Markets Cast Doubts on Japan's Anti-Deflation Policy

By Tani Sadafumi

At the Council on Economic and Fiscal Policy on Feb. 27, the Japanese government drew up a comprehensive package of countermeasures to fight deflation. Regarding the supply of public funds as capital to financial institutions, the government stated in the policy "any and all necessary measures shall be implemented, including capital reinforcement" if there were signs of a financial crisis. The government also requested the Bank of Japan (BOJ) to implement drastic changes in monetary policy. Upon this request, at the Monetary Policy Meeting the next day, the BOJ decided on an additional monetary easing policy incorporating an increase in the outright purchase of long-term government bonds as the principal measure. The government and the BOJ seemed to offer harmonious attitudes to cope with deflation, but the anti-deflation policy undeniably impressed us as a temporary expedient. Earlier at the Council on Economic and Fiscal Policy, Prime Minister Koizumi Jun-ichiro referred to the need for a further anti-deflation policy by saying countermeasures would not end with this policy.

In addition to the request to the BOJ for a drastic monetary policy, the anti-deflation policy presented four measures: 1) accelerating the disposal of non-performing loans (NPLs), 2) stabilizing the monetary system, 3) taking measures for the market and 4) taking countermeasures for the credit crunch. In detail, the special inspection of large banks by the Financial Services Agency is being made more rigorous and the results of the inspections are being publicized. Based on the results, companies with excessive loans from banks are being prompted to choose either to attempt reconstruction by making banks waiver their NPLs or to liquidate themselves under the Corporate Reorganization Law or the Civil Rehabilitation Law to accelerate the disposal of NPLs. Banks are also being urged to sell their NPLs to the Resolution and Collection Company.

To stabilize the monetary system, the government requested the BOJ to furnish special funds without collateral and limits to financial institutions that run short of funds, even after the end of March this year of full refund guarantees on bank deposits. As described before, the government has also decided to supply financial institutions with public funds if there is a threat of a financial crisis.

Regarding the monetary market, a restriction was imposed on short selling in which an institution sells borrowed stocks with the aim of buying them back at a lower price. To prevent stock prices from dropping because of the elimination of mutual stock-holding between banks, financial institutions are being requested to sell stocks aggressively to the Bank Equity Purchasing Corporation, which will hold the stocks temporarily. The countermeasures against the banks' unwillingness to grant loans include the relaxation of repayment conditions for small and medium-sized enterprises that receive loans from banks on special guarantees by the Credit Guarantee Corporation.

To implement an additional monetary easing policy, the BOJ increased the monthly outright purchase of long-term government bonds from ¥800 billion to ¥1 trillion to ensure a sufficient supply of funds toward the end of the fiscal year. The BOJ applied the official discount rate to the Lombard-type lending facility on any business day from March 1 to April 15, suspending the current restriction on the maximum number of days for such use, namely five business days in a reserve maintenance period.

Despite the cooperative attitudes of the government and the BOJ, market analysts and economists were severe in evaluating the anti-deflation policy. Sato Masatoshi, senior strategist of Mizuho Investors Securities, said, "This policy looks like an immediate measure to stop stock prices falling rather than an anti-deflation policy. The market is temporarily responding to a styptic agent, but stock prices will very likely drop further if the Prime Minister does not take drastic measures as soon as possible." Matthew Poggi, economist of Lehman Brothers (Japan), criticized the policy, saying, "This policy adds nothing to the one declared two weeks ago. It does not include detailed methods for re-injecting public funds into banks, and thereby makes clear the government's intent to take no action until a financial crisis actually happens." The BOJ's monetary policy also received critical comments, such as "There is only poor substance in the policy." by Mizuno Atsushi, chief fixed income strategist of Deutche Securities Ltd., and "The contents of the policy are just the same as we expected." by Ueno Yasunari, chief market economist of Mizuho Securities Co.

Some of the government staff who took part in making the anti-deflation policy themselves said, "You should not expect much effect from the policy" in recognition of a lack of decisive factors. An executive of the Financial Services Agency reviewed it honestly, saying "We took pains to find out how we could arrange existing policy measures to give them a new appearance." Even Hayami Masaru, governor of the BOJ, had to expressly emphasize that "you can call it additional monetary easing" at a press conference. According to a BOJ executive, the monetary policy publicized at the end of February was not "additional monetary easing" but simply a "measure to help banks to raise funds at the end of this fiscal year." The BOJ's measures can be seen as a mere policy of taking action with fewer side effects, although it seems unable to stop deflation.

The economic statistics announced at

the beginning of this year clearly showed a trend of deflationary recession in the Japanese economy. The consumer price index has kept falling for the past three years, consumer spending has kept decreasing for the past nine years, the value of contracted machinery orders, which is a leading indicator of plant and equipment investment, has basically been decreasing, and the overall unemployment rate has been at a high level. Although the money supply has grown, bank loans have decreased for more than four years. These indicators show a condition of "financial paralysis" in which the large amount of funds supplied from the BOJ cannot sink into the real economy.

Under these circumstances, a financial crisis in February or March seems plausible and the Nikkei average has dropped below the ¥10,000 level. Recently, a reconstruction plan based on banks waivering their NPLs was settled for major supermarket chain Daiei Inc., a typical enterprise with massive amounts of loans from banks. However, this remedy has been criticized as a way to delay the solution to the problem. On the other hand, public support for the Koizumi Cabinet has fallen drastically since the sacking of former Foreign Minister Tanaka Makiko. Public-opinion surveys have indicated that an increasing number of people are asking for economic stimulus measures rather than structural reform.

A meeting of the finance ministers and central bank governors of the Group of Seven countries was held in Ottawa, Canada, on Feb. 8 and 9. All the attendants recognized that Japan is the largest risk to the world economy. On Feb. 18, U.S. President George W. Bush had a conference with Koizumi and expressed all-out support for the structural reforms.

The Koizumi administration found itself in a situation where it must take anti-deflation measures quickly without abandoning structural reform as its lifeline policy while giving consideration to the economy, political affairs and the world situation. Nevertheless, there was no room for additional fiscal action because the government had committed itself to capping government bond issuance at ¥30 trillion. The government could not deny the validity of its own draft budget for fiscal 2002 (April 2002 to March 2003) while the draft budget was being discussed in the Diet. On the other hand, the BOJ has had a negative view of the effect of additional monetary easing when the short-term market interest rate has been kept at nearly zero due to the past quantitative monetary easing.

Photo : The Mainichi Newspapers

Koizumi (left) and Takenaka (right) at the Council on Economic and Fiscal Policy

Thus, the anti-deflation policy was obliged to be a "jerry-built" one that was a collection of the inexpensive policy measures which had already been prepared by the policy authorities. The countermeasure also lacked consistency. Accelerating the disposal of NPLs to promote structural reform may be effective, but the measure actually enhances deflation rather than stops it. The government intends to lessen this negative effect by implementing an additional monetary policy, stabilizing the monetary system, taking measures for the market and taking countermeasure for the credit crunch.

The problem is that we can hardly know from this collection of inconsistent policy measures how painful it will be to dispose of NPLs and how the pain can be allayed by other policy measures. The government, in June last year, appealed to the people to be ready to bear the pain, saying in the "Outline of Basic Policies for Macroeconomic Management and Structural Reform of the Japanese Economy" (the so-called "big-boned" policy) that "We regard the next two to three years as a period of intensive adjustments for the Japanese economy. Though we may have to accept low economic growth in the short run..." However, this clear message sent to the people has become fuzzy with the implementation of the policy.

During the making of the anti-deflation policy, there was a lack of unity within the government and between the government and the BOJ. Regarding the supply of public funds to financial institutions, Finance Minister Shiokawa Masajuro and Takenaka Heizo, state minister in charge of economic and fiscal policy, initially took up a positive attitude while Yanagisawa Hakuo, state minister in charge of financial affairs, kept a prudent attitude. The government finally formed the united view that new public funds are not necessary at the current stage but will be implemented if a financial crisis is expected. Against this view, Hayami exceptionally requested a meeting with Koizumi and advised him to quickly supply public funds.

Regarding the monetary policy, Hayami insisted, "In the current situation of the Japanese economy, monetary policy cannot affect commodity prices." This opinion encountered much criticism from government members who admitted "the BOJ should be independent of the government but never independent of the nation of Japan" (according to a Finance Ministry executive). After all, the BOJ "could not help but go with the government" (according to a BOJ executive) regarding the anti-deflation policy. It was natural that there were differences in opinion between them. It was also natural that the market felt doubts about the capabilities of the policy makers, who continued to be involved in controversies even though a crisis might be just around the corner. JTI

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