

MOF Takes a Wrong Policy Course

By Sakamoto Sakae

Ministry of Finance's wrong judgement

It was expected that the Japanese economy would be set on a recovery track in the second half of 1997, but this didn't happen. Instead, pessimism about the economy's future began to prevail through the summer and autumn of the year. The main causes of this are as follows:

- (1) Consumer spending, the main driving force in the economy, has been stagnant since the consumption tax increase in April.
- (2) The automobile industry, the most glamorous member of the manufacturing sector, is doing poorly as sales of four-wheeled motor vehicles have stayed low as a fall-back in demand followed a rush in purchasing just before the consumption tax increase.
- (3) Excess inventories of goods at manufacturing industries, which had been declining since 1996, have been tending to swell again, reflecting the above trend.

Gross domestic product for the April-June period of 1997, announced by the Economic Planning Agency in early September, showed a decline of 11.2% in annual rate from the preceding quarter. The diffusion index announced by the Bank of Japan in its quarterly survey of enterprises (*tankan*) showed a deterioration of business confidence, indicating the possibility of the economy stalling. The stock market, which is a leading indicator of economic activities, presents an equally dismal picture. The Nikkei stock average declined below ¥17,000 in late October, down from more than ¥19,000 at the outset of the year. Bank of Japan Governor Matsushita Yasuo told the media in late October that the process of economic recovery had not disintegrated, but he admitted that economic stagnation was becoming protracted.

An economist for a major bank

described the present condition of the economy saying: "In short, the Japanese economy is now marking time. Personal consumption expenditures and housing investment are stagnant in reaction to the rush in demand prior to the consumption tax increase, and only firm capital investment by industry and strong exports are propping up the economy."

Japanese industry is trying to find a way of survival overseas, considering the promotion of exports to be the only recourse, as domestic demand is hopeless. This is a behavioral pattern repeated by Japanese industry in the past, and the United States government has repeatedly warned Japan not to resort to this old tactic.

U.S. encourages Japan to expand domestic demand

U.S. Secretary of the Treasury Robert Rubin gave a lecture in Seattle, where he made a stopover on Sept. 18 on his way to a Group of Seven meeting in Hong Kong. He said in the lecture: "In Japan, which chairs this G-7 meeting, Prime Minister Hashimoto Ryutaro established an objective early this year, which we welcomed, of encouraging a strong domestic demand-led recovery, and avoiding a significant and sustained rise in the external surplus. It is important to Japan and the U.S. that Japan succeed in these objectives. Recent developments have reinforced concern in financial markets about the strength of domestic demand growth and the risks of a significant sustained rise in Japan's trade surplus."

The weakness in domestic demand in Japan compared to the U.S. and the Japanese economy's dependence on exports were high on the agenda for the G-7 meeting held in Hong Kong on Sept. 20. It was said in an unofficial document for press briefing that the major challenge for Japan was to

achieve the objective of strong domestic demand-led growth. Regarding exports, it was said that the weak yen was inducing Japanese companies to depend on exports and that an excessive fall in the value of the yen should be prevented.

An official statement released by the chairman after the G-7 meeting said: "We agreed that exchange rates should reflect economic fundamentals and that excessive volatility and significant deviations from fundamentals were undesirable. In this context, we emphasized the importance of avoiding excessive deviation where this could lead to the reemergence of large external imbalances." An informed source said that the statement, with its focus on the yen's exchange rate, had been proposed by Japan.

Strong yen or weak yen?

The Ministry of Finance cannot adopt a domestic stimulus package of the traditional type, based on additional budget appropriations for public works projects, because reform of public finances (reduction of the budget deficit) is the supreme imperative for the ministry.

Even though G-7 members are demanding that Japan ensure economic growth led by strong domestic demand, the ministry can prepare only a menu of measures that cannot produce an immediate effect, such as "deregulation" and "liquidization of land." The official discount rate, which is now almost 0%, cannot be lowered further. If the rate is lowered even by a fraction, it will defeat its purpose. Business corporations and individuals would be shocked by this and think that the already poor condition of the economy had worsened, deepening their pessimism even further.

Now that Japan finds itself in such an impasse, the Ministry of Finance seems to have concluded that the exchange

Photo: Kyodo News Service



G-7 in Hong Kong: Japan's over-dependence on exports was high on the agenda

rate is the only tool with which to allay the misgivings in Western and Asian countries toward Japan. However, the foreign exchange market ignored the Hong Kong declaration immediately after the G-7 meeting. Market players doubted that Japan meant business when it said it would arrest further depreciation of the yen, because the expansion of exports on the basis of a weak yen is Japan's last resort to keep its economy afloat.

Deputy Vice-Minister for Financial Affairs Sakakibara Eisuke, known as "Mr. Yen," baffled at this market reaction, expressed strong dissatisfaction with the market players' "superficial" interpretation when he met the press. In response to the protest by "Mr. Yen," the yen's exchange rate once appreciated to less than ¥120 to the U.S. dollar, but later returned to somewhere between ¥120 and ¥125. It seems that the foreign exchange market saw through the Ministry of Finance's tricks and real intentions.

Argument for an income tax cut becomes louder

The tax-raising package (the consumption tax increase and the abolition of the special tax cut) enforced in the spring of 1997 froze consumer spending, which was beginning to recover. The rise in healthcare costs in the autumn dealt an additional blow to consumer morale. At the Japan-U.S. summit in the spring and the G-7 meeting

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Six months after the controversy between Japanese and U.S. finance officials, it has become clear that the Japanese Ministry of Finance made the wrong choice of policy. The people's distrust of the Ministry of Finance, which originated in the clumsy way it handled the failures of financial institutions, has been given additional fuel for exasperation. The ministry's macroeconomic policy fiasco will lend support to the views of Diet members who advocate splitting up the ministry, asserting that it is a useless body. An economist for a major trading company has analyzed and criticized the ministry's economic policy, saying:

"The present policy mix in Japan consists of a credit relaxation and a stringent budget. First, this policy mix has the effect of lowering domestic interest rates. Second, under an open economic system, capital flows out of Japan in search of higher interest rates, which results in depreciation of the yen. Third, the international competitiveness of exports from Japan becomes stronger under a weak yen, and the nation's trade surplus swells. In a nutshell, this policy mix curbs domestic demand and stimulates external demand, so evidently it runs counter to Japan's international commitment to bring about an economic recovery led by domestic demand.

"Therefore," the economist continued, "the government should make a turnaround in its fiscal policy if it

held in Washington around the same time, officials of the U.S. Department of the Treasury repeatedly warned Japan against the deflationary effect (the effect of curbing an economic recovery) of the series of tax increases. The department was critical of the Ministry of Finance's policy of giving priority to a budget deficit reduc-

wants a domestic demand-led economic recovery to start. At this point, an income tax cut is the most desirable action, because an income tax cut will stimulate domestic demand, put upward pressure on domestic interest rates and cause the yen-dollar rate to move in the direction of a stronger yen, which will curb a further expansion of the trade imbalance.

However, the government is hesitating to change its policy course because it is being hamstrung by the fiscal reform imperative (a reduction of the budget deficit). The government should quickly change its policy course because the danger of an economic stall is increasing."

Another upward revision of the yen's rate possible

Probably because the performance of the U.S. economy is outstanding relative to the rest of the G-7 countries, two regular, major demands by the U.S. toward Japan (demand for domestic demand-led expansion of the Japanese economy and for curbing the expansion of Japan's external surplus) are not so strong now as they were in several similar situations in the past. The U.S. motor vehicle industry is watching the Japanese government's policy of allowing the yen to remain weak with a stern eye, but U.S. industry as a whole is not so nervous.

The present U.S. economic euphoria will end eventually, and then the state of affairs in which U.S. industry can afford to be lenient toward Japan will collapse. The Wall Street crash in late October, which Federal Reserve Board Chairman Alan Greenspan described as an adjustment of an excessive rise, may have been a precursor to this. In that event, the U.S. government's tolerant attitude will change, and Japan may be forced to take measures to lead the yen sharply upward, as it had to do several years ago, in order to curb exports. ■

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