# Tapping Possibility of New Macroeconomic Policy

By Tsutomu MIYAGAWA

## Economic Policy After Change of Power

It is almost half a year since the first full-fledged change of government in postwar Japan. The phrase *seiken kotai* (regime change) later won the top award of most popular words/phrases of 2009. During that period, the general public was glued to the new administration's economic policy initiatives such as a plan to abort the decades-old Yamba Dam project in a move to reassess public works projects and the open process of sorting out and curtailing wasteful fiscal spending under a budget review program. Also spotlighted were measures to help small and medium-sized firms struggling to pay back debt. The administration of Prime Minister Yukio Hatoyama thus maintained relatively high support rates of around 50% through the end of 2009. Specific policy measures won a certain level of recognition from some economists. However, criticism remains that the Hatoyama administration's grand vision is still unclear as to how it is going to steer the Japanese economy in the future.

Against this background, Deputy Prime Minister Naoto Kan declared in November 2009, following the release of the government's monthly economic report, that the Japanese economy was in the grip of deflation again. It was the first time in three years and five months that the government officially recognized the downward price trend as deflationary. The government also pointed out the need to take measures to keep the economy from slipping into a double-dip recession. After the declaration, the yen appreciated sharply and stock prices plunged, sparked by fears of debt default in Dubai that hit global financial markets Nov. 27. These factors combined to prompt the government to unveil a plan to compile a larger-than-projected 7.2 trillion yen second supplementary budget for fiscal 2009 through March 2010. The Bank of Japan (BOJ), for its part, expressed its willingness to supply 10 trillion yen in fresh funds to the financial system in three months and even more if necessary. These moves indicate that recovery of the Japanese economy was still erratic even a year after the so-called Lehman shock of September 2008 that led to the financial meltdown worldwide, prompting the government to take traditional fiscal and monetary policy measures to keep the economy afloat.

However, it remains an open question whether traditional macroeconomic policy is really effective. It calls for the government to boost fiscal spending and the central bank to actively funnel funds to private financial institutions in dealing with a recession. Looking back on Japan's economic history, such "core" financial institutions as Yamaichi Securities Co., Hokkaido Takushoku Bank and Long-Term Credit Bank of Japan collapsed successively in 1997 through 1998. During the ensuing recession, the conservative administrations of Prime Ministers Keizo Obuchi and Yoshiro Mori implemented fiscal expansion programs. Falling in step with the government moves, the BOJ adopted an effectively zero interest policy – and later the policy of quantitative credit easing. Despite these fiscal and monetary steps, the Japanese economy remained mired in mild deflation during the first half of the 2000s. It was only after 2003 that economic expansion became palpable for the Japanese public as the mess of swollen structural bad debt, triggered by the burst of the asset-inflated bubble economy in the early 1990s, was resolved to some extent.

## Limits to Traditional Macroeconomic Policy

Why did traditional macroeconomic policy become ineffective? In considering the effects of economic policies, macroeconomics experts in recent years put greater weight than before on the role of "expectations" households and corporations have. Households, for instance, determine their consumption attitudes while mulling the likelihood of tax hikes and pension problems. They are largely well aware that greater fiscal spending helps raise the cumulative balance of outstanding government bonds and prompts the government to raise tax rates in the future, thus resulting in lower household income. Accordingly, even if the government takes measures to lift household income in the short term, they do not have any effect of increasing consumption sustainably. To the contrary, households find it easy to spend even if the government raises taxes as long as they are convinced that revenues from higher taxes will be used to alleviate their future social security burdens. As shown by the *Table (Business cycles in Japan),* since the recession that started in 1997, private consumption marked lower growth rates than before then, regardless of whether the Japanese economy was in a boom or recession. This is because the past successive governments, irrespective of what political party governed the nation, did not adopt policies aimed at ensuring stable future income for Japanese taxpayers.

Slow growth in private consumption indicates that expansion of domestic demand is unlikely, and thus greatly affects corporate capital spending policies. Since the adoption of a near-zero interest policy in 1999, Japanese interest rates have been kept at extremely low levels in disregard of business cycles. Such low rates used to stimulate capital investment, but during the economic recovery period starting in 2002, private capital investment grew at the lowest rate in Japan's past economic recovery periods. This shows corporations had no choice but to shy away from investment in areas with little growth potential even though they stood to benefit from low interest rates and abundant funds.

In this way, both consumption and investment – widely seen as the two main pillars of domestic demand – depend on what the Japanese economy will look like in the future. However, it seems the current government led by the Democratic Party of Japan prioritizes short-term pump-priming measures in its economic policy. The debt relief measures for small and medium-sized firms and the central bank's supply of extra credit to the financial system may help struggling businesses raise the cash needed to finance their daily operations in the immediate term. But such measures seem unlikely to encourage corporations to shift to a more proactive investment stance over the medium to long term. Even if fund-raising conditions are eased, corporations will opt to use funds for safe-haven government bonds rather than for risky investment areas. Actually, Japanese financial institutions have actively increased buying of government bonds since their bad assets were wiped out.

TABLE

**Business cycles in Japan**

| | GDP | Private consumption | Private capital formation | Public capital formation | Net exports |
|---|---|---|---|---|---|
| 1/1980-1/1983 | 2.46 | 2.84 | 0.21 | -0.53 | 15.66 |
| 1/1983-2/1985 | 3.61 | 3.07 | 8.48 | -4.96 | 17.10 |
| 2/1985-4/1986 | 3.44 | 3.12 | 8.47 | 3.65 | -17.18 |
| 4/1986-1/1991 | 5.36 | 4.42 | 11.99 | 3.05 | -8.05 |
| 1/1991-4/1993 | 0.32 | 2.40 | -10.38 | 11.75 | 4.49 |
| 4/1993-1/1997 | 2.93 | 2.81 | 6.24 | -1.74 | -5.14 |
| 1/1997-2/1999 | -0.55 | -1.02 | -2.35 | 4.02 | 13.54 |
| 2/1999-4/2000 | 2.81 | 1.12 | 12.64 | -12.60 | 13.73 |
| 4/2000-1/2002 | -2.45 | 0.71 | -10.83 | 0.03 | -5.25 |
| 1/2002-4/2007 | 1.94 | 1.21 | 4.01 | -7.82 | 32.51 |
| 4/2007-3/2009 | -3.71 | -0.63 | -12.98 | -0.57 | -24.52 |

*Note: 1) Figures denote annual growth rate.*
*2) Growth rate during recession in white column, and during recovery in blue column*
*Source: Economic & Social Research Institute, Cabinet Office, Government of Japan*

## Growth Vision-backed Macroeconomic Policy Needed

As mentioned above, short-term macroeconomic policy measures need to be supported by a medium- to long-term economic vision if they are to be effective. In the market economy, individual economic entities have a variety of medium- to long-term economic views. The economy as a whole develops as such entities are sorted out through market transactions. Since the collapse of the bubble economy, households and corporations have deprived themselves of vitality, with years of economic slump weighing heavily on them. The Japanese economy thus depended to an unprecedentedly large extent on external demand in the current and previous recovery phases.

Under such circumstances, the government must take the leadership in hammering out a growth vision. The phrase "growth policy" may make things uncomfortable for some people as it reminds them of the economic policy pursued by the three successive administrations starting with one led by then Prime Minister Junichiro Koizumi. Following the inauguration of the Koizumi administration, the Japanese economy temporarily picked up on the back of two main economic policies – one for resolving the bad-debt problem and the other for ensuring sustainable economic growth. Such policies, however, obviously left behind numerous negative elements at the same time. Except for a few economists, many did not fully discern the worsening inequality of income distribution as instanced by increased poverty. In hindsight, it would be safe to say the negative aspects of the two economic policies appeared because corporate earnings were not distributed adequately to workers but were largely reserved internally. For corporations, building up their internal reserves may have been a tool to defend against hostile takeover bids in the wave of globalization. But corporations need to recognize that prioritizing internal reserves took a toll on workers.

Thus, a new growth policy must be intended not merely to identify and promote growth industries for the corporate sector. It should also pay consideration to the future direction and shape of household income and social security. Certainly, the current administration has come up with such policy measures in support of socially disadvantaged people as the introduction of child-rearing allowances and a system to provide income support for individual farming households. However, those measures now up for Diet deliberation were proposed sporadically, with little consideration paid to their effects on the Japanese economy as a whole. What is important for the current administration is to consider how to incorporate the household-oriented policy measures into its own growth vision.

Some critics may say there is no need for the government to create any growth vision now that Japan has become a mature country, although such a vision may have been necessary in the era of high economic growth. But it should be noted that Japan's per-capital gross domestic product (GDP) currently ranks as low as 19th in the world in the aftermath of a decade of slump triggered by the collapse of the economic bubble. Besides, China is projected to surpass Japan to become the world's No. 2 economic power next to the United States in 2010, pulling Japan down to third place. GDP is not the only criterion of affluence, indeed.

But if the current situation is left as is, it seems extremely difficult for Japan to maintain the living standard it has built up over the last 60-plus years since the end of World War II. It should be kept in mind that newly emerging economies are rising rapidly in pursuit of material affluence. The wave of globalization has come to a lull in the wake of the Lehman shock. The letup provides Japan with a good – and the last – opportunity to reevaluate its economy's strong and weak points. This will enable the government to create a new economic system in which the fruits of economic growth are adequately distributed to workers. JS

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