

BOJ may ease policy Wednesday

The Bank of Japan (BOJ) will complete a two day policy meeting on March 17th. The BOJ has been under significant pressure from the Japanese government to take action to combat deflation and boost the Japanese economy. Japan's consumer prices declined for the 10th month in a row in December with CPI declining by 1.3%. The CPI report confirms that deflationary pressures continue in Japan. Recent Japanese economic data has been mixed but generally points towards improvement in the economy. Exports rose more than expected in January reported up 40.9%. This marks the third biggest monthly gain in Japanese exports on record. Imports rose for the first time in 15 months reported up 8.6% in January. Japan's industrial production rose by 18.5% in January. Machine tool orders rose at a record pace last month. Japan's unemployment rate posted a modest decline to 5.1% in December from 5.2% in November. Consumer confidence and business confidence posted a slight improvement in January. Japan's Q4 GDP however grew at a slower annual rate reported at 3.8% compared to 4.6% in the preliminary report. In February the BOJ elected to hold monetary policy unchanged, said that the economy is picking up and that the pace of improvement in the economy is likely to remain moderate until the middle of fiscal 2010.

The BOJ policy decision is close call with BOJ members divided over whether additional easing is justified in light of the recent uptick in Japanese economic activity. The BOJ could expand its lending auctions, elect to buy more government bonds, focus on intervention or do nothing at Wednesday's policy meeting. After an emergency meeting in December the BOJ elected to expand its liquidity auctions by ¥10trln offering loans to commercial banks at 0.1%. Japanese press reports that the BOJ may elect to expand its liquidity measures to ¥20trln at this week's policy meeting. Some of the BOJ board members question whether further ease will do much to combat deflation or boost the economy and the BOJ may want to focus on actions that would weaken the value of the JPY. The BOJ could buy more government bonds or intervene to try to weaken JPY. There were reports in the Nikkei Tuesday that the Japanese government may be considering tapping FX reserves to increase spending. Japan's Finance Minister Kan denied these reports but if the Japanese government were to tap FX reserves to increase spending it would increase the risk of a downgrade of Japan's sovereign debt rating. Depleting the reserves would make physical interventions more difficult. BOJ officials may be reluctant to expand quantitative ease by buying bonds in light of the uncertainty about the Japanese government spending plans and because of the current improvement in Japan's economy. If the BOJ elects to expand its liquidity operations the JPY would likely experience short-term selling pressure. If the BOJ elects to buy government bonds it essentially would be printing money and JPY could experience a more significant decline.

Last Friday, Japan's PM Hatoyama warned that Japan was ready to act if the JPY moved sharply and he called for international cooperation to contain JPY appreciation. Hatoyama's comments increase the risk of intervention to try and weaken the JPY. A strong JPY tightens monetary conditions and contributes to deflationary pressures. As noted above the BOJ upgraded its outlook for the Japanese economy which makes a monetary policy ease less likely. In response to Japanese government pressure on the BOJ to combat deflation the BOJ policy decision may be more targeted at the JPY than the Japanese economy. Best guess is that the BOJ may elect to leave monetary policy unchanged and look to the April meeting for its next policy change with a greater focus on targeting JPY strength. Market consensus is the BOJ will likely elect to expand its funding auctions but stop short of announcing a plan to buy Japanese government bonds.

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