3

The Short and Long of Fiscal Policy

Fiscal stimulus, like any other economic policy, is subject to cost-benefit analysis. Even if there is evidence that fiscal stimulus had a significant positive effect on Japanese growth when it was tried in late 1995, there remain two concerns: First, would current circumstances, such as financial fragility and consumers' thrift, diminish or offset short-run effects of additional stimulus undertaken now, that is, would any fiscal expansion be effective? Second, would the long-run costs of additional public spending and, therefore, of adding to the outstanding stock of public debt, outweigh the short-run benefits of additional growth now? These concerns have been widely expressed by Japanese policymakers, with the long-run issue invoked frequently as a justification for the austere policies documented in the previous chapter.[1] Both, however, rest on fundamental misconceptions of the current economic situation in Japan and of the determinants of savings and growth.

In essence, the effectiveness of the 1995-96 fiscal expansion was to be expected, because Japan not only has underutilized productive capacity, as evidenced by its unprecedentedly high unemployment rate and falling

1. On both aspects, the statements of LDP Secretary-General Koichi Kato have been prominent and representative. As reported in the *Nihon Keizei Shimbun* (''Permanent Tax Cuts Not Effective in Stimulating Economy,'' 6 May 1998), Kato ''questioned the need for permanent income tax cuts, insisting that previous cuts have just boosted national savings, and further tax cuts more likely would end up there as well. . . . [He] underlined worries about future pension costs and said that while some temporary slowdown in the pace of fiscal consolidation is warranted, Japan still must pursue its longer-run interest in a more fiscally conservative way.''

price level, it has also diminished demand for investment. The recent sharp rise in Japanese households' propensity to save is an additional reason why stimulus is called for, rather than a sign that fiscal policy will be ineffective. There are signs of emerging panic among consumers—a serious matter indeed, as discussed in the next chapter—but that is actually something that expansionary government policy can reverse rather than encourage, and it is not indicative of a systematic ''Ricardian'' offsetting response by the private sector to government spending. Finally, the connection between the long-run burdens of an aging society in Japan and the optimal policy of today is far more tenuous than often held. The direct long-run costs of a marginal increase in total government debt are few, and the current benefits are potentially very large.

In this chapter, I recap the likely short-run determinants of fiscal-policy effectiveness and show how the current Japanese situation seems to be as favorable as possible. I then examine Japanese savings behavior and argue that, both historically and during the 1990s, fiscal policy had little effect on it. As a result, fiscal stimulus sufficient to improve growth expectations should stop the precautionary rush to savings rather than increase it. This would, in fact, be a rational response on the part of the Japanese public, because—as a clarification of certain basic facts about the influence of government debt on long-run Japanese growth prospects reveals—neither the direct effects of government debt nor the necessary adjustments to equalize generational distribution pose as much a constraint on the present or are as important for the future as is often stated.

The Most Appropriate Situation for Fiscal Stimulus

When the government injects money into the economy, through deficit-increasing tax cuts or public spending, it increases aggregate demand. In older macroeconomics textbooks, much was made of the ''multiplier effect''—public money would go into the private sector, where individuals would spend a portion and save a portion (which banks would lend), and of that spent portion, the individuals receiving the money would spend a portion and save a portion, and so on, summing up to a net expansionary effect on GDP some multiple (greater than one) of the original fiscal stimulus. In more recent times, it has been fashionable to play down the size of multipliers. Deficit spending potentially ''crowds out'' private investment by increasing demand for savings and driving up interest rates; some of the remaining fiscal stimulus can leak abroad in the form of increased imports because an interest rate rise should lead to an appreciation of the home currency. Some of the initial spending is on imports, in any event. Additionally, to the extent that fiscal stimulus is viewed as temporary, some portion of the population will save much

of the increase in cash that comes their way so as to smooth out the benefits over their lifetime.[2] All in all, there is a seemingly daunting list of reasons to limit faith in the effect of fiscal expansion under normal conditions.

Yet, while all of these are theoretically plausible effects, the actual magnitude of these offsets to fiscal policy depends on the contemporary context and the public's attitude at the time of the stimulus effort. In fact, most of these offsetting factors have proven to be small in the current Japanese context. For the September 1995 fiscal expansion, we have already seen that the rate of growth of both investment and net exports rose, and interest rates fell, while the consumer side of the stimulus was indeed spent rather than bottled up in savings accounts.[3] There would seem to be a prima facie case that successful fiscal expansion is possible in Japan, at least in the short run while there is underutilized capacity (as though the Reagan fiscal expansion of 1982-83 in the United States was not demonstration enough of the general case).

Ultimately, the short-run effectiveness of fiscal expansion depends on the availability of savings in the economy to finance the expansion. When an economy has excess capacity and limited demand for new investment, newly issued government debt has little with which to compete for the supply of capital. The indicators of room to expand in this sense are the interest rates in the economy. When the supply of capital grows scarce, its price is bid up, and government spending crowds out private investment, which cannot pay the higher interest rates. The fiscal impulse, of course, tells only part of the story, because monetary policy also affects interest rates. Monetary policy can accommodate fiscal expansion by moving to offset whatever rise in interest rates the issuing of government debt causes. This possibility is generally overlooked if not actively opposed in most policy discussions today, because a central bank engaging in such accommodation must purchase the government bonds by printing money—this is generally referred to as the *monetization of deficits*, and it is the primary source of sustained rises in inflation and inflation expectations. That potential rise in inflation, however, is a cost like any other to be weighed against

2. This life cycle response to changes in income should not be confused with the ''Ricardian'' response to changes in government spending. The relevance of these aspects of savings behavior is discussed in the next section.

3. When banks have weak balance sheets they may be expected to take in deposits more to build up reserves than to lend. That would further diminish the effect of fiscal stimulus to the extent that savings are recycled by the banking system. The private banking system is no longer as important to the transmission of fiscal policy in Japan as it was even a few years ago, however, reflecting regulatory changes as well as the natural adaptation of the nonfinancial sectors of the Japanese economy to a persistently weak banking system. This also reflects, however, a worrisome trend toward disintermediation from that weakened banking sector, which presents a mounting risk to the Japanese economy in a different way. I discuss these points in chapter 4.

the benefits of monetary accommodation, and it depends upon the current level of inflation and inflation expectations.

Even then, there is no one-to-one correspondence between interest rates and investment, because the degree of interest sensitivity of investment will vary. Moreover, investment demand depends not only upon interest rates but also upon the expectations of aggregate demand growth in the economy. If the expansionary effects of fiscal stimulus on national income stimulate investment demand more than whatever induced rise in interest rates diminishes it (either because there is so much capital available that interest rates do not rise or because the investment response to the change in demand outweighs the response to the change in interest rates), then fiscal stimulus crowds investment *in*. So, the appropriateness and effectiveness of expansionary fiscal policy depend on a number of factors.

In the Japanese economy of 1998, all of these factors are not only favorable for the effective use of stimulative fiscal policy, they also explain why fiscal stimulus must be undertaken before monetary or financial-sector efforts. The Japanese economy currently suffers from a dire case of the paradox of thrift. Individual Japanese consumers have decided in large part that they must save a greater share of their income, and individual businesses looking at their balance sheets and income projections have made a similar decision.[4] Yet, if everyone and every business simultaneously attempts to build up their cash positions by cutting back spending, no one is better off. The 100 yen I do not spend at the barber when I skip a haircut gives the barber reason not to spend 100 yen to eat out at lunch. In turn, the fellow at the *soba* (noodle) stand has 100 yen less income and 100 yen less available to buy this book from the Institute for International Economics, and so on. Normally, this cycle of saving, which results in contraction of spending and in further saving, can easily be dealt with. Positive developments in the economy restore people's and businesses' confidence that national spending will rise so that they can spend. Failing self-correction through swings of the business cycle or a positive shock, expansionary monetary policy provides people with more cash balances and restores aggregate demand. So long as expectations for the economy, particularly for the return on investment, are above some minimum level, declines in interest rates will prompt investment and satisfy individuals that a sufficient supply of cash is available.

When expectations for the returns to investment in an economy drop too low—as arguably they have in today's Japan—declines in interest rates no longer stimulate investment and any increase in the money supply is hoarded by cash-hungry individuals. This is because fearful citizens react to negative predictions of future income growth and to a general

4. The grounding of this rise in saving based on precautionary motives is discussed in the next section.

increase in uncertainty with a greater desire for liquidity. The interest rate paid to savers, which is the premium people are paid for giving up liquid cash and tying up their savings in investments instead, must rise to pry cash loose. At the same time, as overcapacity builds up and securities are sold off to raise cash (perhaps as part of a market panic that is not entirely justified), the rate of return on investment declines. If the difference between the rate of return on capital (its marginal product) and the rate of interest required to clear the money market (the liquidity premium) widens—say, because the perceived risk-adjusted return on capital drops faster than monetary expansion lowers the rate of interest on savings—investment demand declines and there is too much saving for the economy to absorb.[5] In such a situation, aggregate demand will be below capacity even with declining or zero short-term nominal interest rates.

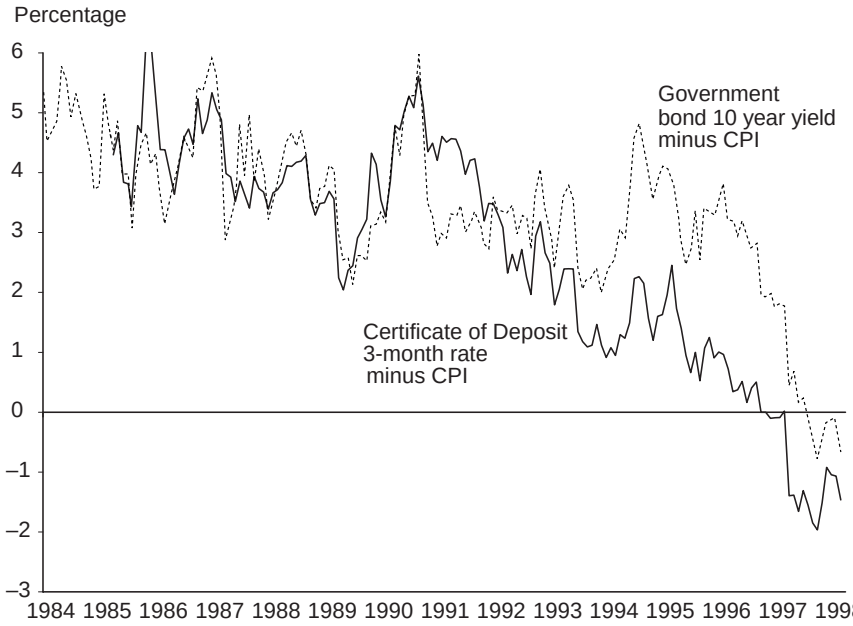
Asset markets will reinforce this development because holders of government bonds will then fear a capital loss in their holdings if interest rates rise (as they must, eventually, if nominal interest rates are at zero and/or if the economy begins to rebound). These bond holders will also sell bonds for cash, contributing to the liquidity premium and the wedge between the market interest rate and the return on investment. This not only further diminishes the interest elasticity of investment, it also weakens the link between shifts in the money supply and interest rates that are prompted by monetary policy. Such a situation, where interest rates become insensitive to monetary policy and investment becomes insensitive to interest rates, all because expectations concerning the long-run return on capital drop without regard for policy, is what Keynes called the *liquidity trap* (see Keynes 1936, chapter 17).[6]

What does this hypothetical instance of the paradox of thrift have to do with today's Japan and the practical relevance of fiscal policy? Everything. There is strong evidence that monetary policy is ineffective in moving the money supply and investment in Japan at present. Despite negative long-term real interest rates for a year and negative short-term rates for over 18 months (see figure 3.1), investment has steadily declined since the end of the 1995 stimulus (as discussed in the previous chapter). Aggressive expansion since mid-1995 of the narrow money supply, in part through yen depreciation, has not resulted in a commensurate expansion of credit; as seen in figure 3.2, the M1 measure of the money supply has been growing at a double-digit rate on average for over two years, while the M2 measure has grown at less than half that rate (normally, the broader aggregate will grow at a faster rate than the narrower, as can

5. Krugman (1998a) offers a formal model along these lines.

6. Tobin (1987, chapter 1) and Skidelsky (1992) give good discussions of Keynes' use of the concept.

Figure 3.1 Real interest rate, 1984-98

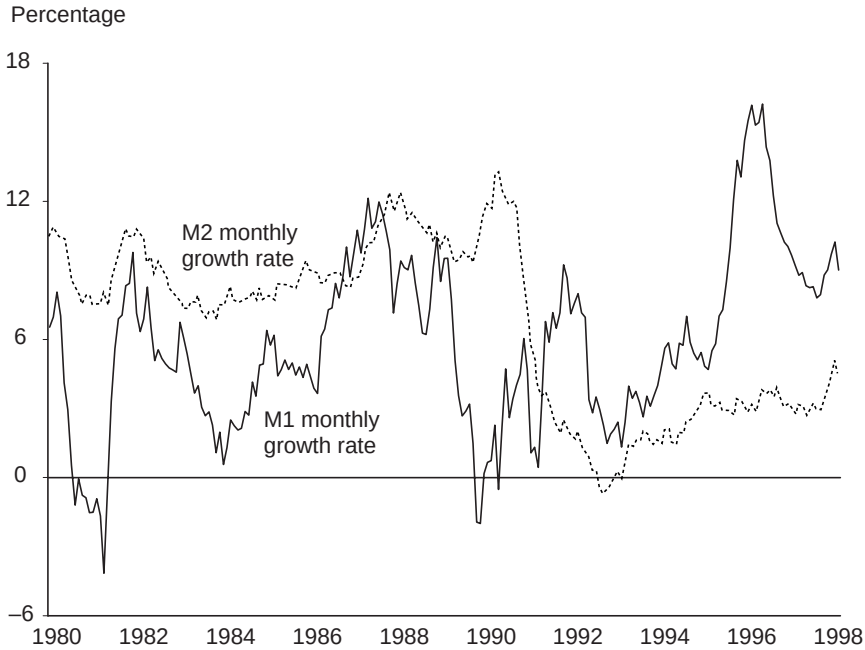


Source: Economic Statistics Monthly, Bank of Japan.

be seen in M2 versus M1 growth through 1991, because it includes the narrower aggregate as a component of it). The lower rate of growth in M2 than M1 while both short- and long-term interest rates drop is consistent with a hoarding of cash by investors and banks. Figure 3.3 shows the steady rise of cash as a share of M2 plus certificates of deposit outstanding, further underlining the point. After fluctuating between just 6.5 and 7 percent from 1984 to 1993, even during the bubble years and the crash, the cash share is now 25 percent higher, a substantial shift. Saving propensities have been rising in Japanese society in tandem with demand for liquidity. While the annual national-accounts data show only a small rise in private saving through 1996 (for the latest available data, see figure 3.4), the surplus rate, which is based on a monthly survey, has been climbing since 1992 (see figure 3.5), and the quarterly saving rate from the same survey has risen from 25.5 percent in 1992 to 30.4 percent in the first quarter of 1998.[7]

7. The surplus rate is defined as disposable income minus living expenditure divided by disposable income, while the savings rate is defined as a residual from other questions about pretax income. The *Family Income and Expenditure Survey* has been collected monthly since 1950, and currently surveys 8,000 households representing 84 percent of the population.

Figure 3.2 Growth in monetary aggregate

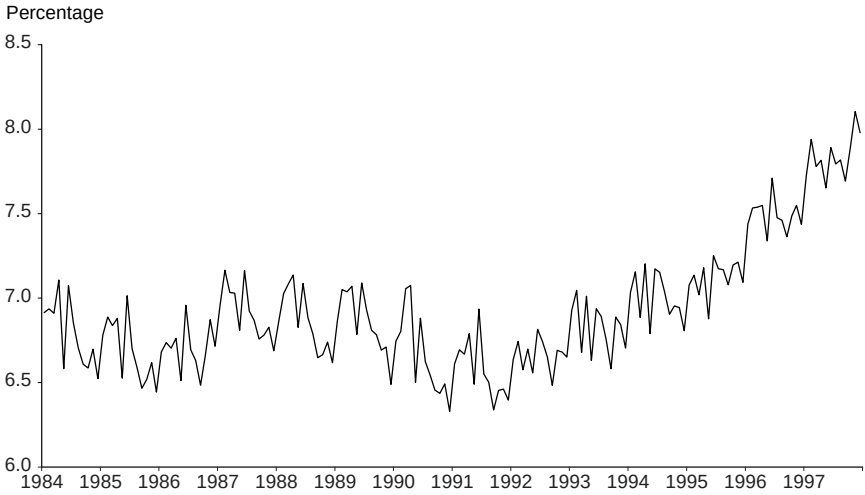


Source: Economic Statistics Monthly, Bank of Japan.

The complementary reality of the ineffectiveness of monetary policy caused by the liquidity trap is the near-zero interest elasticity of investment demand. As described by Vickrey (1992) and Tobin (1987), the recycling of savings into the economy can be stymied by a rise in precautionary saving out of fear, that is, a distrust of calculations concerning the future. The key point is that the interest rate that clears the money market need not be the one that brings about full employment. As Tobin (1987, 80) notes, Keynes' ''skepticism [regarding the efficacy of monetary policy in a deep recession] arose from his belief that the long-run expectations governing the marginal efficiency of capital are so volatile and unsystematic that central banks might well be unable to offset them by variation of interest rates.'' The good side of all this is that in Japan today the primary short-run channel offsetting fiscal expansion no longer holds.

It is biased upward by its underrepresentation of younger and low-income households, but the trend should be more accurate than the annual Standard National Accounts (SNA) data (see Matsuoka and Rose 1994, chapter 4).

Figure 3.3 Share of cash in M2 and certificates of deposit, 1984-97



Note: Seasonally adjusted by author.

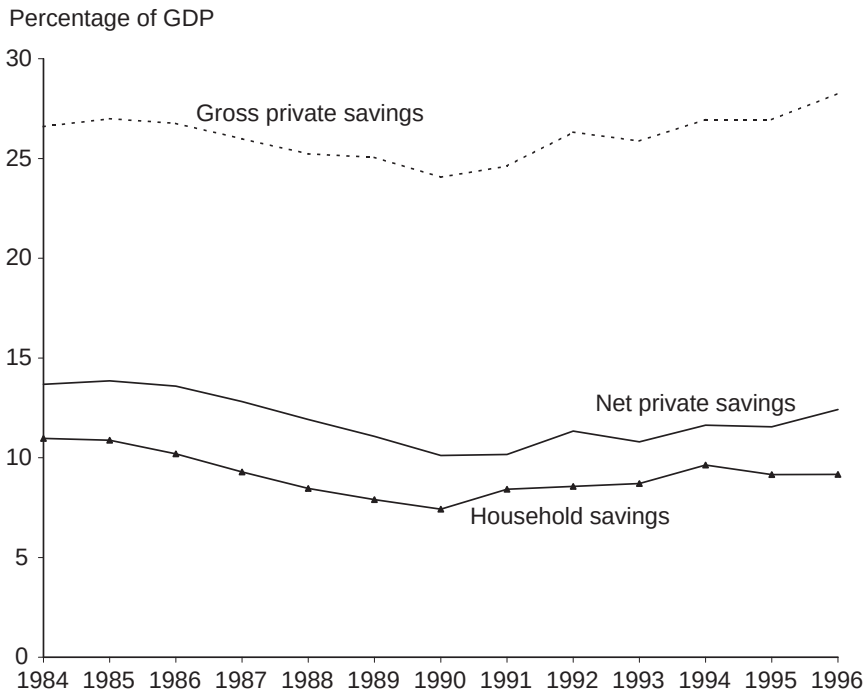
Source: Economic Statistics Monthly, Bank of Japan.

A rise in public spending will not immediately drive up interest rates because there is an oversupply of savings, and, to the extent that it eventually does move interest rates, the effect on investment will be small. Under these circumstances, monetary policy's ineffectiveness constitutes an automatic accommodation of fiscal policy without immediate inflationary consequences. When fiscal expansion eventually creates sufficient demand to raise interest rates and inflation, the goal of policy has largely been attained. At that point, when savings are being employed and the gap between the return on investment and the liquidity premium has been closed, monetary policy can take over from fiscal stimulus to the extent necessary.

It is precisely under these dire circumstances of an uncertainty-driven lack of propensity to spend, as obtains in Japan today, that fiscal stimulus is called for by Keynes. As Krugman (1994, 31-32) observes,

> So the usual and basic Keynesian answer to recession is a monetary expansion. But Keynes worried that even this might sometimes not be enough, particularly if a recession had been allowed to get out of hand and become a true depression . . . [households] may simply add any monetary expansion to their hoard. Such a situation, in which monetary policy has become ineffective has come to be

Figure 3.4 Private saving rate, 1984-96



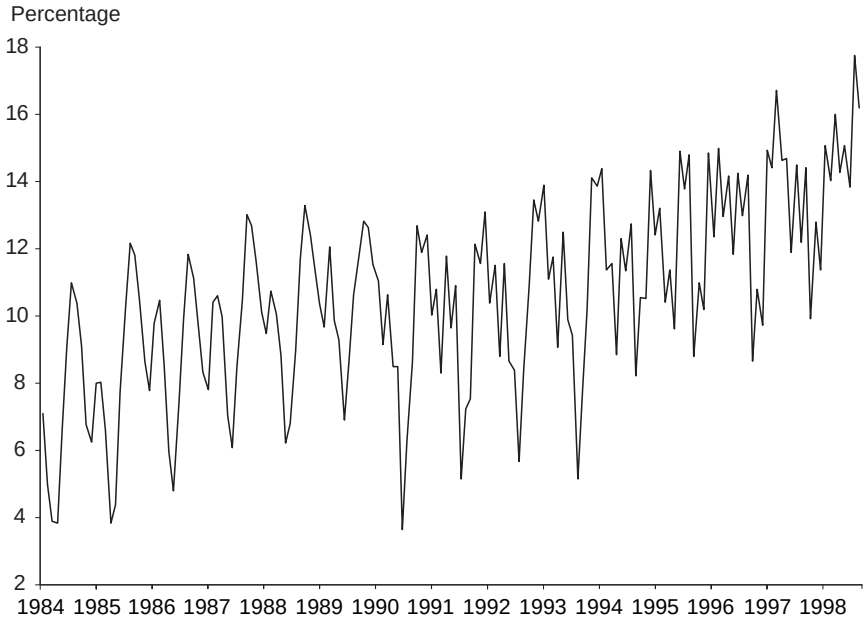
Source: Economic Statistics Monthly, Bank of Japan.

known as a ''liquidity trap''; . . . The Keynesian answer to a liquidity trap is for the government to spend.[8]

It is for this reason that Krugman's (1998a) call for ''turning on the presses'' at the Bank of Japan in response to the liquidity trap would not be effective. In his model, printing yen drives down the interest rate in the money market (i.e., saver's liquidity premium) to a potentially negative rate of return on capital. However, that reverses the endogenous and exogenous variables—the binding constraint is the interest rate premium necessary to clear the money market because of people's uncertainty. The goal of policy should be to reduce uncertainty and drive up the return on capital, and monetary policy cannot affect those factors directly when demand for cash is too strong. The liquidity trap possibility had been ignored for years by economists in part because it requires such an ad hoc assumption that the public's fear can cause interest rates to diverge from the fundamental long-run return on capital for an extended period.

8. Tobin (1987, 7-8) adds, ''What does the *General Theory* itself say about policy? Fiscal policy, long regarded as the main Keynesian instrument, is introduced obliquely as a means of beefing up a weak national propensity to spend in the event monetary policy fails.''

Figure 3.5 Seasonally adjusted surplus rate, 1984-98



Source: Household Income and Expenditure Survey, Management and Coordination Agency.

To base it on rational actors, Krugman (1998a) requires that the return on capital represent the actual return, which is why that becomes the rate that cannot be altered (except by structural change). The point is that individuals' perceptions of an economy's future can have significant implications for the short-run effectiveness of policy, regardless of this perception's relation to the fundamentals. This is a fact that those who observed Japan's bubble economy of the 1980s or who find some plausibility in Radelet and Sachs' (1997) interpretation of the Asian financial crisis as panic driven should not find surprising.

Whether or not the label ''liquidity trap'' is justified in the case of Japan today, the hoarding of cash, rising savings levels, low interest rates and deflation, and an absence of investment demand—all of which clearly are present—make this the perfect time for expansionary fiscal policy. As Bosworth (1993, 42) summarizes the impact of fiscal policy in an open economy, ''The extent of the offset [to stimulus] coming from higher interest rates depends on the interest elasticity of the demand for money,'' and Japanese money demand appears to be independent of interest rates at present (see figures 3.1-3.5 and the discussion of them earlier in this chapter). On the trade side, if capital mobility is somewhat limited, it is

likely that the inflow in capital in response to a fiscal stimulus will fall short of the initial deterioration in net exports, so that the exchange rate will appreciate less than usual. This is the case in Japan today, where the connected lending and ownership of the Japanese economy has made yen-denominated assets difficult to sell in international capital markets because buyers and sellers have asymmetric information about their risks and liabilities. If interest rates do not rise, in any event, the exchange-rate and net-export offset to fiscal expansion will be diminished.[9] In sum, to whatever extent fiscal policy begins to compete for capital, it is reversing the negative expectations and crowding investment in, and until it does so, its expansionary impact will not be offset.

The presumed unwillingness of banks to lend is another aspect of the Japanese economy that might work against the effectiveness of fiscal policy. If people save most of the money that they receive from the stimulus in banks, and if the banks in turn hold on to most incoming deposits due to their limited capital bases, then the money will not circulate widely through the economy. This is more a possibility than a major effect in current practice, however. As will be discussed in chapter 4 on risks to the Japanese outlook, evidence of a sharp credit crunch, that is, banks withholding lending, is limited at best up until very recently, despite press coverage to the contrary. This apparent lack of lending constraint makes sense for two reasons: First, to the extent that Japanese banks have low or negative net worth, they have an incentive to lend *more* rather than less, albeit inefficiently, to high-risk, high-return projects, because the bank management and ownership would share fully in any positive developments but have only what is left (if anything) in net worth to lose.[10] Second, the problem at present in Japan is a lack of investment *demand*, including demand for loans, because firms are carrying too much outstanding nominal debt (built up, along with Japanese asset prices, when their net worth was higher) and prospects appear to be too bleak to justify adding to capacity. Moreover, even with the rising savings rate depicted in figure 3.5, Japanese households are still spending 80 percent of their disposable incomes; so long as any rise in their income due to fiscal stimulus is viewed largely as permanent, which it would have to be if growth is ever to be maintained, that ratio of spending should

9. Bosworth (1993, 18) establishes a long-standing pattern in the responses of the yen, based on data from prior to the current situation, that while there is a strong negative correlation between foreign (US) interest rates and the exchange rate, there is no evidence of a positive correlation between the exchange rate and the Japanese domestic interest rates.

10. This is an example of moral hazard, where the incentives created by deposit insurance are perverse for the insurer's (i.e., the public's) interest. Mishkin (1991) gives a summary of how asymmetric information in financial markets leads to various inefficiencies, such as this incentive to ''bet the bank'' once net worth sharply declines.

continue, and bank deposits would not absorb more than a small portion of the stimulus.

Moreover, the amount of new deposits that banks would want to put aside for improving capital/asset ratios, though large, is finite. Japanese banks have on the order of 780 trillion yen in outstanding assets in total at present, and an (overstated) capital base of 29 trillion yen, for a ratio of 3.7 percent (*Economic Statistics Monthly*, Bank of Japan). While short of the 8 percent required by the Basle capital accord for the capital-to-assets ratio, any rapid build-up of deposits would give the banks greater access to capital markets and more incentive to write off bad loans and lend carefully, further strengthening the banks' positions beyond the direct infusion of deposits. As Keynes wrote to President Franklin D. Roosevelt in 1934, even if banks piling up excess reserves meant that spending $200 million a month would not work to stimulate output, spending $400 million a month would (quoted in Schultze 1992, 211).[11] The imminent danger is not that Japanese banks will sit on deposits and not lend what comes in, but that, if the Japanese public's expectations continue to fall, they will be rapidly deprived of deposits and contract current lending further, as discussed in chapter 4. This is not to say that a cleanup of Japan's sizable bad-loan problem and recapitalization of its viable (and only its viable) banks would not aid matters immensely once fiscal stimulus restarts growth—some ways to do that are part of the program for Japanese economic recovery suggested in chapter 5. But fiscal stimulus need not wait for financial reform in order to be effective, and financial reform without fiscal stimulus is unlikely to address people's low expectations.[12]

Precautionary Hoarding, Not Ricardian Saving

One aspect of the link between the short-run and long-run effects of fiscal policy is the influence of fiscal policy on savings behavior. In the previous section, the maintained assumption was that fiscal policy primarily affects savings through its influence on income growth and expectations thereof. This is consistent with a rising savings rate and cash hoarding in the face of declining interest rates and provides seemingly ample motive for precautionary thrift in today's Japan. An alternative interpretation is that savings rise to offset any fiscal expansion because households see in such a policy future tax rises that they or their heirs will bear. This interpretation is at first glance plausible as well, because both savings and deficits have

11. For reference, $400 million was 6 percent of US GDP at the time, so Keynes was illustrating the general point rather than recommending such monthly largesse.

12. In fact, financial reform done properly will likely be contractionary in the short run, which is all the more reason to mitigate its effects with fiscal stimulus (see chapters 4 and 5).

risen with the Japanese recession in the 1990s. Meanwhile, the Japanese government, among others, has repeatedly made fearful reference to the aging society and mounting future burdens, perhaps to raise consciousness of the need for future tax revenues and for younger savers to self-insure. Distinguishing between these two alternative motives for the sharp rise in Japanese saving in the 1990s—the precautionary and the Ricardian—is critical to deciding upon the utility of fiscal expansion.[13] If the rise in savings is precautionary, fiscal stimulus should crowd in investment by encouraging Japanese households to spend, as discussed in the previous section. If the rise in savings is Ricardian, that is, largely driven in offsetting response to government expenditure, further government spending will be neutral and not affect economic growth. While this latter response would lead to an offset of fiscal stimulus, it comes through an entirely different channel than those discussed in the previous section and does not put pressure on interest rates.

Realistically, the question of a Ricardian response to government spending is one of how many obvious additions to outstanding Japanese government debt will be offset by saving today, given the oft-expressed concerns for the aging society, rather than whether savers are or are not fully Ricardian. To the extent that today's individuals view money spent on them or bonds sold to them by the government as a net benefit rather than one they will have to pay back in full in their lifetimes, government spending will raise individuals' wealth or income and, therefore, their consumption.[14] This view can stem from the fact that people's motive to leave bequests for their children—say, sufficient to make up for government-debt increases incurred during their lifetime—is not always strong (or they have no children); it might also be that the discount rate of individuals is higher than that of the government, which will presumably outlive them. In either case, the further off that tax increases can be deferred relative to people's time horizons, the greater the wealth effect of the current issuance of government bonds (and the greater its effects).

Even if households are sufficiently long-lived, and/or have children that they care enough about, to expect to bear some of the taxes for today's government spending, there are several other reasons why Ricardian equivalence would not hold. If the government can borrow at a lower interest rate than can individuals and if some individuals are liquidity

13. This theory and the term ''Ricardian'' are due to Barro (1974). The emphasis here is on the *change* in the rate of savings. Like most economists, I believe that much of savings behavior can be explained by the Life Cycle/Permanent Income Hypothesis. Most of these aspects, however, such as demographics or social security coverage, did not change sufficiently in 1990s Japan to explain the rise in savings.

14. This discussion draws on Blanchard and Fischer (1989, chapter 3); Romer (1996, chapter 2); and Frenkel, Razin, and Yuen (1996, chapter 8).

constrained,[15] then any government tax cuts are equivalent to government borrowing on the individual's behalf, and consumption will rise. Also, individuals have an interest in minimizing the effects of taxes on their economic decisions at any given time, irrespective of the total lifetime (or longer) tax burden that they face. In the words of Vickrey (1992, 305):

> If sales or earnings taxes are the relevant revenues, deficit financing would mean lower tax rates currently with expectations of higher rates in the future. It would then be individually rational for taxpayers to shift expenditure and earning effort toward the present, even with certainty as to future tax rates and full concern for progeny, with a current stimulating effect on the economy. Uncertainties and liquidity constraints would have a further effect on the same direction, in addition to whatever 'debt illusion' there may be in giving more weight to bonds possessed individually as assets than to the debt as a collective liability.

With these many potential reasons, there has been little surprise that evidence supportive of Ricardian equivalence has been difficult to find and certainly insufficient to be considered when governments make financing decisions.[16]

Returning from the general to Japan in particular, the sources of Japan's historically relatively high savings rate have been the subject of intense study. The broad pattern of Japanese savings behavior has been established to include a substantial decline in the national savings rate since the mid-1970s. This decline, which is robust by any means of measurement, stabilized in the late 1980s. This movement, however, goes precisely the wrong way in relationship to Japanese government deficits if Ricardian equivalence were to hold—private savings dropped as government deficits rose to postwar highs in the late 1970s and early 1980s and did not decline while deficits shrank sharply in the late 1980s. In a series of papers, Horioka and various coauthors made more sophisticated tests for the determinants of Japanese savings, holding other factors constant and using a variety of methods (Horioka 1990, 1993, 1995, 1997; Horioka et al. 1996; Horioka and Watanabe 1997). They found substantial support for the idea that a combination of life cycle and precautionary motives could explain much of the variation in Japanese savings behavior over time and across individuals. Importantly, they demonstrated that the rate of savings in Japan is influenced negatively by the retiree/worker dependency ratio and by the extent of social security coverage and positively by the level and growth rate of income. These findings are consistent with life cycle motivations and inconsistent with Ricardian ones. Independently, Bosworth (1993) also demonstrated the significance

15. That is, if these people could borrow more against future income or current assets than capital markets typically allow them to, they would do so.

16. See Bernheim (1987) for the standard summary of the original empirical results. Romer (1996, chapter 7) gives a more up-to-date survey along these lines.

of income and demographic factors for Japanese savings behavior, and Cigno and Rosati (1997) showed savings to be a declining function of the level of social security coverage and a positive function of income.

Even more importantly for the current policy discussion, Horioka (1990), Horioka et al. (1996), and Horioka and Watanabe (1997) find direct evidence from government surveys of Japanese savers that precautionary motives have been the most cited motive for savings even prior to recent stagnation. ''Precautionary motives [are] defined as motives arising from uncertainties concerning future income and/or expenditures. Examples include saving for income fluctuations, unemployment, illness, accidents, natural disasters, and longevity risk'' (Horioka and Watanabe 1997, 538). While answers to survey questions may be unreliable, the bias should run *against* admitting to this motivation, because the option of stating that the motive for saving was to leave bequests to the subjects' children was offered and could have been taken to look good.[17] Horioka (1990) finds that the proportion of households in Japan saving for precautionary motives and the household savings rate have shown parallel movements over time. Accordingly, interpreting the rise in savings in the 1990s as a precautionary response by Japanese savers to a rising likelihood of unemployment or income fluctuation would be well in line with the established patterns of Japanese behavior. Thus, if expansionary fiscal policy can decrease the likelihood of unemployment or the variability of income, it should lead to a decline in savings, which will reinforce aggregate demand further.

Economic research has long acknowledged the role of precautionary motivations for saving, especially in causing short-run fluctuations in the savings rate. Carroll (1997) points out that Milton Friedman's original ''permanent income hypothesis'' included many references to people's desire for a buffer stock of savings over time. In general, as individuals' risk aversion and income uncertainty (including transitory shocks to income such as recessions) increase, so should savings, and movements of income from the future to the present (such as through a tax cut today) should work in the opposite direction, even if expected lifetime income is unchanged.[18] And Japanese savers are not alone in stating in surveys that being prepared for emergencies and hard times is the most important motivation for saving.[19]

---

17. In fact, very few Japanese savers surveyed claimed to be saving to leave their children money and of those so claiming, a majority were doing so for self-described nonaltruistic reasons (e.g., assuring oneself of a place in the child's home).

18. See Barsky, Mankiw, and Zeldes (1986), Blanchard and Fischer (1989, chapter 6), Caballero (1990), Carroll (1997), and Zeldes (1989) for formal demonstrations of this point.

19. Carroll (1997) cites surveys in the United States that put the precautionary savings motive first among 40 percent of those answering, the most popular response by far.

As a result, Japanese policymakers should recognize two realities. First, Ricardian concerns are not motivating current rises in Japanese saving. Not only will fiscal expansion draw down savings (and increase consumption), but repeated reference to coming government tax burdens will only contribute to a contemporary source of panic without serving any long-run purpose. Second, Japanese savers may be thought of as having some target wealth-to-permanent-income ratio, so that efforts to raise wealth and diminish uncertainty—say by a program of fiscal expansion, stabilization of the price level at above-zero measured inflation, and clean-up of the financial system, as I propose in chapter 5—will reverse the rise in savings to the Japanese public's benefit. The appropriate response to increased Japanese fear about the future is not to validate it by government speech or inaction, because persistent precautionary saving can bring about economic contraction of its own accord (as discussed in the previous section).

Why Today's Deficit Does Not Imperil Tomorrow's Elderly

There is doubt in Japan about whether a rise in the deficit today would be worthwhile, even if fiscal expansion were effective. The aging of the Japanese population, and the mounting social security and health care obligations associated with that trend, are seen as predominant concerns. This is a false opposition. While the rising future burdens of today's and tomorrow's Japanese taxpayers are indeed worthy of serious public concern, they are in no meaningful sense related to the budget decisions of 1998. To make such a link, one would be required to believe either that rising Japanese debt levels are in and of themselves burdening the economy so greatly that a little more debt will be unsustainable, or that the direct costs of an incremental rise in Japanese debt are large enough to outweigh the benefits of fiscal-led expansion, or that the amount of money saved by today's austerity will aid in rectifying the generational imbalance, or that additional deficit spending today is unlikely to be reversed. Yet none of these is the case. The Japanese debt level is currently sustainable, the direct long-run costs of an additional couple of percent of GDP in debt are far outweighed by the benefits, the generational imbalance is so largely dependent upon demographic forces that even a balanced budget this year would not affect it, and there is no historical or institutional reason to think that today's deficit rise would not be reversed in better times. Being realistic about what today's deficit spending implies for Japan over the long run—rather than hiding unfounded assertions behind claims of opposition to ''short-sighted'' or ''spendthrift'' behavior— is an act of responsibility.

What matters for a country, like any growing business or household, is whether its *net* debt is growing faster than the country's income. If debt grows faster than national income for an extended period, the government is racking up obligations faster than its ability to pay them. Net rather than gross debt matters because a government's assets can be sold, just as any other property owner can draw down capital to pay off loans. Table 3.1 and figure 3.6 chart the path of Japanese government debt and deficits as a share of GDP. Note that the Japanese government was in surplus in 1987-92, even on structural deficit measures, and that net debt was declining from 1984 through 1992. In addition, after several years of general government deficits in the 1990s, the social security surpluses and assets held in FILP leave a net debt of only 15 percent of Japanese GDP, the lowest level by far in the G-7 (see figure 3.7). To give a sense of scale, 15 percent of a year's national income is only two years' worth of the annual transfer payments from western Germany to eastern Germany made since 1991. The gap between net and gross debt in Japan is clearly the largest in the G-7. If social security trust funds in the United States were not considered, so that gross debt levels were compared, the United States would be on a par with Germany, France, and the United Kingdom; the difference in gross debt between Japan and the G-5 would then essentially come down to the accumulation since 1992. In other words, Japan's poor gross-debt position is an artifact of the current business cycle, so it should be reversible, while its more important net-debt level is a world leader.

One can, of course, keep redefining what constitutes ''net'' debt—Asher and Smithers (1998) throw in a large number of contingent claims, such as the underfunded pension liabilities of the Japanese economy, and produce catastrophic figures for the outstanding obligations of the Japanese government. There are three problems with such exaggeration. First, precisely because these are *contingent* claims, they are unlikely to come due all at once, and it is unlikely, even over very long periods, that all will have to be paid (no one declares insurance companies insolvent by comparing their assets to what would happen if all policies in force had to be paid simultaneously). Second, this underfunding of contingent claims is true of all OECD economies (see Hutchison 1992). It is difficult to see how capital markets could punish Japan by withdrawing funds or raising risk premiums without doing so largely equally to all the countries and, therefore, to none of them. Third, as discussed below with regard to generational accounting, almost all definitions of contemporary government debt situations misrepresent their countries' long-run social security imbalances, so it makes sense to limit discussion of the current debt snapshot only to those explicit obligations and credits of the government—the standard definition of net debt. And Japanese government net debt is still lower than it was in the early 1980s, while its social security surplus has been rising (see table 3.1).

Table 3.1 Government budget balance as a share of GDP, 1983-96

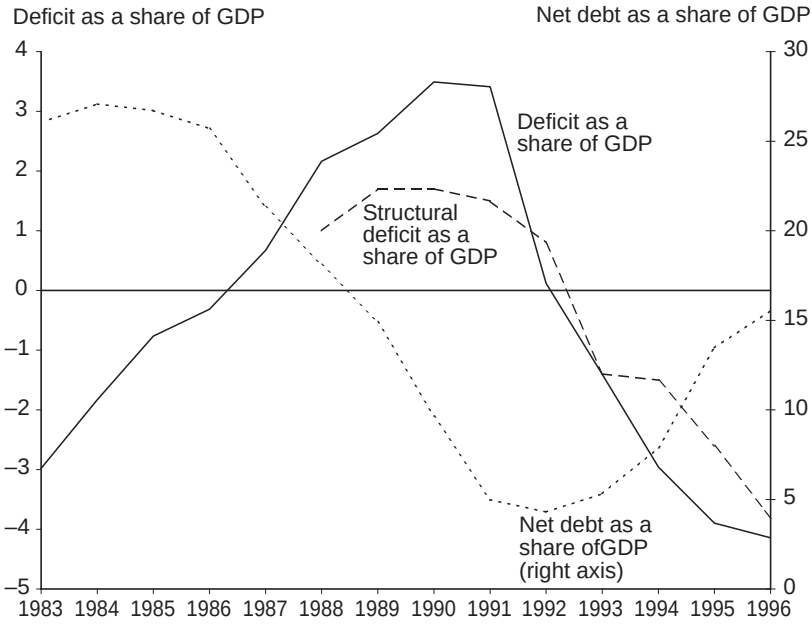
	Balance (fiscal year)						Memorandum		
	General	Central government	Local	Social security	Net debt (calendar year)	Gross debt (calendar year)	Central government net debt	Local government net debt	Social security net debt (−asset)
1983	−2.9	−4.9	−0.8	2.7	26.0	66.6	na	na	na
1984	−1.8	−4.0	−0.6	2.8	27.1	67.9	na	na	na
1985	−0.8	−3.6	−0.3	3.1	26.7	68.7	na	na	na
1986	−0.3	−3.0	−0.4	3.1	25.7	72.1	na	na	na
1987	0.7	−1.9	−0.2	2.8	21.3	74.5	na	na	na
1988	2.2	−1.1	0.1	3.2	18.1	72.7	na	na	na
1989	2.6	−1.2	0.6	3.2	14.9	70.0	na	na	na
1990	3.5	−0.3	0.3	3.5	9.6	69.1	34.0	8.4	−32.8
1991	3.4	−0.2	−0.1	3.7	5.0	66.7	31.3	7.8	−34.1
1992	0.1	−2.1	−1.1	3.4	4.3	70.0	31.8	9.0	−36.5
1993	−1.4	−2.8	−1.6	3.1	5.3	75.1	33.7	10.6	−38.9
1994	−3.0	−3.7	−2.0	2.7	7.9	82.2	36.5	12.8	−41.1
1995	−3.9	−4.2	−2.6	2.8	13.5	89.7	40.2	15.2	−43.4
1996	−4.1	na	na	na	15.5	94.2	na	na	na

na = not available.

Note: Gross debt includes all financial liabilities. Net debt includes gross debt less all financial assets except corporate shares, as defined by the System of National Accounts, and covers the general government sector, which is a consolidation of central government, local government, and the social security sector. Changes in ''net debt'' do not equal to the ''general government balance'' because net debt is based on the calendar year and all balance figures are based on the fiscal year. Moreover, changes in net debt are adjusted for changes in the value of government assets and liabilities (e.g., US Treasury bonds).

Source: Annual Report on National Account, Economic Planning Agency, 1997, *http://www.epa.go.jp (17 April 1998).*

Figure 3.6 Government debt and deficit as a share of GDP, 1983-96

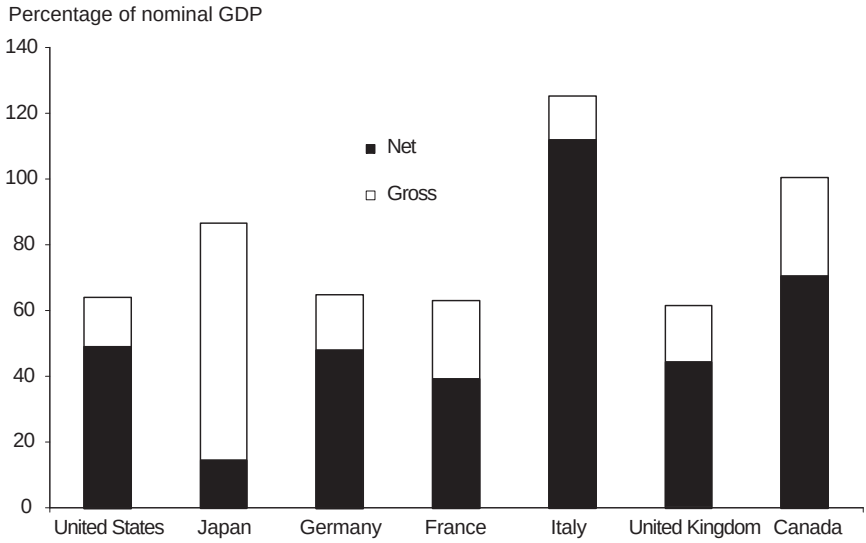


Sources: OECD National Account 1997, OECD; *Annual Report on National Account 1997*, Economic Planning Agency; *World Economic Outlook*, May 1998, IMF.

The Japanese economy is growing more slowly in the 1990s than in the early 1980s, which somewhat changes the importance of the same net-debt level (though, as argued in chapter 1, that growth differential is in large part temporary, which minimizes the difference). The key question is whether the nominal rate of interest on the outstanding debt is greater than nominal GDP growth, because so long as income growth exceeds interest payments, debt will decline as a share of GDP. This means that there are two ways to reduce the debt burden: run surpluses or increase the rate of growth of the economy. Either one is equally effective. If fiscal stimulus were to lead to sustained growth, the debt incurred in stimulating the economy would pay off; even if deficit spending simply moves growth forward, there is no reason not to wait to run surpluses to repay the debt until the growth rate is higher. As shown in figure 3.8, until the 1990s, the yield on a 10-year Japanese government bond was below that of the (nominal) rate of growth of the Japanese economy. At any foreseeable growth rate, this beneficial differential will return. There are no obvious signs that Japanese debt growth is on a consistently rising path that is unsupportable by Japanese economic growth.

Next comes the question of the direct costs of budget deficits. When the United States ran exceptionally large full-employment government

Figure 3.7 General government financial liability in 1996



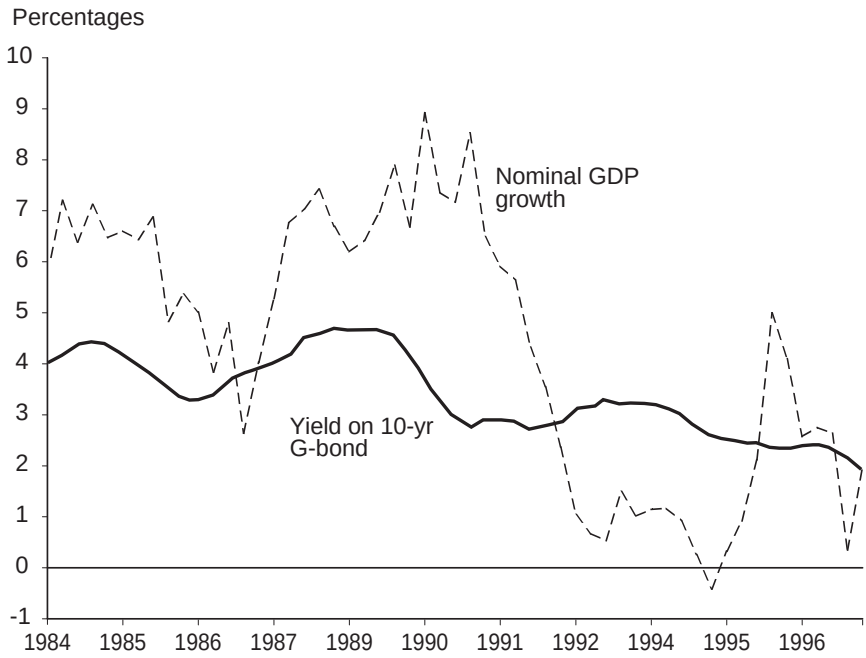
Note: Gross liabilities include all financial liabilities as defined by the System of National Accounts and cover the general government sector, which is a consolidation of central government, state and local government, and the social security sector. Net liabilities include all financial liabilities less all financial assets as defined by the System of National Accounts and cover the general government sectors.

deficits in the 1980s, this became a much studied phenomenon. Perhaps surprisingly, most mainstream macroeconomists were not as terrified by deficits as the popular impression would have it.[20] Buiter and Kletzer (1992) list four reasons why a policymaker or citizen might be concerned about public deficits and debt. First is financial crowding out, the displacement of private investment or an increase in the balance of payments deficit, as discussed in the first section of this chapter. Because Japan is at present below full employment and has a lack of investment demand and a balance of payments surplus, this is hardly relevant. Second is the desire to smooth the collection of taxes over time, to minimize their distortionary effect on savings and investment decisions. As Buiter and Kletzer (1992, 290) point out, ''The proposition that balanced budgets are sub-optimal is, however, more robust [to changes in specific assumptions] than the tax smoothing result.''

The third reason why policymakers and the public might be concerned about deficits is fear that mounting public debt will persuade the govern-

20. Though they all certainly advocated at least a gradual return to budget balance over the business cycle as well as a slowdown in the rate of debt accumulation (see Friedman 1992, 1994; Ball and Mankiw 1995).

Figure 3.8 Yield on government bond and GDP growth, 1984-96



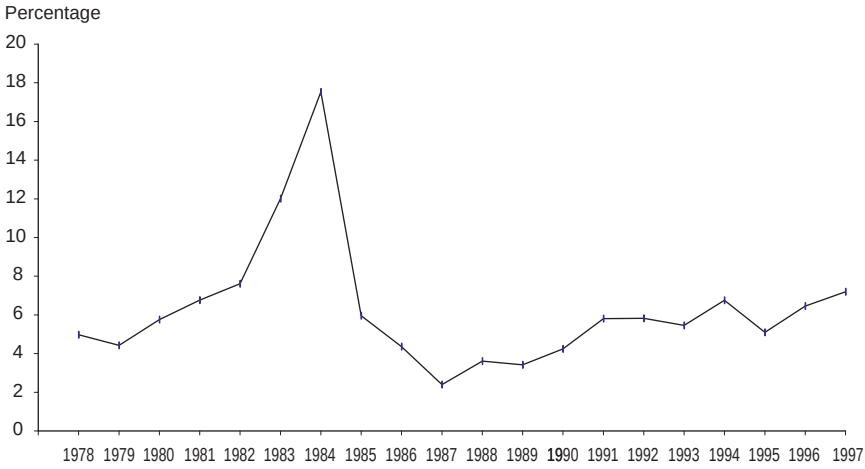
Note: Both data are monthly.

Sources: Economic Planning Agency, http://www.epa.go.jp; *Bank of Japan*, http://www.boj.or.jp.

ment to monetize the deficit and cause severe inflation in so doing. The idea that the now independent Bank of Japan would ever engage in such behavior is absurd, especially because the burden of Japanese public debt is sustainable. Unless the Bank of Japan aggressively prints money, such monetization and hyperinflation cannot occur.[21] Finally, the Japanese government could go bankrupt, that is, it could partially or wholly repudiate its debt obligations. Such a tactic is in the government's interest only if nominal debt grew faster than nominal national income for an extended period—like a firm, a government's willingness to repudiate debt depends entirely on its net worth and ability to access capital markets. If the government still has enough net assets and credibility to be able to roll over its debt, it has an interest in maintaining its access to credit; the government will choose to go bankrupt only when it has so little to lose that the one-time benefit of debt repudiation outweighs the benefits of continued rollovers. The five years of a Japanese growth rate below bor-

21. See chapter 5 for a discussion of why and how a modest positive inflation rate in the current Japanese context would be helpful if implemented.

Figure 3.9 Foreign share of purchases of Japanese public and corporate bonds, 1978-97



Source: Bank of Japan, *Economic Statistics Monthly.*

rowing costs (interrupted in 1996) depicted in figure 3.6 are hardly sufficient to run the Japanese government into insolvency, and, thus, there is insufficient incentive to repudiate the debt. From the perspective of its net-debt level, this is a far-fetched hypothetical.

Even if the Japanese government were to remove some of its debt burden either through direct repudiation or through inflation, the costs would be lower than in most other countries. This is because its debt is almost entirely domestically held and is completely denominated in yen. Government refusal to completely pay off debt in Japan would, therefore, simply constitute an internal redistributive tax that transferred wealth from government bondholders to government transfer and spending recipients; inflation would perform the same redistribution so long as benefits were indexed. If the central bank accedes, government repudiation faces a hard constraint only if the borrowing was from international capital markets, particularly in foreign currency. As can be seen from figure 3.9, outstanding foreign purchases of Japanese debt (public and private) is very small.[22] There remains the small possibility of a ''hard landing'' for the yen if the Japanese government were to pursue an unsustainable course of debt accumulation, which would arise first as a higher risk premium on yen-denominated borrowing. Starting from a net-debt

22. Direct numbers on foreign holdings of Japanese government bonds are unavailable, but most estimates would put them at around 1 percent of the total outstanding. The foreign purchases of Japanese bonds spiked up in 1984-85 because of a number of regulatory changes that eased banks' ability to engage in bond transactions.

level of 15 percent of GDP, however, the government would have to accumulate a lot more debt to make that threat real. While there is some evidence of a ''Japan premium'' for Japanese banks borrowing in the interbank market, that is directly associated with the information problems and systemic uncertainties of the Japanese banking sector—Japanese government bonds and nonfinancial corporate paper continue to be issued at extremely low rates of interest.

It remains to assess the long-run direct costs to the Japanese economy of carrying government debt, even if the amount is sustainable and unlikely to result in bankruptcy, hyperinflation, or a hard landing. Presumably, government borrowing takes away capital from other purposes once an economy returns to full employment. Thus, even if the debt-to-GDP ratio is stabilized or slowly brought down when the Japanese economy recovers, there is the potential for ongoing losses from the debt that is rolled over. As the IMF (1996, 50) put it in their review of fiscal policy, ''Why persistent budget deficits are a problem [is because] . . . government dissaving hurts national saving and lowers future living standards because either investment is reduced or borrowing from abroad is increased, and with it, future obligations to service foreign debt out of future national income.'' Because Japanese savers are not Ricardian, and the borrowing of a few percent of Japanese GDP is a large enough amount to affect interest rates (given that the Japanese government mostly draws on domestic savings sources), government debt will absorb capital that presumably could earn a higher return if invested in the private sector. Like many effects discussed in this chapter, however, the relevant question is how large is this long-run cost of debt, not whether it exists.

Ball and Mankiw (1995) and Elemendorf and Mankiw (1997) propose a clever thought experiment to put an upper bound on the quantitative importance of a society's debt to its economic welfare—the parable of the ''Debt Fairy.''[23] Imagine that the Debt Fairy appeared one night, and replaced all of the Japanese government's outstanding bonds with useful private capital of equal face value. This would take care of the entire gross (not net) debt of Japan, about 100 percent of GDP on latest figures. What would be the effect on Japanese economic growth? If the entire gross debt of the Japanese government were replaced, the government would no longer have to pay debt service of under 1 percent of GDP (100 percent of GDP in debt times a real interest rate of below 1 percent—see figure 3.1). Assume that factors of production, like capital, earn their marginal product. The marginal product of capital can be thought of as the capital share of national income divided by the capital/output ratio. In Japan, the capital share of national income is around 0.4, and the

23. This was developed with regard to the discussions of the United States deficit in the early 1990s.

capital/output ratio is about 3.6, which together imply a marginal product of capital of 11 percent. Output would be raised by the marginal product of capital times the additional capital stock, or 11 percent of GDP. As discussed in chapter 1, however, there is good reason to doubt that Japanese capital investment is as productive as American, which would reduce this product. Assuming a Cobb-Douglas production function, the marginal product of capital is proportional to the capital/output ratio. Thus, if capital stock rises from 3.6 times output to 4.6 times output, or by 30 percent, while output rises by 11 percent, there is an 18.5 percent drop in the marginal product of capital, to about 9 percent.

This 11 percent gain means that even if the *entire* accumulated government debt of Japan were replaced by useful capital, the lump-sum benefit to the economy would be on the same order of magnitude as the lost output in the Japanese economy just since 1994 (see the cumulative cost estimates in chapter 6). Avoiding the costs of insufficient countercyclical policy in the form of wealth forgone during the mid-1990s could have done just as much for Japanese economic welfare as paying off the total public debt would. If, as McKinsey & Company (1996) and Alexander (1997) argue, the return on capital is much lower than assumed here, the benefits of the Debt Fairy's replacement are lower still. Whatever the rate of return of Japanese capital, this comparison is overly generous to the benefits of debt reduction, because not even fiscal responsibility's strongest advocates in Japan in the 1990s propose anything more than a measured reduction in the debt level, if not just stabilization; the magnitude of the benefits of shifting capital from the public into the private sector declines one for one with the size of that substitution, so the actual benefit of any debt reduction policy would be much lower.

Furthermore, this parable is, by construction, the source of an *upper-bound* estimate on the benefits of public-debt reduction. To the extent that the marginal productivity of capital declines as the stock of capital increases (something that the Japanese experience of the 1980s would certainly seem to illustrate), or that at least some portion of government expenditure went to productive uses that earned returns similar to those on private investment, or that it was interest-sensitive consumption rather than investment that was crowded out—all of which are likely to have held to some degree in Japan or any other economy—the quantitative benefits of replacing government debt with private investment would be lower still. So on any reasonable reading of the data, the long-run cost to output of rolling over total gross Japanese public debt is smaller than that incurred by allowing subpotential growth for even a few years in the 1990s—and the direct cost to the economy of incrementally increasing the public debt by a few percent of GDP to stimulate growth is indeed negligible.

Yet the Japanese public sector appears to need a greater share of national income in the future, not a lower one. Japan is aging, and current

Table 3.2 Summary of expected pension burden

	Pension balance		Dependancy ratio		Pension expenditure	
	2020	2030	2020	2030	2020	2030
Australia	−2.9	−3.8	25.1	33.0	2.9	3.8
Austria	−4.5	−6.8	32.6	44.0	12.1	14.4
Belgium	−5.4	−8.6	31.9	41.1	10.7	13.9
Canada	−2.8	−4.3	28.4	39.1	6.9	9.0
France	−3.9	−5.8	32.3	39.1	11.6	13.5
Germany	−4.8	−9.1	35.4	49.2	12.3	16.5
Italy	−2.1	−7.1	37.5	48.3	15.3	20.3
Netherlands	−2.6	−5.4	33.9	45.1	11.2	12.1
Spain	−3.6	−6.3	30.7	41.0	11.3	14.1
Sweden	−6.2	−7.2	35.6	39.4	13.9	15.0
United Kingdom	−1.1	−1.5	31.2	38.7	5.1	5.5
United States	−0.9	−2.3	27.6	36.8	5.2	6.6
Japan	−5.6	−6.6	43.0	44.5	12.4	13.4

Source: OECD (1997d).

social security surpluses will not be sufficient to pay for today's middle-aged to receive the same benefits that their parents now receive upon retirement. This reality goes without question. Recognizing that retiree/worker dependency ratios will rise throughout the OECD and especially in Japan (see table 3.2) is not the same thing, however, as putting a number on the problem. Clearly, despite the well-known demographic trend in Japan, interest rates (even real interest rates) remain lower there than elsewhere in the industrialized world. Generational accounting schemes, following the work of Auerbach and Kotlikoff (1987), have been designed to give quantitative estimates of what would be required of today's taxpayers to restore generational equity. The conclusion of the most recent study is that Japan's demographic trend is so substantial that ''eliminating official debt would have a minor impact on the Japanese imbalance'' (Kotlikoff and Liebfritz 1997, 15).[24]

In Japan, as in all the OECD countries, if no further demographic change took place, 75-80 percent of the current social security imbalance would be removed. This would swamp the influence of any contemporary debt position.[25] If a society truly wishes to rectify its generational inequities with regard to lifetime net social security benefits, it must take on the problem directly. The society can decrease the dependency ratio by allow-

24. This again refers to the *entire* Japanese debt, as in the Debt Fairy parable. See also Takayama, Kitamura, and Yoshida (1998) from the same multiauthor NBER research project.

25. ''The complete lack of any consistent relationship between nations' generational imbalances and their deficit or debt positions is not surprising given that, from a theoretical perspective, there is no intrinsic connection between the two measures'' (Kotlikoff and Liebfritz 1997, 11).

ing immigration, increasing fertility, or, most promisingly for Japan, increasing female labor-force participation. Countries can also reduce benefits and/or raise the retirement age. Any short-run finite increase in government debt, which therefore does not involve a long-run commitment to expanded social security benefits, will not affect this problem. Individuals who wish to protect their own children can, of course, simply leave bequests sufficient to make up for the intergenerational transfers that the social security system gives them. Because Japanese (or for that matter OECD) citizens are not voluntarily making this decision in large numbers, democratic consent would be needed to impose such a move.

An analogy between the Japanese economy and a rice paddy puts the long and short of fiscal policy in perspective. Japanese policymakers, the farmers, have received word that, barring major change in human behavior, global warming is coming in 30 years. When temperatures rise and the water table sinks, the farmers will have to shift a lot of water from other uses if they want to keep growing rice. Meanwhile, a drought has hit this year, independently of the long-run trend. Clearly, the farmers should use the water held in the town reservoir to save this year's rice crop. Holding on to that small store of water for global warming 30 years hence will make no real difference to the problem and would sacrifice this year's crop as well. Similarly, the aging trend in Japan is very real, but withholding the money from the appropriate policies to respond to today's crises only harms the Japanese economy today without doing anything to truly prepare it for its future burdens. It is a false trade-off.

The sustainability of the outstanding level of Japanese government debt, the limited direct cost of its crowding-out investment, and its lack of relevance for the problem of aging in Japan all depend upon the assumption that debt will not grow explosively. Some discussions of government spending in Japan, however, seem to take it for granted that debt accumulation is a slippery slope—if Japan does not reverse its deficit spending in the 1990s, it will open the floodgates. Even though most of the deficits incurred in the 1990s were the result of the economic downturn and not discretionary fiscal expansion (as established in chapter 2), is such a spiraling path of deficits likely to occur in the future? Clearly, those who supported Prime Minister Ryutaro Hashimoto in passing the original law that required deficit reduction by 2003 felt that a long-run commitment was necessary. Japan was not alone in such legal efforts to contain public spending in the 1990s, which may indeed have been part of the impetus. A long literature in economics, going back to the work of Buchanan and Tullock (1965), provides apparent intellectual justification for such fears of government's tendency to grow if unchecked. Finally, the late 1970s and early 1980s in Japan have been seen by some as an immediate historical example of the difficulties in bringing rising budget deficits under control.

Despite this generalized perception, the vision of public-debt accumulation as an explosive process is not supported by the evidence, either in

general or with regard to Japan in particular. Institutionally, budget deficits are most likely to rise where there is no centralized coordinator of the budget process, such as the Appropriations Committee in the US Congress (see Schick 1996); they are also more likely to be uncontrolled when a weak or multiparty coalition holds legislative control (see Alesina and Perotti 1995, 1996). In both cases, the impetus for expansion is the same—the need for extensive logrolling and side payments to get any fundamental legislation passed. If the budget process is properly designed and majority party discipline is strong, the tendency to logroll is diminished.

In Japan, the Ministry of Finance serves the coordinating role similar to that of the Appropriations Committee, and the inability of Diet members to amend the General Budget without calling a ''no confidence'' vote further enforces discipline (see chapter 2). While the LDP in Japan is often referred to as a coalition of factions, it would have to go a long way to reach the levels of intracoalition bargaining and free riding of the true multiparty governments in, for example, Belgium and Italy—countries where lack of government discipline truly did result in accelerating growth of government deficits. Moreover, fiscal laxity generally tends to be politically popular only if the monetary authority is prepared to accommodate the deficits, that is, print money and cause inflation to cover the mounting bills; if rising deficits require significant interest rate increases, or the amount of redistribution involved in the inflation tax becomes so high as to be visible and publicly troubling, deficit spending incurs political costs. This is why the governments of Belgium and Italy were able to significantly reduce their debt levels (albeit from very high starting points) by joining the European exchange rate mechanism. The Bank of Japan provided this type of hard constraint while under the direction of the Ministry of Finance, and its move to independence will only strengthen its ability to hold the line.[26]

Historical precedent as well as institutional structure would seem to justify confidence in Japanese policymakers' ability to restrain future debt accumulation, even if, as I argue they should, they do engage in deficit spending now. Figure 3.6, which shows the time path of Japanese government deficits since 1983, demonstrates how a combination of conscious choice and business cycle swings moved deficits up and down. No institutional change took place within the Japanese government, nor does the timing of the swing fit with the one time that the LDP lost a majority in the Diet. Yet the Japanese government decreased deficits, then ran surpluses, and then fell back into deficit again. There is no suggestion of a correlation of deficit spending with political weakness. The Japanese budget consoli-

26. See Ueda (1993) and Cargill, Hutchison, and Ito (1997) for historical analyses of Bank of Japan monetary policies.

dation through the 1980s was achieved slowly, through gradual tightening toward ''zero-ceilings'' on ministry budget increase requests and through tax revenues increased by bracket creep. Meanwhile, nominal expenditures were eroded by inflation (see Schick 1996, 18-21; Asako, Ito, and Sakamoto 1991).[27] As in the United States in 1998, unexpectedly high growth and tax revenues were the final push to achieving budget balance in 1988 and 1989.[28]

In fact, the general course of Japanese debt and deficits is similar to that of the United States and many other OECD countries, in that it was significantly influenced by variation in the rate of economic growth (that is, cyclical factors), it rose and fell in long slow-moving (not explosive) trends, and, when debt reduction was desired, deficits did eventually decline. Behavior also consistent across Japan, the United States, and post-Maastricht Western Europe was that announcements of budget targets and rules were never strictly met but were good indicators of an ongoing desire to make progress toward greater fiscal restraint.[29] Finally, in keeping with the earlier discussions in this section, none of the OECD countries that experienced multiyear rises in debt prior to reversing the trend—not the 1980s United States, Italy, or even Belgium—suffered calamitous blows to national economic well-being. Deficit spending of explicitly limited size and duration, as advocated for Japan in chapter 5, would incur even less cost.

The costs and benefits of fiscal-policy choices do not end with vague references to long-run concerns or principles of thrift. In the short run, the effectiveness of fiscal policy depends on the economic situation, particularly the distance of the economy from full employment and the readiness of savers and investors to respond to interest rates. Where savings are driven by precautionary motives, as in Japan today, the appropriate fiscal policy response is very different from when savings behavior is in response to long-run government plans. The long-run influence of today's fiscal expansions in any situation is far smaller and less constraining than is frequently assumed, so long as today's expenditures are not part of an explosive expansionary trend. As seen in the historical

27. It is worth observing that, as in the 1990s, an announced multiyear target for budget consolidation (a September 1979 commitment to end dependence on the issuance of deficit bonds by fiscal year 1984) was pushed back for several years, to 1990. This relaxation of a budget rule or target did not lead to calamity, and, in fact, the trend toward budgetary consolidation continued slowly but unabated. This is an important example to keep in mind if the Japanese government fully reverses itself on its legal budget balancing target (now for 2005), as recommended in chapter 5.

28. Asako, Ito, and Sakamoto (1991) identify surprise versus planned changes in Japanese government expenditures and revenues for the 1965-1970 period.

29. See Blinder (1987) for a discussion of US budget politics such as Gramm-Rudman-Hollings in the 1980s.

record, and as limited by institutional arrangements, such explosive trends are rare for industrial democracies. The long and the short of fiscal policy for Japan in the 1990s are encouraging about the benefits of a truly expansionary fiscal response to the current downturn. The concerns about fiscal policy usually invoked to argue against such a policy do not hold up to analysis either as relevant or of sufficient magnitude to matter.