond and commercial paper issued by other companies as collateral.

Japanese media reports said demand has been strong for loans and the central bank is considering expanding the program to double its original size.

The Japanese financial system is widely regarded as in better shape than fellow banks in the U.S. and Europe, although it proved uniquely vulnerable during the financial crisis. The global deleveraging seen during the autumn transformed into an exodus of capital from Tokyo's equity market, sending shares sharply lower and undermining the capital base of banks, leaving them unwilling or unable to lend.

The BOJ's actions so far don't yet add up to up to quantitative easing -- a program that entails dropping interest rates to zero and injecting new money into the financial system to boost the supply.

The central bank in fact may be unwilling to go that far amid concerns the policy could backfire, leading to decline in the balance of funds held in call-market deposits.

Barclay's Capital said there's some evidence the balance of funds has already declined, as happened when the BOJ unveiled its previous zero-interest-rate policy. That suggested monetary policy may already be at its limits in terms of interest rate cuts.

Broad plan to come?

SocGen's Maguire said the next move by the Bank of Japan, potentially as early as June, will be the unveiling of an interventionist policy in the economy wherein the central determines what companies will survive and which will fail, under a broad plan aided by central bank funding.

"It's a pick-winner policy and it effectively chooses which industries will remain," Maguire said. "Japan is so far into unconventional monetary policy at this point, there is little else they can really do."

Already, the central bank slashed interest rates to 0.1% from 0.3% in December, and introduced a program to purchase 3 trillion yen of commercial paper and asset-backed commercial paper through the fiscal year ending in March. But there's little to suggest Japan's economy is about to bottom anytime soon, and downward momentum appears to be gathering speed, in spite of the central bank's efforts.

The latest GDP data underscore why many believe radical measures are necessary.

Inventories remain at relatively high levels, suggesting companies are likely to roll out additional output cuts and layoffs, adding to the thousands announced in recent months by companies including Toyota Motor Corp  TM +0.84% (7203) and Sony 6758.SNE -0.66%.
Analysts said household spending and business investment, which fell 0.4% and 5.3% in the quarter, look set for additional declines in coming quarters.

"It's painting quite a weak backdrop for the labor market and consumption in the second and third quarters," Maguire added.

Barclays Capital forecasts the Japanese economy won't bottom until the October-to-December period this year, and even then their outlook is for stabilization rather than a quick rebound.

"It will be more like an 'L' shaped development," said Barclays Chief Economist Kyohei Morita in Tokyo.

He said any rebound in Japan's economy would depend upon the success of fiscal stimulus packages in spurring growth in Japan's major trading partners. Most crucial would be any potential up tick in China's rate of GDP growth, which should be shadowed by a rebound in Japanese exports with a lag of about one quarter.

Barclays estimates Japan's economy will likely contract 9.8% annualized in the January-to-March quarter.

Japan's powerful export engine has been derailed by the global slump, leading to a decline in shipments and a reversal in the nation's normally bullet-proof trade surplus.

The knock-on effect of the slump has been dwindling capital expenditure. Data released last week showed orders for Japanese machinery orders fell 1.7% in December, the third straight month of declines. Against the year earlier period, December orders were down 26.8%.

Credit Suisse says the overseas economic stimulus plans currently being drawn up will help some basic materials companies but are unlikely to be much aid to the broader export sector "until overseas consumer spending and corporate capex start to recover."
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