Update on the Japanese Economy

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With the arrival of this fall, the Japanese economy seemed to have started to change for the better finally after its long stagnation. This is in view of rising stock prices, improving corporate performance, a positive real growth for seven quarters in a row (though the deflator has been negative for 22 quarters in a row), a rather rosy outcome of the latest Tankan survey, and other positive indicators.

Politically, Koizumi was easily re-elected as the President of the ruling Liberal Democratic Party and triumphantly reshuffled his cabinet and party leadership by almost destroying his party's largest faction. Though the newly merged opposition party advanced at the recent general election, the ruling coalition managed to retain power with the help of Komei-to, which might be a real winner at the election.

On the surface, it seemed at long last that Japan had entered a new stage of recovery and reform. However, there are still several concerns.

The first concern is exchange rates. After the G-7 finance ministers and Central Bank governors stressed the desirability of exchange rate flexibility on September 20th in Dubai, the U.S. dollar has started to fall and the Japanese yen has started to rise, and stock markets have been adversely affected, though not too seriously.

Why has this happened? For some years already, the United States had been almost the only net importer of the last resort for the rest of the world, thereby supporting the economies of other countries. As a result, the U.S. current account deficit had reached 5% of its GDP, but the attractiveness of the American economy and financial markets had managed to maintain capital inflow to cover such a current account deficit, by absorbing about 10% of the gross savings of the rest of the world.

Such a situation had been said to be unsustainable for some years already. However, capital inflow continued -- though increasingly more inflow of official funds rather than private capital -- mostly from the monetary authorities of East Asian countries, particularly China and Japan. These countries had been either pegging or nearly pegging their currencies to the U.S. dollar through massive exchange market intervention and the consequent accumulation of enormous U.S. dollar reserves, which means their continued investment in U.S. government securities.

Such a situation did have some merits both for the United States and for East Asian countries. The continued purchase of U.S. government securities by East Asian central banks financed American twin deficits, one fiscal and the other external; helped to keep U.S. interest rates low and supported American consumption and investment; and thus enabled Americans to continue their purchase of foreign goods and enabled East Asians to continue their export-led growth.

This situation, however, caused many problems as well. The U.S. net external liabilities increased so much that the possibility of the decline of foreign investors' confidence in U.S. economy and financial markets was gradually getting larger. American manufacturers, their employees and those unemployed in this jobless recovery of the American economy complained about the flood of foreign-manufactured goods in the United States, and began to want to see the appreciation of East Asian currencies, particularly Chinese yuan and Japanese yen, and some import restriction of steel and textile. Getting gradually closer to the next Presidential election, such complaints and demands were becoming more vocal and more politica1.

While the dollar's decline against East Asian countries was minimal because of market intervention, the dollar declined mainly against European currencies, just when the continental European economy was suffering from some slowdown, without effective fiscal and monetary stimulus due to the tight fiscal discipline under the Stability Pact and the cautious monetary policy of the European Central Bank. This was the background situation behind U.S. Treasury Secretary Snow's recent repeated emphasis on exchange rate flexibility and the G- 7 statement last September.

Between the current situation and the situation after the Plaza Accord of September 1985, there are similarities as well as differences.

On both occasions, after being overvalued for some time, the dollar began to finally fall. But there are several differences. In 1985 the dollar peaked in February, but started to depreciate drastically only after the Plaza Accord of G-5 countries in September of that year. Thus, the dol1ar’s fall then was primarily government-led. This time, despite the G- 7 statement on exchange rate flexibility, the leading officials of the United States, Japan and China are still repeating that their exchange policies are unchanged. Thus, this time the fall of the dollar is more market-led, though triggered by the G- 7.

Many Japanese had hoped that Americans and Europeans would tolerate Japan's cheap yen policy, since they must have considered Japan’s quick recovery very important for the world even with such an exchange rate policy. But the logics of international economics and American and European domestic politics did not work the way many Japanese had hoped.

The biggest difference between 1985 and 2003 is the difference of economic conditions in Japan. In 1985, we were also worried about the possible negative impact of the sharp rise of Japanese yen on the Japanese economy. But we did have much room to maneuver on both the fiscal and monetary fronts, and the economy was strong enough to continue its growth and expansion.

At present, however, we are in the very early stage of economic recovery, and the recovery itself is primarily exported. The sharp appreciation of Japanese yen will definitely hurt our export sector, the almost only successful sector in the economy. Since China is not expected to revalue its currency too soon, the pressure on Japanese yen may be greater. The response of Japanese manufacturers to such development will be further outsourcing of productive activities to other countries, such as China. In other words, Japanese companies will be able to overcome the rising yen through more globalization but with inevitably adverse impact on the domestic employment.

The second concern is the banking problem. In the past, business upswings used to be initiated by the recovery of smaller companies, because smaller companies who had been crowded out from bank credits by large companies during the boom were able to borrow from banks more easily during the business downswings. This time, however, the recovery seems to have started with export-oriented large manufacturers, but not smaller companies. This is not only because smaller companies themselves are also busy to restructure their management after their excessive expansion during the bubble period, but also because the lending ability of banks has declined due to the accumulation of bad loans.

Bad loans were originally the products of too easy lending decisions by banks and too easy borrowing decisions by borrowers during the bubbles. But even after those bubble-based bad loans have been substantially liquidated, new, originally good loans can become bad loans as long as the economic stagnation continues. In other words, the solution of the bad loan problem is one of the prerequisites to the economic recovery, but without economic recovery the solution of the bad loan problem is not possible. Banks continue to use up their current profits to cover their loan losses.

According to our FSA, the ratio of bad loans to the total bank credits was 8.4% as of the end-March 2002, and the FSA is urging banks to halve this ratio by the end-March 2005. Whether this target will be attained depends on not only banks' determination and supportive schemes but also general economic conditions.

There are many other dilemmas in dealing with the banking problems; generally speaking, dilemmas between the need for immediate financial stability even through rescue operations on the one hand and the need for long-term financial stability through reforms on the other.

Private banks are required to improve their profitability by cutting their costs and increasing their revenue, even through higher lending rates and commissions. But as long as banks concentrate their efforts on their own restructuring, smaller borrowers will continue to have difficulties in receiving new credits. In fact, our regulators have been instructing banks to improve their profitability, and at the same time, have been asking them to lend more to smaller companies. These instructions are said to be confusing bank management.

Japan is still overbanked, and it may be desirable to reduce the number of banks through tougher regulatory demand for the early end of state guaranty of bank deposits or the introduction of differenciated deposit insurance premium, which would force more mergers of weaker banks with stronger banks. But as long as the banking situation is fragile, the too early end of the state guaranty of bank deposits would undermine the public confidence in the financial system. Thus, though time deposits are no longer state-guaranteed beyond 10 million yen per depositor, the state guaranty of ordinary deposits is still maintained.

When Resona Bank was found short of required own capital ratio, public funds were injected, but unlike in the cases of the previous nationalization of Long-Term Credit and Nippon Credit Banks, the interests of Resona's shareholders were all protected. This action was criticized as creating a "moral hazard", but it triggered the recovery of bank share prices and even led to the recovery of share prices in general. Financial markets reacted more favorably to bailing out rather than more disciplined action.

Resona's case also demonstrated a problem of our tax system. After the Financial Supervisory Agency was formed a few years ago, the liquidation of bad loans was urged by the regulator, but without making such liquidation more easily tax exempt. Instead, banks were allowed to include the amount of the possibly later refundable taxed amount in the required amount of own capital. But when Takenaka was appointed as Chief Regulator, he suggested that the amount of such deferred tax assets to be counted into own capital should be reduced without changing tax treatment of bad loans. The tax authorities seem to have no intention to change the tax treatment of bad loans. Such an attitude is the major bottleneck to the conclusion of an effective tripartite written agreement on bank supervision between ASA, MOF and BOJ, whose good model already exists in the United Kingdom between its FSA, Treasury and Bank of England.

The third concern is the issue of reform versus recovery, though I have already touched upon it in connection with banking problems.

Koizumi has been repeating “no recovery without reform", while his opponents in and outside his party argue “no reform without recovery”. Though I personally believe that some recovery is necessary to achieve reform, recovery advocates have problems. Roughly speaking, they seem to be divided into two groups: advocates of fiscal stimulus, and those of monetary stimulus.

Fiscalists rightly emphasize the need to counteract the so-called fallacy of composition, namely the cumulative deflationary effects of restructuring efforts of the private sector, and the need to improve business sentiment possibly with revived stock markets. But most of them are not specific about the steps to be taken, including steps to reduce fiscal imbalances over time, and some of them seem to want to repeat the traditional pork barrel spending increase.

Monetarists generally believe that deflation is primarily a monetary phenomenon, and that further easing of monetary conditions by any means will eventually lead to the rise of prices of assets, such as land, stock and foreign currencies and finally import prices and consumer prices, thus creating inflationary expectations which would accelerate consumption and investment in anticipation of further rise of prices. Many of them also advocate “inflation targeting”, expecting the announcement effects of such a target on financial markets, consumers and investors. But in my view, deflation is not only a monetary phenomenon but also a real economic phenomenon, caused by cyclical factors, such as excess capacity, as well as structural factors, such as demographic changes in Japan, the increased availability of cheaper labor in foreign countries after the end of the cold war, and the technological innovation which has been reducing the costs of production.

There are a variety of reformists, but Koizumi's reformism is more in rhetoric than in substance. Nevertheless, he has been successful at least in reforming faction politics within his own party, by appointing party officials and cabinet ministers by himself, often disregarding the recommendation of faction leaders, though some argue that the election result was not the reform of faction politics but simply the victory of Mori faction over other factions, particularly the Hashimoto faction.

Even in political areas, however, Koizumi's reform plan is by no means perfect. For instance, there has been no attempt to challenge the biggest deficiency of our political system, namely, de-facto hereditary succession of constituencies occupied by conservative politicians, which has been discouraging well-established professionals, bureaucrats and business leaders to enter politics with their rich experience and expertise, due to a kind of seniority system developed in Japanese politics. Here "seniority" means ‘relative frequency of re-election".

In economic areas, the major problems of Koizumi's plans are three at least:

1) the opposition of vested interest groups in and outside the government;

2) the uncertainty about, or probably the lack of, the immediate positive impact of those plans on the recovery of the economy; and

3) the unwillingness or inability of Koizumi to make crucial decisions by himself by outsourcing such decisions to others, often those without political clout.

In my view, the problems of the Postal Savings service and the road agency should be dealt with as a part of the overhaul of the so-called "fiscal investment and loan program", generally known as "Zaito". In addition, the reform of medical care and pension system cannot be postponed either. However, these problems are not only difficult but also time consuming. The formation of more independent, more neutral commissions under well respected chairmen, like Doko at National Railway privatization, might be desirable, in order to avoid unnecessary politicization of these very important issues.

Before closing, I would like to share with you my several observations about the recent general election.

1. The election should have been contested more on foreign policy issues, not only on the steps to be taken or not to be taken by Japan on Iraq and North Korea, but also on the balance between the simple-minded support of the Bush administration on the one hand and more consideration to other members of the international community, particularly East and Southeast Asian countries and the United Nations, on the other.
2. The involuntary retirement of Nakasonene and Miyazawa has reminded us of the need to reform the proportionate representation scheme which now serves mainly to save unsuccessful candidates in single person constituencies.
3. One of the positive results of this election was its contribution through election campaign to better general recognition of the need to reform our pension system. Though views are still divided, important issues seem to have been identified, such as the need to reduce both the burdens of younger generations and the benefits of pensioners and the need to cover a greater part of pension by the government, which might inevitably require some increase in consumption tax.