Lost Decade and Beyond

By Ito Takatoshi

The Japanese economy has performed poorly in the last 10 years. The news at the beginning of 2002 is hardly any better than the previous decade. The growth rate has turned negative again. We have experienced three recessions in 10 years. The deflationary trend has accelerated and monetary policy does not seem to be effective after the nominal interest rate was lowered again to virtually zero in March 2001. Fiscal spending has been repeatedly employed since 1997. Deficit spending is, however, not desirable any more, despite difficulty in traditional monetary policy, since the ratio of long-term debts to the gross domestic product (GDP) has risen above 130%, and credit rating agencies such as Moody's Investors Services and Standard & Poors have downgraded Japanese government bonds. The unemployment rate has risen above 5%, and worst of all, financial vulnerability has become a concern again. Banks are not able to make enough profits because they have to deal with old and new non-performing loans (NPLs). After writing off NPLs and evaluating equities on their balance sheets at market prices, banks will be undercapitalized.

Japan's economy is in a deflationary spiral – the first time this has happened to any major industrialized country since the Great Depression of the 1930s. Declining consumer prices and asset prices make consumers withhold purchases of durables, and firms delay investment plans. The best investment is to hold on to cash as the "real interest rate" is above 2% (the nominal interest rate is 0% and the inflation rate is -2%). Uncertainties in the future pension system and weak financial institutions make consumers save more. Lower costs in other Asian countries, especially China, induce Japanese firms to invest outside Japan. Deflation is increasing debtors' burden much more than lenders and borrowers anticipated at the time of contracts. In the deflationary spiral, lower consumption and investment lead to the suppression of demand, creating further deflation.

Some economists regard the long-term decline of Japan's economy as inevitable. The overseas investment by the manufacturing sector is causing a "hollowing out" within Japan. Competition with China is going to become intense, and this is also a source of deflation and wage cuts. Although this reasoning is not necessarily correct, policy measures to adapt to the changes in external environment are important. If Japan fails to address the necessary changes in industrial structures as a mature economy, economic growth in the future may suffer.

If the adverse trends such as a declining population, deflation and low economic growth continue, and if Japan does not make serious attempts at fiscal consolidation, then at some point the Japanese government bond market will crash.

Indeed it is difficult to come up with policy measures to lift the Japanese economy out of the deflationary spiral, but the following arguments are noteworthy. One of the most important measures to stop deflation is that the Bank of Japan shows a resolution to stop deflation and takes actual steps. The best way is to adopt inflation targeting to send a strong signal of fighting deflation to the markets.

Conventional monetary policy measures taken by the Bank of Japan through interest rates and intermediation will not work, as the nominal interest rate cannot become negative. In unusual circumstances, unusual monetary policy measures are necessary. Aggressive monetary easing through purchases of real assets, such as stock mutual funds, will be needed.

On the fiscal side, any increase in fiscal deficits will be counterproductive, as it will increase the possibility of a further downgrading of Japanese government bonds. Tax reform and fiscal spending reform should be revenue-neutral, yet it should be demand-stimulating and supply-side enhancing. Radical changes in thinking concerning the fiscal situation are also called for.

Bank supervision has to be totally revamped to force banks to recognize all NPLs (strict classification) and make provision for them. Loans to poorly performing companies have to be stopped and written off, rather than evergreening. If these measures make some banks become seriously undercapitalized, they will have to be nationalized and restructured. The current banking situation – too many banks, too many bankers and too narrow a spread has to be corrected. A lean and mean banking sector has to be formed through bank restructuring and consolidation.

Japanese firms have to be encouraged to make products and services with high technology and significant added-value. Increasing productivity in each firm, rather than protecting jobs, is the key. Even old industries, like agriculture, will have to be transformed to increase productivity in order to open the Japanese market for regional economic integration. The supply-side policy is important. If instead Japan tries to cling to conventional policies with vested interests by closing markets, or if Japan tries to compete with China by lowering domestic wages, then the Japanese economy will slip back to the rank of developing nations. JJTI

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