

Japan's Economy – Analysis of the Recent Situation and Future Perspectives

(Two-part series – part two)

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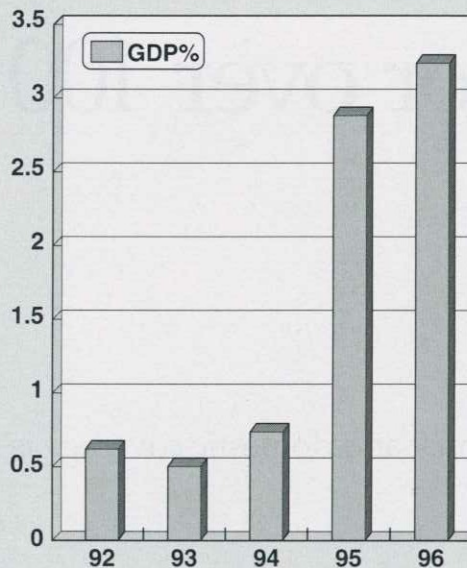
3. Policy Packages for the First Downturn Which Produced Effective Results

● **Eight Economic Stimulus Packages**

from '92-'95 (\$65 billion) to increase public works, private investment and private consumption

● **Official interest rate**

lowered 6 times (to 0.5%)



During the '92-'95 recession, the GOJ implemented a total of eight stimulus packages totalling \$65 billion, and the BOJ lowered its official interest rate six times to a record low of 0.5%. These actions helped to produce the economic recovery shown in the graph, which contradicts the prevailing viewpoints. In '95 and '96, the economic growth rate was around 3%.

An old Japanese proverb says that success always contains the bad seed of the next failure. This economic recovery included two bad seeds.

The first one was the set of political taboos that were created in the process of helping the economy out of its first recession. Despite its success, the GOJ was attacked by the public and the mass media for its excessive

expenditure and huge accumulation of public debt.

The second seed of failure was the GOJ's eagerness to address, expedite and strengthen various reforms, which would undoubtedly have positive effects on Japan's economy in the long run but some negative effects in the short term.

3-(1) Political Taboos Created in Pulling the Economy out of the First Downturn

- (1) No more spending policy
- (2) No more increases in the budget for public works projects
- (3) No more public money for the banking sector

The policy of overspending and the huge accumulation of public debt created three political taboos :

- (1) No more spending in general—spending policy induced the huge accumulation of public debt.
- (2) No more increases in the budget for public works projects—many cases of useless public works projects were revealed.
- (3) No more public money for the banking sector—the initial use of public money was inadequately explained to the public.

Unfortunately, after Japan's economy entered its second downturn, these taboos delayed the relaxation of the policy of fiscal restraint.

3-(2) Six Reforms to be Addressed, Expedited and Strengthened after the Economic Recovery

- (1) Economic Structural Reforms—deregulation
- (2) Banking System Reforms—Big Bang policy
- (3) Fiscal Reconstruction Reforms—tax hike
- (4) Administrative Reforms
- (5) Social Welfare Reforms—premium hike
- (6) Education Reforms

The GOJ thought that a recovering economy would make it possible for the government to take bold steps to implement important reforms. The GOJ realized that Japan needed to carry out structural reforms in various sectors, but the recession prevented it from taking action.

After it succeeded in bringing about an economic recovery, the GOJ felt that it was high time to address, expe-

dite and strengthen six reforms, including a crackdown on the high-cost structure, boosting deregulation in the financial sector, abolishing foreign exchange controls and reducing the corporate tax rate by 4%. It also wanted to change the economic system, reform the stock market, reduce the huge public debt and pursue the goal of fiscal reform.

Unfortunately, these sincere but rather hasty approaches were to be the cause of the second sharp downturn or crisis.

4. The Three Main Factors Behind The Second Downturn

(1) Short-term (or Policy) Factors

The consumption tax hike and the abolition of temporary income tax reductions ignited the second downturn.

(2) Mid-term Factors (Credit Crunch)

The bad loan problem and Big Bang policy induced a credit crunch, which has been a factor behind the current crisis.

(3) Structural Factors

These reduced economic recovery power.

The Japanese economy entered the second downturn in April 1997.

(1) Short-term (or Policy) Factors

The recession was triggered by tax hikes.

- 1) The consumption tax hike (from 3% to 5%) increased the public burden by \$50 billion
- 2) The abolition of the temporary income tax reduction increased the public burden by \$20 billion.
- 3) The social insurance premium hike increased the public burden by \$20 billion.

The total effect of these hikes decreased domestic demand by some 1.5%. The government had been aware of the negative impact of these increases on the economy in the short term, but it felt that it had no real

choice if it wanted to avoid future shortfalls in the social security budget.

(2) Mid-term Factors (Credit Crunch)

After the second downturn began, the credit crunch phenomenon began to spread, contributing to the critical situation that had developed by November 1997.

What were some of the factors behind this credit crunch?

- 1) The Bank of International Settlement requires banks to maintain a capital adequacy ratio of at least 8%.
- 2) During the economic bubble, banks accumulated huge amounts of bad loans.
- 3) The banks tried to reduce the amount of these bad loans, which resulted in a sharp decrease in their capital and assets.
- 4) The Big Bang deregulation program forced banks to speed up the clearance of bad loans and to maintain a capital adequacy ratio of 8%. This led to a shrinkage of lending capacity and some banks virtually stopped extending new loans.
- 5) The bankruptcy of several financial institutions interrupted the smooth flow of money last November.

This credit crunch phenomenon is very dangerous for the Japanese economy, because it leads to a sharp decrease in private investment and creates the following vicious cycle:

credit crunch —► bankruptcy of businesses —► increase of bad loans —► a more serious credit crunch

The widespread feeling that public funds should no longer be used in the banking sector made it difficult for the government to develop a new policy for dealing with the credit crunch.

(3) Structural Factors

The structural factors which I mentioned previously continued to have a negative impact on the economy and substantially weakened its ability to recover.

5. Basic Strategies for The Second Downturn

(1) Adopt measures to end the current dangerous credit crunch

—(\$600 billion) Public money is utilized to replenish the deposit insurance fund and increase banks' capacity to lend money.

(2) Bolster the economy by expanding domestic demand

—change the tax systems to reduce the burdens (for both income tax and corporate tax)
—continue implementation of fiscal stimulus packages

(1) Anti-Credit Crunch Measures

To end the current dangerous credit crunch as soon as possible, the GOJ is implementing a new policy.

The GOJ is already prepared to provide up to \$600 billion of public funds if necessary.

Approximately \$350 billion will be used to replenish the fund for dealing with ailing banks including the protection of depositors. The remaining \$250 billion will be used to help banks to increase their lending capacity.

This policy is also very important to prevent the Asian currency crisis from getting worse and to set the stage for an economic recovery in Asia.

(2) Anti-Recession Measures

Secondly but most importantly, Japan badly needs to bolster its economy as rapidly as possible, not only for our own sake but also for the other ailing Asian economies.

- 1) The GOJ has already implemented income tax reductions worth \$20 billion and corporate tax reductions worth \$10 billion.
- 2) The GOJ is now preparing to reduce these two taxes to the level in other industrialized countries. (around 40% for corporate tax, 50% for the maximum rate of income tax) These measures will reduce the taxpayers' burden by more than \$70 billion.
- 3) The GOJ has already implemented economic stimulus measures worth around \$160 billion from this April.

Now it has announced other fiscal measures amounting to \$240 billion. The emphasis will be on new types of public works projects.

6. Reasons for my Cautiously Optimistic View

- (1) sense of crisis about the current economy
- (2) plenty of funds
- (3) good manufacturing bases supported by traditional and advanced technologies and by big and small firms
- (4) huge market of high-income consumers

I am cautiously optimistic about the future of the Japanese economy.

- 1) First, the Japanese people have already recognized the seriousness of the situation and have begun to take action, based on a sense of crisis.
- 2) Japan still has plenty of capital. It is the largest creditor country in the world and the largest capital supplier to the world market. If it can make full use of this capital, its economy will recover and it will be able to help other Asian countries in various ways.
- 3) Japan is good at producing commodities with basic technology as well as high technology. Japanese manufacturing industries are supported by both large companies and small and medium-sized companies.
- 4) Japan also has a huge consumption market not only in terms of size but also in terms of per-capita income.

These are the reasons why I believe that Japan can come back again.

Questions and Answers

Why does the GOJ maintain a high level of public works spending despite the bad reputation these projects have acquired in the past?

It is true that many people inside and outside Japan including the U.S. gov-

ernment have strong doubts about the value of public works projects;

- 1) because public work projects are notorious for wasting money in some cases (examples include a beautiful road in a mountainous area that only animals use),
- 2) because public work projects have a relatively small effect on economic expansion, compared to past cases,
- 3) because one-shot measures are not effective.

On the other hand, in the midst of this gloomy economic outlook, who, other than the government, can spend money? Even after \$20 billion income tax reductions were made this year, private consumption has actually decreased and private investment is expected to decrease substantially this year. In this context, government spending, especially on public works projects, is important for an economic recovery.

Economic stimulus measures for this recession include income tax reductions and corporate tax reductions, which will expand demand in the private sector in the long run. In the midst of such a deep recession we badly need public works projects or public demand to ignite the fire of economic expansion. Of course, we need new types of public works projects, not the same old ones.

Why do these policy-packages not include a reduction of the consumption tax?

Some U.S. government officials and Japan's Communist Party have the same opinion on this matter. This recommendation for a consumption tax cut may sound attractive but, in my opinion, it is not wise.

Japan's tax structures are overly dependent on direct taxes. Japan's corporate tax rate is one of the highest among the advanced countries, and income tax (maximum rate of 65%) is also too high. Without quick revision of these tax structures, Japan's economy will suffer from a hollowing-out of vigorous industries and capable

personal resources.

Japan is also becoming an aging society at an unprecedentedly high pace, which means that Japan needs to repeatedly raise social insurance premiums.

So from now on Japan will have to shift from direct taxes to indirect ones under a long-term perspective. It is not wise to go in a direction which is the complete opposite of the goal.

Why did the GOJ not take drastic measures that would let ailing banks to go out of business?

The GOJ deeply regretted the past protective policy for banks, and it adopted the bold liberalization measures known as the Big Bang. Drastic measures would have been appropriate if the economic situation was more stable than it is at present.

The Japanese government and people have learned a lot from the recent series of bankruptcies. There are two kinds of crises. If the crisis is not so serious we can let banks to go out of business, but we cannot let this happen during such a severe crisis. The recent bankruptcy of Hokkaido Takushoku Bank clearly demonstrates the devastating impact of a major corporate failure on a regional economy.

What we badly need at present is not the bankruptcy of financial institutions, but a quick recovery of Japan's economy. Under these circumstances we had better choose the policy that economic recovery is more important than a theory that ailing banks should be pushed out of the market.

I am glad to see signs that the U.S. government is beginning to understand the Japanese government's policies for dealing with the serious situation facing Japan, especially after the virtual collapse of the LTMC hedge fund. **UT**

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