# 5

# A Program for Japanese Economic Recovery

The appropriate policy response to Japanese stagnation is one, first and foremost, of expansionary macroeconomic policy. As argued in chapter 1, strong potential growth is being forgone because of a lack of aggregate demand, so stimulus is called for. As documented in chapter 2, fiscal policy was successful in raising the Japanese growth rate in 1995, the one time it was tried. As demonstrated in chapter 3, the current conditions of the Japanese economy, if anything, increase the likely effectiveness of fiscal policy, and the aging of Japanese society has little to do with such a policy's benefits. Finally, as discussed in chapter 4, the mounting financial distrust at home and the apparent recurrence of economic crisis abroad mean that a rapid response to restore the confidence of Japanese citizens in the stability of their purchasing power and their financial system is required. So long as the economic turmoil of Japan in summer 1998 does not generate wholesale capital flight, this program can still be effective. It is within the power of Japanese policymakers to bring about lasting economic recovery in Japan without unnecessary pain or complete overhaul of the Japanese system. Delay in undertaking the required efforts costs the Japanese people more wealth forgone and risks a crisis that policy cannot easily repair.

In summary, Japanese macroeconomic policy should begin with the passage of a true fiscal-stimulus package. This package should be of sufficient size to raise growth above the Japanese potential growth rate of 2 to 2.5 percent, that is, 20 trillion yen, or 4 percent of GDP based on



Institute for International Economics | http://www.iie.com

current data.[1] Unlike the package of the Hashimoto government of April 1998, discussed in chapter 2, the amount spent should equal the headline total, it should be implemented completely before calendar year's end, and it should consist primarily of permanent income tax cuts. This fiscal policy should be accompanied by a monetary policy that is committed to reversing deflation and minimizing uncertainty about the future price level—a goal best served by the announcement of a small positive inflation target of 3 percent and not by the conscious depreciation of the yen. The idea is to encourage stabilization and long-run planning, not simply to inflate in an unanchored manner. Cleanup of the Japanese financial system is needed to make the recovery sustainable. The restoration of incentives for Japanese savers to keep their money in identifiably solvent private-sector banks should be the fundamental goal of financial reform. This requires steps to close banks, shore up the credibility of deposit insurance, and encourage the shift of savings from the public to the private sector. The details of how to implement these policy measures, and the reasoning behind them, are given in the course of this chapter.

There is no shortage of policy advice available to the Japanese government, from Japanese, American, and other sources. Some of the components of the program I offer here have been advocated and opposed, singly and in various combinations, by numerous observers. My hope is that, by having brought the reader to this program through a systematic analysis of the Japanese economic situation, these recommendations will follow logically from that analysis and, therefore, be both more persuasive and form more of a consistent whole than they would if such a program were simply listed. Although the current Japanese situation is indeed dire, and without decisive policy action subject to the possibility of rapid decline, this program for recovery is not a complicated ''all or nothing'' shock-therapy plan. No wrenching transformation or overhaul of the Japanese model beyond banking reform is required.

That being said, the components of the complete program do reinforce one another in bringing Japan out of its current economic stagnation. The combination of fiscal stimulus and expansionary but anchored monetary policy should raise return on investment and stabilize price expectations and the yen. In turn, this should encourage reinvestment and spending in the Japanese economy, which should improve the balance sheets of banks and households. The proper sorting of viable from insolvent banks should make sure that this capital inflow is not wasted on further risky loans. The issuance of short-term government debt to fund the fiscal stimulus, the conscious contraction of the Postal Savings system, and the refinement of deposit insurance should reinforce incentives for Japanese

---

1. This assumes a contraction of the Japanese economy of 1 percent in 1998, much less than the −5.2 percent annualized rate announced for the first quarter of 1998, but still the decline that would occur without fiscal action.



Institute for International Economics | http://www.iie.com

savers to reinvest in their private economy. Together, these measures will restore financial confidence sufficient to promote the maximum lasting effect of the tax cuts.

Moreover, even taken as a whole, this program is not one that should lead to policy overload, either political or financial. In expenditure, it consists almost entirely of the fiscal expansion effort, which, as discussed in chapters 2 and 3, should be seen as money well spent and not out of line with international standards for fiscal expansion. The monetary and financial recommendations consist of changes in the conduct of policy rather than new spending. In political terms, because these are for the most part macroeconomic policy suggestions, they can be accomplished with minimum exposure to special-interest or even legislative interference, especially because they do not directly reallocate benefits among groups (except, perhaps, the power of the Ministry of Finance). Only the financial reform aspects of the program would require some real political leadership in facing up to the ties between bureaucracy and business, as the stasis to date on this front has demonstrated, but none greater than that required in the US savings and loan crisis, for example. Programs that instead call for the total and drastic structural reform of the Japanese economy risk bringing inertia at best and open resistance at worst, and ultimately, they are unnecessary. Most ''reform'' beyond the immediate amount required for the cleanup of the bad loan problem, even if salutary in the long run, presents opportunities for future growth that can wait until macroeconomic policy has taken effect.

Thus, this program and its salutary impact on the Japanese economy are well within the realm of the attainable. My program's benefits would be sizable, both for Japan and for the world economy. First and foremost, true fiscal stimulus in combination with stabilization of inflation expectations should at least be attempted, before resorting to aggressively inflationary policies or accepting current growth rates. This course seems obvious, especially because fiscal policy was effective in stimulating growth in 1995 and in mistakenly contracting the economy in other years, while monetary ease and the yen's decline have already proven ineffective in bringing growth to Japan. In comparison to the calls made by some for the acceptance of continued stagnation either under the heading of ''creative destruction'' or as the only real spur to break deadlock or both, it offers more solid ground for sustained growth. Compared to the combinations of forced structural change and outright economic suffering being borne at present by most of Japan's neighboring nations, its requirements are meager. This stands to reason because Japan is far more a transparent market economy and far less subject to uncompetitiveness and foreign indebtedness than any of the Asian-crisis economies, rhetorical comparisons aside.

To close this chapter, I address the question of whether the United States has a role to play in Japanese economic recovery. Change in Japa-



Institute for International Economics | http://www.iie.com

nese economic policy must come through a recognition of Japan's own self-interest in making that change, and this book is premised in part on contributing to such a recognition. It is possible that American diplomacy and economic policy could contribute to the likelihood of such a change. Furthermore, to the extent that the international environment in general, and the yen/dollar exchange rate and the US-Japan bilateral trade relationship in particular, affect Japanese economic prospects, American policy can influence the course of events. My primary recommendation is that the United States should end the intermittent jawboning of Japanese policymakers and most forms of diplomatic pressure based on low-level intergovernment communication. Instead, if the United States is to do anything, it should offer the Japanese government a *positive* opportunity for cooperation in a centralized, explicit manner (e.g., concerted foreign-exchange intervention) in return for an explicit timetable of fiscal expansion and financial cleanup in Japan. The key is to offer benefits that Japan cannot attain through unilateral action and that can be withheld until Japanese policymakers act. The United States has no punishment strategy to use upon Japanese policymakers that will not impose unacceptable risk of some harm to the rest of East Asia and the United States as well, which is why the positive should be emphasized.

## Fiscal Policy Measures

### True Fiscal Stimulus of 4 Percent of GDP

Fiscal stimulus will work to raise the Japanese economic growth rate. As discussed in chapters 2 and 3, a stimulus package must consist of actual government return of funds to the private sector, that is, an increase in the deficit, to be effective. In size, fiscal stimulus must at a minimum be large enough that its effects can be seen and felt by all citizens. The best way to assure this response is to promote growth *above potential*. Only above-potential growth would start to take up the ample excess capacity and reemploy the unemployed in Japan, both of which are necessary to raising growth expectations and decreasing uncertainty in the Japanese economy. As analyzed in chapter 1, Japanese potential real GDP growth is likely between 2.0 and 2.5 percent annually. Fiscal policy that merely keeps growth nonnegative, but below potential, will allow excess capacity and unemployment to continue to rise, likely further damaging confidence. Such limited spending will therefore be transitory and a waste of money in a way that a sufficiently large program would not. For these reasons, the impact of fiscal policy will be felt only with a stimulus of at least 4 percent of GDP, or 20 trillion yen, given current forecasts for Japanese economic contraction of 1 percent or more in 1998 and potential growth in excess of 2 percent.



Institute for International Economics | http://www.iie.com

This recommendation assumes a multiplier on fiscal policy of at least one. Given that the combined 1.6 percent of GDP spending and 1.3 percent of GDP consumption-tax shift[2] of 1995-96 resulted in GDP growth of 3.6 percent in 1996, when there were no other positive developments (as discussed in chapter 2), this multiplier seems reasonable once the potential growth minimum is exceeded. That such a sizable fiscal stimulus will feed into a sustained upswing in growth, of course, cannot be completely guaranteed. Even in the unlikely event that such a stimulus were to be mostly saved or were to simply increase this year's growth at the expense of next year's—neither of which is likely to occur, as argued in chapter 3—this stimulus would still have been useful by staving off a collapse of financial confidence in Japan until the world economy would be better prepared to handle it and by aiding both Japanese banks' and consumers' balance sheets. As argued in chapter 3, there is every reason to expect that appropriately strong fiscal policy will accomplish a great deal more than that in the current Japanese situation.

The Japanese government should, in fact, complete its U-turn in a decisive manner and repeal the law that requires a limit of deficits by the year 2005. The law has already been revised to push back the target date from 2003 and to include an escape clause for severe economic downturns. Such explicit budget rules are never credible or effective—the Maastricht deficit and debt criteria failed to be met even less than strictly by most of the participants in the European Monetary Union; the Gramm-Rudman-Hollings and other balanced-budget rules were ignored in the United States in the 1980s and 1990s. Furthermore, the premise of an exact deficit target is misleading because there are limits to what economic effects deficits capture, and it is the trend of net debt that matters. Keeping the budget austerity law on the books just undercuts the government's credibility that it is doing right by stimulating. The Japanese government should accompany this package with accurate statements to the effect that the 1995 fiscal package was a success, that other previous packages do not constitute evidence that fiscal stimulus does not work (in part because there was also contractionary fiscal policy undertaken), that other countries have engaged in fiscal policy of this magnitude when required, and that there really is as much in this package as claimed. In essence, an exercise in honest confidence building would increase the likelihood of success.

## Make the Stimulus Consist of Permanent Tax Cuts

The 4 percent of GDP stimulus could conceivably be reached through public works spending, corporate tax cuts, temporary tax rebates, or

2. A 2 percent cut in taxes times the 0.65 share of consumption in GDP.



Institute for International Economics | http://www.iie.com

some combination thereof. Best structured, however, the stimulus package would consist of permanent cuts in taxes. As is well known, permanent tax cuts will have larger effects than will temporary ones because consumers will treat them as an ongoing rise in income rather than a one-time windfall to be spread out over several years. Because there is no good evidence that Japanese citizens (or anyone else) are fully Ricardian, they are therefore unlikely to treat much of a current tax cut as a future tax rise that is relevant to them (see chapter 3). If anything, the return to their control of a greater share of their own current income should decrease their income uncertainty, whatever their long-run expectations, and work to diminish precautionary saving. Another reason that permanent tax cuts will have larger effects than will other forms of stimulus is that for Japanese households their effects are immediate and tangible, whether on consumer purchases or on take-home pay.

There are several other reasons why permanent income tax cuts are to be preferred to the public works spending that has been the mainstay of Japanese economic proposals to date. First, reducing direct taxes lowers distortion of pricing in the economy, thereby increasing economic efficiency, while the creation of targeted public works projects adds to distortions by supporting sectors (e.g., construction) and projects (e.g., large bridges that carry no traffic) that the market would not. Of course, these effects are second order compared to the ultimate need for fiscal stimulus, but, given the choice of composition of that stimulus, tax cuts yield benefits greater than their listed size, while many forms of government spending yield less. In addition, public works can impose future carrying costs, such as bridges that require maintenance, which further distort allocation. Reduction of income taxes can, at the margin, increase the supply of labor and investor effort in the economy by increasing the incentive to pursue earning opportunities.[3] In general, economic performance is improved by moving resources from the public to the private sector.

Second, permanent tax cuts now are likely to force permanent cuts in public-sector spending in the next several years, much as Reaganomics did in the United States.[4] It has recently been established that fiscal consolidations that rely on cuts in government expenditure are much more likely to be successful (in the sense of the improvement in fiscal situation being sustained) than consolidation efforts that rely on tax increases.[5] Spending

3. This last possibility should not be oversold. Even strong supporters of Reaganomics are unable to demonstrate large benefits on this front in the United States as a result of the 1980s tax cuts. Lindsey (1990), a Bush administration official, puts the total benefit of Reagan-era tax changes at less than 1 percent of GDP, while others put it much lower.

4. Some would argue that this was, in fact, the underlying intent of the Reagan fiscal policies (see Stockman 1987).

5. See Alesina and Perotti (1995, 1996) and the discussion in IMF (1996).



Institute for International Economics | http://www.iie.com

increases have the opposite dynamic, tending to become entrenched. Moreover, a tax cut establishes a usefully transparent ''line in the sand'' for Japanese policymakers, who are subject to the sort of pressure for stealth austerity discussed in chapter 2—they would have to expose any efforts to undercut the stimulus package before it runs its course, by either raising taxes or visibly cutting main-budget spending. A stimulus based on public works would run the wrong way in both the long and the short term by adding to the fiscal burden in a manner that is far more difficult to reverse while allowing cuts in the stimulative program to be hidden (as they were in the consistently large gap between stated and actual spending in all prior Japanese fiscal packages).

Third, permanent tax cuts are more restorative than are public works for an economy hindered by a lack of confidence and by overcapacity. For one thing, they are widespread rather than targeted to particular regions or sectors, and they are, if anything, progressive so that those with the most to fear from continuing stagnation (e.g., the potentially unemployed) benefit the most. For another, they would be likely to produce visible effects quickly. This is not only because of tax cuts' lack of implementation lag, but because the efficiency of the mostly tradable-goods sectors in the Japanese economy, from which consumption and durable goods would be purchased (e.g., cars and electronics), is much higher than that of the sectors usually targeted for public investment. These efficient sectors would be expected to respond quickly with production as they head back toward their efficient scale of operation, which is likely to further increase demand. Public works spending is self-limiting as well as oriented toward the less efficient areas of the economy—people know exactly where the money is going (not to them) and when the flow will end. This is why even Japanese government estimates of the multipliers on tax cuts, which play down their immediate effects, are greater over multiyear periods than are estimates of the multiplier for public works, which drop off after the first year.[6]

Finally, the decision to make the fiscal-stimulus package consist mostly of tax cuts would be seen as a clear confidence-restoring break with past policies by Japanese elected officials. The LDP's relationship with local construction and agricultural firms, and the role of public works spending disbursement in that relationship, reflects the overweighting of rural votes in the Japanese electoral system. This reality is well known to the Japanese public. Efforts to pursue national goals without obvious side payments would be a refreshing break from ''business as usual,'' a break likely to be welcomed in an atmosphere of general concern about corruption scandals that involve Diet members and bureaucrats.

---

6. See, for example, Kawasaki (1996). The difference in multiplier estimates between tax cuts and public works would be higher if they were permanent rather than assumed to be temporary as in most Japanese government analyses.



Institute for International Economics | http://www.iie.com

Of course, it is naive to pretend that this pork-barrel setup is not precisely the reason that past Japanese fiscal-stimulus efforts have largely consisted of public works spending. There are reasons to think that this might be subject to change, however, in addition to the one based on the present popular desire for clean government in Japan. One is that the wasteful nature of this process was less noticed and remarked upon while times were good, while in today's stagnant economic times the Japanese public is far more aware of the costs. Another is that Japanese politicians are becoming more aware of the limited relevance of such spending to their reelection prospects. As summarized in Cargill, Hutchison, and Ito (1997, chapter 7), the only solid evidence of a political business cycle in Japan indicates that there were attempts to time the calling of elections to coincide with good economic performance. This is hardly an option in the current situation. Furthermore, their research does not support the idea that public spending buys votes.[7] The results of the 12 July 1998 elections for the Upper House of the Diet appear to confirm that generalization. A third reason to believe that it is politically feasible to pursue tax cuts rather than public spending is that Japanese business lobbies have come to see their interests as closely tied to the restoration of Japanese economic confidence and efficiency, rather than to the continuation of the subsidization of the LDP's local construction and agricultural support network (as with the public in general, more difficult economic times diminish tolerance).

There is a choice between cuts in income and consumption taxes. While consumption tax cuts might provide a greater initial bang for the buck, as seen in the 1996 response to the change in the consumption tax rate, there are long-term reasons why income tax cuts are to be preferred. In general, indirect taxes (such as sales taxes) distort private economic decisions much less than do direct taxes (such as consumption taxes). In a time of heightened concern about structural inefficiencies in the Japanese economy, it makes little sense to increase the proportion of taxes raised by distortionary means. A consumption tax cut would also be a less credible permanent commitment because of the long-run need for Japan to move toward greater reliance on indirect taxes as the population ages (and fewer citizens are wage earners). Internationally, most countries in the OECD and outside it are shifting the tax burden in this way. These pressures would explain the widespread presumption that political resistance, especially from the Ministry of Finance, would be stronger against consumption than income tax cuts.

7. This is not to suggest that Japanese LDP members plan their party's strategy on the basis of reading academics' books. This is rather to point out that such political disbursement of goodies has not played a systematic role in previous Japanese elections and, therefore, should be seen as a luxury that helps members to enjoy their careers but not a necessity to keeping those careers.



Institute for International Economics | http://www.iie.com

Cutting income taxes would in fact be a tax *reform* in and of itself because of the current inequities of the Japanese tax system. Half of Japanese households pay no income taxes, with those who are too wealthy to receive income from salary or who manage to classify themselves as farmers or business proprietors, as well as the poor, avoiding the burden. Wage earners' disproportionate burden should be eased. By cutting withholding taxes, the very salarymen who have the greatest combination of a motive for precautionary savings (because they have a job to lose) and discretionary income (because they are above the income minimum for taxation) get the benefit of the stimulus. Ultimately, the total size and timing of fiscal stimulus and the concentration of it in permanent tax cuts rather than public works spending are more important than the allocation of tax cuts between consumption and income taxes. Given the choice, however, income tax cuts should be emphasized.

## Issue Short-Term Debt to Fund the Stimulus

Part of what afflicts the Japanese economy at present is excess demand for liquidity, as discussed in chapter 3. Although expansionary monetary policy is currently unable to satisfy households' desire for cash, fiscal stimulus drives up the return on investment and increases the absorption of savings. Proper debt-management policy, that is, the conscious structuring of the maturities of the government's portfolio of outstanding debt, can aid in this regard as well. Short-term government bonds (with a maturity of three years or less) are distinct both from currency and from long-term government bonds in their characteristics and in their perception by investors.[8] When the recommended fiscal-stimulus package of permanent tax cuts requires the Japanese government to issue 20 trillion yen in new debt (as well as the inevitable increase in the debt because of the ongoing recession), the government should take advantage of this fact and issue the debt with short maturities. If this infusion of short-term government-guaranteed obligations into the market provides securities with a mix of safety and liquidity that some hoarders of cash are willing to accept, it will relieve the demand for liquidity and increase the effectiveness of future open-market operations.[9] If the relative supply of long-term Japanese government bonds decreases, there should be some ''crowding-in'' of longer-term corporate investment, because at the margin some bondholders will prefer corporate assets to short-term government

8. See Friedman (1978) for a discussion of how the imperfect substitutability of different government obligations leads to financial effects of debt management.

9. As Ueda (1990) notes, the relative unavailability of short-term Japanese government obligations has been a continuing source of illiquidity in Japanese bond and broader markets. Thus, this issuance of short-term debt would have an additional long-term benefit.



Institute for International Economics | http://www.iie.com

debt when forced to choose between various imperfect substitutes for the long bonds.

Issuing short-term obligations to cover the deficit will also minimize the interest burden of the fiscal stimulus package by taking advantage of current low Japanese interest rates and of the usual spread between long- and short-term rates. Increasing the depth and liquidity of the short-end of the Japanese government bond market will support the long-run development of the yen as a reserve currency. Finally, funding the additional deficit with short-term debt will provide another impetus to eventual government spending cuts, which would complement the tax-cut pressure cited above, by forcing the Japanese government to quickly and visibly confront the decision of whether to roll over or pay off some of the debt.

## Monetary Policy Measures

### Announce an Inflation Target of 3 Percent for 2000

The primary contribution that monetary policy can make in today's Japan is to stabilize inflationary (and deflationary) expectations. Uncertainty about future price levels, and deflationary expectations in particular, can have disastrous effects on the real economy. The current deflation in Japan increases the real burden of outstanding nominal long-term debt, discourages consumption if people wait for prices to drop before making durable-goods purchases, and raises the rewards of holding cash. There is no question that the Bank of Japan can prevent a full-fledged deflationary spiral—even when a central bank cannot affect interest rates or investment as usual, it can still affect nominal quantities such as the price level, simply by changing the rate at which it prints money. There is little question that the Bank of Japan is already attempting to do so through money creation. This is insufficient, however, because there remains great uncertainty about whether prices will stabilize or whether the yen's decline and government debt will ultimately lead to inflation. Any sort of long-term planning is severely hindered by such uncertainty and, as discussed in chapters 3 and 4, investor and consumer uncertainty is the true source of danger to the Japanese economy. Moreover, if the Bank of Japan inflates without a target, it gains little credibility from any success it has stopping deflation, because it does not offer a goal or standard against which its progress can be measured.

What is needed is a nominal anchor, that is, some visible commitment by the monetary authority, the Bank of Japan, to a specific path for the price level. Such an anchor, with which Japanese markets and individuals can monitor the maintenance of this path by monetary policy, will pin



Institute for International Economics | http://www.iie.com

down price expectations. The Bank of Japan's best option for removing price uncertainty is to announce an inflation target.[10] An inflation target is a publicly announced, numerical goal for a specified measure of the inflation rate over a set time horizon. While it is usually seen as a way to cap inflation expectations, an inflation target is actually a *floor* as well as a ceiling for the rate of price increase; the central bank can create inflation with reference to the target without fear of igniting inflationary expectations or having its policy moves misunderstood. To cite two examples, Canada in the early 1990s and Sweden during the Great Depression used announced inflation targets in just this manner, first to anchor long-run price expectations, and then to create sufficient inflation to offset deflation in the short run.[11] In Japan today, such a target would lead to a firming not only of consumer prices but of asset values, because it would limit how much the yen could fall (assuming that there are Japanese and foreign investors ''bottom fishing,'' that is, waiting to put their money back into Japanese corporations in hopes of finding bargains, as indeed seems to be the case).

Visible increases in inflation without an explicit commitment to its future level, however, will just add to uncertainty and harm investor confidence. That is why a public and positive but specific and finite inflation target is preferred to an unanchored monetary policy based on just ''turning on the printing presses,'' as has been advocated for Japan by Milton Friedman, John Makin, Paul Krugman, and others. While both policies would be effective in stopping deflation, aggressive monetary expansion without reference to a specific finite target will on net increase rather than decrease uncertainty. The question of when the Bank of Japan would slow the printing presses would arise, as would concern that the Japanese government wished to inflate away its and the banking system's nominal debt. Together, these would encourage further withdrawal of capital from the Japanese economy. Investors waiting to put money into Japanese assets would only see their estimates of currency and default risk rise, likely more than offsetting any purchase incentive arising from the halt of declining prices. Similarly, Japanese consumers that face a rising inflation rate of uncertain duration and without a clear upper bound would have some additional incentive to spend now, before their cash holdings eroded too much in value, but this effect would likely be overwhelmed by greater precautionary panic as they watched their yen-denominated purchasing power, domestic as well as international, further

10. Bernanke, Laubach, Mishkin, and Posen (1998) give a comprehensive analysis of this monetary framework in theory and in practice (but make no specific reference to Japanese monetary policy).

11. Bernanke, Laubach, Mishkin, and Posen (1998, chapter 6) discuss the Canadian experience in the 1990s. Jonung (1979) gives a history of Sweden's success in avoiding the worst of the Great Depression through target-based monetary policy.



Institute for International Economics | http://www.iie.com

erode. A 3 percent inflation target should be sufficient to capture many of the gains to be won by engendering belief among consumers and investors that prices will not drop further, without incurring additional costs to purchasing power and confidence.

In addition, inflation and especially inflation uncertainty have costs themselves.[12] Deflation is without doubt much more costly than single-digit inflation, as recent Japanese experience reconfirms, so achieving a positive rate of inflation in today's Japan is a worthwhile endeavor. Rises in inflation expectations tend to be persistent, however, especially when inflationary policy is a clear break from past practice, as would be the case for the Bank of Japan.[13] This would potentially present Japanese policymakers with a dangerous dilemma just a little bit down the road, because they would face whatever inflation level they incurred as part of the monetary ease in addition to inflationary pressures that arise when the Japanese economy does recover sufficiently. They would be left with the terrible choice of disinflating by contractionary policy the moment the economy picks up slack or allowing inflation rates and expectations to rise further as additional inflation is accommodated. By committing to a finite, small, publicly known inflation target, one that anchors expectations over the longer term, the Bank of Japan can avoid this additional cycle of rising inflation and the pressure to reverse it.[14] Thus, on several grounds, if the Bank of Japan engages in money creation, as it should, it should do so through the framework of an inflation target.[15]

In operational terms, the Bank of Japan should announce an inflation target of 3 percent annually for summer 2000. It should also announce that over some appropriate longer term (say by 2003) the rate would be brought down to 2 percent.[16] The 3 percent rate is chosen to be clearly

12. See Fischer (1981) and Briault (1995) for excellent summaries of these costs and Sarel (1995) for evidence that the direct costs rise sharply once inflation rates of 8 percent are exceeded.

13. See Ueda (1990) and Cargill, Hutchison, and Ito (1997) for histories of the success of the Bank of Japan in combining low inflation with steady growth through most of the 1970s and 1980s.

14. It is true that in so doing, the Bank of Japan would forgo the reduction of real outstanding debt that rising levels of inflation greater than a steady 3 percent provides, something that often historically has been used to alleviate wide debt burdens. Yet, by giving up this benefit, the central bank would also avoid the rising interest rates with which today's global financial markets punish countries that are perceived to be attempting to inflate away their debt.

15. It should be noted that when the Bank of Japan was given greater legal independence in April 1996, there were indications that the Bank would adopt an inflation-targeting strategy. While this intent has been affirmed at various points, and reports suggest that some members of the bank's new Monetary Committee are in favor of such a move, such a policy has not yet been adopted in the form of a publicly announced target.

16. Mishkin and Posen (1997) discuss in general terms the operational issues involved in the design of inflation targets.



Institute for International Economics | http://www.iie.com

positive. Because biases in the measurement of inflation mean that CPI inflation of 1.5 to 2 percent is probably consistent with true price stability, and anything lower is actually deflation (let alone the negative measured inflation of today), the target should be greater than that bias.[17] The additional amount above the measurement bias in the short-term inflation target of 3 percent is intended to put enough distance between the target and deflation so that it will be clear that inflation expectations should be positive. Otherwise, imperfect control of inflation could lead to continued deflation and deflationary expectations simply by trying to hit a positive target with too little margin for error on the downside. The target is set for two years ahead both because it usually takes that long for monetary policy moves to fully affect inflation and because encouraging Japanese citizens to look to near-term stability beyond the immediate uncertainty is beneficial. The target should be defined as a 3 percent year-over-year rate of *core* inflation, that is, the change in the CPI excluding the influence of energy and food products. The reason for the exclusion is that there can be changes in inflation from commodity price movements (up and down) that will mask general movements in the price level and in expectations, and the latter are ultimately what count.

## Do Not Rely on Yen Depreciation as a Policy

To the extent that it is a matter of policy choice, further yen depreciation should not be substituted even for part of the necessary fiscal stimulus and, in fact, should actively be discouraged on its own terms. A depreciation would certainly fit the pattern of some Japanese attempts in the 1990s and earlier to make up for slow growth at home by expanding net exports. Krugman (1998a) sees yen depreciation as a natural and agreeable result of aggressively expansionary monetary policy and Sachs (1998) advocates actively seeking to drive down the yen's value. A depreciation of the yen is, in partial equilibrium, stimulative for the Japanese economy by making Japanese goods cheaper abroad. The ultimate goal of Japanese economic policy, however, is sustainable growth, and a yen decline is at best a very indirect way to increase growth and more likely would actually worsen the Japanese situation.[18] When the yen depreciates, it significantly affects economies throughout East Asia, even ones such as China, with which

---

17. This is true for all countries, because basket-based measures of the cost of living inherently take poor account of quality improvements and changing tastes, even though public discussion of this fact has largely been confined to the United States. See Shapiro and Wilcox (1996) and Advisory Commission to Study the Consumer Price Index (1996).

18. This leaves aside the fact that the export and import elasticity of exchange rate shifts are not the same for large rapid swings as for smaller or slower ones. In other words, even if a 5 percent yen depreciation increases net exports by a given amount, a 20 percent depreciation in the same time span is unlikely to produce 4 times as large a rise in net exports.



Institute for International Economics | http://www.iie.com

Japan is not in direct export competition.[19] This offsets the direct economic boost to Japan from the yen decline in two ways: first, it lowers growth in East Asia and, thus, demand for Japanese goods from, and returns on Japanese investments in, those countries; second, it increases the likelihood of currency depreciation and devaluation in the rest of East Asia.

Even leaving consciously competitive and political pressures for matching devaluations aside, markets recognizing that the real underlying economic conditions of these countries relative to Japan would not be altered by Japan's nominal move will mark down their respective currencies when the yen declines. As a result, any yen depreciation largely shifts the burden of imports from the East Asian economies onto the G-7 (excluding Japan) rather than improving Japanese growth prospects and diminishes the purchasing power of East Asian consumers in the process. In addition, as discussed in chapter 4, the perception that a declining yen is the source of major trade deficits elsewhere could engender a protectionist response (see Bergsten and Noland 1993).

Two additional major disadvantages arise for Japan from any attempt to drive down the yen, and both are analogous to the negative effects of using excessive inflationary finance to stimulate the economy.[20] First is the hit to Japanese citizens' purchasing power and to the attractiveness of yen-denominated assets, both of which result from a sharp fall in the yen; in a time of precautionary-motivated savings, this further shock to people's sense of wealth could have major effects.[21] The second major disadvantage is the ultimate need for the yen exchange rate to return to some fundamental equilibrium value over the horizon of a few years; just as the existence of excessive inflation would prompt an eventual disinflation, further deviation of the currently undervalued yen from its equilibrium rate will simply require an eventual reversal and then give-back of whatever gains were made on the trade front.[22] As seen in 1993-95, and consistent with past experience, such sharp yen volatility in and of itself imposes costly adjustments on Japanese business.

---

19. Noland, Liu, Robinson, and Wang (1998) analyze in a detailed computable general equilibrium framework the macroeconomic and trade effects of devaluations in the region, with special attention to China.

20. This is only logical because a conscious effort to depreciate a currency is essentially an open-market operation where the central bank prints money with which to purchase foreign exchange, rather than to purchase domestic bonds.

21. It is amazing how much ink can be spilled arguing that savers will respond today to a mounting government obligation 30 years down the road that they may never feel, while the reality that they can lose a significant portion of their purchasing power for imported goods and foreign assets in a matter of weeks is assumed not to be of greater immediate concern.

22. Driver and Wren-Lewis (1998) estimate that the fundamental equilibrium exchange rate in 2000 for the yen is 77-95 to the dollar, far from current levels. Other estimates assume a yen at a long-run average of 100-120 per dollar.



Institute for International Economics | http://www.iie.com

In addition, just as sharp or unanchored increases in the inflation rate risk igniting spirals of inflationary expectations that are incommensurate with the intended policy, exchange rates have a well-established tendency to overshoot, and sometimes, when declining, to occasion a run on the currency (see OECD 1988, 18; Bergsten 1998).[23] As discussed in chapter 4, we have already seen the first signs of capital flight from the Japanese economy and yen-denominated assets—further decline of the yen's value could bring about a true crisis, as we had a taste of in June 1998. For this last reason alone, Japanese policymakers should abjure any conscious effort to depreciate the yen. Luckily, the adoption of the main legs of the program outlined in this chapter should stabilize and then appreciate the yen as well as promote growth directly in a way that yen depreciation cannot. There is no reason to adopt a second-best policy of yen depreciation when there are better alternatives that lack such attendant risks.

## Financial Reform Measures

### Recapitalize Only the Better Banks

There is no issue in the current Japanese economic situation about which there is as much intellectual agreement as the need to recapitalize the viable Japanese banks and close the ones that are not. Current estimates of the outstanding bad loan problem in the Japanese banking system total over 60 trillion yen, up from 48 trillion yen of nonperforming and questionable loans cited in a July 1995 announcement by the Ministry of Finance. It is only logical that the total amount of bad loans would continue to climb without reform, because banks that are already insolvent or close to it have an incentive to continue to take on risky loans in the hope that some will come through. This is an instance of moral hazard in that the shareholders and managers in low or negative net worth banks have incentive to bet what little is left because any further losses will be borne by the taxpayer and the bettors will share fully in any improvement in net worth. Moreover, the continued economic stagnation and deflation make it more difficult for nonfinancial businesses to make their previously set loan payments, also leading to an increase in bad loans. In any event, it would be impossible for the Japanese banking system to recapitalize directly via financial markets today, given the general risk associated with the Japanese banks because the good banks' attributes are not easily separable from the systemic risks and given the sheer size and number of similar securities that would have to be issued at the same time.

23. Dornbusch (1976) gives the original theoretical model for exchange rate overshooting.



Institute for International Economics | http://www.iie.com

In theory, the banks could also recapitalize by cutting back their ratio of loans to capital; in practice, only the good (i.e., solvent) banks have an incentive to do so (as discussed), while Japanese regulators have tended to engage in ''regulatory forbearance'' that encourages weak banks to keep lending rather than take losses. Furthermore, when Japanese banks cut back significantly on lending, as they did in the nascent credit crunch in 1997-98 discussed in chapter 4, economic activity is further sharply contracted.[24] So public injection of trillions of yen into the banking system and public supervision of the disposal of distressed loans, real estate, and other assets are required to restore the Japanese financial system. Government use of the Resolution and Collection Bank to create a liquid market in the disposal of foreclosed real estate, like the activities of the Resolution Trust Corporation in the United States, will be needed. Use of the Resolution and Collection Bank as a ''bridge bank'' to give loans to small businesses alleviates the immediate concern of a credit crunch for small indebted businesses in Japan, but it is a short-term palliative.[25] The underlying and more dangerous problem is the disintermediation of funds from the Japanese private banking system. That is why the focus must be on the restoration of incentives for Japanese savers to keep money in the solvent private-sector banks; in the long run, reintermediation is the only lasting way to alleviate the credit crunch.

Unfortunately, while there is great intellectual agreement on this need for financial reform, there is great political disagreement. A vocal portion of the Japanese public has conveyed an extreme dislike of the idea of using public funds to ''bail out'' failed institutions; a less-public constituency of bankers and regulators has shown a more effective resistance to the idea of sorting out which banks should survive and which should not prior to the injection of government funds. Yet, without a decision to put money only into those banks that are currently solvent or can easily be made so, the Japanese government would be encouraging exactly the behavior that has led to much of the current bad loan situation and spending far more than needed to reestablish the nation's financial system.[26] Markets, recog-

---

24. Mishkin (1991) summarizes the asymmetric information view of financial markets in which contractions in credit decrease the efficiency of allocation of investment to productive projects, leading to further decreases in lending and investment, with harmful effects on growth.

25. In an interview with the *Nihon Keizai Shimbun* on 16 June 1998 LDP Policy Chief Taku Yamasaki ''envisioned turning the semigovernmental bank into a public bank empowered to extend loans to [nonfinancial] corporations by tapping into the *zaito* [FILP] funds.'' This statement reveals a continuing misunderstanding of the uses of an entity like the Resolution Trust Corporation in the United States, which is meant to dispose of loans, marked down, to alleviate financial fragility, and *not* to keep nonbank borrowers afloat.

26. Goldstein (1998) discusses the general problems of fixing failed financial systems following a lending boom if supervision has been lax.



Institute for International Economics | http://www.iie.com

nizing this fact, will continue to punish the entire Japanese financial system so long as the uncertainty over particular banks' viability and their potential obligations to other banks are unresolved.

This will lead to a particularly dangerous instance of adverse selection in the lending market for banks—the only banks that will be willing to pay the current ''Japan premium'' on more than the bare amount necessary to roll over current payments will be those that have the least net worth and the least to lose by gambling with the new capital. Meanwhile the good, or at least better, banks that should be able to borrow at a lower rate absent this general uncertainty will not attempt to raise capital. Financial markets, recognizing the situation facing them, will cut back on the total capital made available to Japanese finance. Thus, the attachment to the past ''convoy'' or ''no failure'' policies of the Ministry of Finance hurts exactly those banks that are most viable while continuing the cycle of bad lending by the others. A four-wheel drive vehicle, where each wheel helps the others, can navigate slippery patches where normal cars would skid as one tire slips. The same four-wheel drive vehicle can get thoroughly stuck by going so far off-road to a spot that a normal car would not reach. Spinning all four of the vehicle's wheels at once only sinks it further into the muck.

The Ministry of Finance has made some minor headway in sorting out the viable from the insolvent banks. Starting in December 1994, the Ministry officially announced a departure from strict adherence to its ''no failure'' policy and threatened some small banks with being declared insolvent if they did not merge with viable institutions. In December 1997, a Financial Emergency Management Account was created in the Deposit Insurance Corporation and funded with a 10 trillion yen new-bond issue to back deposits and to begin disposing of distressed assets. Recently, that 10 trillion yen was supplemented by two loans of 10 trillion yen each from the Bank of Japan to the Deposit Insurance Corporation. Of the now 30 trillion yen total, 17 trillion has been allocated to the replenishment of deposit insurance funds and 13 trillion has gone into the account for recapitalizing banks (Government of Japan 1998a).

So far, however, there is no evidence that in implementation the Ministry of Finance has been selecting the banks for recapitalization on the basis of solvency rather than injecting the money into the entire system. The amount of money now committed may well be sufficient—at 6 percent of GDP, it is four times the amount allocated in the United States in 1991 under the Financial Institution Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to recapitalize the savings and loan industry, and the total bad loan problem in Japan is not much more than 4 to 5 times the size of the savings and loan crisis in the United States—so it is the *conduct* of the recapitalization that is at issue.[27] Giving money to keep insolvent

---

27. Goldstein (1998, 29) criticizes the use of ''gimmicks'' by Japanese bank regulators—such as postponing implementation of the Basle capital standards or artificially inflating banks' capital stock by allowing the higher of book or market value to be used on equity



Institute for International Economics | http://www.iie.com

banks open, however, will prolong the crisis, add to the accumulation of bad loans, and keep the good banks from getting access to capital. This uncertainty-bred adverse selection will lead to more risk-taking behavior by insolvent banks with Japanese taxpayer's money and *less* rather than more capital available for worthwhile investment. The need to maintain the level of aggregate demand even as credit necessarily contracts during the transition to proper standards is an additional reason for substantial fiscal stimulus to be undertaken simultaneously with financial reform.

The government of Japan should treat the rapid gathering and provision of information regarding bank solvency as a priority matter. The sooner disintermediation can be changed into reallocation among intermediaries and the sooner a tendency toward a harmful run on all banks turns into a beneficial run on bad banks only, the better. Just like mobilization for a natural disaster, the government should be engaged in a crash program of hiring and training new bank inspectors. Over time, Japan's bank supervisory staff (under 300 total) will have to increase in any event, given the size of the banking system, so there is no reason not to accelerate the process. Any young college graduate with a modicum of legal or economics training could be put through a crash course of accounting, finance, and standards in a matter of weeks. Not only would these young people be engaged in public service, they would be reassuring the public that long-time corrupt relationships were not a factor in supervisory decision making. Rather than a standard jobs program, therefore, a ''Civilian Financial Conservation Corps'' would allow these young no-longer-unemployed to do well by doing good. In the interim, and to conduct their training, private-sector auditors could be hired. The market will try to make these judgments of solvency itself, say, through some savers shifting their money into perceived ''too big to fail'' private banks and thereby potentially depriving smaller viable banks of loanable funds. Better for the government to provide accurate information.

## Protect No One but Depositors

As the process of sorting out the insolvent and the viable banks is completed, some of the insolvent banks will have to be shut down. Deposit insurance exists to prevent systemic risk from arising from this process, that is, to prevent the panic of depositors unable to discern whether their bank is or is not viable causing rushes to their banks to withdraw money and in the process shutting down solvent banks and spreading fear. As noted in chapter 4, even with the existence of freshly replenished deposit insurance, there has been some disintermediation in Japan in the last year

---

holdings—in the previous effort to keep banks open. Mishkin (1994) lists reasons why one would generally expect regulators to prefer not to close banks, although it would be in the public's interest to do so.



Institute for International Economics | http://www.iie.com

(namely, a movement of savings out of Japanese private banks and into Postal Savings and foreign banks and a decreasing deposit-to-currency ratio).[28] Importantly, this process has been going on while shareholders in these banks have been taking their own money out. Calomiris (1998, 3) observes that ''[the banks] have chosen to deplete much of their capital via dividend payments. Unbelievably from March 1993 to the present . . . the stockholders of Japan's largest 23 banks managed to remove 1.2 trillion yen from their distressed banks, while those banks recognized cumulative net losses of 2.2 trillion yen.'' In other words, Japanese bank managers and shareholders are being allowed to increase the likelihood of insolvency and the size of the resultant loss to the Deposit Insurance Corporation while Japanese depositors and taxpayers are suffering from greater fear and putting up more of their money. This is a truly immoral instance of moral hazard.

As stated at the outset of this section, what should be done to clean up fragile financial systems is clear. The Japanese government just must decide to do it. Some delay in recognition and even some pandering to the interests of bank shareholders and managers is only to be expected, given supervisors' strong incentives not to rock the boat. The treatment of savings and loans in the United States in the late 1980s until the passage of FIRREA in 1991 is an example of just such a delayed response, so one need not go too deeply into claims about the nature of the Japanese system to explain the delay so far. What is important is that matters not simply be left to the lowest common regulatory denominator now that years of forbearance have only made matters worse.

The first principle is to make sure that bank shareholders retain no rights or equity when their insolvent banks are forced to merge.[29] The firing, if not criminal prosecution as appropriate, of bank managers would also help. The second principle would be to put uninsured creditors at the back of the line, paying off only the 10 million yen per account that is insured. Until now, even when the Deposit Insurance Corporation has paid, it has indirectly protected all depositors in full, by transferring their accounts to the new bank without losses, and has shielded other financial firms that hold onto the failed banks' paper. The best thing that Japanese

---

28. Deposit insurance in Japan covers up to 10 million yen per account in most depository institutions; some of the smaller banks are covered by a different fund, while postal savings accounts are covered by a direct government guarantee. Cargill, Hutchison, and Ito (1997, chapter 6) give details on the institutional development of the deposit insurance system in Japan.

29. Most of the small bank and credit cooperative mergers so far in Japan in the 1990s have allowed shareholders in the failed institutions to trade for some equity in the new bank. In the 1997 ''forced'' merger of the insolvent Hokkaido Takushuko Bank with Hokyo Bank, the largest so far, the Deposit Insurance Corporation (DIC) actually bought shares in the failed bank, thereby rewarding those owners who took bad risks.



Institute for International Economics | http://www.iie.com

financial supervisors can do is to close a sizable failed bank soon, and, with great fanfare, directly pay off depositors up to the 10 million yen limit.

It is possible to change these types of regulatory practices quickly—in 1991, for example, the US Federal Deposit Insurance Corporation (FDIC) imposed losses on only 3 percent of the assets of uninsured depositors at failed banks, whereas by 1993, after the passage of reform legislation (the FDIC Improvement Act [FDICIA]), the FDIC imposed losses on 88 percent of the assets of uninsured depositors at banks it closed (Kaufman 1995). This would be an enormous confidence-building measure for a system whose security is clearly doubted by Japanese savers. It would also serve as a warning to managers and shareholders of those banks that are (or should be) in the process of being closed. Again, it would cost no more public funds, but it would require a change in practice.

The Japanese government not only seems to wish to avoid being strict with deposit insurance now, which is perhaps an understandable if ultimately misguided position given the possibility of panic, it also does not seem to grasp the basic concept of moral hazard for investors *in general*. The ''Big Bang'' financial reforms are slated to significantly liberalize securities markets in Japan in the next two years and break down most of the distinctions between bank and nonbank financial activities. At the same time, the government intends to *extend* rather than contract the safety net, requiring compulsory membership of securities companies in an ''Investor Protection Fund,'' which ''will guarantee up to 10 million yen of client assets for nonprofessional investors'' (Government of Japan 1998a). A cycle of liberalization combined with deposit guarantees leading to aggressive financial activities by institutions unmonitored by investors is exactly what led to the savings and loan crisis in the United States and contributed to the financial boom and bust in Japan following the last round of deregulation in 1986. In short, even if the Japanese government manages to extricate itself from the current situation, it may well be sowing the seeds of the next financial crisis a few years down the road by repeating its mistakes.

## Privatize the Postal Savings System

Given a choice between a savings account with a complete government guarantee offering a high rate of interest on deposits and a similar account with a lower rate of interest and less direct insurance protection, most people would choose the former. As the interest rate differential and the perceived relative credibility of guarantee increase, those people who for whatever reason chose the latter (e.g., free toaster or closer branch location) would begin to switch as well. The Postal Savings system in Japan is just such a ''better mousetrap'' for depositors. With an explicit government guarantee, it pays no cost in deposit insurance premiums, and can offer



Institute for International Economics | http://www.iie.com

better rates of return than can private-sector banks; until recently, this advantage was supplemented by government regulations that allowed the Postal Savings system to offer attractive products that private banks could not.[30] As seen in figures 4.4 and 4.5, the Postal Savings system's share of deposits has been rising since 1990. From a starting point of 30 percent of household deposits (about 30 trillion yen), its total holdings and its share of Japanese deposits have been rising even as total bank deposits in the economy have declined.

This switching of savings institutions in fact constitutes a government-subsidized run on the private banking system. This trend is dangerous because it encourages Japanese savers to deplete the Japanese private financial system of deposits at the same time that those banks need to increase their capital. By emphasizing a safer alternative to even solvent private banks, the Postal Savings system also undercuts any confidence built through correct, prompt action on the part of supervisory authorities. In addition, the existence of such an alternative encourages Japanese savers to believe that a better guarantee than that of the Deposit Insurance Corporation exists and that they should seek investments that are risk free.[31] This is yet another instance of moral hazard, where the existence of insurance diminishes the incentive for the Japanese household to monitor its investments. What is of most concern is that further disintermediation from the Japanese banking system encouraged by the Postal Savings system, out of a combination of both direct movements of deposits into the Postal Savings system and contributions to the general air of distrust of private banks, could provoke a sharp decline in deposits and thereby cut lending to productive investments and cause further contraction in the economy.

Government-supported disintermediation is exactly what the Japanese financial system does not need, either from a view of market efficiency or of confidence building or of easing any credit crunch. Financial intermediation is based on information flows and the proper alignment of incentives for allocating capital. While credit rationing through the withdrawal of banking services (as banks themselves decline in net worth and face lower-quality borrowers) does harm small and bank-dependent companies disproportionately, government lending programs directed at these firms cannot solve the problem. There is good reason on both the information and incentive fronts why public-sector lending is inferior to (properly supervised) private banking. So the combination of Postal Savings with

30. Ito (1992, chapter 8) describes the Postal Savings system and its role.

31. Even though the December 1997 package announcing the 10 trillion yen loan from the Bank of Japan to the DIC made explicit that the DIC was now backed by government funds rather than private insurance premiums, switching has continued. This implies that people perceive a benefit to being in Postal Savings and that the guarantees are not truly equivalent.



Institute for International Economics | http://www.iie.com

FILP lending (via the Bridge Bank) is not a substitute for restoration of the banking system and will just perpetuate capital market inefficiencies.[32] So long as Postal Savings takes in new deposits, the Japanese banking system will be weakened.

The Japanese government should therefore declare an immediate moratorium on new accounts in the Postal Savings system and require depositors who hold more than the 10 million yen guarantee limit to either withdraw their excess balances or roll them into short-term Japanese government bonds. As quickly as possible, the entire Postal Savings system should be privatized. Small savers reluctant to return to the private sector should be offered accounts tied directly to the short-term interest rate of Japanese government bonds (backed by the bonds already in the Postal Savings system's portfolio), that is, ''narrow banking'' should be instituted.[33] Clearly, the privatization of the Postal Savings system would require real political leadership. The Ministry of Post and Telecommunications gains enormous scope for action (as well as size) by having the system under its control; the Ministry of International Trade and Industry as well as the Ministry of Finance gain discretionary control over some sectoral allocation of credit in the Japanese economy through the use of Postal Savings funds in *zaito* (FILP) lending;[34] the saving public with accounts at Postal Savings benefits, of course, from the distortion of credit markets in their favor, although they certainly underestimate, as well, the negative effect on them through Postal Savings' harm to the economy.[35]

Still, any short-run constriction of access to Postal Savings accounts would force Japanese savers to find substitutes for those Postal Savings assets in their portfolio; the primary beneficiaries would be private savings accounts and short-term government bonds (created by this program), because at the margin these would offer the closest substitutes. Movements into either would markedly improve matters by shoring up private bank capital and/or by enhancing the effectiveness of monetary policy on investment. Many OECD economies, including most major European economies, have something analogous to the Japanese Postal Savings system (e.g., the French *Livret*, the German *Postbank*). Though none are

---

32. For a statement of the limitations of and long-run need to replace FILP in the Japanese fiscal and financial framework, see Sakakibara (1998).

33. Kubarych (1998) advocates a wider shift of Japanese savings into mutual funds from banks, which would raise returns (and risks) for the long run.

34. Forty percent of FILP funds come directly from Postal Savings, while close to another 40 percent come from recycling of previous loans (originally funded by Postal Savings as well). This constitutes a leg of Japanese fiscal policy on a par with the Supplementary Budgets (see Schick 1996 and Balassa and Noland 1988).

35. See Dobson and Jacquet (1998) for a discussion of potential gains from international liberalization of financial services.



Institute for International Economics | http://www.iie.com

quite as sizable as the Japanese system, they carry many of the same political protections and costs. All of these are moving toward privatization nonetheless. Of course, the Postal Savings system would have to be broken into chunks rather than allowing one new predominant player.

If the privatization is combined with the prior steps in this chapter's program, that is, with fiscal and monetary policy working to stabilize the yen and raise investment demand and with improved supervisory conduct restoring faith in the right parts of the Japanese private banking sector, the financial system will gain strength through voluntary reallocations. A plan to privatize Postal Savings, perhaps as part of an international agreement on financial liberalization, will strengthen this reallocation trend.[36] The government promotion of private disintermediation through favoring of Postal Savings must be reversed to the full extent politically feasible to reduce the risk of outright financial crisis and panic.

## Is There a Role for the United States?

Clearly, the United States has an enormous interest in the recovery of the Japanese economy. In the current East Asian economic environment, a consistently growing Japan is the most important source of stability for the region; a contracting Japan withdraws capital, diverts exports, puts pressure on currencies, and increases uncertainty throughout East Asia. In addition, an economically weakened Japan is incapable of active partnership with the United States, either directly or through the multilateral institutions, in supporting an open world trading system and stable integrated capital markets, let alone undertaking any necessary reforms therein. Finally, an economically stagnant Japan that runs historically high bilateral trade deficits with the United States while the rest of East Asia has to export to the West to extricate itself from severe recession erodes domestic support in the United States for openness at a critical time.

A clear national interest and the ability to pursue that interest are not necessarily coincident, however. Even after seven years of relative economic decline, Japan remains the world's second largest economy and largest creditor nation. Accordingly, it is not only legally sovereign but in many ways resistant to international economic pressure. Unlike a nation whose mistaken policies lead to a balance of payments crisis that makes it subject to the demands of international creditors and even IMF conditionality, Japan's misguided austerity course causes harm without creating obvious leverage points. Until the threat of outright crisis of the sort described in chapter 4 becomes apparent, as in the sharp decline of the

36. If the move to shrink Postal Savings also contracts the availability of FILP to achieve public objectives, it will improve transparency and accountability of fiscal policy—an added benefit.



Institute for International Economics | http://www.iie.com

yen in early June 1998, the interdependence of the Japanese economy with the rest of the world does not seem to motivate action by the Japanese government. The United States' appeals to Japan to take on a leadership role and efforts at ongoing political pressure have not significantly influenced Japanese policy so far. Yet it is action to preempt an acute new crisis in Japan and East Asia, if not positive efforts from Japan to help to work out the effects of the preceding turmoil, that the United States and the world need from Japan.

What is striking about the limited ability of the United States to date to contribute to a change in Japanese policy is that the specific policies desired are in Japan's self-interest, that is, they would increase domestic Japanese economic growth. While this would shift the pattern of trade balances in the world economy, it would overall be a win-win move, good for both countries (as well as the global economy). Usually, the difficulty in international economic coordination comes in getting agreement on who should bear the burden of difficult adjustments that require budget cuts or interest rate rises, not in getting volunteers to expand their economies. This odd reality underscores one of the basic contentions of this book: Japanese macroeconomic policy is driven by a misunderstanding of the country's economic possibilities and of the gains to Japan from changing policy. The frustration of the United States to date also illustrates a basic gap in the international economic system. No matter how greatly the macroeconomic policies of a major economy may affect the world at large, there is no multilateral institution or system of rules (as exists for international trade) to steer that policy back on course. Instead, leadership and active efforts at international coordination are required.[37]

So, what can and should the United States do to encourage Japanese economic recovery? There are essentially three options open to it: diplomatic pressure, economic brinkmanship, and active cooperation. Diplomatic pressure is the least costly option for the United States. It can range from public statements by US officials calling for Japan to exercise its "leadership role," to behind-the-scenes attempts to bargain over specific policies, to linkages of Japanese economic policy shifts with a broad range of diplomatic relations between the countries. Edward Lincoln (1998), a former US embassy official in Tokyo, has advocated a particularly strong "tough love" version of this strategy. In response to the US frustration, Lincoln suggests that the United States shut out Japan from consultation on a wide range of standing issues, playing on both Japanese fears of "Japan passing" and cultural proclivities to view exclusion as social sanction as well as imposing direct costs on Japan by its loss of voice. Until recently, a weaker version of criticism without exclusion has been the de facto US strategy toward Japan.

37. Bergsten and Henning (1996) discuss the potential role of the G-7 in this regard and its failure to take action in recent years.



Institute for International Economics | http://www.iie.com

There are three major disadvantages to any such approach based on diplomatic pressure. The first is that what is being sought from Japanese policy is a shift in national macroeconomic and financial practices, not a sectoral or other subnational issue. Such a national issue is something that does not respond well to low-level international bargaining. It is a well-established regularity in international relations, both theoretical and empirical, that external pressure can help to effect a policy change when a government wishes to dislodge a domestic special interest and then blame the shift on the international requirements.[38] For national policies, however, such an act can be seen as pure capitulation without obvious repayment by the government and so is not viable domestically. This also explains why the *gaiatsu* (foreign pressure) following the currency intervention of 17 June 1998 seemed to produce the most commitment to progress on financial reform to date (of what commitment there was), because this was a micro issue that could be usefully blamed on outside demands. As discussed above, such reform, while helpful, would be insufficient. In the situation with Japan today, it is not self-evident what change in US macroeconomic policy would be swapped for a Japanese expansion, unlike the instances of successful policy coordination in the 1980s when there were clear steps to be taken by both sides. As a result, the political cost in Japan of seemingly unilateral adjustment may be too great and could even work against Japan's self-interest in such change.

A second, related disadvantage is that macroeconomic policies (such as budget levels and interest rates) are widely viewed as matters of national sovereignty. Especially for a weakly supported government, such as the current LDP majority in Japan, the attraction of scoring domestic political points by standing up to ''outside'' pressure and defending *amour-propre* may be irresistible. Moreover, in the current East Asian context, most of Japan's neighboring nations are perceived as being forced to accede to foreign, particularly US, demands for shifts in economic policies; Japan has a particular interest as the putative regional model and leader to not be seen in the same light. IMF conditionality, for all the criticism leveled at it, at least comes from a multilateral institution, which gives a softer political blow to the economy required to change than does the embarrassment of a demand from another country.

A third disadvantage is the absence of an identifiable audience for such diplomatic pressure. The actions of Japanese policymakers since 1992 and their refusal to actively expand Japan's economy and stabilize the yen, even during the Asian financial crisis, just emphasize how domestically preoccupied current Japanese policymakers are. The bureaucracy of the Ministry of Finance, the standard counterpart to the United States in

38. See the edited volumes of Cooper et al. (1989) and Evans, Jacobson, and Putnam (1993) on two-level games in international relations.



Institute for International Economics | http://www.iie.com

such bilateral relations, especially when the US Treasury is the active US representative as it is today, has both ideological and self-interested reasons for opposing change in policy. It can only help the ministry's internal political standing to be able to characterize pressures for changes in policy as assaults on Japanese autonomy and instances of the United States treating Japan like South Korea and the rest. As discussed in chapter 2, bureaucrats in the Ministry of Finance believe that it is the ministry's job to be guardian of Japanese fiscal probity, if not austerity. Thus, it is no surprise that several years of varying degrees of generalized diplomatic pressure and critical discussion have had little effect on Japanese macroeconomic policies in the 1990s.[39]

The second strategy open to the United States is one of economic brinkmanship. Brinkmanship means making a threat to induce a change in a bargaining partner's behavior, where the threat is made credible by deliberately creating the possibility of a shared punishment not entirely under one's control.[40] This is especially useful if the threatening party might renege on its threats when confronted by a small deviation by its opponent. The classic example was the US commitment to protect western Europe from the Soviets during the Cold War. While the United States could not credibly commit to starting nuclear war with the USSR if just Berlin was taken or if there were incremental incursions, it could credibly threaten that a small risk of nuclear war was always present (especially given the presence of US troops), even if the United States would be trying to prevent war. The United States had to incur a small risk of nuclear war to better deter aggression. Dixit and Nalebuff (1991) illustrate the act of making strategies credible through brinkmanship with an example from *The Maltese Falcon*, a book by Dashiell Hammett: near the end, Gutman and associates have Sam Spade captive in his own apartment. Gutman demands to know where the falcon is, and Spade argues that he does not have to tell Gutman, because only the threat of death would make him talk, but Gutman might not risk killing Spade for then he might lose the falcon forever. The key to the strategy's success is whether Gutman can expose Spade to a level of risk that is unacceptable to Spade without it being a level of risk that is unacceptable to Gutman.

In stylized terms, in the US-Japanese economic relationship right now, the United States can get Japanese economic growth and aid in East Asian stability only if the Japanese give the United States the necessary policy changes of the type discussed here. If the United States directly punishes

---

39. It should be noted that Lincoln (1998, 65-66) makes his suggestion out of frustration, not out of high expectations for the success of the strategy: "Tokyo's response to the Treasury Department's complaints during the past year gives little reason for optimism. Nevertheless, this pressure should continue. American economic policy should also assume that Japan's economy and financial system will perform poorly for years to come. . . ."

40. The classic exposition is given in Schelling (1960, chapters 7 and 8, 1966, chapter 3).



Institute for International Economics | http://www.iie.com

Japan for its unchanging policies, say, through trade barriers, it may bring about exactly what it would like to prevent, that is, further economic contraction in Japan or currency-driven instability in East Asia. The question is whether the United States can create enough risk to compel Japanese change without incurring too much risk itself and, thus, substitute the threat for the action.

There are two major avenues of economic pressure on Japan open to the US government. The first is trade protection: implicitly or explicitly, the Japanese government is reminded that if it continues to run a large bilateral trade surplus with the United States, Congress might enact protectionist measures. The threat is credible because the US executive branch, which does the bargaining, does not control Congress' actions (far from it), and so even if it seems that the US government might cave in on its demands rather than resort to trade barriers, it cannot guarantee that it will not. The second avenue is yen depreciation: as Deputy Treasury Secretary Lawrence Summers set out the scenario in his Senate testimony of 24 June 1998, Japan's repeated refusal to take advantage of the window of opportunity for action bought by the coordinated exchange-rate intervention of a week earlier risked the rapid further decline of the yen. As with Congress, the US government does not perfectly control the foreign markets (far from it), and so even if it might seem that the United States would intervene even if its policy demands were not met, rather than let the yen go into a free fall, it cannot guarantee that such intervention would be successful. Both could be used as the basis for brinkmanship strategies insofar as the United States explicitly brings these to the bargaining table with Japan.

The dangers of economic brinkmanship in the current situation are twofold. First, there is the balancing of risks. Is the amount of increase in the risk either of congressional protectionism or of the yen's rapid fall required to convince Japan that the US threat is credible more than the United States is willing to bear? It would certainly appear that the balance of risks is not clearly in the United States' favor on either issue, because it is the US interest in East Asian stability and the Japanese government's willingness to ignore its region that prompt the issue in the first place. The (risk-weighted) direct cost to the US economy of either protectionism or yen depreciation possibly spinning well beyond the US-Japan bilateral relationship, as well as the likely effect on Japanese growth, which is of course the goal of the exercise, make such a strategy one for those with very strong nerves. As Gutman said to Spade, such matters require ''the most delicate judgment on both sides, because as you know, sir, men are likely to forget in the heat of the action where their best interest lies and let their emotions carry them away.'' It would be irresponsible for the United States to undertake such a gamble in the current situation.

It is the second danger that rules out economic brinkmanship as too dangerous a strategy for the United States to pursue in relationship with



Institute for International Economics | http://www.iie.com

Japan. That danger is the inability of the US government to sufficiently reduce the risk to Japan (and its own interests) should Japan comply. It is one thing to put in place a heightened risk of congressional protectionism or of speculative attack on the yen for bargaining purposes—it is another thing to be unable to get back off the brink after bargaining. Brinkmanship can serve as a strategy only when the threatened party can reduce its risk sufficiently by agreeing. ''Otherwise you are damned if you do and damned if you don't, and there is no incentive to comply'' (Dixit and Nalebuff 1991, 173).

Additionally, in the international economic environment of today, any decline in the yen or rise in US trade barriers not only puts Japanese economic growth at risk, it also raises the disastrous possibility of a cycle of competitive devaluations and trade war in East Asia and beyond. The United States can and should work to prevent such an occurrence whether or not the Japanese economy collapses, because there is far more at stake and there exist other avenues to diminish those risks. Even though a switch to expansionary policy in Japan of the sort advocated earlier in this chapter would be the best way for such risks to be minimized, there are alternative ways to decrease these risks, albeit inferior ones. Thus, US government action to increase the possibility of congressional or speculative pressure might raise US risks without being a useful threat to Japan. Economic brinkmanship with Japan would be misguided, and probably unsuccessful, because decreasing not increasing these risks is the only credible strategy of the United States.

The third strategy open to the United States at this time is active cooperation. Instead of risking costs too great to bear or making ineffectual diplomatic overtures, the United States should seek to create a *positive* bargain with the Japanese government for the two countries to take on a policy initiative together. In more formal bargaining terms, even if increasing the growth rate in Japan is a win-win or positive sum game, Japan has a rational interest in extracting in the form of additional benefits from the United States much of the United States's own profit from the bargain, so long as Japan is willing to risk forgoing the initial gain if the bargain falls through. To the more realistic extent that the Japanese government is torn over or less than convinced of the net benefits of macroeconomic expansion, anything that the United States can do to offer additional benefits contingent upon Japanese expansion makes the move more attractive. These benefits need not solely be economic, and in fact they might be more effective if they were combined with things—such as security relations or international recognition—that Japan cannot attain on its own and that cannot be dismissed by mistaken austerity mind-sets. Some might characterize this as rewarding bad behavior, but the United States' primary interest right now is the contribution of Japanese economic growth to the world economy. Furthermore, the idea of a reputational



Institute for International Economics | http://www.iie.com

problem arising out of this precedent becomes irrelevant because no other country would ever need to be rewarded to pull itself out of a recession (at least since the Great Depression made countries aware of countercyclical policy, most countries have been all too happy to expand their economies for their own sakes).

Efforts to establish active cooperation complement the effects of the above program for Japanese economic recovery, though any unilateral US policy move could not substitute for it. To the extent that any US policy contingent on Japanese changes (e.g., coordinated exchange rate intervention) stimulates capital flow back to Japan and East Asia and stabilizes or appreciates those currencies, it will naturally reduce Japanese and East Asian trade surpluses, the dual of the capital account. Nevertheless, a Japanese shift to growth led by domestic demand, to cite an oft-turned phrase, should be sufficiently sustainable and confidence restoring so as to compensate for forsaking continued attempts to rely on net export growth. Remember, any positive US policy would be *conditional* on the implementation of fiscal expansion, monetary stabilization, and financial reform in Japan, so added capital inflow buying assets, supporting purchasing power, and strengthening banks should only amplify the recovery program's effectiveness.

Short of an interest rate drop in the United States, which would be ruled out as contrary to domestic indicators unless crisis were imminent, there is likely little the American government can offer that would serve as a large inducement. Still, the main problem in promoting recovery from previous international financial crises, from Europe in the 1920s to Latin America in the 1980s, was the difficulties in *recycling capital* back to the debtor countries—having them repeatedly export was only a short-run remedy at best. This applies to Japan because, although it is the largely domestic fears that the returns on yen-denominated assets are not worth the risks of investing that underlie the country's stagnation, the result is unmet demand for liquidity there as well. Thus, should crisis levels of capital flight begin to occur, some interest rate flexibility from the United States may in the end be required.

The role of the US in Japanese recovery, however, is ultimately only a supporting role, so long as it avoids the dangers of economic brinkmanship. The United States-Japan exchange rate intervention of 17 June 1998, combined with explicit G-7 warnings that the markets should not expect too much from Japan too soon and that Japan's time to act is limited, however, seem more likely consistent with a continuation of diplomatic pressure and/or a shift to a yen-depreciation brinkmanship.[41] Expansion-

41. Some commentators have suggested that joint intervention to stabilize the yen was actually a result of direct White House and State Department tactical decisions to ensure a more stable yen/dollar rate during President Clinton's trip to China, perhaps over Treasury Department desires. That would be an interpretation even less suggestive that preparations for high-level coordination between the United States and Japan were in the works.



Institute for International Economics | http://www.iie.com

ary Japanese economic policy in line with the program offered in this chapter will be sufficient to restore Japanese growth without US action. Nothing the United States can do unilaterally can substitute for that shift. It is possible, however, that a strong high-level positive initiative by the United States to coordinate policy with Japan could increase the likelihood of such a shift and of its effectiveness. If Japan fails to cooperate, the United States's efforts should be concentrated on keeping the world trading system open and exchange rate changes constructive rather than competitive, so as to limit the damage of Japan's decline.



Institute for International Economics | http://www.iie.com