

The choice of prioritizing fiscal restructuring and structural reform Interview with Toshiki Tomita (Director, Nomura Research Institute)

<General perception of the Japanese economy >

lio: First, I would like to ask you about the current state of the Japanese economy and your evaluation of the recent turn of events.

Tomita: Looking back at these past ten years, I think that the Japanese economy had been viewed only in light of the bursting of the bubble economy.

But what actually happened in the world was, firstly, the end of the Cold War, which caused the industrial structure to undergo change on a global scale. Abundant labor at an extremely low cost, together with the cutting-edge technology of developed nations and the modularization of IT, all lead to a large scale change in the global industrial structure. Secondly, the development of information and communications technology affected corporate management in major countries. I think the 'siege mentality' over the Japanese economy is created by this lack of awareness at a global level, by the focus on the bad loans problem since the bursting of the bubble economy, and by debating about the Japanese economy only from the perspective of aggregate demand policy.

After the two World Wars, people had come to perceive economic boundaries; and so people came to emphasize social security policies and restricted capital outflow. In other words, they were following the principle of putting the national economy at the center of interest. But with the end of the Cold War, the northern and southern boundaries economically, and the eastern and western boundaries politically had completely collapsed. In other words, people, goods, and money came to move freely around the world.

One such example would be the case of the United States in the 1980s, when it suffered a huge budget deficit, and there was heated debate over the sustainability of the, "twin deficit", fiscal and current account deficits. But in the end, with people, goods, and money being able to move freely, the United States was able to finance it without a major confusion.

When thinking about the economy in the 21st century, Japan was probably not able to acknowledge that such great forces were at work.

When we think about measures for economic stimulation, major countries have already been adopting monetary policy over fiscal policy since the 1980s. The Mandel Fleming Model says that fiscal policies are ineffective in an environment where there is free capital flow.

But in Japan, protective measures, or in Prof. lio's words, "dependency on the government," became a common policy under an aggregate demand control policy. Furthermore, in the 1990s, the aggregate demand control policy became the victim of, "government dependents," causing fiscal policies to expand. But what's happening now is a textbook case of fiscal policies having no effect where capital, people, goods, and services move freely.

I think our nation has a poor understanding of Keynes' theories. Keynes' theories came about in 1936, between the two World Wars. It was a time of block economies, where people and money did not move internationally. It is a theory which was formulated at a time when no one could conceive of the notion of optimal allocation of global resources. In our country, this Keynesian approach was taken during the days of Finance Minister Takahashi Korekiyo, that

was from 1931 to 1936 when the February 26th Incident occurred, while the US, between 1933 and 1937, was in the New Deal policy era. The speed of growth of the percentage of outstanding government bonds, vis-a-vis the economic scale, is much larger in Japan in the 1990 than during those two periods. But, although Japan has taken much larger stimulative measures than in the days of the typical Keynesian policies, the country can still not recover from this economic slump.

When we consider this, we had better understand that our economy exists within an open economy.

lio: Then what are your thoughts on the government's role?

Tomita: The government should provide dreams to people, but the problem is that this dream has always been handed over like a gift from heaven.

I believe that a lot has changed for the better under the Koizumi Administration. One benefit has been the revelation to the general public of who has opposed reform. Another is the restraint on public works spending, including the 1 trillion yen cut in subsidy to government affiliated corporations that was spelled out in the budget for 2003. Of course, what is important is whether or not things continue in this direction.

<Fiscal deficit and government bonds>

lio: I would like to ask about fiscal deficit and government bonds. How do you explain this phenomenon where the interest rates don't rise despite the government continuing to issue government bonds?

Tomita: The current low interest rate is not a result of control. The rate has been set freely in the market, and capital flows freely internationally. Theoretically, the low interest rate means that expected inflation rate and expected growth rate remain extremely low. But that doesn't mean it is all right to continue issuing government bonds.

Deflation implies that the prices of goods are becoming lower compared to the currency and government bonds. Prices go lower because people buy government bonds or because they prefer cash. So some recent economists say let's adopt a policy to lower government bond price or the value of the currency by issuing more government bonds and taking a more expansive monetary policy; or in the same way let's take economic stimulative measures while promising never to raise taxes in the future. But I don't think the general public will believe that. At a time when people are beginning to realize that the social safety net, such as public pension or the medical and welfare systems, are unsustainable under current circumstances, more people will think that the government is unable to sustain a current system by increasing deficit, which in turn triggers further insecurity and prompts people to save more.

lio: But now it would be possible to continue issuing government bonds as interest rate remains low despite a sense of insecurity about the future, consequently increasing the deficit. How do you think the reversal of this trend occurs?

Tomita: Because it seems that the trend may be reversed, it appears that one method to keep the incumbent administration in power is to create a mechanism which will not reverse the trend. That is indeed a headache. For example, the administration tries to pressure the Bank of Japan into increasing its buying operations. That will provide some leeway to finance the burgeoning debt. But out of the massive 1400 trillion yen in financial assets, the government guarantees bank savings and postal savings. That means over 55 percent, or

roughly 60 percent of the 1400 trillion is guaranteed by the government, so they are almost the same as government bonds.

The next question will be: Is that sustainable? If it becomes apparent one day that it isn't sustainable, people will begin to flee from government bonds; or people may well begin to flee before the recognition of such fragility.

There is always the chance that troubles may just suddenly occur. A typical example from the past is the government guarantee on war factories during World War II. When the GHQ came into power, it annulled the government guarantee. It's possible that something as drastic as that may occur bringing a sudden end to the guarantee of bank saving deposits and postal savings.

lio: Maybe we are forcing ourselves to believe the voices of the optimists because it is so hard to conceive of such a terrible situation. How can we counter this?

Tomita: Such people appear to believe that the government can easily change various systems in this country, such as the social security system or the education system, or that the government can easily raise taxes. But actually it's not so easy. When we reach a point where we can't issue government bonds, the only thing we can do is "default".

Confidence in Japan is already waning. Let's take an example. At the moment the Asia Development Bank finances in US dollars and offers loans to developing nations. The Japan Bank for International Cooperation also offers foreign lending by issuing dollar-denominated bonds guaranteed by the Japanese government. But the interest rate to be financed by the Asia Development Bank is lower, and so from the standpoint of economic rationality, the receiving nation will not welcome Japanese lending because they end up paying higher interest. This situation shows how low confidence in Japan is.

Furthermore, Italian government bonds and Spanish government bonds are also denominated in yen, but compared to these, the interest rate in Japanese government bonds is higher. If Japan was managed by the Italian system or the Italian government, then interest rates would be lower.

lio: Then is our only option to decrease spending and increase taxes?

Tomita: That appears to be the only option, but I'm worried that such moves will be accepted politically and adopted by the citizens only after the situation has turned very bad; and the situation can turn very bad, very easily. There is an abundance of short-term government bonds, but if the interest rate rises for some reason, then the cost of paying interest will also suddenly rise. The cost of interest payment is currently decreasing although the amount of government bonds has doubled.

lio: Some say the country will eventually face inflation and all cause of worry will disappear.

Tomita: As I said in the beginning, when one considers the global change in industrial structure, I don't think there will be inflation. Unless Japan starts to restrict capital outflow to overseas, there won't be inflation. Until then, interest rates will rise, the economy will worsen, and prices will not rise.

There is debate about inflation targeting. But unless the Bank of Japan actually goes as far as to buy real estate, or even TV sets and refrigerators, prices won't rise; and even if it did, interest rates would rise first, the economy would shrink, whereupon prices would stay where they are, and in the end there would still be no inflation.

<On deflation>

lio: Next I would like to ask about the problem of deflation. There is the argument that in order to do away with deflation, the Bank of Japan should continue monetary easing, along with buying more government bonds and even shares. What are your thoughts on this argument?

Tomita: Taking such measures will further undermine the already low global confidence in Japan, and further lower the confidence in Japanese government bonds. Japanese government bonds are currently maintained only because the Japanese people continue to buy them. But since capital flow remains unrestricted, this situation could change overnight depending on the decision of the investors. There were a couple of times when the yen was strong stepwise, but the moment investors think that the days of the strong yen is over, there is the possibility that funds will flow out of Japan en masse.

What is most disturbing about this scenario is that there may be a political move to restrict capital outflow. Something like, "Why are you buying US government bonds? You're being unpatriotic."

The former Finance Minister Korekiyo Takahashi was very wise, and implemented a law imposing capital controls on July 7, 1932, banning investment in foreign securities in order to get Japan out of deflation. Since capital stays in the country and the Bank of Japan continues to underwrite government bonds, the economy comes out of deflation. Furthermore, the domestic interest rate which stood at 4 percent started to decline to 3.5 percent and further. But what happened was that Japan was issuing pound-denominated bonds, and the interest rate spread between them and UK bonds began to widen from about 1931. When UK government bonds stood at 4 percent, Japan's pound-denominated bonds stood at something like 20 percent. However, because Japan maintained its economic seclusion, domestic rates remained low and Japan was able to continue issuing government bonds. That was only possible because it was in the days of block economy; and the need to sustain this block ultimately prompted Japan to invade China.

Yet, if Japan took such measures today, the world economy would come to a halt. While Japan does not have the international presence or influence economically as it used to have before, Japan still has the world's largest net overseas assets and still maintains a lot of influence. Japan should definitely avoid taking such measures.

lio: Is deflation, then, a bad thing?

Tomita: It's hard to say whether it's good or bad. Deflation was deemed bad because it causes a downward spiral in wages, which induces the dysfunction of the market economy and makes it difficult to conduct reform. In other words, we've created a democracy where deflation cannot be tolerated because it is accompanied by social pain. But don't we see more reform taking place now than when prices were rising? So if we think of deflation as a catalyst for reform, which is better: moderate inflation, or deflation?

Unfortunately, Japanese firms were only able to conduct reforms under deflation. If the Japanese people and the firms they work for were ready to conduct restructuring following the structural changes in global economy, then inflation would be more appropriate. But Japan, unfortunately, still doesn't have such a culture. Only from around 1998, when prices clearly started to become lower, did the rigid atmosphere of Japanese firms begin to change, and they finally started to conduct reforms.

lio: Are you saying that coming out of deflation should not necessarily take priority?

Tomita: Yes. There is a reason for this deflation. In China, the epicenter of deflation, deflation is gradually progressing. And the common phenomenon in developed nations is that the rate of price growth was slower in the 80s than in the 70s, and slower in the 90s than in the 80s, and even slower now.

What's characteristic in Japan is that the price gap between home and abroad is very large due to the disparity in the growth rate of productivity in the manufacturing and non-manufacturing industries, so unless this situation is also corrected simultaneously, prices must continue to decline.

<The bad loan problems>

lio: What are your thoughts on Japanese bad loan problems?

Tomita: First, when we think about bad loan problems, we must look at the problem of having too many banks in this country. When we compare outstanding lending to GDP, the peak in terms of all domestic banks' base stood at 100 percent in 1990-1991. We're finally down to 90 percent now. Before the bubble economy, the figure stood at 70 percent; and even then, people started to point out the problem of having too many banks in Japan. By contrast, the figure in the US stands steady at about 40 percent. This figure means that in the case of Japan, banks bear the largest portion of the risk inherent in the Japanese economy.

But without the recognition of this fundamental problem, the government won't implement the deposit insurance cap. So the banks' outstanding debt stays high and the government's guarantee continues to be attached to it. The debt of the banks is deposits from the standpoint of ordinary people, so people will continue to save as long as the government remains to guarantee the deposits. Therefore, there is no motivation to get rid of the bad loans.

lio: Then what should be done?

Tomita: Lift the freeze on the payoff system, and try to shift savings into other assets. People often say that Japanese 'saving' behavior tends to be safety-oriented, but actually such behavior stems from the government's guarantee of savings; so Japanese people are attracted to save. But it just looks safe in appearance. This trend leads the country as a whole in a very dangerous endeavor.

lio: People may rush to buy government bonds once the payoff system is implemented.

Tomita: Then that's that. Japanese financial institutions are now trying to make a profit by buying government bonds. However, financial institutions should collect funds through their credibility. There is no way one can make profits by managing something with a higher credibility than oneself, in this case government bonds. I think it's more efficient on the whole for individuals to own government bonds than for the banks to continue to hold them. The ultimate role of the bank is to judge whether a loan will actually be returned at their own risk, in other words, the screening skill of the bank is the source of its added value.

<Japanese financial institutions>

lio: Maybe Japanese banks lack this most valuable asset. Do you think that it was wrong for the banks to make loans just on the basis of collateral?

Tomita: That's right. The screening skill of the banks has now been called into question. Screening of investment opportunities generates information, and financing is the industry which creates information on making judgments over investment appeal; and as an industry the banks' capability to make this judgment is now being called into question. As self-protection, firms and individuals tend to refuse to borrow money if real estate is set as the collateral. But this serious problem exists for people who nevertheless must borrow, and for banks which must lend to make a profit. The current irony is that government affiliated financial institutions are now trying to implement a business model such as those based on an uncollateralized loan system.

Of course some banks with screening skills will emerge in the process of their internal restructuring. In that sense, I don't think all banks will continue to call for collateral, such as real estate, to make loans. But when we try to think of how many banks serve as a 'money center bank', I think it's inevitable that banks will be selected under the Takenaka plan. Some banks will go out of business. They won't be able to maintain their international reputation.

What's difficult is such decisions cannot be made by the government just through the market, like corporate restructuring. Unfortunately, only the stock market can do such selection in Japan. That's why the stock market is sagging. For example, if banks like Tokyo-Mitsubishi had to go through the same screening as others, it would need to increase loan-loss reserves, and then its financial statements would look worse. The current share prices might reflect such expectations.

One event I thought important was the guilty sentencing of the former bank head of the Long Term Credit Bank. That should send a very strong and obvious message to the market economy. In other words, the refusal to increase loan-loss reserves suggests abandoning one's duty.

lio: Do you believe the Financial Services Agency is doing the right thing, making banks increase loan-loss reserves?

Tomita: The actual situation is that the FSA made an effort to increase the banks' loan-loss reserves, however, there was a gap between the banks' self-assessment and the checks conducted by the FSA.

What's difficult is whether the firms' evaluation should be made as the liquidation value or as going concerns. The problem becomes the individual responsibility of bankers when they evaluate the firms.

But since bankers in Japan cannot make such decisions just by taking collaterals, the financial reconstruction commission has been formed by the government. However, even this doesn't work so well either.

What would happen is that the banks would be pushed into a tight spot by the markets, as they were in 1998. That year, the markets drove the banks into bankruptcy. At that time, the banks immediately became insolvent, and only the liquidation value remained. But that turned out to be a considerable burden for the people.

lio: There is an opinion, therefore, that it would be better to inject public funds first.

Tomita: The premise of such an argument is that it would lead to lower social cost, but the injection might provide a firmer grip for the government. I worry more about the problems which relate to the slackness of bank management induced by government support and its control. For example, the role of politicians would be extended, and they would become able to arbitrate for specific loans, like directing funds for public works. I fear that people might start to think that the savings are the same as public funds since the government guarantees the

savings.

<On structural reform>

lio: Next I would like to ask about structural reform. My understanding is that the Japanese economy currently lacks the physical power needed to strengthen economic growth and increase productivity, and I recognize that structural reform enhances this kind of power.

Tomita: There are two issues as regards structural reform. The first is to have firms shift their management resources to an area where one can expect higher productivity and where one can expect higher demand. That's what Japanese firms should do in the first place, and to establish the system supporting such moves in various industries and people's lives should be the primary meaning of structural reform.

The second issue is the deep sense of insecurity held by the people that current systems, such as the medical system and the pension system, cannot be sustained if there is no change. The second point of structural reform would be to conduct reforms to sustain systems which make the public feel secure. In other words, it is a structural reform of society's safety net.

I would like to highlight these two points: sustainability and revitalization of the private sector.

lio: If that is the case, and we think about the current public finance situation where the government continues to issue government bonds which may not be sustainable, fiscal reform might be part of the structural reform. From this perspective, an injection into public funds is unavoidable in terms of getting rid of the bad loans, so we can't avoid seeing the fiscal deficit expand, even temporarily. What are your thoughts on this type of argument?

Tomita: It's okay if people recognize the public funds as a cost for pursuing reform of the financial sector in the right direction. But I think there is a gap as to how the public perceives this. Some may see this as merely saving the banks, while others may see it as a price to pay to revitalize companies. The trouble is that no one is sure what the purpose of the public fund injection is. But then no one has tried to clarify it.

If more capital over the cost of the deposit payoff system was injected after strict assessment by market value, this action would just save the banks. So the renovation of the industry must also be conducted at market value, and the cost which arises after this procedure is complete should be perceived as a burden which imposes on us.

The next question then would be whether saving banks is good or bad. We have avoided implementing the payoff system, since we have to protect the savers, and a lot of money is needed for their protection. The current rationale to inject public funds into banks is that the important financial intermediary function of them is not working.

However, I doubt these reasons. Even if the banks' intermediary function is weakening, it's not the case that they have lost it completely. Healthy firms can still obtain funds.

lio: So what you are saying is that the banks should be judged through the market represented by the stock prices and so on, and the government should buy up bad loans based on the price set by the market if and when a "bad loan market" is set up?

Tomita: In order to make that possible, what we really need is a screening function of loans. We need a kind of system to induce the banks to be able to make their decision to offer loans not on the basis of collateral. If the RCC takes away what can be renovated, the banks will miss out on their own profitable investment opportunities.

lio: We sometimes hear that bankruptcy is caused by the banks' reluctance to lend to small firms. What are your thoughts on this point?

Tomita: That is partly the case. But in order to make a judgment on such banks' behavior, we must evaluate past cases, which was the assurance and special guarantee of the credit guarantee associations. Someone must make a proper assessment of the previous associations' actions. We must clarify what constitutes the costs, what the public is paying for, and how heavy the social burden is for a particular policy.

<Conclusion>

lio: Lastly, what do you think of this idea? In order to reduce the budget deficit, we reach a nonpartisan agreement to raise the consumption tax, for example 1% every year, and we make that a constitutional agreement as well. Then the value of current consumption would rise, and that would stimulate the economy.

Tomita: True, that would appear as a price rise from the viewpoint of the consumers, but what's important for the firms is not a price rise but an increase in added value. So gradually raising the consumption tax does have the facet you mentioned, but it doesn't increase a firm's added value at all.

If we have to raise the tax in the future, we must address this issue of inequality in the tax burden which has remained ambiguous due to the complexity of income perceived by tax authorities in the past. I don't think the Japanese population has ever seriously considered the question of fairness or unfairness.

For instance, I hear various problems are arising, particularly in local areas. The fee to send a child to a nursery or a kindergarten depends on the family's income. So the child of an employee would be paying high fees, while the child of a self-employed worker who may be living in a large house and own one, or even two Mercedes, would be paying next to nothing. That's where the problem lies. This tax burden based on income should also include assets in the calculation, or else the problem of pension payments will arise in this aging society. Whether to clarify this issue of inequality of the tax burden or to resolve the problem through consumption tax is still open for debate.

The so-called "kuroyon" problem (referring to the perception that salaried workers paid taxes on 90 percent of their incomes, small business owners on 60 percent, and farmers 40 percent) can be resolved by increasing the weight of the consumption tax, but what needs to be discussed before that is how to do away with this kind of inequality of the tax burden and discuss the issue of equality.

lio: Then could the budget deficit be reduced?

Tomita: Ultimately, there have only been three ways in which the problem of budget deficit has been resolved. First is by "inflation". But this probably won't happen. Of course, inflation would occur if Japan could financially isolate itself, but that's inconceivable as I mentioned before. The second is by abandoning guarantees, such as for savings, even if the government doesn't default its bonds like the past government default of debt during the war. Japan had better work to improve the confidence others have in the country while such measures proceed. The third is the traditional way, to make its public finance healthier.

When we consider how to draw up a process that can be realized politically, if we can't take action unless some critical situation hits us first, then we are truly living in the midst of deep

tragedy.

lio: If we can draw up a policy in which we can imagine the tragedy before the actual tragedy hits us, and if all agree on the fact that we can overcome the tragedy before it hits us, then things will start rolling in the correct direction.

Tomita: That was my logic when I was talking about the Japanese economy. I have continued to argue such a story. I have argued that we must overcome this problem with the power of democracy before we collapse under the rising interest rates in the market. Now, our country's democracy is being put to the test. This is my logic, but since interest rates don't rise, some people might call me the boy who cried wolf.

What's worrying me is that although I believe my logic holds truth, and I try to convince people of it, the debate we see in the media is so confused that I can't convince anyone.

lio: In my view, the economists also argue such various differing opinions, and it looks difficult for them all to agree.

Tomita: Economics itself has also many problems in Japan. What's particular about Japan is that after the surrender of Japan, Marxist economics became the mainstream. The Keynesian economics exists as a succession of that, according to this trend of economics, and we must all be warm-hearted. Therefore, Marxist economics are still taught in Japanese universities, and Keynesian have followed Marxist. Keynesians believe the function of market economy is incomplete. When I have talked with Keynesian scholars, this point has been made by them. Underemployment will be caused by the downward spiraling of wages, so it becomes necessary to implement measures to arouse effective demand. But I think the price mechanism works even in underemployment. In the long run, people will do anything they can in order to make a living.