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The Case for Fukui

Like Masaru Hayami, his predecessor as governor of the Bank of Japan, the 67-year-old **Toshihiko Fukui** *is a veteran BOJ official who believes that printing money cannot substitute for thorough reforms. As he told the* Asahi Shimbun, *"It is wrong to think that the current deflation can be stemmed through monetary easing alone…Structural reforms are more important than ever before."*

BY RICHARD KATZ

A long-time Tokyo observer argues why a reformer, and not a deflation fighter, is Japan's best bet.

It is hard to see how Japan can revive unless reformers are put in charge of key policymaking institutions. That is why the appointment of Toshihiko Fukui as governor of the Bank of Japan is a positive step.

Like Masaru Hayami, his predecessor, the 67-year-old Fukui is a veteran BOJ official who believes that printing money cannot substitute for thorough reforms. As he told the *Asahi Shimbun,* "It is wrong to think that the current deflation can be stemmed through monetary easing alone…Structural reforms are more important than ever before." The top priority is dealing with the horde of "zombie borrowers," Fukui explained to Bloomberg, "Those borrowers that should leave the market still remain and exacerbate deflation and harm the profitability of the healthy."

The limited impact of monetary easing is recognized even by many of those who press the BOJ to conduct more "unconventional stimulus." Consider this statement: "Unless banks make progress on bad-debt disposal, the monetary easing by the Bank of Japan will not produce results, making it impossible to beat deflation." It sounds like the BOJ, but the actual speaker was Heizo Takenaka, the minister for both economic policy and financial services. How about this one: "Neither monetary

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policy nor banking policy can fully succeed without the other in achieving the goals of strong economic growth." That's the message delivered in Tokyo last November by John Taylor, a renowned monetary economist now serving as the U.S. undersecretary of the Treasury. And finally: "Policy measures to strengthen [Japan's] banks are a prerequisite to restoring the effectiveness of the monetary transmission mechanism." That comes from IMF economists in their book, *Post-Bubble Blues.*

Given the slowness of government efforts on the banking problem, the next few years will bring neither recovery nor cataclysm, but continued malaise.

There is, of course, an alternative view. Some still harbor the futile hope that massive money-printing, like the government's spending on "bridges to nowhere" in the past, can substitute for reform. Critics claim that the BOJ could create 3–4 percent inflation at will and that this inflation would, in turn, revive private demand. Some even suggest that the BOJ buy up assets used as collateral for bank loans, from corporate equities to office buildings.

Author Richard Katz's new book is **Japanese Phoenix: The Long Road to Economic Revival** *(M.E. Sharpe, 2003).*

While many economists support such measures, the most fervent advocates are the opponents of reform. They hope that higher stock and property prices can make bad loans good without painful restructuring of "zombie" borrowers. The more Japan's leaders grasp at monetary straws, the less likely they are to undertake true reform.

Indeed, as of deadline time in mid-March, anti-reformers were exaggerating the dangers of an alleged "March crisis," i.e., yet another fall in the stock market, to justify their case. Arguing that various accounting and banking reforms were hurting stock prices, they called on the government to reverse them. They also amplified past calls for the BOJ to buy stocks and real estate. In the panicky atmosphere, these calls on the BOJ were joined even by some of those who had supported Fukui, such Hiroshi Okuda, chairman of both Toyota and the Keidanren business federation. While Takenaka has so far opposed any reversal or delay of the banking reforms, he has unfortunately joined the pressure on the BOJ. Fukui is likely to resist a simple bailout, while looking for something the BOJ can do.

The main alternative was **Nobuyuki Nakahara,** *a fervent advocate of "inflation targeting." Even those who liked Nakahara's policy stance, including many in Washington, regarded him as too loose a cannon to be effective.*

If deflation is a product of weak demand, then the solution is to boost demand directly.

WHAT FUKUI WILL DO

In his basic philosophy, Fukui represents continuity with Hayami. However, even Fukui's critics acknowledge that he possesses greater political acumen, more flexibility, and a denser network of supporters in politics and business. Consequently, say BOJ officials, Fukui could be more effective than Hayami in building consensus for reformist policies.

A key turning point came in January when former Prime Minister **Kiichi Miyazawa** *personally warned Koizumi that inflation targeting could raise long-term bond rates (and thus lower bond prices) long before inflation showed up. That would hurt the government's ability to finance its debt, impose a stiff capital loss on the banks' ¥80 trillion ($666 billion) stake in JGBs, and depress the economy. Koizumi then publicly repudiated inflation targeting.*

Fukui wants the BOJ to exert a direct impact on the bad loan problem, possibly through its bank examination authority. The BOJ cannot legally enforce its findings but it can turn a brighter spotlight on problems. In addition, he wants to find new ways to add liquidity. Options under discussion include an increase in purchases of Japanese government bonds (JGBs), asset-backed commercial paper, and perhaps Exchange Traded Funds (i.e. stock market index funds). How the latter squares with Fukui's opposition to artificial support for stock prices is unclear. On the other hand, Fukui is hesitant to buy foreign bonds in order to depreciate the yen.

No one has yet presented solid evidence that deflation is the cause of Japan's chronically weak demand.

To a large extent, the BOJ's hands are tied. It can refuse the most outrageous bailouts, like buying buildings. But it cannot force the government to institute structural reform. Regardless, the BOJ has no choice but to keep the financial system stable. It can, and will, keep long-term interest rates on the floor while ensuring that the banks stay liquid. Unfortunately, the government keeps using these easing measures, not as breathing space to weed out the zombies, but as fuel to sustain them. The BOJ ends up being an "enabler" for the very policies it decries.

WHY KOIZUMI NAMED FUKUI

Prime Minister Junichiro Koizumi did not prefer Fukui, but he had no viable alternative. Originally, Koizumi wanted a "deflation fighter" from the private sector. But, as Koizumi's relations with business leaders soured, he found no takers. Besides, business leaders thought it dangerous to choose a neophyte.

In reality, deflation is not the cause, but the result, of the bad debt problem.

The main alternative was Nobuyuki Nakahara, a fervent advocate of "inflation targeting." Formerly the head of Tonen Energy, Nakahara served on the BOJ's nine-person Policy Board where his proposals for greater purchases of JGBs as well as foreign bonds were often outvoted 8–1. Even those who liked Nakahara's policy stance, including many in Washington, regarded him as too loose a cannon to be effective. Fukui, by contrast, inspired confidence among bureaucrats, business executives and many politicians.

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FUKUI DOMINATES TROIKA

Along with Fukui, Koizumi appointed two deputy governors: Toshiro Muto, a former vice finance minister, and Kazumasa Iwata, a top economist at the Cabinet Office.

Iwata, a career academic, has neither the political base nor the personal heft to sway the Policy Board toward inflation targeting. Muto is a heavy-hitter and a longtime confidante to Koizumi. Nonetheless, Fukui will dominate. Traditionally, the BOJ governor is a real power, not a figurehead. Moreover, as a 40-year BOJ veteran, Fukui commands the enthusiastic loyalty of most of the senior staff.

Muto's highest priority is making sure that the BOJ keeps buying lots of JGBs in order to keep long-term rates down. Even though the government debt is already at 140 percent of GDP and rising, ultra-low rates keep the interest bill lower today than it was back in 1986. Within limits, the BOJ will have to comply to maintain financial stability. Sooner or later, the BOJ will lift its self-imposed limits on buying JGBs.

WEAK DEMAND CAUSES DEFLATION, NOT VICE VERSA

If monetary stimulus had the power to revive Japan by itself, it would have done so long ago. At first, some proponents said ultra-low interest rates could revive Japan. The BOJ lowered overnight rates to less than 0.5 percent back in 1995 and at virtually zero since 1999.

When that didn't work, some monetarist economists claimed that "quantitative easing" would do the trick. They argued that, whenever a central bank increases the "monetary base," i.e., the small slice of the money supply that it directly controls, then the broader money supply and nominal GDP rise in tandem. That textbook trend used to hold for Japan, but since the late 1990s, that normal linkage has broken down. Since March of 2001, when the BOJ agreed to try quantitative easing, it has hiked the monetary base 40 percent. Interest rates certainly responded; a 10-year JGB now yields a record low 0.75 percent. But the rest of the broad money supply, which reflects the economy's need for money, barely changed. Meanwhile, bank loans, prices, and nominal gross domestic product all keep falling (see Figure 1).

What would announcing an inflation target accomplish? It's hard to believe that a BOJ promise of 3–4 percent inflation would be a self-fulfilling prophecy.

In a sense, the BOJ already has an inflation target, since it has promised to pump out money until inflation rises above zero percent. Under political pressure, Fukui could change that promise to 3–4 percent inflation. That would change nothing of substance—as long as Fukui refused to buy masses of stocks, buildings and other assets to back up that target.

No one has yet presented solid evidence that deflation is the cause of Japan's chronically weak demand. In reality, causality goes the other way: weak demand leads to deflation. During the last decade, the best predictor of price trends has not been monetary policy but the demand-supply gap, i.e., the gap between actual GDP and full capacity GDP. When demand is too far below potential supply, prices soften. Since 1987, there has been an extremely high correlation, 88 percent, between the demand-supply gap in one quarter and deflation a year later. Prices are falling today because GDP is 4 percent or so below full capacity (see Figure 2).

The more Japan's leaders grasp at monetary straws, the less likely they are to undertake true reform.

If deflation were, in turn, exerting a negative backlash on demand—as it did in the United States in the 1930s—then worsening deflation should be followed a year later by even weaker demand. In reality, there is no such correlation.

Some argue that deflation worsens the nonperforming loan problem because it lowers current revenue compared to old debt. This ignores the fact that it also lowers costs. In reality, deflation is not the cause, but the result, of the bad debt problem. Sick borrowers in industries with excess capacity cut prices to the bone in order to survive.

Suppose the BOJ could create inflation at will. Who exactly would launch a buying binge in response? Automakers can build 15 million vehicles a year but can't sell more than 11 million. Many other industries are in similar straits. Why would companies go even deeper into debt to add still more useless equipment just because prices are going up?

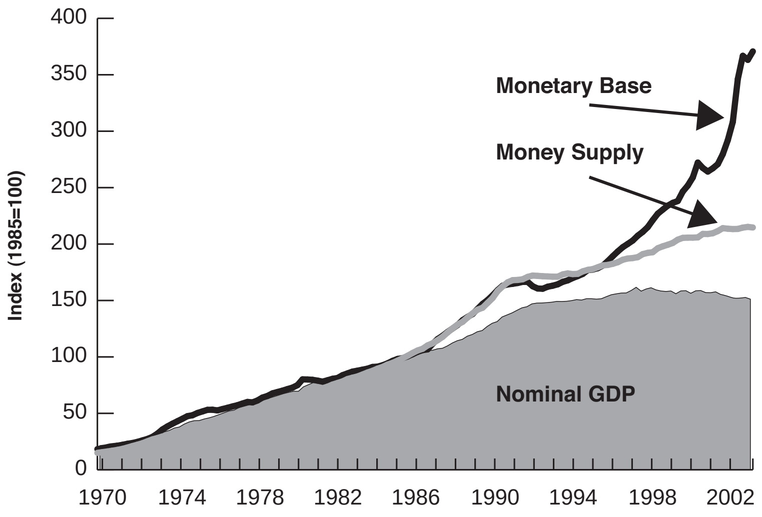
The inflation faction contends that consumers are delaying purchases as they wait for prices to go down. If so, then the household savings rate should be rising. In reality, the savings rate has steadily fallen from 12 percent in 1995 to 7 percent in 2001. Consumer spending is barely higher than six years ago because total employee income is barely higher.

Then there is the strange proposal that Japan import inflation by depreciating the value of the yen. Sure, a cheaper yen would boost Japan's exports, albeit not enough to eliminate its chronic demand shortfall. But to believe that paying more for imports will boost growth is to believe that higher oil prices spur growth. Fukui rightly rejects this notion.

Even if one accepts that a bout of inflation would be helpful by permitting negative real interest rates, the BOJ alone cannot do the trick. Central banks can no more create steady, manageable inflation just by setting a target than they can destroy it that way. To be sure, the BOJ can boost the price of any asset it buys. If it offered to print unlimited money to buy buildings at dou-

Fukui could be more effective than Hayami in building consensus for reformist policies.

Figure 1
Pushing on a Monetary String: Bank of Japan Pumps Out Money, Economy Fails to Respond



Source: Bank of Japan and Cabinet Office.
Note: Money supply equals all the rest of the money supply (M2 plus certificates of deposit) except for the monetary base. For further explanation, see text.

ble their current price, building prices would immediately double. Developers would construct buildings just to sell them at high prices to the Bank. Prices and vacancies would rise in tandem. However, on the day that the BOJ stopped buying, prices would fall back to earth. Such a move would recreate the late 1980s bubble and bust on a grander scale. To his credit, Hayami blocked such schemes and so will Fukui.

WHAT IS TO BE DONE?

Beyond saying what it cannot do, the BOJ has to stress what it and the government can do. If deflation is a product of weak demand, then the solution is to boost demand directly. The surest initial step is a permanent consumer tax cut, as well as tax breaks for housing, on the order of a few percent of GDP, all indirectly financed by the BOJ. That would directly put spending money into people's pockets without raising interest rates. The record shows that consumers do spend money from tax cuts.

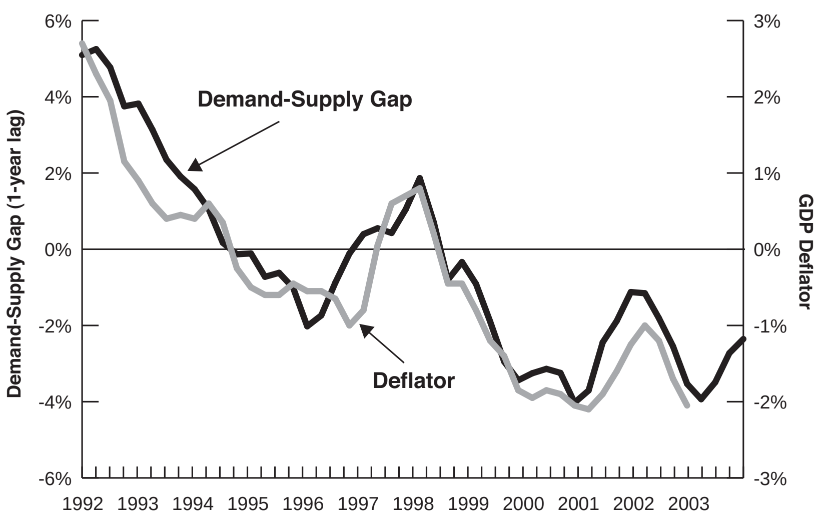
However, that stimulus will not help for long unless the government uses the breathing space to fix the banking crisis. A self-sustaining private sector recovery cannot occur until the bad loan/bad borrower problem is solved.

The chances of near-term cooperation by the government and the BOJ on the right policies are low.

Both Fukui and Takenaka are amenable to this three-pronged approach. Unfortunately, Koizumi clings to near-term fiscal austerity. Consumer taxes are to be raised by ¥1.4 trillion ($11 billion) this year via hikes in alcohol and tobacco taxes, as well as social security and health premiums. Meanwhile, Takenaka's efforts on bad loans are being stonewalled by the banks, borrowers, and politicians as Koizumi stays above the fray.

Unfortunately, the chances of near-term cooperation by the government and the BOJ on the right policies are low. Hence, so are the chances for near-term revival. But, in the long run, it can only help to have reformers such as Fukui in crucial posts. ◆

Figure 2
Weak Demand Causes Deflation, not Vice Versa



Source: Cabinet Office and author calculations based on International Monetary Fund data.
Note: The demand-supply gap is the gap between full-capacity GDP and actual GDP. The chart shows how the gap in any given quarter affects inflation/deflation four quarters later. So, the lines for the year 2000 show the deflator in 2000 and the demand-supply gap a year earlier.