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MARKET CALLS

BoJ Watch: Climbing on Board

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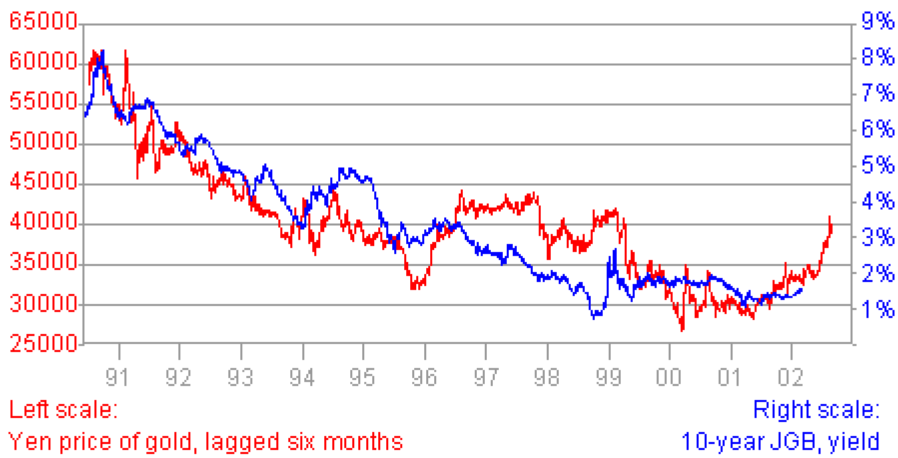
Confirmation that the **Bank of Japan** is acceding to the government's request for "bold" anti-deflationary action could mark a critical turning point in Japan's decade of deflationary misery. Having already added liquidity sufficient to begin relieving the yen scarcity, the BoJ's announcement Thursday that it is boosting outright purchases of Japanese government debt by 25% has the potential to deal a decisive blow to the deflation expectations climate. No question, it's always advisable to maintain a certain reserve of skepticism regarding BoJ policy implementation -- the Japanese central bank's reputation for ineptitude has been well-earned over the years. But the BoJ's announcement appears to leave little latitude for exercise of the sort of discretionary policy authority that has always been its undoing. The near-universal consensus backing the action among the political-economic elite probably invests this decision with about as much credibility as is possible within the realm of Japanese policymaking.

The early rebound of the yen since the BoJ announcement, with the currency strengthening nearly a full yen to about 133.3/$, in part reflects relief that the action reduces the risk of systemic crisis. As seen in the 10% rally of the Nikkei equity index since word of the likely BoJ response first leaked last week, the policy shift also is injecting a note of optimism about Japanese growth prospects, marginally increasing demand for the currency. We'd expect these yen-positive factors to be overwhelmed in fairly short order, though, by the reality of the BoJ's aggressive additions to yen liquidity, with the yen/$ rate resuming its move toward the 140 mark.

Indeed, the BoJ decision should contribute significantly to a repricing of Japanese asset classes that have most directly discounted both current and expected future deflation. We think long-term Japanese government bonds belong at the top of that list. After a period of volatility and confusion over the implications of the decision for JGBs, we expect to see a run of sustained weakness in the yen-denominated bonds, with 10-year yields rising medium-term toward 2% from current levels just above 1.5%. Over a somewhat longer-term horizon, as the market is assured that the deflation is extinguished, a rise in yields to at least 3% should be seen.

Actually, we'd have expected JGBs to show somewhat more of a positive response initially to the decision, with yields falling only slightly from 1.54% to 1.52%. As a short-run announcement effect, it would be no surprise to see the bonds rally some here, under the supposition that the BoJ's increased demand for bonds should raise their price. In a market of more than Y500 trillion in outstanding government debt, however, such supply-demand flow considerations will be overwhelmed by factors influencing the value of the stock of existing debt. And that is primarily a function of the expected real value of the bond's nominal repayment stream, which is determined by monetary policy. Think of it this way: although the BoJ's stepped-up purchases might marginally increase demand for the bonds, those very purchases increase the supply of yen liquidity relative to demand, reducing the purchasing power of the currency. Indeed, that is the desired effect in the effort to combat deflation. Since the yen is the unit of account in which the bonds are priced and the medium in which repayments are made, printing new money with which to buy the bonds will reduce the bonds' value, thus raising yields.

JGB yields versus the yen gold price



To some extent, this dynamic has already been demonstrated since the BoJ adopted a "quantitative" policy approach last year. Starting last March, the BoJ increased its outright purchases in several stages, going from Y400 billion per month to Y800 billion. Over the same time, JGB yields have risen to their present levels from just above 1%. The accompanying chart also provides a graphic illustration of the degree to which JGB yields since early in the last decade have closely correlated with the deflationary rise of yen purchasing power reflected in the yen price of gold. Regression analysis demonstrates that with a six-month lag, the yen gold price explains 70% of the change in JGB yields. Provided that relationship holds, the far right side of the graph suggests the potential for a rise in JGB yields based on the yen's depreciation against gold already seen since the fourth quarter of last year. Thus, we'd view any significant JGB rally from current levels as a chance to increase the bet on a subsequent reversal. TM