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MACROCOSM

Japan: Here We Go Again

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Japan's anti-deflationary efforts remain mired in politics and incompetence.

Senior Japanese officials are again groping for a lifeline to keep Japan's foundering financial system from sinking ever deeper into a deflationary abyss. This week's spectacle found **finance minister Masajuro Shiokawa** and his chief international deputy separately issuing what amounted to calls for significant yen depreciation, whether measured internationally in terms of foreign exchange or domestically in terms of the general price level.

Shiokawa took the highly unusual step in published comments over the weekend of specifying what appeared to be a target range for the currency's value of 150-160 yen per dollar, a 19% to 24% weakening from then-extant levels around Y122/$. He later backtracked and claimed his remarks were misunderstood as suggesting such levels would be "desirable," when he meant to convey only that they would be "appropriate." The markets, however, understood that one way or another, the **Ministry of Finance** was signaling a desire for a weaker yen, and quickly sold the currency down to a level just around Y124.5/$, which has held since early Monday.

That impression was reinforced by publication in Monday's *Financial Times* of an op-ed co-authored by **vice finance minister for international affairs Haruhiko Kuroda**, calling for "aggressive monetary reflation," as part of which the **Bank of Japan** would set an inflation target of 3%. That would also necessarily entail a significant yen weakening, unless the BoJ coordinated with **the Fed** and other major central banks to jointly reflate without affecting currency cross rates. Kuroda, in fact, proposes in his article that exactly such policy coordination be undertaken, but the chances of any joint reflation at this point are remote. Indeed, when Kuroda himself later stepped into the fray over Shiokawa's comments, he averred that the "too-strong yen" should continue "correcting." Thus, the coordinated-reflation idea offered in his op-ed amounted to a fig leaf for his real objective, which is to reflate the yen's real purchasing power, come what may for the currency's forex value.

If all this has a certain ring of familiarity, it should. Over the past few years, MoF officials have from time to time demonstrated an eagerness to see the yen fall to facilitate relief from Japan's unending deflationary ordeal. Perhaps the most notable jawboning episode came about this time last year, reflecting a clear consensus in the senior MoF bureaucracy that in furtherance of an anti-deflation orientation, a sustained yen depreciation could not be avoided (see "BoJ Watch: The Falling Yen" December 17, 2001). Speculation that this rhetoric ultimately would be confirmed with an aggressive policy thrust from the Bank of Japan brought the currency to better than four-year lows around Y135/$ by early this year.

Those indications of relief, however, turned out to represent a false hope. While the always-obstinate BoJ reluctantly responded to the government's request for "bold" action by agreeing to boost its outright purchases of government debt, the added liquidity proved insufficient to slake the market's long-denied thirst for yen. Almost immediately upon the BoJ's announcement in late February, the yen began its long climb back through the Y120/$ level, which is the range it

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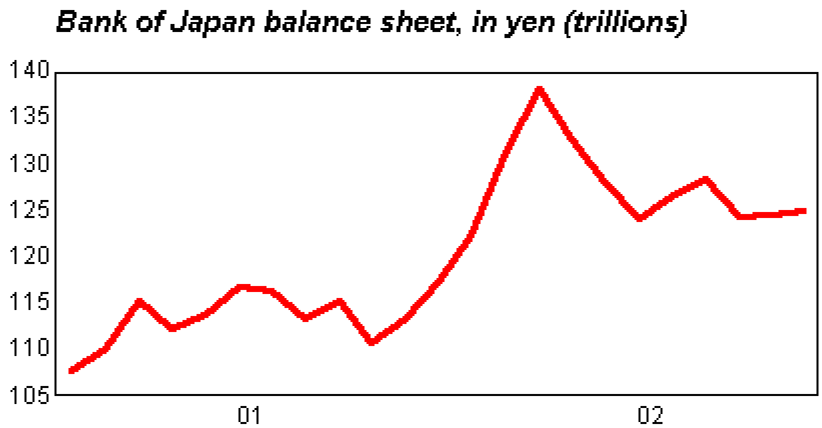
had largely held until this week. That, even after the BoJ in late October again upped its outright purchase objective, from Y1 trillion to Y1.2 trillion per month. A hint as to why setting such arbitrary objectives has thus far failed to show any real results is provided by the chart below. It shows that the total asset base of the BoJ balance sheet peaked in April, and has since declined by some 10%, even as the bank has ostensibly increased its monthly bond purchases by a total of 50%. In other words, whatever action the BoJ has undertaken to inject additional yen on a gross basis has been insufficient to offset the balance-sheet dynamics that are resulting in a net liquidity drain. And because for all practical purposes it remains blind to the market impacts of its own actions, the central bank appears to have no understanding that the additional purchases have been insufficient to overcome the deeply-imbedded deflationary influences.



Will it be different this time? Thus far, the BoJ has been silent in response to the MoF's exhortations, which may reflect a calculated decision to remain institutionally inconspicuous during a delicate transition period for the central bank. After nearly five years of exquisite ineptitude, **BoJ chief Masaru Hayami** is due to step aside in March, and speculation over the course the **Koizumi administration** might seek to follow in naming his replacement is already running rampant.

Undoubtedly, the signals on that score sent by this week's exercise in verbal currency intervention are not going unnoticed in the BoJ's palatial Tokyo headquarters. But whether those signals will break through the prejudices of the hide-bound central bank is an open question. Just last week, Hayami was asked by a parliamentary committee whether a weaker yen would help relieve Japan's deflationary plight. "A weaker yen is generally positive for the economy and...would boost prices," he responded. "But at the same time, it is doubtful how much artificial manipulation of a currency is possible and we need to think about the impact overseas" from a weaker yen. Then, the central banker again displayed his almost incomprehensible ignorance of the destruction wrought over the past decade by the deflated currency, destruction for which the BoJ bears complete responsibility. "It is because of the economy and a strong currency that Japan has presence and has a say in the global economy. I think we should maintain this," he said. In other words, for Hayami, a sentiment no doubt shared at the senior levels of the BoJ, a "strong" yen remains a point of pride, no matter the damage done in its name. TM