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The turning point is here – Japan must abandon the “policy of permitting deflation”

- A new ruling party will cause the yen to plunge and stocks to surge -

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On November 14, the decision to dissolve the Diet was confirmed and the general election will take place on December 16. Immediately after this announcement, the yen weakened by ¥2 against the U.S. dollar. Furthermore, on November 15 Japanese stocks posted the only gain among the world’s major stock markets. The reason is that the Democratic Party of Japan is very likely to lose the election, resulting in Shinzo Abe of the Liberal Democratic Party, who wants to wage a war against deflation, becoming the next prime minister. The November 15 market movements clearly show how large the yen’s premium was because of the Bank of Japan’s policy of permitting deflation. This also shows how large stocks were discounted because of this policy. If there is a new administration in Japan and a basic shift in the Bank of Japan’s stance of allowing deflation, we are likely to witness dramatic shifts in the directions of the yen and Japanese stocks. We may even see a stock market rally greater than the upturn that followed the dissolution of the Diet in 2005 over the postal privatization scheme of then Prime Minister Junichiro Koizumi.

The focus of debate will shift to the economy (fighting the strong yen and deflation)

Shinzo Abe, who is now president of the Liberal Democratic Party, is committed to ending the yen’s strength and deflation. He wants an inflation target of 2%-3%, unlimited monetary easing by the Bank of Japan to end deflation and amendments to the Bank of Japan Law. Other political parties expected to succeed in the election, such as the Japan Restoration Party and Your Party, are backing similar policies. With Japan on the verge of another recession, actions to stimulate the economy are needed now. With pressure on the Bank of Japan mounting, the conditions are in place for a prolonged downturn of the yen and upturn in stock prices.

The economy has instantly become the focal point of the election. The Noda Cabinet has accomplished the consumption tax hike, pension payment cut and other proposals that may negatively affect the economy. However, Japan’s GDP shrank by 3.4% in the third quarter of 2012, pointing to the danger of another recession. The GDP declined because of the end of the eco-car subsidy, falling capital expenditures and exports, and other factors. So this is not necessarily a one-time event. In the fourth quarter, most people believe that a further GDP decline is inevitable because exports to China are declining and much earthquake reconstruction demand has run its course. Furthermore, the collapse of the consumer electronics industry, factory closings and other events are severely impacting regional economies in Japan. As a result, there are increasing demands from Japan’s large cities and other areas of the country for immediate action to support the economy.

No reason for any expectations regarding China

There is little hope concerning the expected economic upturn in China. Growth of the trade surplus in October was good news, but the cause was stagnant imports, a sign of lackluster internal demand. China implemented a one trillion yuan economic stimulus program in 2012. However, the benefits were barely visible compare to the four trillion yuan program of 2008. Most likely, declining financial strength now that foreign currency reserves have peaked is responsible. In addition, the Financial Times (November 13, 2012) reported that China’s State Reserves Bureau started buying aluminum and zinc for stockpiling. The aim is to push up market prices in order to assist government-owned companies associated with aluminum and zinc. This forceful market intervention shows that the Chinese government is responding to economic difficulties by simply pushing problems farther into the future.

The Bank of Japan and experts are justifying actions that merely create an alibi

In this environment, demand on the Bank of Japan's policy initiative is increasing. Thus far, the Bank of Japan has withstood criticism for its conventional half-hearted monetary easing (implemented in small amounts while the bank is believing there are no benefits) that was like creating an alibi. Many experts are people who understand the bank's position. This could perhaps be called the "inevitable deflation belief." This includes the belief that (1) structural reforms are needed (people have called for reforms for many years but they have still not been achieved), (2) deflation and excess supply are historic global trends and (3) enacting further financial initiatives would be pointless. Is this really true? Are these people denying the monetary easing success story that achieved reforms in the United States? Even if we assume that the U.S. monetary easing produced no benefits (or that byproducts produced an enormous reverse effect), then the only course of action would be to keep waiting for the failure of this monetary easing is certain to come. On the other hand, if we believe that U.S. monetary easing can succeed, there is room to enact financial initiatives. Deflation war defeatists are people who decide that deflation is a global and historic trend that is impossible to resist, and who don't even think that resistance should be tried but then fail to resist. The conclusion is that the Bank of Japan must evolve in order to advance to a new age of financial policies.

Why doesn't the Bank of Japan try creative monetary easing even though there is good reason to test this stance. The reason is probably that the bank does not believe the harmful effects of deflation are very serious. However, there are growing signs of economic weakness as Japan prepares for a general election. Consequently, voters will most likely refuse to accept the passive observer attitude (ultimately the attitude of not assuming any responsibility) of the Bank of Japan and many experts.

The problems created by deflation have reached a critical point

Deflation has constantly sapped Japan's economic vitality by causing price declines that obstructed the service sector. This is a sector with substantial growth potential even though productivity is not improving. Deflation triggered a spiral along with the strengthening yen that destroyed industries that were concentrated in Japan. Examples include semiconductors, electronics and basic materials. Moreover, a virtually unlimited preference for cash took hold because of deflation that sucked risk-taking money out of financial markets. Deflation created inequalities in the distribution of income. Individuals on fixed incomes, such as government employees and people living on pensions, benefited while workers' incomes decreased. Wages of the more vulnerable people decreased and the income gap widened because of deflation. Despite the magnitude of this problem, the Japanese government and Bank of Japan merely were idle as deflation continued. This was possible because Japan benefited from strong overseas economies. But Japan can no longer expect these benefits due to turmoil in China. The people, companies and industries of Japan can no longer endure the pain created by deflation. In particular, the yen's upturn after the Lehman shock led to the yen alone strengthening and Japan returning to deflation while other countries enacted beggar-thy-neighbor policies aimed at making their currencies weaker. This imposed an enormous burden on Japanese companies and put the pieces in place for these companies to be the world' s only losers. The symbol of this process is the extreme downturn in Japanese stocks alone in the world in the wake of the Lehman shock.

If a new administration takes over in Japan after the election, a major shift will probably occur in markets as the Bank of Japan enacts extensive reflation measures centered in creative and bold monetary easing. In the United States, there are worries about an economic downturn caused by the fiscal cliff as tax cuts end and spending is cut. But most people expect that the Obama administration and Republican Party will reach an agreement to extend the tax reductions. This agreement will probably cause the dollar to strengthen due to the resulting lower burden on monetary policies. A huge downturn of the yen and upturn of stock prices in Japan are becoming visible after a new party takes over in Japan and the U.S. fiscal cliff is avoided in late 2012 or early 2013.