Japan's Economic Policy Conundrums

Having languished for more than a decade since its bubble burst in 1990, Japan's economy is a major world concern. The prolonged decline of not only Japanese asset prices but overall consumer prices as well has spurred ongoing nonperforming loan problems in the financial sector. The government has sought to combat the economic slowdown with eight fiscal stimulus packages over the last 10 years, with little to show for it but the highest debt-to-gross domestic product (GDP) ratio (140 percent) in the industrialized world. Continued monetary easing has pushed the overnight interest rate to zero, but consumers still don't want to borrow and spend.

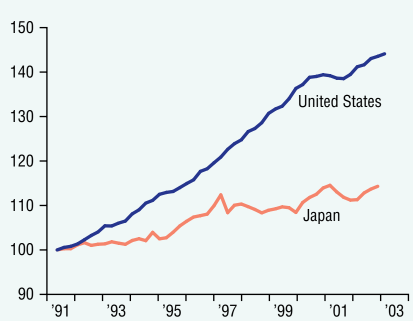
Japan's economy is the second largest in the world—about half the size of the United States' and twice Germany's, which is No. 3. Japan is the world's largest foreign investor; it has maintained a trade surplus for the last 50 years. In 2001, Japan owned 6 percent of the outstanding U.S. Treasury securities (valued at 3.5 percent of U.S. GDP). Most important, Japan's problems are big enough to slow the global economy.

Then Deputy U.S. Treasury Secretary Lawrence Summers said at several 1999 world forums that the world economy cannot fly on a single engine. Can Japan's economy take off and propel the world economy forward as it did until the end of the 1980s?

Chart 1

Real GDP of Japan and the United States

Index, 1991:1 = 100

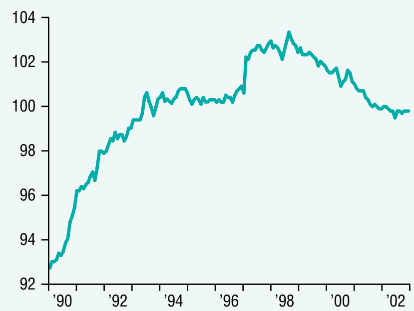


SOURCES: Cabinet Office, Japan; Bureau of Economic Analysis.

Chart 2

Japan's Consumer Price Index

Index, 1995 = 100



SOURCE: Statistics Bureau, Japan.

Current Economic Conditions Are Gloomy

Since 1991, Japan's real GDP has grown only 14 percent, compared with the United States' 44 percent (*Chart 1*). Although Japan's consumer price index (CPI) has risen 3.7 percent over the same period, it has dropped 2.2 percent since 1998 (*Chart 2*). Meanwhile, asset price deflation has become much more pronounced. Japan's major stock market index, the Nikkei, has dropped 79 percent from its peak in 1989. And in the past year, Japan's unemployment rate has reached its highest level in almost a half century (*Chart 3*). It should surprise no one to discover that low investment and consumption growth has characterized this entire period.

The Japanese economy has been injured not only by its prolonged slowdown but, paradoxically, also by some of the Japanese government's unsuccessful but costly attempts at fiscal stimulus. Financial intermediaries are not lending. Conventional macroeconomic policy measures have been exhausted. To the extent that they have been applied, textbook-type policies have been unable to rehabilitate the ailing economy. The obvious but difficult and costly solution of resolving the banking crisis remains to be accomplished.

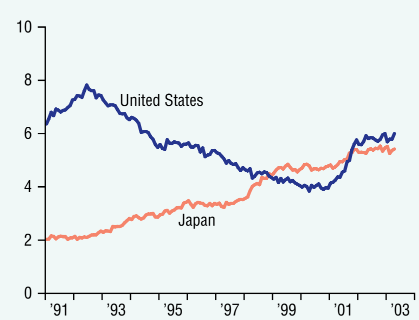
The Troubled Financial Industry. Japan's financial industry ills began with an asset market bust. In 2002, the land-price index dropped to 30 percent of its 1990 peak. The result has been the accumulation of bad loans on banks' balance sheets. The Japanese Financial Services Agency, the financial supervisory authority, recognizes the problem, but structural changes have been slow and capital injections insufficient. Merged banks have been reluctant to lay off redundant workers. Injected capital has not been enough to cover the ever-increasing nonperforming loans. The Japanese government's estimate of bad loans within the financial sector is $266 billion (6 percent of GDP). Other estimates are as high as $1.9 trillion (43 percent of GDP).

Political support for structural reform is almost nonexistent in Japan. Moreover, because Japan's capital market is less developed than that of the United States, alternative funding sources, such as corporate bonds, are not available to absorb shocks to the banking sector. Commercial bank loans currently total about 90 percent of Japan's GDP, but only about 40 percent of U.S. GDP. A Resolution Trust Corp.-type solution, such as was employed in the United States in the 1980s to deal with the savings and loan crisis, would be difficult to implement

Chart 3

Unemployment Rate in Japan and the United States

Percent



SOURCES: Statistics Bureau, Japan; Bureau of Labor Statistics.

in Japan. The entire Japanese banking sector is in trouble, whereas the savings and loan crisis affected only 5 percent of American depository institutions.

Conventional Macroeconomic Measures Have Unexpected Limits. The Bank of Japan has dropped short-term nominal interest rates virtually to zero (*Chart 4*). With the lower bound of a zero nominal interest rate, lowering short-term interest rates is no longer a viable policy goal to boost the economy. Quantitative easing has not worked so far because increasing base money has not significantly increased broad measures of money such as M2+CD. The Japanese financial intermediaries are unable to facilitate the money multiplier effect because they are not increasing their lending.

Japan's gross government debt of 140 percent of GDP is the highest among the industrialized countries (*Chart 5*). The ever-increasing debt led credit rating companies to rank Japan's sovereign rating as low as those of Greece and Botswana. As a result, the government of Japan has become much more cautious in applying stimuli.

Nor does the government view manipulating the exchange rate as a real option. Despite what many Americans believe, Japan is not much of a trading country. Of the 171 countries for which the World Bank records data, only Myanmar trades less than Japan as a share of GDP. According to Haruhiko Kuroda, former vice minister of international affairs of the Ministry of Finance, with an export/GDP ratio below 10 percent, Japan would have a very difficult time boosting its economy much by depreciating its currency. Worse, it would be difficult to persuade Japan's neighbors, especially South Korea, to accept a depreciation of the yen against the dollar. Such a depreciation would be ineffective because Korea and China would more than likely respond with devaluations of their currencies. The Finance Ministry's intention, however, is to maintain a trade surplus through foreign exchange-rate policy as a way to stabilize markets for Japanese government bonds.

Competing Views on Japan's Economic Woes

Many economists have volunteered solutions to Japan's economic problems. With their differing views on the source and cure of Japanese deflation, they fall into one of three camps. The first holds that—rather than a source of economic slowdown—deflation is the consequence of the structural problem of resource allocation, which intensified after the bubble burst. CPI deflation has been minimal compared with asset price deflation, which cannot be halted by macroeconomic policies. Some, such as Fumio Hayashi and Edward Prescott, believe that structural reform in the financial sector to restore productivity growth should be the first priority, and monetary easing may be secondary at best. In 1990, Japanese industrial productivity was 34 percent lower than that of the United States because of inefficient resource allocation. That percentage is probably even greater today. The more industries are regulated and subsidized, the less productive and more expensive they become (*Table 1*).

The second camp believes that deflation itself is the source of the problem. Because they expect future deflation, Japanese consumers do not consume. The process is self-fulfilling. Various creative macroeconomic policy measures to cure price declines have been recommended, including direct monetization of Japanese government bonds by the central bank (Ben Bernanke), inflation targeting (Lars Svensson) and relentless depreciation of the Japanese currency (Allan Meltzer).

The third camp comprises classical Keynesians who believe that only fiscal expansion could stop deflationary spirals (Richard Koo). This argument lost ground as the eight fiscal stimulus packages piled

Table 1

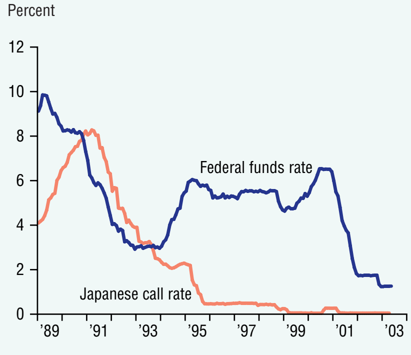
Productivity Gap and Comparative Price Level, Japan–United States, 1990

Sector	GDP per hour worked Japan/United States (percent)	Comparative price level United States = 100
Agriculture	13.8	378.7
Mining	67.4	116.1
Manufacturing	91.2	108.3
Construction	65.0	172.1
Electricity, gas and water	41.3	314.2
Transportation and communication	32.1	229.9
Wholesale and retail trade	65.2	144.3
Finance, insurance and real estate	60.3	211.4
Service and government	90.5	114.0
Total economy	66.0	146.2

SOURCE: Dirk Pilat (1993), "The Sectoral Productivity Performance of Japan and the U.S., 1885–1990," *Review of Income and Wealth* 39 (December): 357–75.

Chart 4

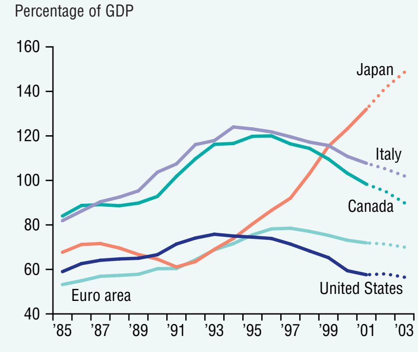
Short-Term Interest Rate in Japan and the United States



SOURCES: Bank of Japan; Federal Reserve Board.

Chart 5

General Government Gross Financial Liabilities



SOURCE: Organisation for Economic Cooperation and Development, *Economic Outlook* 70 (2000).

up government debt without producing the accelerated demand that was supposed to accompany them.

Of the three explanations for Japan's deflation, the Bank of Japan supports the first, or structural argument. It proposes that the Ministry of Finance and the Financial Services Agency reform the banking sector so that banks can lend to more active borrowers instead of simply rolling over dead loans. But the reforms would mean not only the admission of heretofore unconfessed dead loans, but the admission of heretofore unconfessed dead banks. The Bank of Japan accordingly urges the injection of public money. But the bank resolution might still entail massive job cuts and an economic slowdown in the short run, and these possibilities make government officials nervous.

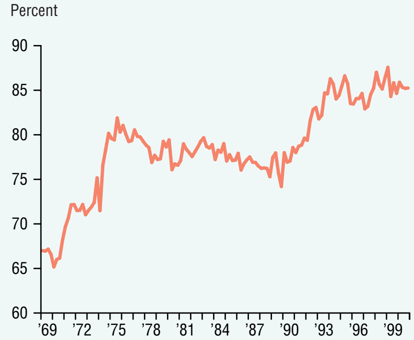
An opposing view, backed by the Ministry of Finance, is that the Bank of Japan's untimely monetary policy was a primary source of the problem. In this view, the solution is for the Bank of Japan to inject more money before beginning the painful restructuring of the previously unadmitted dead banks.

Understanding Japan's unprecedented economic circumstances is not an easy task. Without a consensus on the causes of current economic conditions, Japanese policymakers struggle to agree how to handle the economic problems. However, finding the solution to the ailing Japanese economy would not automatically guarantee recovery. Whether the first camp or the second is right, the solution will require the coordination of policies between the central bank and the Ministry of Finance. Whatever policy they implement will entail high risk and suffering for some people. Political support is the prerequisite. These practical conflicts have so far been difficult for Japan to resolve.

Because of system rigidity in Japan, there was no real policy coordination between the Ministry of Finance and the central bank until last year. Officials of both institutions were discouraged from commenting on the other's policy. There was almost no communication between them even on a personal level. Since the revision of the Bank of Japan Act in 1998, it has become difficult for outsiders (the Ministry of Finance and politicians) to influence central bank policies. For

Chart 6

Labor's Share of Japan's GDP



SOURCE: Cabinet Office, Japan.

example, the Ministry of Finance determines intervention in the foreign-exchange market but is not attentive to the counterbalancing act of buying back intervened currency, or sterilization, that is under the central bank's control.

Why Economic Reform Gets Little Support. After a decade of sluggish economic growth, Japanese leaders have become less confident about their system. Leaders now appear to be more open to foreign opinions, although up to now they have had difficulty acting on them.

Even though Japan is in the midst of an economic slump, a visit can be very misleading for foreigners, who are hard-pressed to find evidence of the economic doldrums. Tokyo's bustling subcenters and packed restaurants and bars belie the sluggish economy. In actuality, the lost decade has not severely affected the average Japanese citizen. Real GDP continued to grow, albeit not nearly at the U.S. rate (*see Chart 1*). Japan's unemployment rate of 5.4 percent is lower than the United States'. Labor's share of GDP has increased almost 10 percent since 1991 (*Chart 6*), while the share due to physical capital has correspondingly fallen.

Under continuing deflation, the rigidity of nominal wages and obstacles to laying off workers have increased real labor income and squeezed firms' profits (*Chart 7*). Labor has little political incentive to back drastic reforms. Diet members might have difficulty in the next election if they support a reform agenda that would reduce the premium the nation is willing to pay for job security. It has been argued that politicians only pay lip service to reforms to appease foreigners—who do not vote—and domestic academicians—who vote but do not make campaign contributions.

The Political Structure Does Not Help. Rural areas in Japan are overrepresented in the government. Agriculture and small local businesses depend heavily on government expenditures. Government capital formation in Japan is about 8 percent of GDP—three times higher than in the United States. As with labor reforms, attempts by politicians to cut back on government spending for agriculture and local small business—with their disproportionately strong lobbies—is difficult politically despite the long-term benefits.

Under these circumstances, the Diet has been pushing the administration for an additional tax cut. A permanent tax cut may help the economy through increased investment and consumption. But with a financial market that is more than fretful about the current 140 percent debt-to-GDP ratio, a tax cut would only be transitory. So far, the principal charm of a tax cut is said to be that it would not harm anyone in the short run. Accordingly, tax cuts' ability to stimulate is impaired because their persistence is not credible.

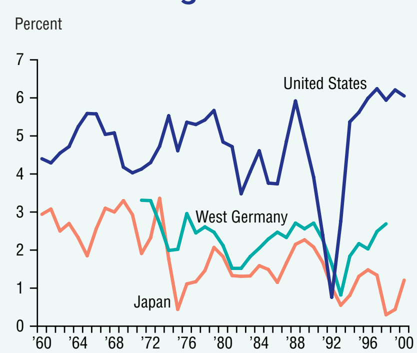
Nevertheless, out of the 80 trillion yen the government spends annually, 30 trillion is financed by new government bonds (*Chart 8*).

Will Japan Have an Acute Financial Crisis?

The evidence suggests that Japan cannot reverse the direction of its econ-

Chart 7

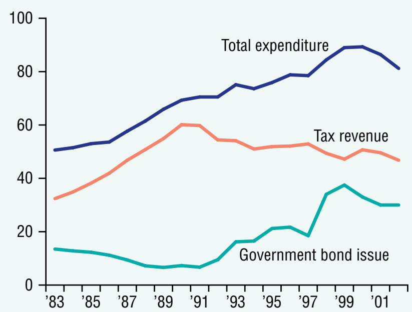
Profit/Sales Ratio in Manufacturing Sector



SOURCES: Ministry of Finance, Japan; Bundesbank, Germany; Census Bureau.

Chart 8

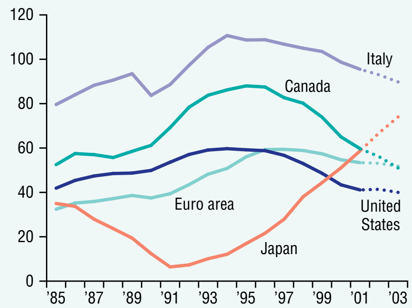
Japan's General Account Tax Revenues, Total Expenditures and Government Bond Issues



SOURCE: Ministry of Finance, Japan.

Chart 9

General Government Net Financial Liabilities



SOURCE: Organisation for Economic Cooperation and Development, *Economic Outlook* 70 (2000).

capital flight. The government and the central bank own the majority, 56 percent of the total, while commercial banks own 32 percent. Under current corporate governance, the managers of Japanese commercial banks do not feel responsible to their shareholders. Japanese bankers would follow instructions from the Ministry of Finance. Unless economic conditions deteriorate drastically and the government is paralyzed, it is hard to imagine any major private agency selling its government bonds.

For these reasons, there appears to be no momentum for drastic reforms or any indication of a potential financial crisis in Japan. Japan's economy may be sluggish for quite some time, but it will not implode.

omy immediately. Does this mean that a financial crisis is imminent?

Fearing it would lead to turmoil in the banking sector, Japan has delayed for two more years the elimination of blanket insurance on time deposits. Although this antireformist action may be suboptimal in the long run, it does eliminate the possibility of bank runs in the short run. Further stock price declines would not be deadly for the banks that own stocks as part of their portfolios because the Bank of Japan buys the stocks directly from the banks. The recent nationalization of Risona Bank signaled to depositors that their money is safe. A banking crisis triggered by bank runs is a remote possibility in Japan.

Some analysts worry that Japan's growing sovereign debt may cause currency-market instability. They argue that under the current political system, there is no clear vision to reduce the level of outstanding Japanese government bonds. If markets fear the government may default, capital flight may trigger a currency crisis. Aside from the possible retaliatory exchange-rate depreciations by other countries, it is hard to see why devaluation would be problematic in any case, but the sudden unavailability of credit is another matter.

Capital flight from Japan in the near future is unlikely for three reasons:

• Japanese government debts are domestic currency-denominated. It is always possible for the government to monetize the debt. Considering the long-term damage to the country's reputation as well as the immediate cost of financial market disruption, default is not a plausible policy option.

• The size of Japan's net government debt is just half its gross debt. While gross government debt is 140 percent of GDP, net government debt is about 70 percent of GDP—lower than that of some European countries. As long as Japan continues to maintain its trade surplus, the pressures that could result in a sovereign default are probably no higher than for countries like Belgium and Italy (*Chart 9*).

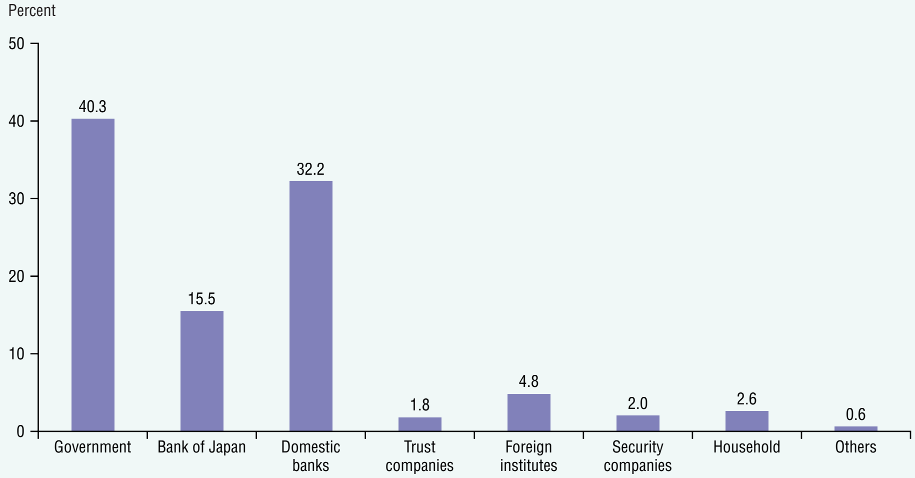
• As of March 2002, foreign ownership of Japanese government bonds is less than 5 percent of the total (*Chart 10*), not enough for foreigners alone to trigger

Is There Hope for Japan's Economy?

The speed of change in Japan is slow by U.S. standards, but there are some signs that Japan's economy is gaining strength. For one thing, frozen labor markets are beginning to thaw. Large Japanese companies have been very reluctant to lay off their "permanent" employees. For example, Fujitsu, a leading technology equipment company, has not laid off a single domestic employee in its entire history. Japanese companies have been slow to acknowledge the need for quicker labor adjustments and have relied on attrition and job relocation for the reductions efficiency and profitability

Chart 10

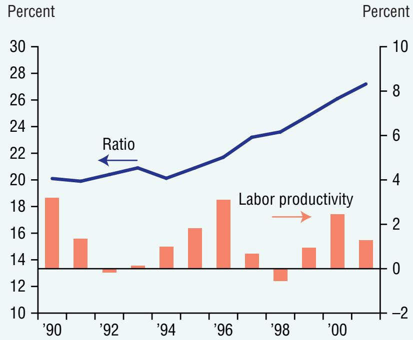
Ownership of Japanese Government Bonds



SOURCE: Bank of Japan.

Chart 11

Temporary Worker/Total Employment Ratio and Labor Productivity in Japan



SOURCES: Ministry of Health, Labor and Welfare, Japan; Japan Productivity Center.

require. Recently there has been one positive sign: Japanese companies are increasing their hiring of temporary employees. The number of temporary workers as a percentage of total employees jumped from 20 percent in 1994 to 27 percent in 2001 (*Chart 11*). Higher labor market flexibility increases labor productivity and enables companies to have higher profits.

In addition, attempts at policy coordination have surfaced. Last fall, when the Japanese stock market showed significant weakness, the Bank of Japan reversed its previous stance and decided to rescue the banks by directly purchasing their equity holdings. Previously, the Bank of Japan had insisted that financial-sector reform was needed before further monetary easing could take place. Now, the Bank of Japan acts like a guardian for Japanese commercial banks, which have a significant portion of their assets in corporate equities.

Further, Prime Minister Junichiro Koizumi fired the minister overseeing the Financial Services Agency, who had been reluctant to use public money to recapitalize the ailing banking system. Koizumi appointed reformist Heizo Takenaka to the position. And, as mentioned earlier, the government has postponed the elimination of blanket time-deposit guarantees for two years.

A flurry of policy actions like these is rare in Japanese politics. It appears that the Bank of Japan has been deeply concerned that the commercial banking sector would collapse if the deposit guarantee was lifted while equity prices were falling. These concerns appear to have resolved, at least for now, the longstanding conflict over which of the three causative arguments is believed correct. The top priority has become monetary easing, with efforts at financial-sector restructuring and reform to come later. With this basic conflict settled, it is possible that policy changes may come faster and with more coordination.

The appointment of new top management at the Bank of Japan raises hopes that policy coordination will be accelerated. The view of the new governor, Toshihiko Fukui, on deflation is not fundamentally different from that of his predecessor, Masaru Hayami, but he is considered better able to work with the Ministry of Finance. The deputy governor, Toshiro Muto, was Japan's vice minister of finance until last year. He will work to increase the Bank of Japan's direct purchase of Japanese government bonds.

Recent changes in labor market conditions, productivity growth and more coordination between the Bank of Japan and the Ministry of Finance are all positive signs that Japan will be able to deliver more decisive policy actions to boost the nation's economy and, one can hope, do it at a faster pace.

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Note

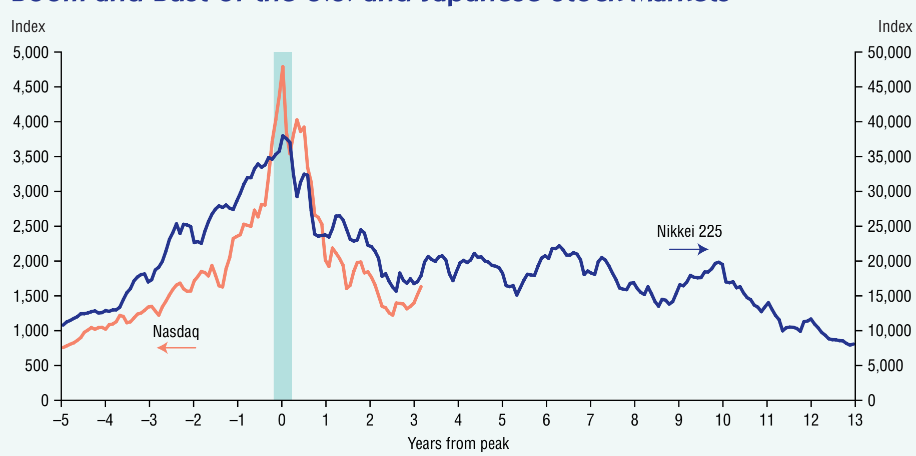
This research has greatly benefited from Koo's three-month stay in 2002 as a visiting scholar at the Policy Research Institute, Ministry of Finance of Japan. Koo appreciates the hospitality he received from the staff members of the ministry. The views in this article do not reflect the official view of the institute.

Does the U.S. Economy Follow the Japanese Path?

There are concerns that the current U.S economy may be following Japan's trail of the 1990s. The patterns of the Nikkei 225 and the Nasdaq indices before and after their booms and busts are strikingly similar (see chart below). Lingering possibilities of deflation and low interest rates intensify the worry. However, the U.S. economy is different from Japan's in several ways.

- The shock of the stock market bust is smaller in the United States. Only the technology-intensive Nasdaq has had a decline in Japan's league. Broader market measures, such as the Dow Jones Industrial Average and the Standard & Poor's 500, have not declined as much.
- A protracted slide in real estate prices has been a hallmark of the Japanese stagnation, but real estate deflation is not part of the U.S. picture and doesn't look as if it will be. Some economists credit the Federal Reserve for lowering interest rates more aggressively than the Bank of Japan.
- U.S. productivity picked up quickly after its asset price bust. In Japan, productivity growth had been sluggish for a decade. It may be because the U.S. labor market is more flexible. It took two years for the U.S. unemployment rate to increase 2 percentage points, whereas it took seven years for Japan to make the same adjustment after its bust.
- The United States has diversified sources of corporate funding, whereas Japanese companies rely mostly on banking. A shock to the banking sector does not influence the rest of the U.S. economy as much as it does in Japan.

Boom and Bust of the U.S. and Japanese Stock Markets



NOTE: Shaded area represents peaks of the U.S. and Japanese stock markets, March 2000 and December 1989, respectively.

SOURCES: Tokyo Stock Exchange; Nasdaq.