RIETI-KEIO Conference on Japanese Economy

Leading East Asia in the 21st Century?

Session 4: "Panel Discussion: The Japanese Economy"

(Transcript)

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Dr. Charles Yuji Horioka, Professor, Institute of Social and Economic Research, Osaka University: …virtually zero during the first quarter of 2003, which is the last quarter for which data are available. Moreover, many people are predicting that growth will be negative during the current quarter and that the Japanese economy will slip back into recession. In fact, the Bank of Japan (BOJ) recently downgraded its assessment of the Japanese economy.

There are a lot of negative factors currently facing the Japanese economy, which are causes for pessimism. Number one, the uncertainty caused by the recent financial difficulties at Resona Bank; the collapse of equity prices; the trend toward a stronger yen, which will hurt Japanese exports; the SARS crisis, which will hurt exports to the Asian markets; the weakness in the world economy as a whole, for example, the US economy and the German economy and so on; and there are other negative factors as well, so I think there is considerable cause for pessimism suggesting that there is some role that the government should play in bringing about economic recovery in Japan.

In my remarks, I would like to consider the causes of the current recession. Based on my analysis of the causes of the recession, I will make some recommendations about what the government can do to bring the Japanese economy out of recession.

Looking first at the causes of the current recession, my opinion is that the main cause of the current recession are the policy failures of the Japanese government. In my opinion, during the late 1980s, as Dr. Nakahara discussed in his remarks, the monetary authorities engaged in overly expansionary policies, which led to the bubble economy. By contrast, during the early 1990s, the monetary authorities engaged in overly tight monetary policies, which led to the collapse of the bubble economy and the subsequent recession. After that, the monetary policy was made more expansionary, which was a move in the right direction, but then some mistakes in fiscal policy occurred. In other words, there was inadequate fiscal stimulus during the late 1990s. I will not go into detail about this, but one good example is the experience of April 1997. Until then, some temporary income tax cuts were in place, but those income tax cuts were abolished. At the same time, the consumption tax was raised from 3% to 5% just when the Japanese economy was showing signs of recovery. This double whammy caused the Japanese economy to sink back into recession. There were other examples of fiscal policy mistakes as well during the late 1990s.

Also, I think there was an inadequate response to the bad loan problem—basically, the government doing too little, too late; inadequate employment policies which have led to record-high levels of unemployment; and also, inadequate social security programs—the government has been engaging in various ad hoc reforms, which have increased people's uncertainties about the viability of social security in the future.

As I see it, those government policy mistakes are the main cause of the current recession. Next, I would like to discuss the specific problems brought about by these policy failures. The policy failures that I have discussed led to stagnation of household and corporate incomes; the collapse of asset prices (land and equity prices); deflation in the sense of falling prices, which will induce people to postpone their purchases in anticipation of lower prices in the future; a shortage of bank credit, especially to small- and medium-scale enterprises; and increased uncertainty about the future—in particular, about employment, public pensions, old age, and so on. These problems, in turn, led to this decade-long recession, in my opinion.

Finally, I would like to make some policy recommendations for bringing the Japanese economy out of the current recession taking account of what the causes of the recession were. I believe that fiscal policy, monetary policy and other more micro-policies, are needed, so I will discuss each of these in turn.

Looking first at fiscal policy, I think that more fiscal stimulus is needed, but I do not think that broad personal and corporate income tax cuts should be used because the government in Japan already has a huge debt, amounting to about 140% of GDP, so that any broad tax cut, which is not very effective, should be avoided. What I would propose instead is targeted and temporary tax breaks on consumption, housing investment, plant and equipment investment, and research and development, because such tax breaks will be much more effective, and at the same time, less costly than broad income tax cuts, and will also bring about inflation, if they are phased out gradually. For example, if the consumption tax were to be abolished temporarily and then gradually raised, for example, by 1% or 2% a year, that would not only stimulate consumption as people try to take advantage of the temporary abolition of the consumption tax, but it would also artificially create inflation of 1% to 2% a year, so it is a way of using fiscal policy to end deflation and to artificially create inflation.

Turning to my recommendations about monetary policy, I think that the Bank of Japan is doing the right thing in pursuing a zero interest rate policy, which is a very expansionary monetary policy. I think that this stimulative monetary policy should be continued in the future until the economy recovers.

Some people, including perhaps Dr. Nakahara, have advocated this inflation targeting, but I think it should be pointed out that in effect, the Bank of Japan has already implemented inflation targeting because it has pledged to continue its zero interest rate policy until prices stabilize, i.e. stop falling. However, I think it should even go a step further and pledge to continue the zero interest rate policy until prices not only stop falling, but also start rising.

Turning to my other recommendations, I think the government should resolve the bad loan problem immediately, injecting public funds into the banking system if necessary. In terms of employment, the government should increase employment opportunities by creating incentives for workers to obtain job training and new employment; for private firms to hire more workers; and by hiring more workers itself, as a last resort. The government should reform social security to eliminate people's concerns about their future, social security benefits and their old-age retirement security. Finally, I think the government should delay structural reforms until the economy recovers. Of course, structural reforms are good in the long run and will bring about substantial benefits. But in the short-term, they will inflict pain, so I believe they should be delayed until the economy has recovered fully.

In my opinion, the long-term prognosis for the Japanese economy is bright and I think the Japanese economy can recover from the current stagnation if the government implements the various policies I am advocating. Thank you very much.

Dr. Masahiro Kuroda, Chairman, Member of the Academic Advisory Board, RIETI/ Vice President & Professor, Faculty of Business and Commerce, Keio University: Thank you very much, Professor Horioka. I would like to summarize a little bit the discussion points of the four presentations. One point is that Professor Aoki and Professor Hamada just focused on slightly long term factors; especially, Professor Aoki who mentioned how to change the Japanese economic structures, including institutional factors. Also, Professor Hamada agreed with that point and that some sort of change in the expectations of the people is very important in these matters.

On the other hand, Professor Nakahara and Professor Horioka believe that the short-term matters, as regards causes of the depression. Especially, for Professor Horioka, the causes of the present Japanese deflation come from policy failures. That is a very important point, I think. Therefore, I would like in the second round to speak a little bit about whether the causes of the deflation come from the long-term structural matters, or short-term policy failures. What do you think about that, Professor Aoki?

Dr. Masahiko Aoki, RIETI President, Professor, Stanford University: I am not really a macro-economist or monetary economist and I do not consider myself to be an expert on this, but Professor Hamada pointed out that an increase in the base money is not really transformed into an effective increase in the supply of money. Here, the expectation really matters, he pointed out. The question is how this expectation can be changed.

This really relates to questions about institutional change, too. It is very much related. In my definition, institutions are often taken for granted—rule of the game. Like lifetime employment, there is no actual contract about lifetime employment written between employer and the employees, and there is no law, which explicitly enforces lifetime employment. The main bank system was not written as a law. All these institutions, like lifetime employment, the main bank system, and so forth, evolved as a result of the interplay of players in the economy, not only just the government but also all the other players, including households, banks, and so forth.

Because of this nature of institutions, it is very difficult to change. This difficulty, which we are facing in macro-policy, is somewhat very much related to this problem. So I would like to ask Dr. Nakahara and Professor Hamada, as the experts on monetary policy, how we can change the minds of the people as regards these expectations of inflation. That might give us some kind of clue to understanding also how the institution can be changed. I am not completely convinced by the argument of Professor Charles Horioka, that all the problems are rather a problem of government policy failures. I do not think the Japanese government is clever and pursuing the right policy, and so forth—I do not believe that from my daily observations at RIETI—but I do not think that changes in the government policy can really change institutions, so in that sense, I am a little bit skeptical.

Dr. Kuroda: Thank you very much. Professor Nakahara, you mentioned the depression of the Japanese economy being sort of in the final stage. In that case, for the recovery from the final stage, you mentioned including the price of land and stock. Is it possible to make that into some policy?

Mr. Nobuyuki Nakahara, Former Member of the Policy Board, Bank of Japan: Japanese deflation consists of two things: one is general deflation, and the other is asset deflation. The Bank of Japan as a central bank has never spoken about asset deflation. When I was sitting on the policy board of the Bank of Japan for four years, I raised asset prices and which authorities would be responsible for managing asset prices. The traditional Bank of Japan people would never talk about asset prices. There is nobody. Also, even in the United States, there are no authorities that would talk about asset prices. But anyway, there is general deflation and asset deflation.

As for general deflation, there are three scholars who dealt with this: one is Keynes, then Fisher, and Schumpeter. I think as far as Schumpeter is concerned, structural reforms or constructive destruction has not proved to work in terms of getting out of deflation. However, what the government has been doing up to date is structural reform only—and that will not do. The Japanese government adopted stimulating fiscal policies à la Keynes a number of times. It succeeded on a few occasions but it failed on other occasions. That is also the case with monetary policy.

I have been advocating since February of 1999 that the Bank of Japan should adopt inflation targeting, backed up by continuous increase in base money, up to around 20%, and my policy proposals have been accepted and became the Bank of Japan's policies. However, the fact is, when the annual rate of change of monetary base increased, that is accelerated, after a certain period of time that had a very favorable impact on the economy, particularly through the rise of stock prices.

Let me give you an example. When the Bank of Japan decided to follow the zero interest rate policy in February of 1999, some time after that, the annual rate of increase of base money started rising to a higher level about 25%. That, to my mind, brought about the recovery towards the summer of the year 2000. Then there was a very famous controversy, whether to raise the interest rate from zero to 0.25% or 1%; I opposed, but the board raised the interest rate anyway which caused the collapse of the recovery.

The second time was when the Bank of Japan switched from traditional interest-targeting policy to reserve-targeting policy in March of the year 2001, and then the change of the rate of increase of the monetary base started rising very sharply towards early 2002. To my mind, that has brought about the current recovery, which incidentally is perhaps the shortest among the post-war economic recoveries because the Bank of Japan started decreasing the base money rate of increase very sharply, and now it is down from about 35% to 11%. I would predict that the Japanese economy is heading toward another recession and the peak of the recovery was registered in the first quarter of this year.

But anyway, again, this increase, acceleration in base money growth, did have a favorable impact on M2+CD which reached the peak of 3.5/3.6%, but then it came down all the way to the current 1.4%—almost nothing. So my contention is that the monetary policy of the Bank of Japan is not doing any good. What is being done is being done only to accommodate demand for current accounts, and the current account of all the banks together with the Bank of Japan now reaches about 30 trillion yen; and that is caused by the Bank's desire to have cash out of a so-called precautionary motive. It is true that as for a transaction motive, cash is flooding the market. But there is precautionary motive, and also speculative motive, or asset investment motive, and I think I have been maintaining that this transmission mechanism through asset markets, such as stock markets and the forex market, is very important.

So in any case, Schumpeter will not work; as for Keynes—we experienced, we succeeded, we failed; and as for Fisher, I think we are now in true debt deflation, so we would have to enforce inflation targeting. My thinking on inflation targeting as of now is that perhaps it would be useful to commit the Bank of Japan to maintain a zero interest rate policy up until—I should say, not over a certain calendar time, but over an entire business cycle. Zero interest rate policy should be maintained up until GDP growth rate reaches 2% to 3% at least for two, three years. That has been my idea since I proposed inflation targeting, but my inflation targeting included a certain time period, let us say, in the next two or three years' time. Now, my thinking is not that, but going back to my original thinking, that is up until GDP registers 2% to 3% growth rate, at least for two or three years. Until such time, zero interest rates should be maintained. That is not for nominal but real term GDP.

It is very interesting that a lot of people oppose inflation targeting for various reasons. One is because of what would happen if long-term interest rates should rise before the real economy improves. My answer to this is, “Well, that is okay. If the real economy is not recovering, we should continue zero rate interest targeting, and we should try to buy long-term Japanese Government Bonds (JGBs) as much as possible and to contain a rise in long term interest rates.”

Another figure comes from prominent politicians, such as Mr. Miyazawa, who are also afraid that inflation would do more harm than deflation. I should ask him, “Mr. Prime Minister, what did you do with Keynesian policy?” He piled up debt after debt and, frankly speaking, he failed but now he is talking about an anti-inflation targeting position; and it sounds very funny to me because I think this is really debt deflation and something should be done about it.

Lastly, very interestingly, you may have noticed that the Bank of Japan’s explanation of what has been happening has been changing. Quite recently, there has been a paper written by staff, and that paper says that deflation was brought about initially by the rising supply capability of newly developing countries. Now, they shifted to China, which was the case during my term. That is, the impacts of Chinese exports and of Chinese low-wages have been so large that China had an adverse effect of depressing the Japanese price level. Now they have abandoned that, very simply because China’s imports are only 1.5% of the entire Japanese GDP.

Now, the Bank of Japan is saying that the true cause of deflation is a lack of total effective demand. It seems as if they would like to ask the Ministry of Finance (MOF) to issue more JGBs, etc. That is, they would like to see the MOF taking responsibility, not themselves. However, my policy proposal, quite recently, has been that the government should issue JGBs amounting to 10 trillion yen or 2% of GDP, for three consecutive years; and these JGBs should be effectively monetized by the BOJ. We should see what might happen during the next three years, which to my mind, is a very crucial time for the Japanese economy. Thank you.

<u>Dr. Kuroda</u>: Thank you very much. Professor Hamada, you also mentioned the relations with the base money and money supply. What do you think about this point of Professor Nakahara’s?

<u>Dr. Koichi Hamada, Professor, Department of Economics, Yale University</u>: The main reason why the monetary base does not transmit M2 to M3 money concept is that

people the hold money. So the high-powered money comes to the public, but many people just hold onto it, and it is not multiplied by banking sectors and so forth. That is because people are afraid of putting money into the bank, etc., the 2K problem was another thing.

So this attitude coupled with a nominal interest rate that is 0.005, means that it does not matter whether you go to the bank more often or just to keep it in your hands. Again, deflationary expectations, or at least the cure of deflationary expectations, will raise the nominal rate of interest and change that kind of attitude. Also, Keynes' famous liquidity trap situation is happening because long term JGBs are only 0.5%, so any fluctuation in interest rates upwards will cause people a great loss. Politicians are probably more worried about capital loss incurred by the commercial bank sector, it seems. Anyway, Mr. Miyazawa is too old to intervene in the current situation. That is a typical Japanese example of old people having a very strong authority. My position is now changing in favor of this, but it is still not healthy. The Bank of Japan will incur a great loss but it is combined with government accounts, so we do not to need to worry about that.

Firstly, two things: one thing is that I brought a good luck charm from Yale University because I am surrounded by almost entirely by Harvard constituents. Joseph Schumpeter claimed that deflation will revive the economy because people work harder, and that was refuted by many economists, as well as being refuted by historical experiences during the Great Depression, but Professor Shumpei Takemori—in spite of his first name—explains very clearly that Schumpeter has lost his ground, and Shumpei claimed it is very unfortunate that the phantom of Schumpeter is now wandering around. The spirit of Irving Fisher should be around too.

However, I would like to make clear just one thing about the Chairman's remarks that I was talking somewhat against the two speakers, because that is not true. I completely agree with Dr. Nakahara and Professor Horioka. Probably, as a result of being free now, far away in the United States, I recognize the importance of real adjustments, more seriously than before, because I always had to convince BOJ people, or very understandably, economists who say things quite contrary to the elementary first year of macro-courses that are taught worldwide.

Dr. Kuroda: Thank you very much, Professor Hamada. Finally, I would like to ask Professor Horioka to speak. You mentioned your recommendation for the policy. I think you agree on all of the points, even that on monetary policies. I was concerned about the fiscal policies. You mentioned tax cuts except income tax. Would you explain more about this related to the government budget and creating an effective demand?

Dr. Horioka: I guess my main argument is that targeted and temporary tax cuts will not only be more effective but also have a less adverse impact on the cumulative government debt than broad-based income tax cuts. That is the reason why I would favor these more targeted tax cuts. In the case of an income tax cut, whether you are talking about the personal income tax or the corporate income tax, you receive the benefit of that tax cut whether or not you spend. But in the case of a consumption tax cut or an investment tax credit, or some tax break for research and development, you only get the benefit of that tax cut if you actually engage in that activity, so it will have more of an effect. Furthermore, if you make the tax benefit temporary, people will rush to engage in the activity being targeted before the tax break is abolished. For all of the reasons, I think these temporary tax cuts are much more preferable.

But I just wanted to say one more thing responding to Professor Aoki. I still believe that government policy failures are largely to blame for the decade-long recession. I also think that government macro-economic policies can be effective in bringing the Japanese economy out of this recession. But at the same time, I do believe that some structural or institutional transformations are necessary and I would agree also with Professor Aoki that, of course in that regard, there is a limit to what the government can do and some private sector initiative is necessary.

Dr. Kuroda: Thank you very much. Very interesting presentations. Our time is fairly limited, but I would like to open the floor to only just two questions. There are four, but please, the first person.

Q: Thank you, Mr. Chairman. I am an Emeritus Professor of Hitotsubashi University. I was very much impressed by today’s investigation. Very deep, but covering mainly development in the 1990s; and I think we had better inquire why the Japanese economic development growth rate has been halved since the oil shock of 1974. Before that, the International Monetary Fund (IMF) collapsed, the exchange rate was freed, capital movement increased, and everything was liberalized. Thus, it created speculation on the exchange rate, as well as on the stock exchange, and as Mr. Nakahara mentioned, somebody called this financialization, and financialization is very bad.

This time, the collapse in Japan also comes from that sense of rushing to consensus, to force everything to be free too early. It is premature for Japan. Certainly, it was premature for Thailand, and others, so they had a crisis in 1997-98. However, the present government forced us from indirect financing to direct financing. That means we private men should also do some speculating. This is very bad. We have to stop this kind of mindset, which in Japanese is called *zaiteku* that is quite easy and quite profitable, so we do not make real investment like investors, and so on. This is my question.

Dr. Kuroda: Thank you very much.

Q: Then, what we should do? I have some answers, but that is another story. Thank you very much.

Dr. Kuroda: Thank you very much. Can someone answer that if it is okay? I think it is a very difficult thing to answer that question. We have to analyze this stage of the development of the Japanese economy from the viewpoint of deregulation or regulation, and it is a fairly difficult question, I think.

Q: …quite Americanized economists like Mr. Hamada, or Mr. Heizo so and so…

Mr. Nakahara: I think I would like to make a comment on the foreign exchange rate. I think when I entered the BOJ in the fall of 1998, the yen weakened to more than 145. At that time, what happened was—and this is what I heard from US government sources—Ruben put very strong pressures on MOF of Japan to intervene and strengthen the yen. If the yen had weakened at that time, let us say, to 150 or 160, the situation might have changed drastically but anyway, from that time on, the yen strengthened rather than weakened.

Secondly, in order to get out of this deflation, foreign exchange rate is very important, and that is, for example, what Svenson has been proposing: to weaken the yen to 160, 170, but that has not changed. It is very interesting because this time, too, Secretary Snow of the United States is talking about the weakening of the dollar. As I implied, relying on a weaker foreign exchange rate is perhaps one of the last resorts to get one's economy from deflation, and if the United States tries to do that, it would shake the entire world, period.

Dr. Kuroda: Thank you very much, Professor Nakahara. I'm sorry, but we have already run on beyond schedule and I would like to ask for the floor discussion to be right after this session. Therefore, I would like to close this session. Thank you very much again to all of the panelists.

Moderator: Thank you, Professor Kuroda, and the panelists on this session. Now we have reached the final program of this conference, which are the closing remarks by Professor Aoki, Chief Research Officer at RIETI.

Dr. Aoki: On behalf of one of the sponsoring institutions, RIETI, I would like to say just a few words to close this session.

This conference was first conceived upon the prospect of an honorary degree being conferred on Professor Dale Jorgenson by Keio University; and on behalf of RIETI, I would like to join everyone else in congratulating Professor Jorgenson. But also, I would like to pay my respects to the initiative of Keio University, which has shown an admirable and wise decision to confer the honorary degree on Professor Jorgenson in recognition of his remarkable contributions to economics—or to use Dale's favorite expression, economic science.

RIETI was very happy indeed to co-host this conference together with Keio, in honoring Professor Jorgenson, and indeed, trilateral relations between Professor Jorgenson and Keio University and RIETI have been very close and productive as some of the reports of this conference have amply shown.

Due to the academic background of this conference, I have already clearly stated that I am not in a position to be able to summarize its fruitful results. Therefore, please allow me to conclude my remarks by giving my personal observations regarding the important contributions made by Professor Jorgenson.

As everybody knows, Jorgenson's work has been distinct in that he analyzed empirical data of high relevance to the understanding of our economy and its policy implications based upon a solid theoretical model. When an available theory or model is deficient for understanding the data, he does not shy away from conceiving, building and testing new models of his own consistent with the basic neo-classical principle. As a result of this methodology, he sometimes comes up with conclusions that are not necessarily consistent with the prevailing conventional wisdom, but turn out to be right later on.

I remember that he used to speak about the great potentials of Japanese productive growth, in the 1960s and 1970s when Japan was still obsessed with a ‘catching-up’ mentality. As Professor Kuroda mentioned this morning, Jorgenson and Kuroda came up with objective comparative assessments of absolute levels of productivities on a sectoral basis between Japan and the United States in the late 1980s. The result was not congenial to the ears of businessmen and laymen who believed Japan to have a leading edge in productivity at that time. However, as Professor Kuroda mentioned this morning, their results are now accepted as authoritative. I personally am proud that their joint paper was published as the leading article of the first issue of the *Journal of Japanese and International Economy*, which I founded and edited.

Now it seems that Professor Jorgenson has come up with other counter-intuitive empirical results. Japan’s output growth has not been as bad as official statistics tell us after measuring output with the proper price index, taking account of the progress of IT as well as taking into account measured output as software productions.

The contributions of IT to growth are not so bad, even though somewhat inferior to the United States. As I expressed in the last panel discussion, these results are more consistent with my pedestrian observation, as well as theoretical analysis from the perspective of a comparative institutional analysis. A Japanese proverb says, “What happened twice will happen a third time,” and I hope that Jorgenson’s claim will turn out to be right again. I hope that this *kaizen* in our academic understanding will happen faster, remaining consistent with the available potential of information technology. The contents of this conference have been recorded and put on RIETI’s website. I hope that they will be disseminated widely and invite further discussions and debates.

In conclusion, let me thank the participants from abroad, as well as inside Japan. I also thank Keio University for co-sponsoring this conference and providing us with marvelous facilities. I also thank the staff of RIETI for running this conference flawlessly. Finally, but above all, I thank the audience for coming and participating in this conference although discussion from the floor was limited because of time constraints. Thank you all, and now the conference is closed. Thank you very much.