The choice of promoting a comprehensive shift in economic systems by focusing on the links between various economic phenomena

Interview with SAITO Makoto, Professor, Graduate School of Economics, Hitotsubashi University

SAITO Makoto

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<Perception of Economic Problems>

Iio: In considering economic problems, what groupings do you identify? We face a number of problems, such as deflation, disposal of nonperforming loans, a stagnant economy and fiscal difficulties, and all these issues are closely linked to each other. But how does one sort out and classify these problems?

Saito: One major category I have been thinking about is the problem of the financial system. As Japan's financial system undergoes drastic changes, how should we proceed with the disposal of bad loans and the realignment of local financial institutions, how should the four major banking groups change their way of doing business, or how should we change the existing framework of financial markets including the mechanism for public financing? All of these questions fall into this first category.

Secondly, there is the overhauling of the macroeconomic policy framework. With regard to both fiscal and monetary policies, we need to reexamine and make bold changes to the way we operate today. There is no denying that the economic problems we face today are very serious. But it is also true that many of these problems are being caused because the existing policy framework does not properly address today's needs.

Thirdly, there is the problem of mounting frustration among the people. People get frustrated if they often find a great disparity between what they expect and what they actually get. Japan's social security system, for example, has come to embrace too many roles, going far beyond its original function as an income redistribution mechanism. Trying to increase pension or health insurance benefits without discussing the degree of government involvement in both the inter-generational and intra-generational redistribution of income would be next to impossible.

<Financial System>

Iio: Let me first ask you about the problem of the financial system. So, you believe that it is caused by the failure of government policies, financial regulations and the behavioral principle of players in the financial markets to catch up with the ongoing changes in our society.

Saito: Yes, I think so. What happened in the global financial markets in the 1990s is basically as follows. With the advance of information technology, geographical barriers were comparatively lowered while deregulations enabled the invention of various financial schemes and products, paving the way for the development of extremely complex financial technologies.

Against this backdrop, the financial market – which has traditionally been divided by the type of business such as brokerage, insurance and banking – is shifting into a new regime where the market branches out into a variety of financial functions. How to cope with this new phenomenon has emerged as a major policy agenda, although this is not a challenge limited to Japan. In each country, financial administrators have been trying to address the new needs by shifting emphasis "from business types to functions."

Up until now, both major city banks and regional banks have been undertaking a great variety of functions. These functions should have gone through a process of consolidation and fragmentation, but not in Japan. In the United States, for instance, commercial banking and investment banking have been blended to create a new mechanism to meet the needs of new financial markets. In Japan, however, old-fashioned commercial or industrial banks up until recently remained mainstream. All the while, the conventional banking system has been unwillingly embracing various risks. Thus, when these risks began to surface, the banking sector had to suffer disproportionately huge damage. Had the risks been diversified more broadly within the whole economy, the damage could have been shared by all the members of the economy.

If you looked at the pattern of financial sector in the U.S. and Europe, you would find that deposit-taking banks have an extremely low presence in the financial market while the presence of institutional investors, such as pension funds and investment trust funds, is quite significant. For instance, when you get a loan from a bank, the loan asset would be securitized by utilizing various financial technologies and passed onto institutional investors. That is to say, while the lending bank continues to manage the loan, the risk of loan losses is diversified away from the bank.

Behind institutional investors are a number of households investing money in a variety of ways. These include employee pension funds, wealthy individuals, as well as high-risk funds that can afford risk money and take substantial risks. Thus, although the banking sector is the initial source of risks, a mechanism for risk diversification is firmly in place. Also, because risks are passed onto various risk takers through a number of agents, the pricing of risk assets takes place in a transparent manner.

Iio: Politicians and the general public are making a great fuss about the bad loan problem, but they hardly realize that the problem of bad loans is the problem of their deposits going sour. This, too, stems from the same root cause, doesn't it?

Saito: Yes, it does. So, I think what we see today is the aggregation of all these contradictions manifesting in the form of the bad loan problem. If functional specialization, risk allocation and risk pricing had been taking place properly in Japan, banks could have taken more effective measures at an early stage after corporate value began to deteriorate.

In Japan, we are now hearing lots of talk about discounted cash flows (DCF). In the U.S., however, there already exists a clear recognition among major commercial banks and investment banks that the price at which a major loan asset is actually sold is the value of that loan asset. As far as major loans are concerned, it is extremely rare for original lending institutions to keep loan assets for more than two years. Instead, they would securitize and/or resell loans to other institutional investors. In the process, loans are revaluated and priced at fair value. A loan officer who managed to resell loan assets at a higher price than their purchase price would be given high marks. Likewise, a loan officer capable of taking timely actions to stop losses would be positively evaluated.

It is because such a mechanism was not functioning properly that the Japanese banking sector ended up with massive nonperforming loans. Troubled loans have not been assessed in an accurate and proper way. Also, a loss control mechanism – under which banks are supposed to charge higher interest rates for high-risk borrowers so as to set aside allowances for loan loss reserves and write off irrecoverable debts left by inevitable bankruptcies – has ceased to function at all. All the while, as often pointed out, the adequacy of applied interest rates has been left unchecked against the credit risk of each borrower, a problem that concerns not only bad loans but also standard loans.

As is currently being discussed in the political arena, the problem of bad loans boils down to the question of who is going to bear the costs and who is going to take the initiative in disposing of them. It is thus important to maintain a forward-looking stance and take measures in such a way that a new financial system will emerge through the process of disposing of bad loans. Then, while proceeding with the disposal of bad loans and after drawing lessons from the process, we need to explore new forms of banking and securities business that match a new financial system. In this sense, there are many interesting questions that need to be addressed, and I expect that various attempts, including private-sector initiatives, will be made, from which new forms of financing will emerge.

Iio: So, you do not side with the view that Japan's financial system remains sound or those who believe that the ongoing bad loan problem is an unfortunate outcome of the burst of the bubble and subsequent deflation, and thus can be solved by cleaning up balance sheets. Instead, you believe that Japan's financial system itself is undergoing changes and therefore it is important to draw up a blueprint for a new financial system and implement the kind of policy measures which, in the process of solving the bad loan problem, would facilitate transition to a new system?

Saito: Yes. Implementing such measures on the financial system side would bring about business and financial restructuring on the part of corporate borrowers. Also, when various moves emerge on the financial front, we will begin to see business restructuring or what is generally referred to as corporate reconstruction or business reconstruction.

A substantial number of companies would be able to avoid further deterioration in their business performance and would improve performance if only they could secure appropriate financing that allowed them to realign business structures and/or make additional investments in better business areas. For instance, they could expand into a new field of business or choose to merge with a rival company. The presence of excessive debts is one reason why not enough corporate or business restructuring is taking place. The existing creditors are the first to take the fruits of corporate revival, and so there exists a situation where new money suppliers would be often left with no return.

Once a company carries out financial restructuring and successfully consolidates liabilities, reducing the amount of debts owed to existing creditors to the level equivalent to the current value of its business, then, the company is able to deal with business restructuring in one fell swoop because new investors from then onward will be able to expect appropriate returns on their investments. Totally helpless businesses cannot be revived though.

Iio: Although some businesses are totally helpless, the presence of excessive bad loans is preventing the revitalization of businesses even in hopeful areas. That is how you see the current situation?

Saito: Yes. And because of this, the value of corporations has been continuing to deteriorate while no business realignment takes place, resulting in the fall in overall share prices. It must be recognized that financial restructuring and business restructuring need to be carried out simultaneously.

Where the market functions properly, the Modigliani-Miller theorem is supposed to apply. This says that the left side of the balance sheet, showing the components of corporate value, is not linked to the financing and capital structure of the company, and it is assumed that a good business project always finds ready investors and induces capital investment. Once trapped in a debt overhang situation (underinvestment as a result of excessive debts), a company often loses flexibility for business restructuring because of financial constraints. It is thus necessary to first lift such constraints. In Japan, we have private liquidations and legal liquidations. But there is no such strange distinction in the U.S., where all the cases are handled smoothly in accordance with legal procedures.

Iio: Where does such a difference come from? Are there any deficiencies in the Japanese system?

Saito: According to those involved in actual corporate liquidations, the relevant institutions have been reformed comparatively well. But they say that the existence of various customary practices between creditors and debtors is preventing effective use of the institutions. For instance, banks may not act quickly, or debtors may try to unjustifiably delay repayments.

Iio: So, you mean that there are so many obstacles hampering the formation of a market for debt assets that we cannot push things forcibly where no consensus exists.

Saito: No, we cannot. Behind this lies the serious reality that governance over companies and banks is not functioning properly. I don't believe that the private sector will readily respond, or that things will begin to go smoothly simply by implementing new institutions to break the impasse. A more realistic approach would be for the administrative authorities to first set out a general vision. Then, while making it a rule not to deviate from the principles of the vision, they government should support and implement pump-priming measures designed to induce progressive private-sector initiatives so that the rest of the private sector would follow the move. Otherwise, it would be difficult to change the situation.

Lately, I had the opportunity of discussing bad loan liquidation and securitization schemes with officials of the Financial Services Agency (FSA). My impression is that a range of ideas – including liquidation schemes utilizing the Resolution and Collection Corp. – are already on the table. With just one more push, we will be able to see a certain kind of scheme take root. For instance, we still have some difficulty in finding those willing to invest in the subordinated tranches of securitized loans.

Ordinarily, the original lender transfers a pool of nonperforming assets to a securitization scheme while other banks which have more effective bad debt collection techniques step in as investors – this is how a securitization scheme works. Those in possession of such techniques are able to collect loans by taking the proper steps, even if their claims are subordinated to other creditors. Therefore, they are able to generate profits as an investor while at the same time ensuring that they have an incentive for debt collection efforts. When such an expert debt collector comes in, other players such as institutional investors feel more comfortable about purchasing preferred tranches. This even applies to funds whose underlying assets are bad loans. The prime portion of such funds can be covered by ordinary institutional investors, if a particular financial institution acting as a debt collector comes in as an investor so as to convince other investors of its commitment to collecting debts. But this is exactly where securitization schemes face hurdles and it may be a good idea to have a quasi-governmental institution – the Development Bank of Japan, for instance – play a modest role in providing credit enhancement to induce investments.

This is just an example. But when this happens, a series of funds will emerge that invest in bad assets. Moreover, if it became possible to properly asses incentives for debt collection, loans that are marked to the market value would no longer be considered to be nonperforming.

Likewise, if a brokerage house properly served as a market maker, or an arranger for the pricing of securitized assets, institutional investors would come in. In this context, the disposal of nonperforming loans provides a major opportunity to practice and implement the series of measures that I mentioned earlier, such as risk allocation, risk pricing and functional specialization.

For the moment, however, private-sector banks are extremely risk aversive. Therefore, even if the administrative authorities manage to find the right buttons to push, a range of problems may arise. For instance, there arises the possibility of passing the burden of bad loan disposal onto taxpayers may arise, and the government may have to provide financing in the form of capital contribution or subsidies. Still, I believe that the existing framework can work as long as it is properly targeted. Once we have been through a set of procedures under the framework two or three times, how the whole mechanism works will become clear to those involved in or observing the process. When more parties feel confident and participate in the process, the government and the relevant quasi-governmental organizations can reduce their roles. For the moment, it is still unclear how the Industrial Revitalization Corp. of Japan (IRCJ) will be operated. However, there is a good possibility that an institution such as the IRCJ – if utilized properly and implemented as a special scheme applicable for only a specified period of time without deviating from the original purpose of putting new financial business practices firmly in place – can help create a new financial system in Japan, although it may cost taxpayers more than ¥10 trillion.

When things begin to move, that is, when people come to realize that the risks existing within the whole economy must be taken and priced by someone, ordinary depositors would finally be ready to live with the "payoff" system that provides only limited protection to bank deposits.

Iio: That is the time when ordinary depositors will be asked to take their share of the risks, isn't it.

Saito: When such an idea takes root among people and it is understood that depositors, too, potentially bear the burden of risks, the current situation – where depositors are overly protected and favored in comparison to other investors – will be dissolved. Then, private-sector banks would reduce the size of the deposit division and we would probably begin to see a variety of new money cycles that are more in the nature of direct financing. So, the financial system should be redesigned in such a way as to match new money cycles and risk allocations that begin to work in the private sector. This would be a favorable approach for the financial and non-financial sectors because, as I have mentioned earlier, the bad loan problem needs to be solved from the viewpoint of industrial revitalization. Some people say that we should wait until the ongoing deflation comes to an end before tackling the bad loan problem, but I don't agree with them.

Of course, it is true that a bad loan problem can be more easily solved under inflationary conditions. But I don't think it is meaningful to discuss which should come first. We should think out policies to help raise general prices. At the same time, however, we need to act quickly to realize industrial and financial revitalization without waiting for the implementation of counter-deflationary measures as a precondition.

<The Role of the Bank of Japan>

Iio: Having listened to various scholars and other experts recently, I have come to question to what extent the Bank of Japan (BOJ) needs to be independent. Let me explain why. Under democratic politics, independence is normally allowed within a certain scope of discretion. One typical example can be seen with the administration of justice. Courts are provided with laws, in accordance with which they are to act, and it is considered that no democratic control is necessary because the function of courts is limited to the adjudication of legal disputes in which each party concerned makes a case on a face-to-face basis.

If the independence of the BOJ is important, there must be a designated formula for its monetary policies, in accordance with which the central bank should make modest adjustments. Without such a precondition, I believe it is difficult to justify the independence of the BOJ.

The reality is, however, that we have been hearing lots of arguments as to whether or not to allow the continuation of deflation while various things have been said about possible measures to counter deflation. All these factors considered, it seems to me that there is little foundation for justifying the independence of the BOJ. But at the same time, when we look at situations in other countries, there exist objective circumstances as to why a country cannot be trusted unless it ensures or advocates central bank independence, the independence of the BOJ in case of Japan. I wonder how to interpret the relationship between these two conflicting circumstances. How do you feel about this?

Saito: There are two roles that the central bank of an industrialized country is supposed to fulfill, namely, to ensure price stability and to act quickly when timely measures are needed. In other words, I believe that a central bank has a role to play in dealing with urgent situations that legislative measures cannot address in a timely manner, such as a financial or liquidity crisis. With regard to this second role, most people seem to agree that a central bank is the only institution capable of undertaking such a task though it may not be the best solution.

Concerning the first role, the problem with Japan is that discussions on the BOJ's independence proceeded without discussing what we actually mean when we say "price stability." In the late 1990s, the whole idea that we must, first and foremost, reach a firm consensus on the substance of price stability was eliminated. However, those believing that price stability means a zero growth in the price index are a minority among economists.

Iio: So you believe that the state of price stability is supposed to be a situation where an inflation rate of 1 to 2% is sustained.

Saito: Yes, I believe so for various reasons. Based on this view, I don't see much difference between a mild inflation and the state of price stability. But without forming any firm consensus concerning the definition of price stability, greater independence has been given to the BOJ, an institution with a particularly strong propensity – as compared to its counterparts in other industrialized countries – to be overly conscious of maintaining price stability at an absolute level; and from then onward, discussion went off the track. Another problem that is very unique to Japan is that we ran into the question of central bank independence without clearly separating responsibility for monetary policy from responsibility for national debt management policy.

During a period immediately after World War II, the U.S. Federal Reserve Board (the Fed) was very much servient to the Treasury Department, with its role almost limited to that of keeper of the national coffer. When rising interest rates began to pose a significant risk in the postwar inflation period, the Fed bought whatever amounts of Treasury securities from private-sector banks it could, thereby absorbing all the private-sector risks and losses associated with further rate increases. At the same time, however, the Fed sealed an accord with the Treasury which effectively freed the Fed from any future responsibility for the management of government debts. The Treasury agreed to the idea, too. Thus, from then onward, it has become impossible in the U.S. for the Treasury and the Fed to argue, for instance, over outright purchases of government bonds, a scheme adopted in Japan under which the central bank purchases government debts from the open market and holds them to their maturity. Should the Treasury attempt to persuade the Fed into such a scheme, it would be tantamount to breaking the accord. Japan, on the other hand, has focused so much on the institutionalization of central bank independence that there remains much ambiguity about the division of responsibility between the government and the BOJ, making problems far more complicated. Judging from the current circumstances, I do not think it is a good idea for both the government and the BOJ to make their arguments by citing the provision of BOJ independence.

Iio: At the moment, there are several government agencies that are in charge monetary policy. The BOJ is one and the FSA is another. In addition, the Ministry of Finance (MOF) is also involved with respect to the issuance and management of government bonds. What specific role do you think each of these agencies should undertake and where do you see ambiguities?

Saito: The FSA should play the primary role in areas relating to the stability of the financial system and related prudence policies, while the BOJ should bear its share of responsibility in maintaining financial system stability with regard to the banking sector. As far as these areas are concerned, I don't see much problem with the existing institutional systems, though I have an impression that the BOJ might have been stepping in too much lately with respect to financial system stabilization policy.

To be sure, it is necessary for the BOJ to grasp the financial condition of banks linked to the BOJ Financial Network System (BOJ-NET) from the viewpoint of the necessity to sufficiently provide settlement services for them. Since the BOJ-NET is the very mechanism providing such settlement services, the BOJ, as the operator of the mechanism, certainly has administrative responsibility.

There are some difficult aspects to the division of functions and responsibilities between the Ministry of Finance's Financial Bureau and the FSA. Because of the presence of the government's Fiscal Investment and Loan Program (FILP), the MOF basically continues to hold control over the public financing mechanism, which is a problem very unique to Japan. In reforming the private-sector financial system, there is no avoiding the question as to how to redesign the public financing system.

Meanwhile, the existing issues between the MOF and the BOJ – other than the one discussed earlier concerning the management of government bonds – include the question regarding the right to intervene in foreign exchange markets. The MOF currently fully retains the power to intervene whereas the BOJ, merely as the agent of the ministry, actually buys and sells the yen and other currencies in the markets. But we may rethink whether it is desirable to divide responsibilities between them.

Iio: Do you believe it is more desirable to let the BOJ undertake all tasks relating to international finance?

Saito: The BOJ is the party that actually carries out the task of intervention, and in this context, I would say it is better to leave it all to the BOJ. After all, the question of whether or not to sterilize money released through foreign exchange interventions concerns monetary policy.

Iio: So, that is to say that the management of the money market and the management of the foreign exchange market have been unified into one, isn't it?

Saito: Yes, I think so. After all, how to stabilize domestic prices and what nominal level should be targeted in guiding foreign exchange rates – both of which boil down to the question of the yen's value – are inseparable from each other in such a globalized market as the one we have today.

Iio: Then, do you believe that the current situation still needs to be sorted out? That is to say, the BOJ should retreat a little bit from the area of financial system stabilization and instead take care of international monetary affairs, whereas the MOF should fully take charge of the management of government bonds, or national debts. Furthermore, in doing so, you see some difficulties regarding the handling of quasi-governmental financial institutions or the FILP program, which are currently under the auspices of the MOF's Financial Bureau. That is, you think it is difficult to unify authority over monetary policy because of the presence of the FILP program that has two aspects, namely, the financial system stabilization issue regarding the institutional management of the FILP program and the monetary market issue regarding the management of FILP funds.

Saito: How to share and separate responsibilities among these three agencies – the FSA, the BOJ, and the MOF – is a very difficult question.

<Deflation>

Iio: Next, let me ask about the mechanism of macroeconomic management. First of all, how do you define the problem of deflation? Some people keep on chanting that deflation is a monetary phenomenon, while others say that deflation is caused by a demand-supply gap. How should we understand this problem?

Saito: On this topic, there is a substantial generation gap between older economists, above and around 45 years old, and younger ones.

Iio: How do they differ?

Saito: Not many young scholars point to disequilibrium, such as a demand-supply gap, as a source of deflationary pressure. They don't think that way. The framework of economics including macroeconomics has changed drastically. For instance the way of thinking up until recently used to be that, one would assume a world of extremely competitive equilibrium in the first place, and whatever phenomenon that cannot be explained by that equilibrium would be regarded as a "disequilibrium phenomenon." When there is a certain phenomenon that deviates from the ideal world, adjustments are supposed to occur in such a way as to correct the deviation, and deflation is considered to be one of them. This may sound correct but theoretically it is extremely incoherent. Coming up with this idea of disequilibrium, which is to bring a framework that cannot explain the reality in the first place and say that there is this gap because the reality is this, is almost like abandoning the logic of economics.

Owing mainly to the advancement of game theory, a new framework of economics that can handle a variety of equilibrium concepts has been developed. Here, whatever situation that exists is regarded as an equilibrium phenomenon that is occurring within a certain kind of framework. The situation that exists now is perceived to be equilibrium, setting aside the question of whether it is desirable or not.

Based on this, it is hard to accept an idea in which deflation is attributed to a demand-supply gap. A certain scholar has even said that Japan has been suffering a demand-supply gap of 5 to 6% since the late 1990s and the gap has recently widened to 10%. That translates into ¥40 to ¥50 trillion, doesn't it? It would be understandable if we had such a situation for several months, but for it to go on for several years there would have to be something extremely wrong with the mechanism of Japanese capitalism.

Regarding the way of looking at deflation, the low interest rate environment began in mid-1995 when the BOJ cut the target rate for overnight call loans by 0.5 percentage points. Around the same time, that is, in the latter half of the 1990s, we began to see the consumer price index (CPI), an indicator of the final value of goods, flatten out or show signs of mild deflation. Although the wholesale price index (WPI) had begun to fall earlier than that due to the effect of import prices, the basic picture is that the low interest rate environment and mild deflation which began in 1995 and was still continuing in 2003.

So, it has been eight years. It may sound intelligible to attribute this situation to a demand-supply gap, but I find such an idea hard to accept. Actually, throughout that period, the BOJ has been maintaining a two-digit increase in the monetary base, and despite this, we are in the situation that we see today. Given this fact, it is hard to believe that such a situation is not equilibrium but being maintained by a demand-supply gap. This state of affairs, which has been continuing for so long, should be looked at as a phenomenon that is occurring in a certain kind of equilibrium, though it is not a desirable equilibrium. This is how younger scholars see it.

When interest rates are kept at an extremely low level, as is the case in today's Japan, the opportunity cost of holding currency is so negligible that symptoms such as currency hoarding and the retention of money within the currency market inevitably occur. This is a situation referred to as the "lowering of the velocity of money." When people say that prices are a monetary phenomenon, they are referring to the relationship that an increase in money supply causes a proportionate increase in prices when the velocity of money remains constant, that is, assuming that money supply times the velocity of money equals the price level. However, we have been witnessing a situation where an increase in money supply does not lead to an increase in prices because interest rates are extremely low and the circulation of money has slowed down substantially. And there are a series of monetary economic models that can explain these situations as an equilibrium phenomenon.

Then, it is not so surprising that substantial gaps began to emerge between the actual growth in money supply and the movement of prices, a phenomenon that led to the ultra-low interest rate policy. As evidence to show that this is an equilibrium phenomenon, let me point to the behavior of market players. Being in this situation for a prolonged period of time, they have discounted the situation to adjust their investment activities.

Despite the significant interest rate risks involved, market players have been showing little hesitation in purchasing Japanese government bonds (JGBs). This kind of phenomena can be better explained by assuming that people regard the ongoing conditions – extremely low interest rates and mild deflation – as an equilibrium which would continue for some time and that they are behaving in accordance with such a prospect, even though such equilibrium is not at all desirable. Under this framework, it is hardly meaningful for the BOJ to boost the current account balance from the present level of more than ¥20 trillion to ¥100 trillion. The velocity of money would go down further and the BOJ would end up becoming a major holder of JGBs. This is about the only outcome we can expect.

Many people would agree that we need to shift into mild inflation, believing that mild inflation is preferable to the current situation. But there is good equilibrium and bad equilibrium. And currently, we are being bogged down in bad equilibrium with everybody behaving adaptively to it. So, what can we do to shift to good equilibrium? First of all, we need to break the existing equilibrium. People's expectations must be toppled so that they can be guided to a new and good equilibrium.

A transition from one state of equilibrium to another must occur all at once, not gradually. In terms of policy measures, this means the implementation of inflation targeting and the aggressive buying of corporate stocks as a means to break the existing equilibrium. For instance, the aggressive buying of land would topple people's expectations and the existing equilibrium. When this has been done, not only a hike in prices but also other drastic changes in nominal variables – such as interest rates and foreign exchange rates – would occur suddenly. This would surely generate inflation but at the same time interest rates would shoot up.

However, there is an alternative measure as well. Although it seems that I am the only one saying this, I am rather confident about my idea. If we could redirect market expectations toward inflation by slightly raising interest rates, prices would increase due to factors relating to the quantity theory of money, without any aggressive money supply policy.

Up until 1995, the velocity of money supply was very stable. Since the 1970s, it has remained stable for years, even before and during the bubble era. An empirical study shows that the aforementioned phenomena – currency retention and the lowering of the velocity of money – began to occur when overnight call rates fell to the level of 0.5%, or 0.3 to 0.4%. When this happens, whatever quantitative easing measures are used, they bear no fruit. Therefore, I believe that somewhere around 0.5% is the threshold level where people, in particular those at private-sector companies and investors, begin to recognize the cost of holding money.

So, if the monetary authorities guide interest rates upward slightly and announce their intention to raise the target balance of current accounts by 2% per annum – in other words, if the central bank raises its benchmark target rate to create a situation where people do feel the cost of holding money while declaring its plan to continue to pump more money into the market – prices will inevitably go up because it is the only way make the final balance.

Under the current framework, however, quantitative easing policy is being implemented as an extension of the zero interest rate policy whereby the central bank supplies more money while keeping interest rates at zero. As its governor says, the BOJ should leave it to the market to decide interest rates, if it wants to raise the price level. The BOJ should send out a message that it would tolerate a modest increase in interest rates, or the central bank may as well go further to say that it will raise its target rate by a little bit, while at the same time stating its intention to continue to increase money supply. Then, as a resulting equilibrium, we will probably see a rise in prices.

I believe that the threshold rate for this would be 0.5%. At that level, companies, investors and whoever else holds assets in large lots cannot afford to let them stay idle. They will then begin to circulate money.

Iio: So, that means they are going to buy the real thing at some point in order to circulate money.

Saito: Yes. If the size of the overall economy remains constant, prices begin to rise and adjustments occur to reduce real purchasing power, thus, the so-called mechanism of the quantity theory of money begins to work. So, the BOJ can first create an environment that allows some flexibility in interest rates and then increase money supply. However, I do not believe that the ongoing situation can be blamed on the BOJ's failure to act or negligence. This is because there was a policy framework referred to as an interest rate policy, under which industrialized countries were to implement monetary policies by means of adjusting interest rates.

In the late 1970s, money supply rules were dominant. However, after disastrous consequences resulted from applying these rules under high-interest rate environments, the monetary policy regime shifted back to interest rate rules. Since then, the Japanese monetary authorities have been implementing policies based on the perception that guiding down interest rates is supposed to be an easing policy. As a consequence of this, we are now having a situation where the rate-reduction policy ceases to be effective with interest rates having fallen to near zero.

So, as argued in articles in some scholarly journals, it has been pointed out that Japan, being caught in a liquidity trap, would have a greater chance of departing from the ongoing zero interest rate situation by shifting to a more money-supply-oriented monetary policy. More explicitly, Lars E. O. Svensson, a Swedish scholar, suggested in his presentation at the BOJ two years ago that a modest increase in interest rates combined with a money supply rule by means of inflation targeting would create a new equilibrium where positive inflation with a devaluation of the yen can occur. It is thus important for Japan to modify the existing monetary policy framework and rules by taking into account various lessons learned under the ongoing zero-interest-rate regime. At the same time, it must be understood that along with an increase in the price level, a series of other nominal variables would have to be drastically adjusted.

Iio: Let me move to the last point concerning deflation. Many people believe that globalization is a major cause of deflation. They say that it is very difficult to stop deflation because any attempt to do so is bound to bring up the question of foreign exchange policy. Some people even suggest that we should learn to live with deflation because, no matter how undesirable, deflation is a reality for us and it would not be a very good idea to stop it in today's society. What would you say to these views?

Saito: Their idea is that we had better get accustomed to the deflationary trend. As I mentioned earlier, a shift to mild inflation would force us to go through very drastic changes even if it is a subtle shift from a mild deflation to a mild inflation. But if we could implement a framework that is neutral to changes in either direction, we would be able to prevent major income transfers such as those discussed earlier and minimize the confusion that would occur when the Japanese economy finally shifts to a mild inflation.

Here, I am referring to neutrality with regard to the price level. For instance, the introduction of indexed government bonds would eliminate the risk of capital losses that bondholders would otherwise suffer when interest rates eventually go up as a result of an increase in the overall price level. In this way, allocation between the private and public sectors would become neutral with regard to the price level.

Japan is now in a situation where the government is forced to issue a massive amount of bonds and purchasers concentrate in particular sectors. For instance, quasi-governmental financial institutions have been underwriting substantial portions of government bonds in a move often referred to as "zaito kyoryoku" (cooperation with the FILP program) with roughly half the net increase in outstanding bonds believed to be ending up in the hands of the BOJ. Given the situation that Japan is in today, holding out neutral contracts, for instance in the form of indexed government bonds, would be a more desirable policy option than forcing a particular segment of the economy to take excessive interest rate risks. By doing so, the government could ensure that there is no redistribution effect as a result of changes in the overall price level.

<Boom-Bust Cycles and Aggregate Demand Management Policy>

Iio: Let me move onto the next subject. Setting aside the idea of disequilibrium, boom-bust cycles certainly exist, don't they?

Saito: Of course, they do. In any capitalist society, such cycles would inevitably occur, probably within the range of 1% above and below the level of gross domestic product (GDP). This is just like how a child develops fever from time to time no matter what precautions are taken. Yet, it is necessary to take the appropriate ex-post measures, such as quickly taking the child to see the doctor.

In this sense, aggregate demand management policy should be implemented to cope with the inevitable fluctuations caused by boom-bust cycles. For instance, appropriate monetary policy measures, probably within substantially reasonable bounds, should be taken relatively early. Also, as to the fiscal area, the government should prioritize a non-discretionary built-in stabilizer policy, such as a taxation system under which people's tax burdens are automatically alleviated in bad economy, rather than increasing fiscal expenditures. In this regard, I believe it is desirable to maintain a progressive taxation structure to a certain extent within the income tax mechanism.

Fiscal and monetary measures within such ranges would be enough to adjust ups and downs of 1% or so. I don't believe that the BOJ and the Japanese government are particularly inferior to their counterparts in other industrialized countries. The problem in Japan is the tendency to put even measures outside the designated ranges in one bag along with those within, and then treat them as one package to counter cyclical fluctuations.

Iio: But based on the theory that attributes deflation to a demand-supply gap, measures to counter cyclical fluctuations are supposed to be same as those to counter deflation. In the world of politics, deflation is often considered as synonymous with recession; and I can say for sure that more than half the legislators believe so. As a result, many legislators say, “Do it immediately, because all the people who come to see me say they are in a big trouble because of deflation.” But I am afraid that when they urge the government to “do it quickly,” the measures they have in mind are theoretically different from the usual definition.

Saito: In the U.S., there is a body called the Council of Economic Advisers (CEA), which provides advice to the president on economic policies. The CEA minutes show that the U.S. made a major shift in fiscal policy in the 1970s, ceasing to use fiscal measures – except as built-in stabilizers – as a means to counter economic cycles. The focus of fiscal policy shifted toward addressing microeconomic issues such as infrastructure development, income redistribution, and the improvement of microeconomic efficiency.

Iio: I have the impression that not only the U.S. but also European countries have adopted this political concept.

Saito: Indeed, the establishment of institutions such as the euro represents such a step. In this regard, Japan has never sorted out distinctions between public investment and counter-cyclical measures, whereby the connection between the two has grown inseparably strong – and this is the root cause for a host of problems currently plaguing Japan.

<Fiscal Problems>

Iio: Concerning the relationship between fiscal reconstruction and macroeconomic management, one idea is to make a 10-year or 20-year debt repayment schedule and fix a long-term plan that calls for gradually scaling back fiscal expenditures and increasing tax burdens. What do you think about such an idea?

Saito: It would be necessary to put forward a precise plan for burden sharing.

Iio: Would it be all right to do so in disregard of macroeconomic conditions?

Saito: Not really. If we do so, there will be an impact. So, it is a difficult question when it comes to deciding whether it is a good or bad idea.

Iio: So, value judgment is a separate issue. For instance, European countries virtually joined the euro single currency when they committed themselves to the European Union.

Although Germany seems to be facing some difficulties at the moment, Europe did set down an institutional framework. Though not necessarily in a way identical to initiatives implemented under the framework for the use of the euro, fiscal reconstruction can be carried out by setting a framework for the single-year balance of revenue and expenditures. The U.S., too, is moving in that direction, albeit on a legislative level. In the case of the EU, which sets a model in terms of political and legal forms, all in all various institutions have been implemented under constitutional agreements. But there must be room for some fluctuation. So, we would need to set a specific range in percentages to determine a target balance. In doing so, what sort of economic impacts should we be prepared for?

Saito: Probably the only thing that the government can do is to ask the private sector to adapt to cyclical fluctuations to some extent. If this had happened in the immediate postwar period or during the Meiji Era (1867-1912), it would have caused substantial confusion. But now that Japan has become such a rich country, it is about time we reconsidered the way we cope with fluctuations occurring in a society marked by very high living standards.

Iio: Keynesian policy surely calls for fiscal expenditures in a bad economy. However, it is based on the assumption that such expenditures will be eventually compensated for. If that is not possible, then a specific framework must be set. Otherwise, we are bound to over-expend.

Saito: The government should remain responsible for dealing with acute depression and managing crises, but it may as well end its role with regard to ordinary cyclical fluctuations. Another thing that I find quite problematic is the insufficiency of the overall social infrastructure, though this involves expenditures over a long period of time. Also I am frustrated with the reality that infrastructures projects, despite the massive fiscal expenditures involved, are not necessarily adding assets to the national balance sheet.

For instance, I have been living in Tokyo for two years and I am overwhelmed by frustration, wondering just why money cannot be spent more wisely to implement a much better city planning project. More money should be spent on such a project even if it means cutting back on expenditures in other areas. All of us, including the private sector, need to think hard about issues such as urban development, disaster prevention and environmental conservation. From there, new demands will be generated and we will be able to lay the foundations for Japan to become a truly prosperous society.

Interviewed on Jan. 23, 2003