Can We See the Light through the Tunnel?
On the Current State of the Japanese Economy

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"The Economist" once praised Japan in the 1960s as the miracle of the rising sun. I used to be in the situation of having to explain why the Japanese economy behaved so well. However, recently Japan is referred to as the country where the sun also sets. Japan appears now in the twilight. In my office, I hear almost every day some new announcement of business statistics, and, during the past year, most of the time I was discouraged by the news. Since very recently, I am slightly more encouraged than before by the recovery of the U.S. economy and a few hopeful signals in the Japanese economy. The hope comes from the recovery of the U.S. economy and the progress of inventory adjustment. Production and export have some optimistic signs, but consumption and employment pictures are still dismal.

I will explain today why the Japanese economy has been struggling for such a long time and what can be done to find the way out of this situation. Let me start the discussion by mentioning some basic difficulties that Japan faces now.

(1) The Japanese economy has structural problems. The real wages are so high that Japanese manufacturing industries are motivated to move out, leading to the "hollowing of Japanese industries."
(2) An overhang of the non-performing debt haunts the Japanese economy. The debt was generated as the result of mismanagement of businesses and policies during, as well as after, the bubble period, and is still growing because of continuing deflation.
(3) The price level is steadily declining. Asset prices, like land prices and stock prices, went down quite rapidly. The Nikkei stock average once fell about 75% from the peak (compare with the 85% decline in the US market during the Great Depression). Land price index went down 55% and still keeps declining.
(4) The unemployment rate was a high figure of 5.3 per cent last month. (Japan used to enjoy the low unemployment rate around 2 to 3 per cent during the high growth period.) The real GDP during the 2nd quarter (April-June) declined with the annual rate of 4.8 percent, during the 3rd quarter declined by 2.0 percent, and in the last quarter of 2001 declined 4.8 percent. It is expected that the estimate of real growth for the fiscal 2001 (ending in March 2002) could be negative, around minus one per cent.

Those problems were amplified by the terror attacks in New York and Washington D.C. Now the Japanese economy is struggling out of the lower equilibrium trap in the multiple-equilibrium world, that is, the self-fulfilling equilibrium of mutual pessimism. It is a natural reaction of people not to travel because of their fear of flying, but it is a coordination problem if people do not join a market because they think that others do not show up in the market.

This long recession started in the early 1990s, has continued through the decade and is extending into the new century. Let me go briefly over the important causes of changes in the structural side of the economy. At its very core, the Japanese economy has structural problems. Real wages are so high that Japanese industries are motivated to move out and this leads to the phenomenon of "hollowing Japanese industries."

During the 1960's and 70's, Japan had a rich source of young labor that was well trained for cooperative working style. Now our population is rapidly ageing. "Parasite singles," a new phrase, describes young people who are staying home with their parents without going into life-time employment. Japan is now surrounded by labor-rich China and other Asian countries, and foreign investment abroad as well as trade accelerates the trend of "hollowing Japan."

During the high growth period, high savings rate was a great source of growth in the 60s and 70s. But nowadays too much savings, or too little consumption, is a factor that drags the economy. During the high growth period, there was rapid technological growth, in a process of catching-up to the western countries. During the process Japan developed a meticulous production scheme. In fact, the U.S. and European firms learned from Japan's total quality control (TQC) and the just-in-time (placard) system of inventory. Now, while the outside world has learned how to use these organizational skills, Japan is learning from foreign management, as is exemplified by the case of Nissan under Carlos Ghosn.

The first lesson is that the Japanese economy cannot enjoy the high real income, and particularly the high real wages. The basic trade theory tells us that real wages should be lower once Japan engages in trade actively with surrounding labor-abundant nations.

Many critics argue that structural problems, in particular the bad debt problems, are the basic sources of present financial difficulties. Here is a Catch-22 situation, a vicious cycle, between non-performing loans (NPLs) and deflation. The existence of NPLs broke the chains of financial intermediation so that the increase in the base money is not transmitted to credit creation and accordingly to the purpose of resisting deflation. In other words, the velocity of money decreases and hoarding develops. This weakens the economic effects of monetary expansion and creates the falling price level. On the other hand, deflationary pressure in the goods market triggers deflationary expectations in the future prices, which, in turn, depreciate stock prices and land prices. Then, this fall in asset prices increases the real value of debt and depreciates the collateral values. This ends up in increases in the value and the amount of NPLs. The amount of NPLs is thus an endogenous variable that is determined by the nominal expected returns in the future.

"Forget the past --- Let bygones be bygones!" "Happy are those who forget what has been done and is not to be undone." This is the first principle of the off-balancing in order to avoid confusion between the past NPL-related projects and the new promising projects. Accordingly, the market-value accounting is its logical consequence. Stock certificates, however costly they were when acquired, provide to their holder no more values than their present values in the market. A friend put it, "There is no use crying over lost horse-race tickets."

"Utilize and make the most of the remaining capacity of non-performing business activities." This is the second principle one should be aware of. Such devices as debt-equity swap, junk bond operations, and issuance of subordinate debt are the means to search through some competitive or market mechanism the best economic agent to do the job and the economic agent to pay the highest bid to do that. Thus the advantages of debt clearance are:

(1)It reveals and endorses the reality. It helps the lenders and borrowers to avoid the confusion or non-transparency between NPL-related projects and a forward-looking project.

(2) It ends the practice of lending to a troubled firm still further in order to receive payments from the loan already made to the firm (oigashi, a Ponzi scheme). This type of operation should be eliminated. Indeed, in this case structural reforms will improve social efficiency.

In any case, the pain is for the immediate, but the benefit for social efficiency will be forthcoming. In any case, though I do think that clearing of non-performing debt is an important objective and will create long-term benefits, I doubt that clearing non-performing debt will create sufficient stimulus to revitalize the Japanese economy immediately. Even though the balance sheets of banking sectors have become sound, it is difficult to believe that the lending activities will be activated without the improvement in profit opportunities in the real sectors of the economy. In order to do that, real wages should be reduced. Work sharing is one way to realize that. Reducing nominal wages faster than prices will do the job, except the following problem. Most nominal loan contracts are written in nominal terms so that deflation in both in wages and prices will create serious increase in the real burden of debtors, a phenomenon called the Fisher Effect. Moreover, as Keynes argued against Pigou a long time ago, falling wages will create the further fall in prices and accordingly lead the economy into a deflationary spiral.

Thus the macroeconomic policies are the preconditions for economic recovery and for the alleviation of the heavy burden of debt restructuring on the financial sector. Restructuring NPLs is tantamount to surgery that must be accomplished. Pessimistic expectations of future price levels and output suppress consumer confidence as well as investors' attitudes and prepare the worst environment for such surgeries. The task of policy makers is to change these vicious cycles into virtuous circles by somehow creating optimistic expectations on the part of consumers.

The instruments of macroeconomic policy are, however, also constrained in Japan.

(1) With a large overhang of government debt amounting to 130 percent of GDP, increases in fiscal expenditures are difficult. In fact, the Koizumi Cabinet attempts to reduce the inefficiencies related to government spending. The restructuring of tax and subsidy schedules in such a way as not to reduce net tax revenues should be seriously considered.
(2) Monetary policy faces the barrier of the zero interest rate. The famous Taylor Rule would designate the monetary policy with a minus two percent interest rate, which is impossible. Thus, monetary policy should be applied in terms of quantity rather than interest rate. Quantitative expansion is limited in effect because of the insufficient transmission mechanism that is plagued by the existence of delinquent debt.
(3) Monetary expansion could work, however, through the exchange market through a gradual depreciation of the yen. Here, Asian countries or the United States may not feel satisfied with the further decline of the yen. In any case, this is the area where international talks and policy coordination are to be seriously called for.

Fiscal policy and monetary policy are two pillars of macroeconomic policies. Let us consider fiscal policy. Stimulating the economy by accumulating increases in government expenditures seems to have been overdone and to be losing its effectiveness. What is required from the fiscal side is that the policies utilize structural incentives. Tax policies can be used to correct the distortions in economic behavior. If consumption is dragging down the aggregate economy, it is natural to consider a temporary reduction in consumption tax and a temporary suspension of tax relief for individual savings for a specified or unspecified duration. The introduction of social security numbers could be considered as well.

To conduct the policy of tax deduction in this country requires courage and may look like leaping in the dark, but the rewards could be substantial. If one traces the process of the recent unexpected recovery of the U.S. fiscal balance, one would quickly discover that the dramatic recovery took place not only because of rising taxes, but also because of the enhanced economic activities and the resulting unexpected increase in revenues.

Next, consider monetary policy. Japan is the only major industrialized country that is experiencing deflation. It is hard to find countries with deflation if we look all over the world— except for Hong Kong and Argentina where the currency board system is used. Not only the prices of goods and services are falling, but also are the prices of assets like land and stocks. The phrase "suspect of deflation," that is often used in this country is grossly misleading because prices are in fact falling and the present situation is nothing but "deflation" itself. Deflation distorts the market mechanism of an economy in which many contracts are made in nominal terms. It hurts the channel of credit by hurting the borrowers and destroying the value of collaterals. When it increases the incidence of bankruptcy, sometimes the government budget is used to rescue the bankrupt firms. This is nothing but shifting the burden of adjustment from monetary policy to fiscal policy.

If there is ever an institution that can cure this deflationary pressure, it is the Central

Bank, that is, the Bank of Japan. The reason that Japan is experiencing deflation is strongly associated to the conduct on the part of the Bank of Japan. Unfortunately, tradition exists in the Bank of Japan to claim that the monetary policy is passive. This is simply wrong. If the Bank of Japan can halt inflation, then it must also be able to halt deflation. Unfortunately, at present, because of inaction in monetary policy, only one of the two wheels of macroeconomic policy, fiscal policy, has been utilized and probably over-utilized.

I hope that, from now on, the monetary policy will be fully utilized again. There are at least four ways to conduct quantitative monetary expansion aside from the traditional short-term interest rate channel:

(1) Engage in flexible purchase operations in long- as well as short-term government bonds.
(2) Refrain from automatic sterilization of buying exchange operations by the Ministry of Finance. This facilitates the channel of monetary policy to the domestic price through exchange-rate movements, even the above channel (1) does not work.
(3) Announce the inflation target of 1 or 2 percent, or at least announce that the Bank of Japan will fight deflation as well as inflation.
(4) Draft public statements for the Governor and Vice Governors in such a way that their words would create optimism in the market. This will help the transmission of quantitative ease in narrower money concepts like Base Money or M(1) to broader concepts like M(3), or broader liquidity, which possesses important links to economic activities.

Historically, the Bank of Japan was pressed by the government, presumably by the Ministry of Finance, not to pursue contractionary monetary policies when the asset market bubbled in the late 1980's. This may be one of the reasons that the Bank of Japan is now reluctant to ease liquidity in face of deflationary pressures. Of course, we should learn from the past but proceed forward with the most appropriate policy at hand, regardless of the past failure. Moreover, now the Bank of Japan is protected, by the Bank of Japan Law, against government pressure.

It is not my main intension to criticize the Bank of Japan, which gathers some of the best and brightest economists on its staff. The central bankers must treasure the newly legislated autonomy of the Central Bank. In doing so, at the same time, they should follow the logic of economics as a universal language. I hope, for the sake of the Japanese people who are suffering from the sluggish state of an economy with falling prices, that the Bank of Japan will base its policies on economic logic that is commonly understood and practiced all over the world, and that it will not stick to its own peculiar logic merely to justify its own policies of the past and present.

I do not think that there is time to talk in detail on the international and regional cooperation problem in Japan. Just briefly, we have a great teacher in Europe to teach us how to realize the dream of one trade area and one currency area across neighboring countries. Again, the cost of creating a regional union is immediate but the benefit will be realized later. If vested interest groups in national politics deter such incentives in Japan, then the road to economic integration may be very long. Or, China and other Asian nations may overtake the initiative and realize economic integration in Asia, where the degree of diversity among nations is great, but at the same time the potential benefit from economic integration will be immense.

Basically, this talk is dominated by the overtone of dismal science. May I add at the end, however, something rosy to this talk:

(1) Let us start from the world situation. The supply capacity for the United States as well as for the world has hardly been damaged. May I trust that the United States is on the road to robust recovery? If one ever unlocks the pessimistic self-fulfilling difficulty of the fear

economy, a demand increase may follow even in Japan.

(2) The inventory adjustment has progressed a great deal. Diffusion indexes show mixed rather than uniformly pessimistic results.

(3) The Japanese still enjoy a high real income level with a civilized, safe society. Everybody recognizes that her (or his) government has a large debt but does not notice that they own a large amount of international assets. Each Japanese citizen possessed almost $10,000 in net assets abroad, and each American *owed* about $4,000 abroad in the end of 2000. If Japanese citizens realize that they are not so poor and spend, most of the problems, such as the balance of payments, deflation, lack of the consumption demand will disappear.

(4) The discussions in the Council on Economic and Fiscal Policy (CEFC) has become lively and the policy process has become much more transparent. The Ministry of Finance ceased to be the monopolizing institution for the budgetary process. Also the taboos on economic policies seem to have been to some extent lifted after the terrorist attacks. Now the Bank of Japan increases the emergency level of the demand deposit of banks and permits un-sterilized intervention. The Ministry of Finance is now more active in exchange interventions. The strict limit of 30 trillion yen for the budget is still officially imposed on the supplemental budget for Fiscal Year 2001 as well as Fiscal Year 2002. The application or the interpretation of the principle to the fiscal 2001 became a little more flexible after the government submitted the second supplementary budget amounting to 2.5 trillion yen.

In place of a conclusion, may I refer to an American proverb, "Every cloud has a silver lining?"