

## **The choice of comprehensively resolving the various problems in earnest through gradual structural reform**

Interview with IKEO Kazuhito, Professor, Keio University

### **The Japanese economy**

lio: May I start by asking what your views on the Japanese economy are?

Ikeo: It may sound like I'm exaggerating, but I think the view differs between those who believe that the so-called post-war Japanese-style economic system itself is posing problems, and those who think that, while the framework of the system itself is holding up, the problem lies within the system.

It is very difficult for someone to determine if the current system under which they are living is about to fall apart and be replaced by some other system, so the economic philosophy and world views of scholars, as well as past experiences and preferences, tend to affect their outlooks, making it difficult for a simple empirical study to produce the answer.

lio: In the world of politics, it's important to create choices, and there exists what you can call a deliberate choice of values and view of the world. Deciding whether to adapt and proceed under the current system or seek a different one is at the root of it all. But when we hold discussions with people from the economic arena, it's hard to see that in economic theories.

Ikeo: For example, as Dr. Komiya Ryutaro clearly points out, even if it can be explained by economic theory, authentic economists can only discuss economic policies with a 40% basis in economic theory. The remaining 60% is actually based on their own experiences and the aforementioned elements when discussing policies, and I think the part which discusses economics as a pure science accounts for only 40%.

When theory and reality contradict each other, it's surely the theory that's at fault, although some economists blame reality. Such views I believe come from differences in an individual's values.

lio: That being the premise, is your view more on the side that the system is now facing a transition? Is it your view that we are in a major transitory period which would take 10, even 20 years to adjust?

Ikeo: To answer your question, my honest feeling is that theory accounts for less than 40%, and my guess is as good as mine.

Japan has experienced a transition in the economic system only once in the modern era: the transition from the pre-war system to the post-war system. The pre-war system, quite different from the post-war Japanese system, was established around the middle or latter end of the Meiji Period and flourished during the Taisho Period.

Taking up on the fact that it flourished during the Taisho Period, Professor Teranishi of Hitotsubashi University calls it the "Taisho System." This system was set up, accomplished some goals, and then later fell apart. Rather than being similar to the post-war Japanese

system, the Taisho system was closer to the Anglo-Saxon type of laissez-fair capitalism. There were bourgeois in pre-war Japan who usurped the working class.

According to Prof. Teranishi's analysis, when we think of the pre-war economy as consisting of two sectors, it was fine when the agricultural sector and the industrial sector matured together. But when the agricultural sector lagged behind while the industrial sector grew, an imbalance occurred among the sectors and the system began to malfunction. As the agricultural sector remained stagnant, the agricultural community was impoverished while the bourgeoisie in the city enjoyed a lavish lifestyle. That created voices condemning capitalism and favoring a controlled economy, and Japan enters the war amid this environment.

Then the system collapses, Japan goes to war, and a new system is constructed after the war ends. I would say the post-war system took shape in the mid-1950s. The system then bore fruit in the 1960s and 1970s. As for how to view the 1980s, I believe the system made a downturn in the 1980s. On the surface it appears to be the most prosperous period, but if we make a very simplistic comparison, it corresponds to the period just before the war, and I feel we must endure hard times for a little longer. I have no grounds for this feeling. It is not a view made as an economist.

lio: You mean it's a perception based on your outlook on the world? Given this, what economic problem is causing the most incompatibility at the moment?

Ikeo: To put it another way, the question is what would you envision to be the next style of system? It may be a very crude argument, but if we take a dialectic line, a thesis/antithesis/synthesis approach would make the next system closer to the pre-war Taisho System I explained earlier, rather than the post-war Japanese system.

Generally speaking, people say it's Americanization but I believe it to be a revival of the Taisho system. People may object because it is called Americanization, so I deliberately explain that it is a revival of Japan's Taisho System.

With that in mind, I think the major problem now is the relationship between public and private, or the relationship between the government and the private sector.

lio: You believe that to be the same for economic issues?

Ikeo: Yes. Aside from this issue of system transition, when we look at the process of economic development, there was a point of transition in the 1970s. The economic progress of the last 100 years since the Meiji Period has been one of trying to "catch up," and this "catch-up" style of economic development ended at some point in the 1970s.

lio: Does that mean we managed to catch up?

Ikeo: A better way of putting this may be to say that we more or less achieved full employment for the first time during that period. Before that time, there was a latent overpopulation in the rural areas, and the industrial sector in the cities was able to pull the labor force from there. For the first time in history, this reserve of surplus workers was spent, and in this context, we essentially reached full employment for the first time in the 1970s.

In other words, this "catch-up" style of economic development "structure" ended at that point.

While functioning under the “catch-up” style – although there may be debate over the issue – there were conditions which justified the government adopting a “developmental policy” of taking the initiative to guide and accelerate the private sector. Of course there is room for debate as to whether this developmental policy was correct or not, but the fact remains that a developmental policy was undertaken and there were conditions which justified such moves.

But upon reaching the turning point in the 1970s, I believe we had reached a point where this relationship between the public and private sector, in which the government leads the private sector, should have been reviewed. But as I mentioned earlier, it is hard to understand what sort of transition might occur in one's own time, hence we entered the 1980s and 1990s without ever addressing the question of reviewing the relationship between the government and private sector. I believe the traditional relationship between the public and the private sector prevailed. Yet, while the old ways have prevailed, the fundamental conditions have changed, so a more precise expression is to say that it prevailed while adapting. It virtually changed from the government leading the private sector to the private sector depending on the government.

In this manner, there was a continued deterioration in the relationship between public and private. This made it difficult to solve problems, and I think this is what is preventing a fundamental resolution of them. A review of the relationship between the public and private sectors, which should have taken place more than a quarter of a century ago, has not taken place, and this is what I believe to be the primary problem.

lio: Does this relate to the malfunctioning of the current economy?

Ikeo: I feel that dependency on the government strengthened during this time. You could say the economy's malfunctioning is influencing this attitude to some degree, but what I believe is that the situation will not change while the government continues to say it must do something.

lio: So your understanding is that while we must fundamentally decrease the role of the government and clarify the relationship between the government and private sector, the path which we are taking now is the opposite one, and consequently the situation worsens. So from this point of view, is the so-called malfunctioning of the economy in the 1990s due to the fact that we are trying to maintain a system that does not match the current climate, or are there other factors involved?

Ikeo: The prolonged stagnation of the economy is heightening the feeling of frustration among the Japanese society in general. A sense of wanting the problem to be resolved soon – I call it, “A desire to brush it away in one clean sweep” – this desire is getting very strong and there is a mood of searching for a panacea or a “come-from-behind” homer. While the traditional relationship between the government and private sector prevails in a transformed manner, the public sector is forced to respond to this desire of the general public. It's against reason. Measures would have borne fruit if they were taken slowly and steadily, but under the current conditions, unless an action is taken every three months the general public and the press criticize. So we must pretend to do something every three months, and policies are adopted every three months, and if no results show, then we try something else. Even if the measure was effective, there are not so many occasions in the field of economics where results show themselves in just three months. As a result of repeating such acts of stupidity, the current situation is that the various resources which could have been allotted to implementing the policies have been mostly depleted.

## **The bad loan issue**

lio: Next, I would like to ask about respective aspects of the economy. Take, for example, the often-mentioned bad loan issue. Has the situation worsened due to the same mechanism, or is this problem heading towards resolution?

Ikeo: I think the issue of the banking sector should be understood as a product of the Japanese economy rather than a mere problem of bad loans. We hear more people saying that it's essential to see finance and industry regenerated together. In that sense, people are becoming more aware of the issue, but the general perception is still that the bad loan problem is the problem of the banks rather than the problem of the entire economy. It should not only be discussed by the general public, who are the depositors, as if it's someone else's problem. During the 1997 crisis, people began to understand that negative impact could reach individuals, but most ordinary people still perceive the matter as if "it's the bank's problem so the bad banks should be punished," and strongly believe themselves to be safe.

lio: Is there no perception that bad loans mean bad deposits?

Ikeo: That's right. We talk about individual financial assets of 1,400 trillion yen, but from a national economic accounting perspective, if the firms are suffering from debt, that means there is an excess of savings somewhere, and that's your savings. But such a perception does not exist.

lio: The value of the public's savings is discounted, but we are under this misunderstanding that the value exists.

Ikeo: And in the meantime, this problem that has dominated a large portion of the Japanese economy has become even more complex, and the bad loan issue and the Japanese economy have come to be two sides of the same coin. People talk about bravely tackling the bad loan issue, but I would be scared if I were them. Tackling the issue bravely means asking if one has the courage to vivisect the entire Japanese economy? I used to be in favor of the hard landing theory, and say in earlier days, "the cancer must be operated on" while it is still in its early stages.

In order to solve the problem, the first thing to do is to prepare the public to bear part of the cost. While there may be a lot of complaints, in order to try and solve the problem in earnest a public consensus is needed on the provision of over several trillion yen in pure public burden.

But no one has come out to explain the need for public burden before the general public.

lio: Then in what form would this burden show?

Ikeo: I may sound like I'm contradicting what I have been saying, but the bottom line is that the Japanese household is the one with the deposit and financial assets. There is this portion that is not being used. If it's not being used, then it's not so important whether it exists or not. It's all to do with a sense of security.

lio: You may have 1 million yen in deposit, but since it's always there, the 200,000 yen taken away from it would go unnoticed, and all one has to do is to take a little away from everyone.

Ikeo: This lack of a sense of crisis over the Japanese economy, this is where we find the underlying strength of it. As Dr. Yoshida Kazuo of Kyoto University says, the high deposit rates help disguise the various inherent problems. Because it doesn't show, there is no sense of urgency in trying to solve the problems. It's just that the saving rate is high and that saving is being wasted, but people feel that high savings mean that assets are growing every year. The truth is that nothing is being built.

So it is important for the public to face the truth. The psychological shock accompanying this realization would likely be great, and one cannot imagine what kind of panic this shock would trigger. The anger and resentment of discovering that what you thought you had was actually worth only half could sweep away one or even two governments.

lio: There are those among the economists who say that a psychological shock would chill the economy and not help resolve the problems. But these people are trying to go forward by adjusting the system, and hoping to see the economy recover while hiding the problem and covering the loss through increased tax revenue. But your opinion is that the problem remains unresolved because two different issues, that of the system and the immediate one of the economy, are being mixed, making it harder to resolve the problem?

If that is the case, can you share with us what you believe are the long-term measures that need to be taken to fix the bad loan problem, including the time frame?

Ikeo: If drastic measures like in the pre-war days were possible, it would be to cut back the savings.

lio: Is that the most practical?

Ikeo: Rather than being practical, as I mentioned before, there is the perception that this is the banks and the firms' problem, but there is actually a different aspect.

The current understanding is that the excess debt of firms from the banks' bad loans, but the banks are actually just a mediator, so if this stage is skipped, then the excess debt of firms become the excess assets of the household. This is the essence of the issue. The final way to resolve this problem is to balance out the excess debt and excess asset. The most direct, violent and barbaric way to do that is to cut the deposits. That is the economic heart of the matter, but such barbaric means cannot be endured in current civilized society.

lio: Why can't it be done?

Ikeo: Because there is a less barbaric, if not more cultivated, way to do it.

That is to replace the excess asset with public debt, and substantially decrease the actual assets of the general public in the form of obligations to bear the public debt. Cutting the deposit by 200,000 yen and having the obligation to pay a 200,000 yen tax in the future are essentially the same in economic terms. That is if fiscal illusion does not take place.

I don't know if it could be called more cultivated, but the modern way to solve the bad loan issue is to first replace it as public debt, and then to write it off in the form of public burden. That's fundamental.

It is impossible to resolve the bad loan issue without using public funds. What the government is saying now is that it can resolve the problem without public burden, but the economic fundamentals of the problem show otherwise. And the root of the problem is the deformed relationship between the public and private sector.

But this method is difficult now, because the public burden has increased too much.

lio: Does that mean you cannot issue more deficit bonds given the budget deficit, and that issuing government bonds will have bond prices failing to hold up?

Ikeo: It may give the impression that I'm procrastinating on the issue, but we must recognize that there is the financial crisis and the fiscal crisis. If we were to do what I just explained without proper preparation and strategic planning, the current public finance may not be able to hold up when collecting the large-scale public funds needed to resolve these two crises. That would call into doubt the chances of the current fiscal system being able to stay afloat, possibly triggering bond prices to plummet. When that occurs, there is the risk of the financial crisis and the fiscal crisis, which currently exist separately, beginning to resonate off each other.

With very careful strategic planning, it may be possible to take action against the bad loan problem now, but I still think it's a gamble even for the most talented individual. For now, the best bet would be to attempt to hold off the fiscal crisis and see government finances gain enough strength so we can increase the fiscal burden in the future to resolve the financial crisis.

lio: So you are saying we must wait until the risk of fiscal crisis lessens. Then, if and when the fiscal situation improves, what measures would be available to solve the problem? What would be the best method?

Ikeo: As I mentioned earlier, as long as we have public perception about the need to bear the burden, the rest will follow through.

The bad loan issue, as a purely economic issue, is not so involved. All you have to do is just to fill in the gaps, and whether that be through fiscal burden or direct compensation, the fact is we need the general public to bear part of the cost. However, because we pretend that we can resolve the problem without public burden, the debate becomes confusing.

## **Public Finance**

lio: Next I would like to ask about Japanese public finance. You mentioned that we are faced with a public finance crisis, but does that mean you see a breakdown if we continue along the current path?

Ikeo: Normally speaking, that would be the case. But since the government is of an infinite existence, the only restriction on government budgets is that the total annual revenue in current valuation for an infinite time span must match the total annual expenditure in current valuation of an infinite time span. So if, for example, a major gap exists in the next 100 years, it theoretically doesn't matter. If a major deficit existed for a particular 100 years, then the next 100 years could be used to return to a fiscal surplus. So there is not much meaning in debating over whether the government's budget restrictions are being kept or not. But we may see that

the probability of sustainability being lost is high when we look at the data from the 1990s until now.

lio: Is the reason why you did not say that it's possible to prepare 100 trillion yen since there won't be a breakdown, because government bond interests will rocket sky-high or bond prices will plummet, and that may pose a problem?

Ikeo: I think we will hold up if we let sleeping dogs lie. But with a slight shock, the probability of a public finance collapse emerging could increase.

lio: It's okay if we let sleeping dogs lie?

Ikeo: At least the current government bond market sees it that way. There are three ways to interpret the current Japanese government bond trading market. The first interpretation is that the market cannot reflect the approaching risk of a financial collapse due to various reasons, caused by the system and other factors. For example, one reason why it's not reflected in the prices is because the Bank of Japan buys government bonds to lift the price. The second interpretation is that there is actually no risk of a fiscal collapse, and hence this fact *is* reflected in the price. The third is that this is another "bubble." It is not a normal situation where price can reflect the current climate. The interpretation is that there is a lot of cash but nowhere to invest, so everyone is buying government bonds. I may be avoiding a straight answer, but it's hard to answer this question.

Although it's hard to disregard the possibility of a "bubble," I have some doubts about fully accepting this interpretation. It's also hard to ignore the interpretations that either the system is preventing the market from reflecting the situation in the form of price, or that there is no crisis to begin with.

While there may be a possibility that the government bond price is not reflecting the situation, the Japanese government bond market, including the future and swap markets, is so large that it's hard to imagine the price is being artificially manipulated. The theory that a large percentage of market participants believe in the possibility of a financial crisis being avoidable should not be ignored; if reality and theory contradict, then it's the reality that is correct.

## **Deflation**

lio: Next I would like to ask about deflation. Here it also appears that opinion is divided among economists.

Ikeo: As for the concept of deflation, the current government defines it to be the fall in prices, but there are cases where we think only about price falls, and cases where deflation traditionally meant not only the fall in prices but the slowing down of economic activity in general. We confuse talking only about price falls with talking about deflation in the traditional sense.

And the current deflation is different from previous deflations when we look at the facts. It's not spiraling. When we discuss this issue, we remember the experience of the 1930s and talk about how we overcame deflation in the 1930s, but this case is different. We shouldn't engage in such sloppy debate but hold discussions after taking a close look at reality. There's been this threat of a deflationary spiral for some time, but we must also be able to explain why this

gradual deflation continues. Current economics cannot clearly explain this phenomenon.

lio: I often hear people refer to Irving Fisher and I also believed that was the case.

Ikeo: Fisher's debt-deflation theory appears similar to our reality but I think it's actually different.

lio: When we talk about debt-deflation, in terms of image, the current bad loan issue looks similar because it's so big. But you're saying it's actually different?

Ikeo: Yes.

lio: How is it different?

Ikeo: First, the spiral hasn't occurred yet. Second, the speed of the fall in the price of the flow of goods and services, and the speed of the fall in asset prices are all different.

If everything is occurring rationally, asset prices should reflect that a gradual deflation will continue for the next 100 years. So we must judge whether reality is being rational or a bubble. But you can only realize it was a bubble after it bursts, so it's difficult for social scientists to take a position when you debate over something being a bubble or just being strange.

As I repeatedly say, if reality and theory contradict, then there are people who believe that theory is correct. If their confidence is based on continued efforts to back up their belief, then that's okay, but I have not worked to prove likewise and I believe that the chances of reality being correct are stronger. I think people should try approaching the issue from the standpoint that reality is correct.

lio: Why is it said that gradual inflation is good?

Ikeo: There exists what you may call a downward rigidity in prices. Part of it may be caused by illusions such as money illusion. But we can point out that revising the price downward is costly. When we consider this, it's easier to adjust an inflation of several percentage points.

More specifically, the biggest point is wages. There is an aversion to lowering the nominal income of wages, and one way of thinking is that gradual deflation is continuing because the nominal wage level is maintained. If we think in these terms, as nominal wages are kept the way they are under gradual deflation, labor productivity must rise in relation to deflation, or else this situation will pressure the economy.

In that sense, in a mild inflation it is easier to make economic adjustments, and if that can be realized without much cost, then I also believe that to be a better option.

lio: Then can we stop deflation?

Ikeo: Deflation continues because there is a supply and demand gap. Because there is such a gap, prices are falling. There is debate over what the size of this gap is, and some estimates claim it to be somewhere between 30 trillion and 50 trillion yen. A six to ten percentage point gap in terms of GDP. This is a large gap. When we try to take fiscal or monetary measures to stabilize the macro-economy, the supply and demand gap is usually somewhere around one percent of GDP.



So when we talk about macroeconomic policies in the normal sense, we are talking about a maximum gap of about five trillion yen. But in reality, the gap is at least 30 trillion yen. Then what should we do? One way of thinking is to take fiscal policy to six times the normal level. If the multiplier is ten, do one trillion. If the multiplier becomes one, then do 10 trillion. That's the argument. As for the monetary policy, it's to continue buying government bonds, since we have an abundance of them. I don't think that such measures are economic policies and I feel those who seriously debate them are simpletons.

In other words, we now have a supply and demand gap that cannot be filled under normal macroeconomic measures. Then it must be filled by adjusting the industrial structure. But the adjustment of industrial structure takes time contrary to macroeconomic stabilization measures. Although people often talk about industrial adjustment, it actually means tens of thousands of people changing jobs. For that reason it is not easy. In that sense, we are now holding a supply and demand gap which can only be resolved through industrial adjustment. But the adjustment takes at least five, normally ten or twenty years. If we think about such a situation, the expectation of a gradual deflation during that time is natural.

lio: By the way, do globalization and deflation affect each other? How should we view this aspect? Some argue that phenomena which cannot be explained by modern economics are occurring under globalization.

Ikeo: I did mention it several times before, but it's true that there are phenomena that cannot be properly explained in economics. It's obvious that every single economic phenomenon cannot be explained by existing economic theories. Then we must make the effort to explain what cannot be explained. But, we must consider whether we need a paradigm shift of existing economic theories to do so.

At this point, I tend to believe in the resilience of the framework of traditional economics. When the times change, people often talk about the need to create "new economic theories as the old theories have died." But the theories which often survive such debates end up being traditional ones. So speaking from experience, the current situation may not be deviating so much from traditional theories.

lio: What is the point that is most difficult to explain about the deflation that is occurring now?

Ikeo: I may be contradicting myself on earlier arguments, in the greater framework, I don't think there's anything that's strange. There are small points which I believe should be looked into carefully and properly explained, but within a larger framework, I have my own particular understanding and I'm not fretting over or worrying about something that is so strange and hard to explain.

lio: So you feel while there are various unknown elements, deflation itself is explainable. Earlier you mentioned that we must be ready for deflation continuing for the next ten years. While it's better to resolve the situation, there are not many means to do so, so are you saying we must take our time?

Ikeo: You don't have to go slowly on purpose, but I think the point is to do the best within the given framework.

lio: What is the best way to remove deflation?

Ikeo: In order to resolve the gap between supply and demand, the current industrial structure of Japan is suffering from an inherent mismatch in the structure of supply and demand. The general picture is of excessive supply. However, we are now also suffering from an invisible over-demand.

It appears, not in the form of cash, but in services such as medical for example. Some hospitals would have visiting patients wait for three hours. No one wants to wait three hours, and the fact that people do wait implies there is an over-demand. Even in the United States, medical care, nursing and welfare are major areas that create employment. As is often said, in the United States about ten percent of its work force engages in medical care, nursing and welfare. That's the equivalent of Japanese employees working in the construction sector. Japan is said to face a larger aging population growth than the United States, so there should be potential demand in such areas.

I meant that it's necessary to both scrap and build. Excess in existing industry should be cut back, or scrapped, while services in demand should be created, in other words, built. Even if this was done, it's hard to see a shift in workforce. The necessary shift in workforce, or the image of a transition in the industrial structure, is, based on Japan's past experiences, like the shifting of the labor force from coal mines when the source of energy shifted from coal to oil. And that wasn't easy. It was even difficult when Japan enjoyed robust economic growth.

lio: Lastly, there is concern over the political possibility of Japanese people not complaining if the entire nation lost its purchasing power. What are your views on this point?

Ikeo: One socioeconomic system is about to fulfill its lifetime as a whole and it would be for the best if the next system immediately appeared before the old system fails. But since that's impossible, there will always be the period during which the system becomes unstable. With that in mind, I think it takes about 25 years to make this shift from one system to the other, and Japan is about to enter this phase.

Different people take different views, and while there is always the option of doing something opposite, everyone will not be satisfied until all remaining options have been tried. For example, Britain didn't make the logical choice in the beginning, but went through a long process of trial and error. Only at the very end did people accept the one remaining choice to be the best choice. That was the process by which Thatcher came about.