Comments on Japanese Economic Policy

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I'm going to focus mainly on macro-economic policies, which I realize is not necessarily typical of commentary on Japan. The literature – and media coverage – tend to treat monetary policy, especially, as subordinate to notions of "industry policy" in Japan.

I. Background: Micro- versus macro-policy in Postwar Japan

For instance, the press in Japan often talks as if low-interest-rate policy is simply a method of helping out troubled banks (a kind of "industry policy" for the financial industry). And the ruling LDP has recently proposed – quite seriously – that the BoJ should raise rates to help pensioners get more income. This attitude is partly a function of history. But it needs to change, because Japan has long since reached a stage where wise monetary policy decisions are just as critical as they are in any other industrial country.

Let me say up front that I am not a believer that government micro-guidance is a main reason for Japan's success. I don't think it can be credited with much contribution after the mid 1960s. What has been important, in my view, is a generally sound macro-economic policy approach, one that promoted reasonably stable demand growth and price conditions, as well as highly competitive industry. One important feature of MITI "industry policy" was the principle that there should be enough strong firms in any industry to assure keen competition among them. Also, manufacturers usually had to meet the stiff test of competing in export markets – at least prospectively – to qualify for help.

But this sort of pro-competitive policy was conceived with clear limits in mind. It was *not* extended to non-trading parts of the economy, especially the service sector.
The role of the latter was to absorb labor – to keep everyone employed at something, as a means to social and political stability. (In financial services, its role was also to be a conduit for administrative guidance, and a retirement home for government bureaucrats.) Protecting the service sector, and some small-scale traditional industry, was a highly successful strategy for re-absorbing a huge returning labor force after W.W.II. And it didn't hurt the economy, judging from the spectacular performance after that.

After catch-up, this sort of thing is no longer helpful. But, having had four decades to accumulate institutional apparatus that supports it and depends on it (in the bureaucracy, the schools, business and financial organizations), the system has proved hard to change. What's happened, therefore, is that the large-scale manufacturing sector of the economy has demonstrated over and over that it can adjust to change – including truly massive appreciation of the yen. But the impact has been relatively little felt in the rest of the economy, whose role was to absorb labor shed by big companies when times were hard. That is what is different about the 1990s cycle: Now, even smaller and service establishments are having to shape up to survive.

II. Macro-policy mistakes in the 1970s and 1980s

I said macro-policy has been generally sound, but there have been some whopping failures:

In the early 1970s, Japan pumped up its money supply in 1971-72 so that – when a world commodity price boom culminated in the 1973 "oil shock" – inflation jumped to well over 20%. Monetary policy (measured by real interest rates) continued easing even when fiscal policy, including Prime Minister Tanaka's grandiose "plan for developing the Japanese archipelago", pushed in the same direction, creating a huge land-price bubble. (This was one of a series of such property inflations that Japan has had since 1950; it was actually as big, in percentage change terms, as the one in the late 1980s). The inevitable "bust" that followed was on some measures the worst recession Japan has experienced since the War – rivaled only by the 1990s one.

In the second half of the 1980s, monetary policy was eased too much again, in an attempt to offset the destimulus of Prime Minister Nakasone's fiscal reconstruction plan, and to stave off yen appreciation. Most important, monetary ease continued too long after it was no longer needed for stabilization purposes. This convenienced the Finance Ministry, which wanted to keep fiscal policy aimed at raising government revenues. (The asset boom helped a lot with this, boosting tax collections from capital gains and a booming financial industry.) The result was the biggest asset inflation that the world has ever seen, followed by a "bust" that is still causing pain.

These two unhappy policy episodes have a number of common features:

One is the rocky adjustment to flexible exchange rates. In 1972, and again after 1985, the authorities tried to prevent, then to delay, yen appreciation, and then over-reacted to it – vastly overestimating the destimulus the economy would suffer from a 17% yen rise in late 1972. They did this again with the much bigger appreciation in 1985-86.

Another is the huge swings in fiscal policy, often accompanied by land-price booms. Partly because they were delayed so long, fiscal stimulus programs in 1974 and 1986 boosted the economy after it was already heading up. There has often been great confusion about the role of structural versus cyclical fiscal changes. The MoF contributes to this, obfuscating the figures to exaggerate prospective deficits, and refusing to estimate fiscal impacts on a GDP basis as other countries do.

These swings drove equally huge swings in the economy's overall savings-investment balance, causing gyrations of the external current account.

The pattern was repeated in the 1980s – attempting to offset initially tight fiscal policy with excessively easy monetary policy, depreciating the yen and ballooning the current account surplus. This meant missing an opportunity to heed the Maekawa report (authored by one of Japan's most distinguished past central bank Governors). That report called for Japan to open and deregulate its economy, to gradually right the savings-investment balance, correct the current account surplus, and adapt to a stronger yen over time. Instead, inefficient sectors (including, importantly, financial institutions) were allowed to become even more bloated on an artificial diet of too-easy money, a real estate bubble, and a weak yen.

III. Where we are now

The dangers of subordinating monetary policy to other goals have been amply demonstrated in the past. Is Japan doing the same thing still?

The 1980s bubble undoubtedly marked the last time some parts of this approach can be used. For one reason, this time the land-price boom was followed by a real bust. Real estate prices had never fallen before (except for one year, 1974, by 7%). The economy suffered a deep recession, leading consumers and businesses to press for price concessions and forcing breakdown of some of Japan's non-competitive structures. (One example is the elimination of many layers of wholesaling.)

This time, financial institutions, too, are unable to absorb the impact of the real estate collapse without serious change: They will have to reorganize themselves, reduce their numbers, and allow some of the shifting of roles that has happened long ago in the United States. (A decline in the importance of banks and insurance companies as intermediaries, for instance.)

Current talk of deregulation is a *response* to a trend already well under way. But the talk is becoming serious, it seems, because officials finally have no other choice.

In fiscal policy, too, we have just ended an era when Japan – uniquely among large industrial countries – had a surplus, giving it room to use fiscal policy to stimulate the economy. This was an immense help in mitigating the past recession. But the stimulus policy itself, combined with prospective aging of Japan's population, has already eliminated that surplus and the deficits are projected to get much larger down the pike. (Charts - 1 and 2). Over the past year, in fact, fiscal policy turned into an enormous drag on the economy – as government investment spending plummeted after the end of the 1995 stimulus programs, and as income and sales taxes were raised this year to redress the government's growing deficit. (Charts 4)

On the current account surplus, I believe we are on a healthy downward trend, long term. In addition to government dissaving, the personal sector's saving rate has been declining since the mid 1970s toward a more internationally "normal" level. But we still have the see-saw created by unstable macro-policy: in the short term, therefore, the external surplus is due for another jag upward this year. (Charts - 3)

From here on, monetary policy really is the only game in town when it comes to counter-cyclical stabilization. Indeed, even if one is relatively sanguine (as I am), that Japan will show its characteristic flexibility – will manage to adjust its welfare arrangements to keep the fiscal bomb from exploding – it's likely that fiscal policy will be a moderate net drag on the economy for a long time to come. (Much as it has been in the United States for the past decade.) This makes it all the more important to keep inflation, and thus interest rates, low. And the only known route to that is steady, successful monetary policy.

Inflation is not a problem now: If anything, at about zero (abstracting from the one-time impact of this year's VAT tax rise) it is still on the low side of what can be considered desirable (given the measurement bias that tends to overstate price increases).

Monetary policy is at its easiest setting ever, and everyone knows it must be "normalized" before long. (Charts - 4). The difficult judgment is when. We had a similar debate in the United States during the 1989-1992 period, when monetary policy was kept unusually easy for much longer than historically "normal" to counter the balance sheet problems left by an asset boom (a mild one, by Japanese standards). As happened here then, Japan already has ample evidence of a cyclical recovery in industry, but asset problems are still weighing down the small firm and financial sectors and land prices are still falling. Also, the timing of tax increases – especially the VAT in April – has confused the picture by boosting demand beforehand and depressing it after. (Charts - 5)

The authorities are likely to wait most of this year, at least, before they risk raising short-term rates from 0.5%. But there are risks on the other side as well – in prolonging a policy mix that (once again) has monetary policy offsetting tight fiscal policy, a combination that tends to weaken the yen and may encourage bankers to delay painful restructuring of their business. A lot hangs on the monetary authorities' timing, and we should wish them a policy process that gives the maximum chance of objective, wise decisions.

IV. An independent central bank?

Which brings us to the question of Bank of Japan independence. A law has just been passed, with great fanfare, to make the BoJ more "accountable" and "independent". Personally, I was disappointed in the result.

- There is no change in the BoJ's legal subordination to the MoF (as opposed to directly reporting to the Diet or Cabinet)
- Government officials will attend BoJ policy meetings (though they can't vote)

- The BoJ's budgetary independence was not confirmed
- The BoJ is "lender of last resort", but the law is vague about who makes decisions: Can the BoJ refuse to lend for government rescue schemes that it deems inappropriate for a central bank, or demand collateral (as the Fed must) to strengthen its position?
- It does not proscribe off-market purchase of government securities by the BoJ

I was even more disappointed in the process, which illustrated a number of problems – and has made me skeptical about how the rest of the "big bang" reforms will go:
- The law was re-written by the MoF – which amounts to having the fox design the chicken coop.
- BoJ officials, who might be considered to know most about central banking, were not formally allowed to participate – though they worked hard at "requesting" revisions on various points, behind the scenes.
- The Parliamentary committee that decided the final shape of the law held its sessions in private – so basic issues that would have been hotly debated in any other country were not aired (although some academics tried to raise them). The debate thus didn't clarify what a central bank is supposed to be.
- Diet members, who in Japanese tradition are not considered competent (and don't have staff) to draft legislation themselves, were persuaded without argument that changing the BoJ-MoF relationship would be "unconstitutional" – even though constitutional scholars do not agree.
- The press took little interest, merely acting as a conduit for whatever information (or misinformation) the MoF decided to provide.

The outcome, however, may still be a good one. Institutions evolve through experience, not by design. And the new setup assures far more transparent decision-making than before. If MoF officials want to countermand BoJ decisions they will have do it publicly, and with explanation.

It is really the actions of BoJ officials themselves that will determine whether they end up with more – or less – independence than before. If they are determined to become an independent central bank, they probably can, over time.
Some signs are good: As one example, the BoJ is proposing to shift to an auction system for the government's financing bills. If accepted by the MoF, that would end the practice of central bank off-market financing, even though it hasn't been outlawed.

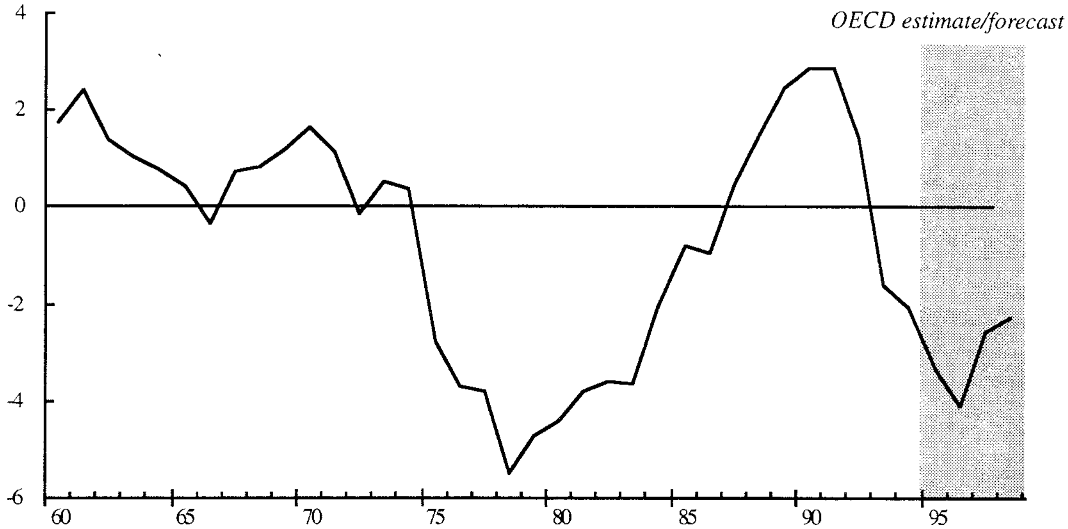
But the current debate on monetary policy still sounds like the same old "consensus" process as before (which means slow, opaque, and full of compromises). Right now, MoF as well as EPA and BoJ officials all agree that the politicians' proposal – to tighten monetary policy to please pensioners – should be rejected. But what will happen the next time BoJ and MoF officials disagree on interest-rate settings, or on some bank rescue plan? We will have to wait and see.

Patricia Hagan Kuwayama
June 1997

The luxury of a big government surplus is gone...

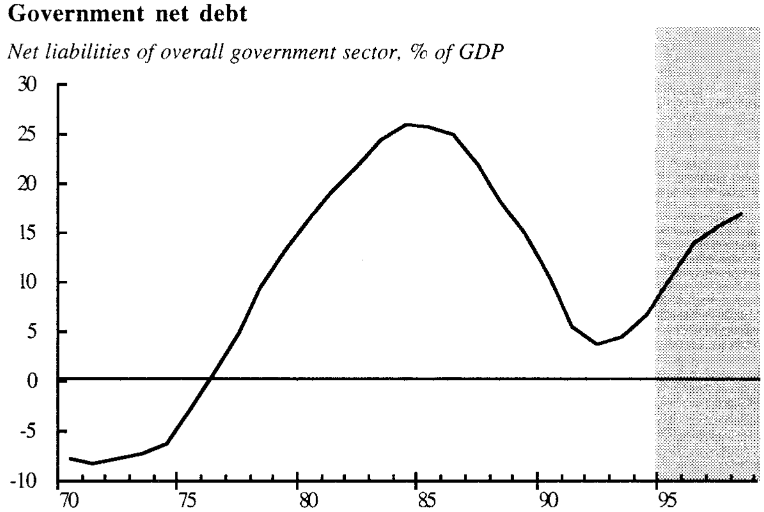
Government fiscal balance

Net lending of overall government sector, % of GDP



Government net debt

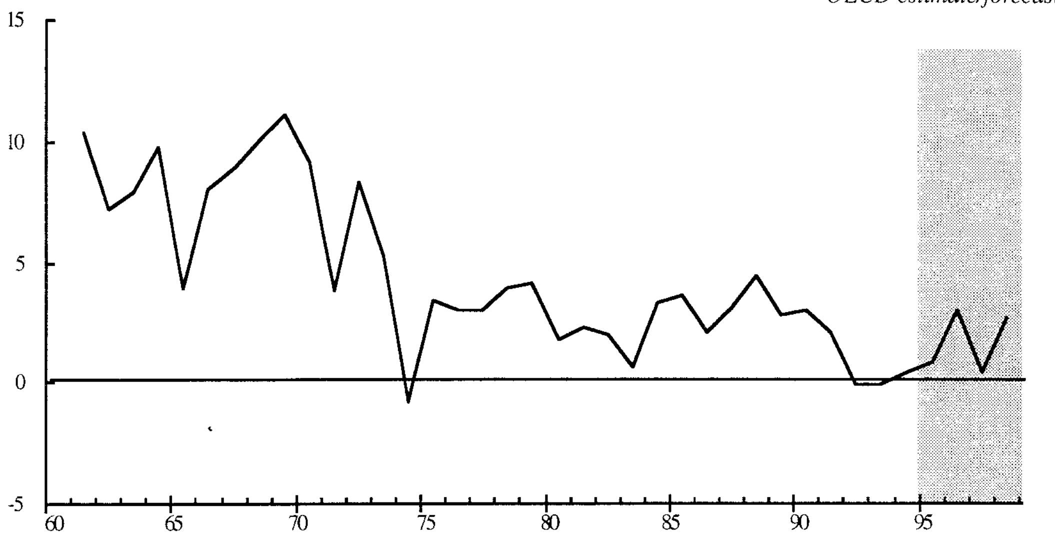
Net liabilities of overall government sector, % of GDP



Macro-constraints are tighter than before: "Miracle" growth rates are past...

Productivity growth

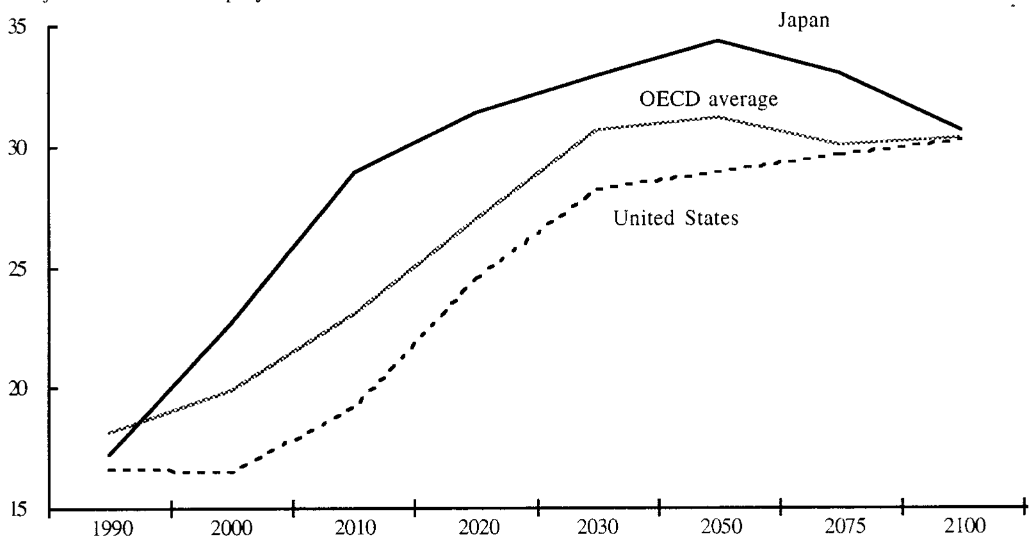
% year-on-year change



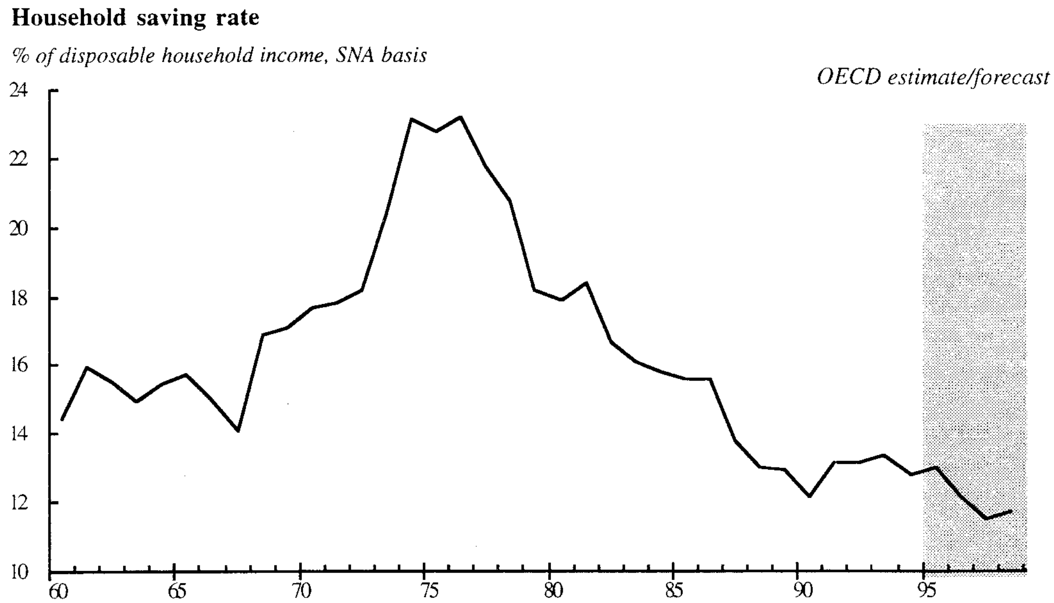
...and the population is aging rapidly.

Population over 60 years old

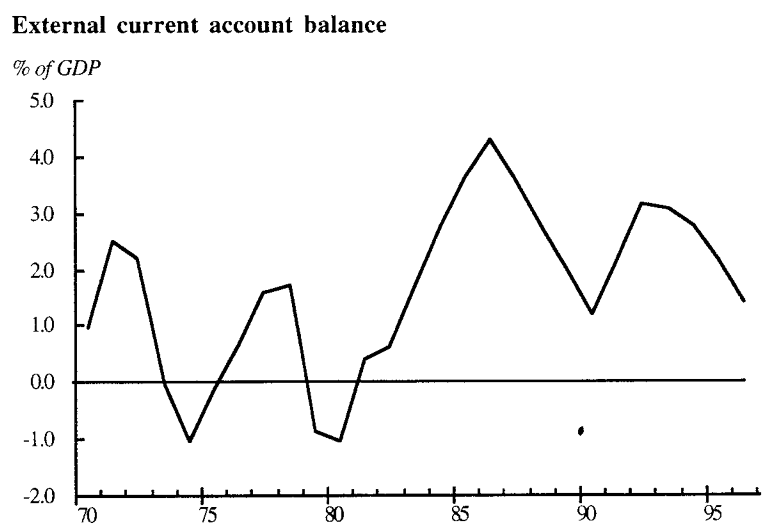
% of total, World Bank projections



Saving rates have fallen over time...

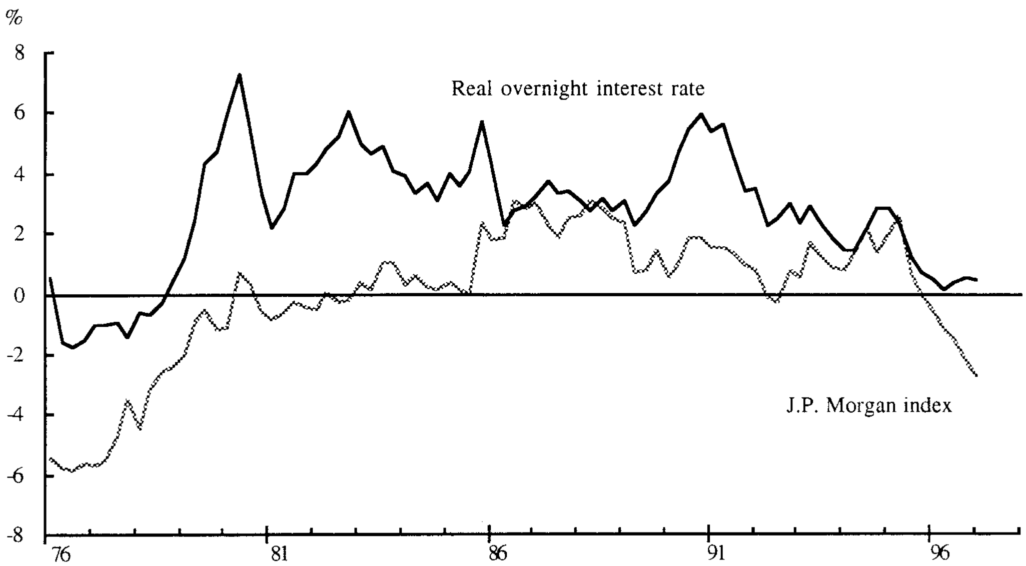


...putting the external surplus on a (jagged) downward trend.



Monetary policy is at its easiest setting in 20 years...

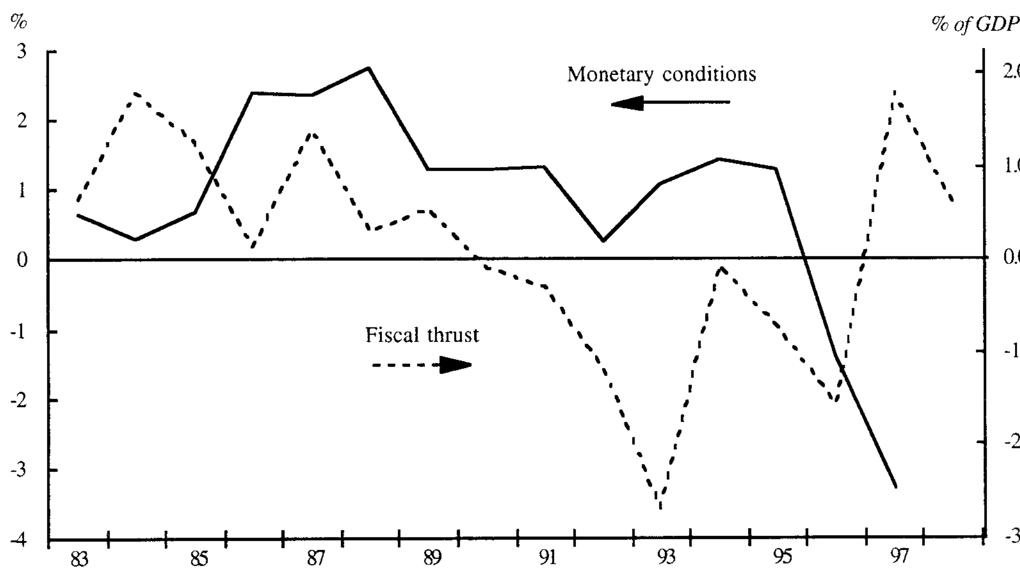
Monetary conditions



Real overnight rate: Collateralized overnight call rate less year-on-year change in GDP deflator
J.P. Morgan index: Weighted average of real overnight rate and real effective exchange rate of the yen

...while fiscal policy has lurched from super-stimulative to super-tight.

Policy mix (+ means tight; - means easy stance)

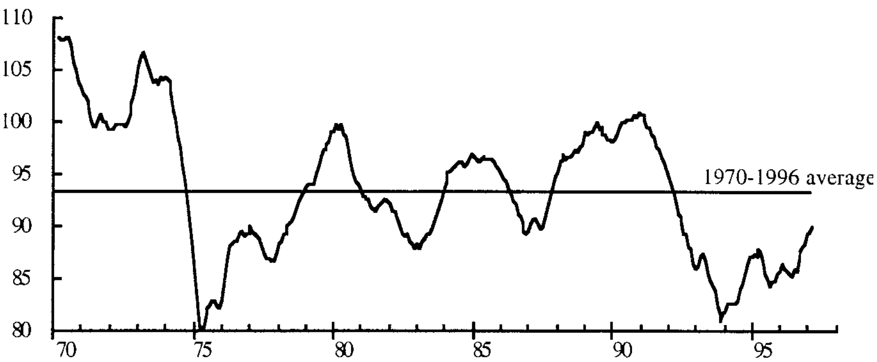


Monetary conditions: J.P. Morgan index (combines real interest rate and real effective exchange rate; measured as deviation from long-term average). 1997 plotting is for May.
Fiscal thrust: J.P. Morgan estimate of discretionary policy impact, net contribution to overall demand as a percent of GDP. 1997-1998 plottings are J.P. Morgan forecasts.

Timing a rate hike is a tough judgment call: Industry is well on with recovery...

Capacity utilization rate in manufacturing

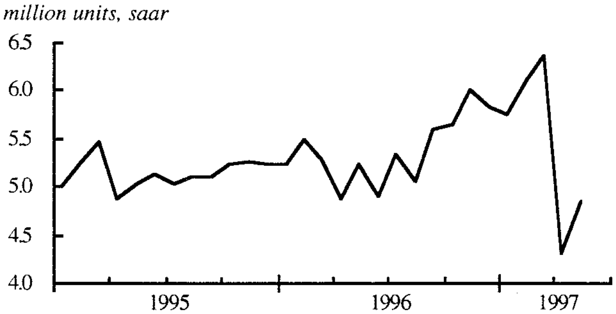
Index, 1990=100, 3 mo. average



...but the VAT hike has distorted the demand picture...

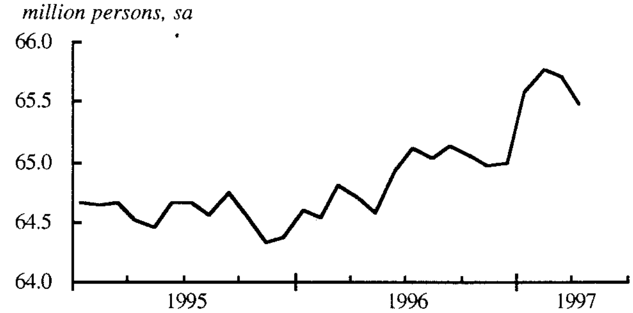
Auto sales

million units, saar



Employment

million persons, sa



...and asset deflation still casts a pall.

Land prices

Nationwide survey, 1985=100