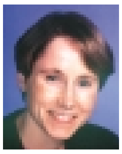
NOT MUCH JOY FOR JAPAN



SOME 20 MONTHS AFTER HIS ELECTION, PRIME MINISTER KOIZUMI HAS STILL NOT MANAGED TO PUT JAPAN BACK ON THE RIGHT FINANCIAL TRACK, SAYS **SALLY WILKINSON** OF DAIWA SMBC.

As 2002 drew to a close, a real sense of *déja vu* hung over the Japanese economy and financial markets. Prime Minister Koizumi came to power in April 2001, promising to fix Japan's banks, tame the budget deficit and trim Japan's unwieldy public corporations, thereby putting Japan's economy back on a stable footing. From the outset, Japan watchers worried that Koizumi was more a populist than a reformer and did not have the political clout to defeat the tendencies of Liberal Democratic Party (LDP) old guard politicians to protect Japan's special interests and maintain the status quo.

Looking back over 2002, such pessimism appears to have been warranted. Faced with a weak economy, 2002 deficit targets were abandoned in favour of yet more traditional, albeit modest, fiscal pump priming. The 2003 budget draft incorporates only minor tax changes, a far cry from Koizumi's plans for sweeping tax reform, mainly because such changes are revenue negative in the short term and Koizumi appears determined to maintain some semblance of budget restraint. Meanwhile, public corporation reform has been put firmly on the backburner, with interested parties unable to agree how to unwind or privatise even the most delinquent and outdated of public entities. But for most Japan watchers, the biggest disappointment has been in the area of bank reform.

RAISING HOPES. The appointment in September of the very forthright Takenaka as new FSA chief raised hopes that the government might finally mean business, leading to a full-scale clean up of Japan's bad loan problem and possibly bank nationalisations. But, facing a backlash from LDP old guard members seeking to protect weak corporates in their constituencies, he subsequently played down his reform plans, even going so far as to suggest that Japan's big banks are fundamentally sound. Of course, this flies in the face of the fact that all of Japan's big banks are woefully under-capitalised by any normal measure and still saddled with huge stock and bad loan portfolios. Meanwhile, the government extended for two more years the full state guarantee on bank current accounts, thereby protecting weak banks from a flood of deposit withdrawals. Therefore, we closed 2002 with the economy languishing, deflation entrenched, the financial sector on its knees, the stock market trading at a 19-year low and Japan's government debt dynamics deteriorating at an alarming rate. Worried about the lack of definitive action to address Japan's structural problems, the three big international rating agencies all downgraded Japan sovereign rating during 2002, to A2 (local currency rating) in the case of Moody's, below that of Botswana.

TOO SOFT APPROACH. Unaccountably, the Japanese electorate has taken all this bad news in its stride, apparently more interested in the World Cup and the return from North Korea of Japanese kidnap victims than the continued destruction of their economic wealth. Koizumi's popularity remains high and the main opposition party, the Democratic Party of Japan (DPJ), is in complete disarray. Indeed, one is almost left with the impression that Joe Public actually favours this softly, softly approach to economic reform.

Perhaps the only domestic entity that has fathomed the extent of Japan's problems is the central bank. Throughout 2002, the Bank of Japan (BoJ) adopted an ultra-easy monetary policy, injecting more and more liquidity into the system at zero interest rates, in the hope this might somehow stimulate loan demand. It did not. Banks simply invested the funds in government bonds. In September, it even went as far as to announce a plan to buy stocks from banks, ostensibly to protect banks' balance sheets from further erosion as the equity market tumbled. In reality, the move was more of a warning shot to the government that it was time to get serious about Japan's banks.

Still, the BoJ does not escape criticism completely. Indeed, the government would like to blame the central bank almost entirely for the country's woes. A more rational view is that the BoJ has failed in its basic task of maintaining price stability and should have moved more rapidly beyond the limits of conventional monetary policy into the unorthodox to halt Japan's deflationary spiral. Of course, it may still get there, but under the current governorship, the bank appears reticent to put its own credibility on the line to halt deflation, while the government continues to dither over basic economic reform.

The same challenges facing Japan during 2002 are likely to persist in 2003. The questions on everyone's lips are will the government finally tackle the bad loan problem, will the BoJ explicitly target inflation and what are the implications for Japanese financial asset prices? The chances are that 2003 proves to be yet another

FIGURE 1
GOVERNMENT DEBT SPIRALS

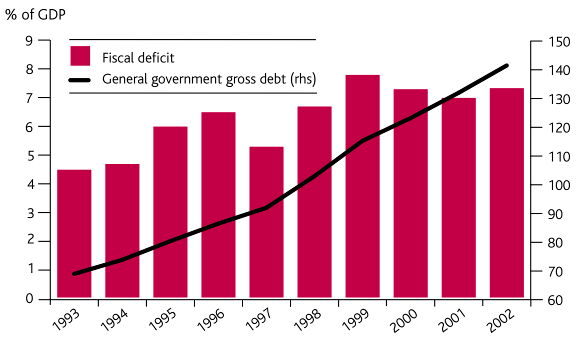


FIGURE 2
STOCK MARKET ON ITS KNEES

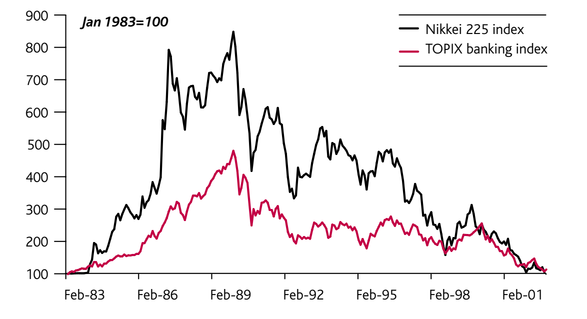
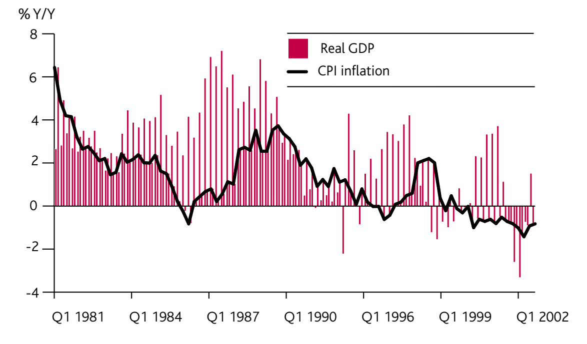


FIGURE 3
ENTRENCHED DEFLATION



Groundhog Day, but there may be reasons to be hopeful. First, the situation is just that bit worse than a year earlier. Second, the international environment in 2003 is unlikely to be supportive, not least because of pending geopolitical developments. Most importantly, the personalities and politics are set to change. Turning first to the BoJ, the terms of the current governor and two vice

'MOST OF JAPAN'S DELINQUENT BORROWERS ARE IN LOW VALUE-ADDED SECTORS OF THE ECONOMY AND THEIR CLOSURE WOULD NOT DENT JAPAN'S ECONOMIC OUTPUT BY AS MUCH AS MANY MARKET WATCHERS FEAR'

governors are due to expire in March/April 2003. While successors have not yet been decided, the smart money is on the installation of a less conservative trio who are prepared to take greater risks with monetary policy. If correct, the adoption of an explicit inflation target and a timeframe for achieving this target may yet be seen in 2003. Such a strategy will presumably involve an explicit commitment by the central bank to buy unlimited government bonds, as well as foreign currency assets.

Of course, whether inflation targeting actually succeeds in creating inflation with growth, rather than stagflation – or indeed no inflation at all – remains to be seen. The odds of success certainly increase if the government simultaneously tackles the bad loan problem, cleaning up the big banks' balance sheets (through nationalisation if necessary) and restoring their credit creation function. The short-term economic fallout of such a strategy is undeniable, but one should not get too hung up on this.

Most of Japan's delinquent borrowers are in low value-added sectors of the economy and their closure would not dent Japan's economic output by as much as many market watchers fear. A bad loan clean up would, however, wipe out many of the companies with which the LDP has long standing 'special relationships'.

THE START TO A NEW BEGINNING? Much depends on whether Koizumi has the political will to see things through. Takenaka's bank package may not have been implemented yet, but there is no doubt it contains sufficient substance to force a rapid overhaul of the banking sector, if it is given the go-ahead. Evidence from 2002 suggests the Prime Minister is more in favour of compromise than a showdown with his LDP colleagues. However, frustrated by the obstructionist behaviour of his conservative colleagues, there is increasing talk that Koizumi may be willing to put his popularity and reform agenda to the test by calling early national elections some time during the first half of 2003 (a general election is not due until June 2004). Most likely, he would run as the LDP's candidate and, given the lack of an effective opposition, there is little doubt that he would secure yet another victory for the Party, allowing him to silence his critics, at least for a period.

Interestingly, there is even speculation that certain disgruntled LDP factions would rather see a break up of the LDP itself, than affirmation of Koizumi's policy ambitions. In truth, a re-drawing of the political landscape, although unlikely, is probably the best thing that could happen to Japan, potentially signalling the beginning of a new, and more fruitful, period. In sum, there is enough to suggest that 2003 could just mark the beginning of the catharsis that Japan so badly needs if it is to have any chance of securing its position as an economic power of the 21st century. Just don't hold your breath.

Sally Wilkinson is Head of Bond Research at Daiwa Securities SMBC Europe.
sally.wilkinson@daiwasmbc.co.uk
www.daiwasmbc.co.uk