TrendMacrolytics

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MARKET CALLS

BoJ Watch: Encouraging Signs

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President Bush's visit appears to have had somewhat of a galvanizing influence on Japanese officials anxious to underscore the significance they attach to tackling the country's debilitating deflation. The Bush trip was preceded in the past week by a fairly direct and open – by Japanese standards, anyway – discussion of means to finally put an end to Japan's relentless price destruction. **Prime Minister Junichiro Koizumi's** statement last week identifying deflation as the worst of Japan's economic problems was no doubt timed to demonstrate his government's seriousness in advance of the U.S. president's Tokyo stay. Postmortems on the Bush-Koizumi parley Monday suggest that the Japanese PM used the occasion to underscore his commitment to ending the deflation.

Senior government and **Liberal Democratic Party** figures now appear intent on following through with a reflationary policy thrust that would – crucially – include an accelerated pace of yen liquidity creation by the **Bank of Japan**. It was no mere coincidence that on the day of Koizumi's meeting with Bush, the Japanese press contained reports that an LDP policy panel will call on the BoJ to use foreign bond purchases as a mechanism for increased liquidity injections. **Finance Minister Masajuro Shiokawa** continues to call for a 25% increase in the BoJ's outright purchases of JGBs. Initially, the BoJ is unlikely to welcome such advice, and will resist for a time as a show of independence from the government. We doubt, though, that the BoJ bureaucracy will have the staying power to sustain a recalcitrant stance for long in the face of mounting political pressure and the continued crippling of the financial system that is the legacy of a decade of deflationary policy error. Given the short-run policy uncertainties, the 10-year JGB is likely to remain in a range around current yields of 1.5% for now, with the yen/dollar rate hemmed within132-135/$. We maintain our JGB short call, and would view any rally from these levels as an opportunity to increase the short position.

No question, a healthy dose of skepticism is always warranted in the space between statements of seemingly good intentions by the Japanese political elite and actual policy implementation. In this instance, it seems unavoidable that anti-deflation action will be tied into attempted disposition of non-performing debt under the all-purpose moniker of "structural reform." In the context of the straightforward monetary reflation that is still required in Japan, such matters rate as a distraction, at best. There is, in fact, significant risk involved in presenting resolution of the bad-loan problem as central to overcoming the deflation. If the political wrangling over the mechanisms required to effect the write down of bad debt is drawn out, it could provide the Bank of Japan with cover to forestall the needed liquidity additions. As it is, **BoJ Governor Masaru Hayami** never tires of expounding on his fervent belief that monetary policy is powerless without action to clear the bad debt overhang from the banking system. In this twisted formulation which undoubtedly reflects the view of the BoJ bureaucracy, it is non-performing loans that cratered the economy and caused the deflation. In reality, of course, monetary deflation crushed debtors and ravaged the balance sheet of the banking system. Without a monetary fix, no "restructuring" can possibly restore the Japanese banking system to good health. Under the circumstances, though, Hayami and his BoJ brethren might well be compelled to take the government initiative as an indication of good faith, and not hold liquidity additions hostage to final agreement on a bad-debt resolution package. TM

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