MARKET CALLS

BoJ Watch: The Incomprehensible Mr. Hayami

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Yesterday's ***Wall Street Journal*** front-page feature on **Bank of Japan chief Masaru Hayami** performed a useful function in at least making clear that Japan's top central banker is thoroughly unfit for the task of rooting out the country's long-running monetary deflation. The piece depicted an obstinate 77-year-old whose worldview remains defined by the trauma of Japan's post-war hyperinflation, leaving him blind to the evidence all around him of the wreckage wrought by the past decade of deflation. Indeed, the article ends on a nearly surreal note, with Hayami actually musing about the beneficial effects of deflation on household purchasing power.

After a number of years spent closely following the culture and milieu shaping the BoJ policy apparatus, the reactionary, inflexible, ostrich-like attitude demonstrated by Hayami came as no great surprise. Those are among the defining characteristics of a central bank bureaucracy that has compiled a record of incompetence unequaled in the industrialized world. Our recent optimism that Japan appeared on track finally to overcoming its deflationary misery was not based on any hope of an organizational renaissance at the BoJ. It was based, rather, on an assessment that, given the growing strains to a financial system paralyzed by the gaping wounds of deflation, the authorities would soon face little choice but to inject yen liquidity sufficient to forestall outright collapse. That view was reinforced when the BoJ acceded to the Japanese government's request for a major boost in its outright purchases of Japanese government debt (see "BoJ Watch: Climbing on Board" March 1, 2002). Again, the best that could be said of the BoJ was that its announced policy appeared to leave it little room for exercise of discretion in following through with liquidity injections of Y800 billion per month.

At least in the short- to medium-term, however, that might not be enough. Comments such as those published yesterday, as well as others recently by Hayami and other BoJ officials, only cast doubt on the anti-deflation objectives of policy, which work to maintain the status quo of deflation expectations. Without a pronounced shift in those expectations, excess demand for money will continue to prevail. As demand for liquidity outstrips even the considerably more ample supply, prices continue to fall, rendering the expectations self-fulfilling. It's true that in the past three months, assets on the BoJ's balance sheet have grown at an annual rate of some 60%. It's also the case, though, that over the same period, the yen/dollar exchange rate, while showing considerable volatility in a range between Y127 and Y135, is, on net, little changed from its position three months ago at around Y131. Given Japan's well-known history of monetary mismanagement, it would not be surprising were there a significant speculative element in current demand for the currency, with players positioned for the all-too-familiar yen rebound. Recall that the currency was trading at Y120 as recent as last November.

In any case, the 10-year JGB yield back below 1.4%, down nearly 20 basis points since early February, is probably the clearest indication available that as yet there has been no relief in the deflation expectation climate. It remains our view that at some point, provided the BoJ follows through on its liquidity pledge, an excess yen supply relative to demand will show through in various market indicators, and a short position in JGBs will be rewarded handsomely. In the meantime, though, it's difficult to justify such a trade, and so we are closing our model position until we see clearer evidence of a tipping point in expectations. TM

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