Market Responded with No Panic to "Re-Downgrade"

By Sakamoto Sakae

Moody's Investors Service, an American credit-rating agency, announced in mid-February that it had placed on review for a possible downgrade the yen-dominated domestic securities issued or guaranteed by the government of Japan, from the current "Aa1". Japanese securities had been downgraded in November 1998, from "Aaa"(the best rank) to "Aa1"(the second rank). If there was another downgrade to "Aa2"(the third rank), Japan would have one of the worst rankings among the advanced industrial nations, in terms of "credibility of government finance". Among the G7 members, only Italy was rated "Aa3", and the US, the UK, France, Germany, and Canada, respectively, were rated either "Aaa" or "Aa1".

Although the yen / USD exchange rate and the price of Japanese securities showed a slight downward move right after the announcement, no substantial moves were shown by the average stock price at the Tokyo Securities Exchange. At the time of the previous downgrade in November, 1998, the value of the yen, government securities, and stocks all went down in a move referred to as a "triple down", and every business sector of Japan was put into turmoil. The mass media was no exception. The above mentioned announcement of "the review for a possible downgrade" was greeted with coolness, probably because of the fact that the minds of market watchers were becoming less pessimistic owing to an observation to the effect that the health of financial institutions was improving and the whole economy was coming back to a reasonable course of recovery.

Standard and Poors (S&P), another credit rating agency, as influential as Moody's, announced four days after Moody's announcement, that the agency would keep the rating of Japanese securities at "AAA"(triple A, the best rank). This is a reflection of the fact that each credit rating agency looks at a subject from a different viewpoint.

Moody's describes the reason of the review for the downgrade of Japanese securities as follows:

Moody's Investors Service placed on review for a possible downgrade the Aa1 - rated yen - denominated domestic securities issued or guaranteed by the government of Japan. The rating agency said the review is prompted by structural problems in Japan's economy that have resulted in a level of public sector debt that will soon be the highest, relative to GDP, among the advanced industrial economies. Moody's said that, given the scale of Japan's fiscal imbalance (compounded by pension system, health care, and financial sector contingent claims), meaningful fiscal correction might jeopardize economic recovery. A private - sector led recovery appears necessary to prevent public sector debt from ballooning, otherwise a politically challenging fiscal consolidation would be necessary. Moody's rating review will focus on future possible public sector debt dynamics, as well as the prospects that the incipient recovery could eventually become sustainable and allow a process of fiscal consolidation. (Moody's Press Release, February 17, 2000)

Not worthy of comment - Finance Minister Miyazawa

The Moody's February announcement was a warning to the financial health of the government of Japan, which had been impaired to a level that the deficit of the Japanese government would not be diminished even after the recovery of the economy. Finance Minister Miyazawa Kiichi did not conceal his discomfort and referred to this announcement, saying: "I am not in a position to mention this. I place no importance on this. In short, it is not worthy of comment." Usui Nobuaki, Administrative Vice Minister for Finance, also said: "We have taken various measures for economic recovery, and they are beginning to work. It is irrelevant. They ignore the point that efforts are being made to improve Japan's situation, (by putting the funds acquired through security issuance for vitalization of the economy)".

Ohba Tomomitsu, the president of the Japan Center for International Finance, and a former Vice Minister of Finance for International Affairs, who had been consistently critical of Moody's posture, commented as follows: "The government of Japan has been making an efforts to cope with the demands by the US and others, who hoped for an early recovery of the Japanese economy and urged the implementation of a positive financial policy. We have steered our economy so that we would proceed, supported by the under-standing of major nations, side by side with these nations. We cannot be content as long as the review for a possible downgrade is placed just because of the outcome of this process. What I have felt with Moody's is that it has been too rigorous in rating enterprises belonging to the Japanese private sector. In rating of government securities, more attention should be placed on whether the government has problems in raising money in the international marketplace. It is true that Japanese government finance is in difficulties, but the fact that we have a big surplus in our balance of payments and our status as a creditor nation should be given more importance." (Asahi Shimbun, 18, February)

A market watcher coolly observes: "Moody's had upgraded the rating of

Japanese financial institutions right before that announcement. This course of action is apparently inconsistent with that announcement, but in fact it is not inconsistent. Increased expenditures mobilized for stabilization of the financial system, distorted the government's finance. The review for a downgrade, either announced or implemented, would have a limited influence on financial markets compared to the previous case. Financial institutions are restoring their health and the economy is being brought back on a recovery track."

Officially, Finance Minister Miyazawa and Vice Minister Usui are rejecting the review for a downgrade as noted earlier, but the honest sentiment of bureaucrats at their ministry could be different. According to " Teiryu (undercurrent)" a column in the Nihon Keizai Shimbun of February 18, the bureaucrats confess their recognition to the effect that: 1. although Moody's announcement has resulted in a weaker yen, reasonable yen weakness will help them enlarge the range of currency policy (prevention of excessive yen strength for export expansion); 2. a warning about the massive issuance of government securities will help them lay out a relevant road map to healthier government finances. The financial system and real economy alike seem to be regaining confidence compared to November 1998.

Miyazawa Kiichi, who heads the Ministry of Finance, showed discomfort about Moody's rating of Japanese government securities

Priority on recovery of economy versus reconstruction of government finances

Regardless of Moody's warning, the Japanese government's debt has reached a serious level. The magnitude of the debt balance incurred by Japanese national and local governments was as huge as 645 trillion yen (nothing less than 130 per cent of GDP) at the end of fiscal 2000 (end of March 2001). Although this is an outcome of the repeated additional issuance of securities for stimulation of the economy, the government and the parties in power have nevertheless confirmed their commitment to the continued issuance of securities, putting priority on an economic recovery.

The position of the government is that "We are to consider reversal to normalization of government finance, only after our finding that the economy is confirmed to be on a recovery track." No one knows at this moment how soon this reversal will happen.

In the face of a pending general election of Lower House members, which is supposed to be held in mid-2000, the national deficit is looming as a political issue. Prime Minister Obuchi Keizo states repeatedly: "We are not going to pursue two objectives at a time. We dedicate all of our efforts and resources to an economic recovery, for the time being at least". Voices are becoming louder among the opposition parties and even among the members of LDP, criticizing the undisciplined spending on an asserted stimulation of the economy, and claiming that the weight of economic policy should be shifted to normalization of the budget balance.

Kajiyama Seiroku, a former Cabinet Secretary General, who fought against Prime Minister Obuchi in the recent LDP presidential election, clearly endorses these voices in an article contributed to a weekly magazine. Voices "in favor of financial discipline over stimulation of the economy" have not gained consensus among political and business leaders. This is because of the bitter experience of a shrinking economy, when former Prime Minister Hashimoto Ryutaro come up with commitments to finance the normalization process at the time of drafting the fiscal 1998 budget. Hashimoto's government mistakenly concluded at that time, in spite of the reality of immature recovery, that the economy had already come back on a course of steady growth, and pulled down the emerging impetus, by raising the rate of consumption and other taxes. Yumoto Kenji, Chief Analyst at the Japan Research Institute, Limited, points out in his report: " I am sympathetic to the prevailing mood of apprehension for a repetition of mistakes made by Hashimoto's government that stalled the economy by a hasty exercise of financial discipline. It cannot be justified, however, to take no measures to wipe out the public concern about a magnified deficit for the future. The biggest problems related to the undisciplined spending over a two-year period are not only the fact that the deficit has swelled up to a serious level, but also the fact that moral hazards and inclination for deferred restructuring are beginning to prevail all over society."

Moody's review of rating may have provoked a lot of controversy, but it was extremely timely. JJTI

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