



Restoring Japan's Economic Growth

Adam S. Posen

INSTITUTE FOR INTERNATIONAL ECONOMICS

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This is preeminently the time to speak the truth, the whole truth, frankly and boldly. Nor need we shrink from honestly facing conditions in our country today. This great Nation will endure as it has endured, will revive and will prosper. So first of all, let me assert my firm belief that the only thing we have to fear is fear itself—nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance . . .

Values have shrunk to fantastic levels; taxes have risen; our ability to pay has fallen; government of all kinds is faced by serious curtailment of income; the means of exchange are frozen in the currents of trade; the withered leaves of industrial enterprise lie on every side; farmers find no markets for their produce; the savings of many years in thousands of families are gone.

More important, a host of unemployed citizens face the grim problem of existence, and an equally great number toil with little return. Only a foolish optimist can deny the dark realities of the moment.

Yet our distress comes from no failure of substance. We are stricken by no plague of locusts. Compared with the perils which our forefathers conquered because they believed and were not afraid, we still have much to be thankful for. Nature still offers her bounty and human efforts have multiplied it. Plenty is at our doorstep, but a generous use of it languishes in the very sight of the supply. Primarily this is because of rulers of the exchange of mankind's goods have failed through their own stubbornness and their own incompetence, have admitted their failure, and have abdicated . . .

Our greatest primary task is to put people to work. This is no unsolvable problem if we face it wisely and courageously . . . There are many ways in which it can be helped, but it can never be helped merely by talking about it. We must act and act quickly.

Finally, in our progress towards a resumption of work we require two safeguards against a return of the evils of the old order: there must be a strict supervision of all banking and credits and investments, so that there will be an end to speculation with other people's money; and there must be provision for an adequate but sound currency . . .

Franklin Delano Roosevelt
First Inaugural Address, 4 March 1933

Preface

Japan is the world's second largest economy and largest surplus and creditor country. Hence, the Institute has devoted extensive and continuing attention to Japanese economic performance, United States-Japan bilateral economic relations, and the impact of Japanese economic policy on the international economy. Our previous publications on these topics include C. Fred Bergsten and William R. Cline's *The United States-Japan Economic Problem* (1985, revised in 1987), Bela Belassa and Marcus Noland's *Japan in the World Economy* (1988), C. Fred Bergsten and Marcus Noland's *Reconcilable Differences? United States-Japan Economic Conflict* (1993), and Yoko Sazanami, Shujiro Urata, and Hiroki Kawai's *Measuring The Costs of Protection in Japan* (1995).

These Japanese economic issues have now become even more critical in light of the Asian financial crisis and Japan's decline from six years of subpar growth into outright recession. An economically weakened Japan, with a sharply declining yen and large trade surpluses, promotes global instability and deprives the rest of East Asia of necessary investment capital and export opportunities. This in turn intensifies the burden of maintaining an open world trading system, uninterrupted financial linkages, and support for the multinational programs necessary for recycling capital back to Asia—in short, the maintenance of an open world economy—on the United States at a time when our domestic political support for that openness is already being severely challenged. For the longer term, the failure of the Japanese economy to right itself in the 1990s, after several decades of spectacular performance in which it was frequently

held up as the economic model for East Asia and elsewhere, raises a fundamental question: "What went wrong?"

In this study, Research Fellow Adam Posen assesses the role of macroeconomic policy in explaining the poor performance of the Japanese economy in the 1990s and its potential role in restoring Japan's economic growth. The analysis demonstrates that there was nothing inevitable about Japanese economic decline in the aftermath of the bubble economy and that the government's combination of fiscal austerity and financial laissez-faire converted a normal cyclical downturn into a deep and persistent stagnation. The Japanese economy suffers from numerous structural inefficiencies which, if reformed, could raise the long-run Japanese economic growth rate—but such factors are not the proximate cause of Japan's slow growth in the 1990s.

Rather than a decline in potential, the problem in Japan has been a failure of the economy to grow at the rate of which it remains capable. Claims that fiscal stimulus was tried and failed in Japan are shown to be false. Serious fiscal stimulus was attempted on only one occasion, in September 1995, and strong growth followed the next year. By contrast, misguided contractionary fiscal policies, notably the consumption tax increase of April 1997, slowed the economy. Moreover, the aging of Japanese society has little to do with appropriate responses to today's crisis, and the current debt position of the Japanese government is far less worrisome than some analysts suggest. Posen argues that the current economic situation in fact presents an ideal opportunity for expansionary fiscal policy to be effective.

Posen offers a program for Japanese economic recovery that combines sizable fiscal stimulus, in the form of permanent income tax cuts, with stabilization of price expectations by means of a 3 percent inflation target and a cleanup of the Japanese banking system. Together, these measures can restore confidence in Japan and thereby induce reinvestment in yen-denominated assets by Japanese and foreign savers. Financial reform will likely have some short-run contractionary effects, as insolvent banks are closed and there is a transitional credit contraction, adding powerfully to the case for linking it with substantial fiscal stimulus. Such a program does not require wholesale reform of the Japanese economy or a lengthy and painful transition in order to reap its benefits. In essence, restoring Japanese economic growth is a matter of policy choice.

This study concludes an Institute trilogy that addresses the Asian (and increasingly global) crisis of 1997-98. Morris Goldstein's *The Asian Financial Crisis: Causes, Cures, and Systemic Implications* (June 1998) delved into the origins of the problem and recommends both direct crisis responses and needed reforms for the international financial architecture. Marcus Noland, Li-Gang Liu, Sherman Robinson, and Zhi Wang's *Global Economic Effects of the Asian Currency Devaluations* (July 1998) assesses the real impact

on the world economy of the crisis to date and the likely response of the United States to the resulting sharp rise in its trade deficit. By addressing the critical Japanese dimension of the issue, this study completes a comprehensive Institute appraisal of both the current problem and what can be done about it.

The Institute for International Economics is a private nonprofit institution for the study and discussion of international economic policy. Its purpose is to analyze important issues in that area and to develop and communicate practical new approaches for dealing with them. The Institute is completely nonpartisan.

The Institute is funded largely by philanthropic foundations and private corporations. Major institutional grants are now being received from The German Marshall Fund of the United States, which created the Institute with a generous commitment of funds in 1981, and from The William M. Keck, Jr. Foundation, The Andrew W. Mellon Foundation, and The Starr Foundation. The GE Fund provides partial support for our research on Asian issues. A number of other foundations and companies also contribute to the highly diversified financial resources of the Institute. About 18 percent of the Institute's expenditures in our latest fiscal year were financed by contributors outside the United States, including about 12 percent from Japan.

Partial funding for this project was provided under our new Akio Morita Studies Program, a program of studies on topics of central interest to the United States and Japan. The program was created in 1997 to honor our distinguished former Director and now Honorary Director, Akio Morita, the cofounder and former CEO of Sony. The Program is funded by the Sony Corporation, the New York Community Trust—the Peter G. Peterson Fund, and Mr. David Rockefeller.

The Board of Directors bears overall responsibility for the Institute and gives general guidance and approval to its research program—including identification of topics that are likely to become important to international economic policymakers over the medium run (generally, one to three years), and which thus should be addressed by the Institute. The Director, working closely with the staff and outside Advisory Committee, is responsible for the development of particular projects and makes the final decision to publish an individual study.

The Institute hopes that its studies and other activities will contribute to building a stronger foundation for international economic policy around the world. We invite readers of these publications to let us know how they think we can best accomplish this objective.

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Director
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Introduction

Economic historians will look back at the 1990s and be struck by the change in relative performance of the world's two major economies. For two decades, the United States had feared economic decline and Japan had led the industrial democracies in rate of growth, even long after catching up to the American level of technology and wealth. Then, in the aftermath of the Japanese asset-price bubble of the 1980s, Japan's economy slowed, stagnated, and finally contracted sharply in 1997-98. Meanwhile, the rest of the Group of Seven (G-7) countries, especially the United States, withstood the initial blows of the Asian financial crisis and recorded outstanding economic performance.

Clearly, something has gone wrong in Japan. Observers, both from within and outside Japan's borders, have offered many combinations of economic diagnoses and policy prescriptions. The coincidence of Japan's turn for the worse with the Asian financial crisis has made proper understanding of Japan's economic plight doubly critical. Because Japan was widely perceived to be the model for the economic miracle in East Asia, the reasons for Japanese economic stagnation in the 1990s will be key evidence in the world's judgment of whether to blame East Asian economic structures for the crisis. The speed and extent of Japan's economic recovery are the most important determinants of the ability of the East Asian economies to come out of the crisis; the extent of Japanese recovery also determines whether the crisis' effects will be contained rather than multiplied and transmitted worldwide.

The long-run meaning and the short-run effects of Japanese economic policies in the 1990s both depend on the answers to two linked questions:

How much growth is enough for Japan? How much can Japanese policy-makers do to attain that rate of growth? For some, Japan's declining performance is proof that the globalizing economy demands ever-higher standards of liberalization and adherence to the market. The key word for them is "reform," meaning change in the basic structure of Japan's economy. As a result, they believe that Japan cannot grow faster than it has been until changes are made, and policy should be radical and microoriented.

For others, they see in Japan's declining performance the result of interest-group deadlock. They believe that a tightly woven and corrupt economic system is at the root of Japan's declining performance. For these observers, the key word is "crisis," meaning a problem so large that interest group ties are wiped out. They believe that Japan should grow once again only when there has been sufficient pain to destroy old ways, and macroeconomic policy should do nothing to stem the tide until that has happened.

A third group sees in Japan's declining performance the mounting burdens of an aging society. The key word for them is "inevitable," meaning that there are binding fundamental limits to short-run growth. They believe that growth now is constrained by the legitimate concern for the future, and policy should adhere to the necessary macroeconomic austerity to provide for that future. Of course, many would combine some or all of these three views in their own diagnosis and cure for Japan's economic decline.

I maintain a different view: Japan's declining economic performance is the result of the domestic macroeconomic and financial policies pursued by Japanese policymakers. The key word for characterizing Japanese economic policy is "mistaken." The stagnation of Japan in the 1990s was anything but inevitable, and it was misguided macroeconomic austerity and financial laissez-faire—not lack of return on investment or political deadlock—that caused it. In the 1990s, Japanese economic policymakers were presented with the opportunity to fight the last war, the demand-shock-caused depression of the 1930s, and they chose to adopt the strategy that lost that war. As a result, growth in Japan could have been much higher in the 1990s than it was.

Today's policy should be one of active macroeconomic expansion to restore that attainable rate of higher growth. The longer that Japanese policymakers leave their economy in decline, the more attainable wealth they forgo for their citizens and the more they risk provoking financial panic in all of East Asia, which could have effects beyond the power of economic policy to easily reverse.

When one focuses on the immediate policy issues, criticism of current Japanese macroeconomic and financial policies is so widespread that the reasons for it are assumed self-evident. Given the role of mistaken ideas

in bringing Japan to this point, it is important, however, to explain in some depth why a shift in Japanese economic policies would be in Japan's own national self-interest. Calls for a switch to "demand-led growth" and for Japan to fulfill its obligations as the world's largest creditor economy have been heard so often and for so long that they sound to some like code words for what the United States wants from Japan. This impression is compounded by the repeated linkage of justified arguments for necessary cleanup of the Japanese banking system with excessive demands for wholesale structural change. Such linkage makes policy demands appear to be the opportunistic resubmission of a long-standing foreign wish list. Moreover, such calls do not address directly the justifications that Japanese policymakers have expressed for their unwillingness to change course. The justifications invoked are indeed mistaken, but must be shown to be based on a misunderstanding of the economics of the current situation in Japan. Finally, analysis should offer an explicit list of appropriate macroeconomic policy responses and their magnitudes rather than merely an exhortation to action. That is what this book will do to address the present urgent policy discussion.

This emphasis on Japan's domestic self-interest is not a matter of cynicism nor of disregard for the external effects of the world's second largest economy. For Japan—or for any other sovereign nation wealthy enough to set its own economic policy—to undertake a shift in its economic policies, its polity must perceive that shift to be in its own interest. History has shown us that major policy choices largely reflect the domestic power of interests and coalitions in a given country. Were domestic interests and coalitions not the dominant source of policy in Japan's East Asian neighbors, for example, their governments would have adapted to global capital flows long before the 1997 crisis. These economies, being smaller and more vulnerable to international pressures, had significantly more to gain from such adaptation than does Japan. Similarly, the lack of international coordination of macroeconomic policies, which produced the sharp swings of the yen against the dollar in the years preceding the Asian crisis, reflected the primacy of domestic concerns in the Group of Three (G-3) countries (though this neglect obviously contributed to international events that have proven domestically damaging in the end). And if this domestic focus is true of any country, it is certainly true of one whose political leadership has been as weakened as that of Japan in recent years.

Yet it is in Japan's self-interest, even narrowly defined to ignore its external environment, to decide that enough is enough. The reality is not only that Japan has been growing painfully slowly for over six years in absolute terms, but that relative to how fast the Japanese economy could have grown even during the 1990s, the shortfall is unprecedentedly large. The Japanese economic situation of the 1990s is the clearest example since

the 1930s of one requiring an appropriate *macroeconomic-policy* response. Comparisons to the aftermath of the 1929 crash come cheap in reference to today's Japan, but the most important historical lesson seems to have been lost. The Great Depression taught us that individually rational optimizing decisions can, under certain circumstances, produce suboptimal economic performance in the aggregate. In less abstract terms, national economies can get trapped in bad situations simply because they respond inadequately to fluctuations in aggregate demand. It is mistaken to see in such an event a change in fundamentals. Macroeconomics exists as a field precisely because national economies are more than the sum of their sector-by-sector efficiencies and waste.

Just as the downturn of 1929-30 became the depression of 1933 when policy mistakes allowed matters to worsen, the Japanese crash of 1992 has become the ill-timed recession of 1997-98 because of government shortsightedness that was highlighted by a return to fiscal contraction in 1996-97. Accumulation of excess capacity and unemployment has eaten at the confidence of Japanese consumers and savers. The resultant rise in fear and uncertainty can turn a recession into a depression if left unchecked by policy, even when those fears stem from the immediate situation and nothing more deeply forward looking. In light of the East Asian economic environment of mid-1998, Japanese households and businesses have ample reason for uncertainty even without the contribution of domestic financial instability.

Broad structural reform cannot substitute for macroeconomic policy response when such a severe decline in aggregate demand occurs, even if these approaches might ultimately complement each other over the long run. Calls for a cleanup of the Japanese bad loan problem, similar to those undertaken in numerous other economies of the Organization for Economic Cooperation and Development (OECD) in the 1980s and 1990s, should not be blown up into an urgent need for the type of comprehensive shock treatment undertaken in New Zealand or the transition economies. In the international policy environment of the 1990s—where there has been a general thrust toward fiscal consolidation and liberalizing deregulation running from the signatories of the Maastricht treaty to the adherents of International Monetary Fund (IMF) austerity programs—it is somewhat understandable that certain Japanese policymakers have forgotten that macroeconomic (i.e., fiscal and monetary) stabilization is irreplaceable. It is also understandable that, when the very advocates of fiscal austerity and structural reform elsewhere have asked Japan to engage in fiscal stimulus, it is seen as contrary to Japan's self-interest even if internationally beneficial.

Still, there is a distinction to be made between recognizing opportunities for further liberalization that over long spans of time can improve economic performance—opportunities that always exist in all economies,

including even today's much praised US economy—and attributing every downturn in national economic performance to overt structural decline. The only *prima facie* case to be made for why Japan's economic structure transformed overnight in 1992 from a model to emulate to something horribly damaging to economic performance is the backward inference that macroeconomic policy has been tried since then but has failed to restore growth. I argue in this book that growth has not returned to Japan because Japanese macroeconomic policy has followed a mistaken course, and the appropriate policies have not been tried. In the present Japanese and international economic environment, substituting structural reform for expansionary macroeconomic policy could be harmful, because the usual short-run effect of such reform is to add to unemployment and excess capacity. Such developments would further fuel Japanese investors' and savers' uncertainty and low expectations, even though sustainable higher growth remains attainable today without such reform. There is no pressing need to forgo stimulating aggregate demand and give up the benefits thereof while waiting for the benefits of further deregulation—the current rate of growth is not enough for Japan.

As it happens, such reversal of austerity would benefit East Asia and the rest of the world as well. It is important that this fact not be used to raise domestic political suspicions about Japan's self-interest in changing policy when it is invoked as an additional reason why Japan should change course. More important, however, Japan must understand that ignoring its external environment is not an option. Public comparisons that focus on explicit lending initiatives to show which countries have “done more for Asian recovery” from the financial crisis are a side show. Without Japanese economic growth at its full potential, East Asian recovery is extremely uncertain and depends all too much on exports to the remainder of the G-7. Without East Asian recovery, Japan will lose significant export, investment, and production opportunities and find its domestic fears heightened. Politically, a Japan that fails to act as a regional leader and global partner when so much is at stake—especially when the action required of Japan is a boon not a sacrifice—will be distrusted for a long time to come.

There are many reasons given for the relative austerity of fiscal policy and the neglect of financial and monetary stabilization in Japan in the 1990s. The first half of this book addresses three related claims that have received significant attention: (1) the stagnation of Japanese growth in the 1990s reflects a decline in Japanese economic fundamentals, not aggregate demand, and so a macroeconomic policy response is inappropriate; (2) significant fiscal stimulus has already been undertaken and failed; and (3) fiscal stimulus is unlikely to have the desired short-run effects, and, moreover, any such benefits of fiscal stimulus now will be outweighed by long-run costs caused by Japan's looming social security burdens.