

<Comments on Naoyuki Yoshino and Eisuke Sakakibara's "The Current State of the Japanese Economy and Remedies" *Asian Economic Papers* vol. 1 no. 2>

**Jeffrey Frankel:** Naoyuki Yoshino and Eisuke Sakakibara present a very clear list of desirable policy changes for Japan, based on an analytical viewpoint that merits serious consideration. Yoshino and Sakakibara's basic point is that the obstacle to expansion today may be the steepness of the IS curve rather than the flatness of the LM curve (i.e., rather than the liquidity trap).

I hesitate in offering my opinion on Japanese economic policies because I am not sure, as of 2002, that we really know for sure what will get the country out of its 10-year slump. Some of the reasons for the spectacular Japanese success during the period that coincided with the Cold War look as good today as they did at that time. They include the postwar land reform and promotion of education, as well as the famous positive attributes of high saving rates, hard work, and attention to quality. To these characteristics I would add a national ability to adapt collectively to new challenges, when the conditions are right. The paper notes the severe economic effects of the 1970s oil shocks and describes the ways in which Japan adapted well to this economic shock. Since the conventional wisdom at present is that Japan is incapable of rapid change, it is worth recalling the earlier evidence to the contrary.

Other shining attributes of the Japanese model, however, have lost their luster. Much that was praised 20 years ago as the secret to success is now decried as the reason for its failure. What has changed little is the tone in which judgment is delivered. In the 1980s,

the U.S. advice to Japan was dominated by the so-called “revisionists,” whose major message can be summarized as follows: “Your institutions are better than ours. This difference constitutes unfair competition. You must become like us.” In the 1990s, U.S. advice was dominated by the triumphalists’ refrain: “Your institutions are worse than ours. This difference is holding back Asia. You must become like us.”

U.S. economists, for the most part, were on the opposite side of the 1980s debate from the revisionists. Nevertheless, when it comes to the nature of the national financial system, even U.S. economists have shared in the about-face. Economists had gone along with the 1980s view that the Japanese financial structure might be an effective way of overcoming the problems of asymmetric information, incentive incompatibility, and short horizons, which were thought to plague the U.S. system. —Attractive features of the Japanese system, delivering a lower cost of capital to Japanese corporations, were thought to include high leverage, long horizons, personal banking relationships rather than arm’s-length capital markets, and corporate governance that emphasizes growth and market share above profitability and stock price— Many analysts now think that the American model has turned out to be better after all, at least for countries that are no longer at early stages of industrialization. For example, the high leverage and relationship banking are appropriate to countries that are in the initial stages of development and have high growth, but they are no longer appropriate when the economy has achieved some degree of convergence with industrialized countries. But in general, I would prefer to avoid the excesses of analysis by hindsight.

The U.S. government has been more consistent over time in its advice to Japan than the pundits have been. For many years, U.S. administrations have urged a combination of deregulatory microeconomic policies and expansionary macroeconomic policies. I agree with this set of recommendations for the current period. (I note in passing, however, that the U.S. admonition that Japan should follow more expansionary fiscal policy has been almost continuous for three decades, and it cannot have been the right answer for all this time.)

Let me elaborate on the case in favor of fiscal expansion with a story. I arrived in the Clinton administration, on the Council of Economic Advisers, in mid-1996. I watched for six months as the Treasury (Summers and Rubin) repeatedly urged Japanese fiscal expansion. At the time, this meant that Tokyo would have to abandon a major increase in the consumption tax that had been long been scheduled to go into effect in April 1997. Finally I asked the Deputy Secretary, “Why are you persisting with this? You know that the Japanese leadership has invested its political capital in the consumption tax; even if they were to have second thoughts, they will never rescind the decision now, for loss of face.” Larry’s answer was, “Yes; I know that they will go ahead with it. But when they do, it will push the Japanese economy back into recession. I want to be in a position to say ‘I told you so,’ so that they will take my advice next time.” This forecast turned out to be prescient, because that is exactly how events unfolded. In the 1990s, at least, the problem looked like a classic shortage of demand, requiring classic demand stimulus.

One can also make a good case against fiscal expansion, at least at this advanced date. Yoshino and Sakakibara argue, with statistics to back them up, that the composition of

public spending is wasteful, particularly the bias toward rural investment. I am convinced they are right. But I am not convinced of their claim that the inefficiency of this public investment leads to a low fiscal multiplier for Japan, if we are talking about the multiplier in the Keynesian sense. Remember Keynes's point about burying bottles with banknotes so that unemployed laborers could dig them up. The repeated rounds of spending occur whether they are a result of wasteful spending or efficient spending. If the initial government project is literally worthless, then the true multiplier pertaining to true real income is decreased by 1, but not from 3 to 1. Furthermore, measured GDP counts a yen of public spending at its full face value, whether or not 100 percent of that yen is spent on public projects. Of course there could well be negative effects on the supply side rather than the demand side.

Another convincing part of Yoshino and Sakakibara's argument is that the rural-biased pattern to public spending is determined by political power. Ten years ago the political scientists would have told us that economic policy reform in Japan would not come until the parliamentary districting system was changed and the LDP's 40-year monopoly on power was broken; at that time, these changes were considered unlikely seismic shifts. In fact, both of those political shifts took place in the early 1990s. But they had almost no perceptible effect on the pace of economic reform. The new prime minister, Mr. Koizumi, is described as both a populist and a reformer. Does that foretell an improvement or a deterioration in the allocation of public spending?

The authors recommend more urban investment than rural investment. They want to "keep the budget tight and change the makeup and regional allocation of public

investment.” I agree regarding the composition of investment. However, the prescription to keep the overall budget tight does not follow from their theoretical framework, namely, an IS curve that is vertical because investment is unresponsive to the interest rate. If this is the right model, then the implication is that Japan needs more fiscal expansion (which is also what the liquidity trap model suggests). Yoshino and Sakakibara mention other factors, such as a high savings rate and high capital mobility, that reduce the multiplier to around 1. I can readily believe that, but those other factors do little to refute the assertion that fiscal expansion might be the only tool available. I understand the reluctance: as of 2002, Japanese debt has become so large that further fiscal expansion might be dangerous. However, a discussion of debt dynamics is missing from this paper. My recommendation for Japan has long been a temporary cut in the consumption tax because it does not threaten long-run fiscal solvency, and unlike other temporary tax cuts this would have a significant effect on spending.

The alternative, of course, is monetary expansion. The paper claims that monetary policy is ineffective because investment is insensitive to the interest rate (IS is vertical, rather than LM horizontal). The interest rate has been driven close to zero, which suggests that more moderate reductions in interest rates were not sufficient to stimulate spending (IS is steep) and that having reached this level, further reductions would in any case be difficult (LM is flat). Regardless, other channels should still work, particularly lower long-term real interest rates and a lower yen. Hence, I would suggest that the Bank of Japan try a concerted program of buying both Japanese Government Bonds (JGBs) and foreign currency, while announcing targets for a positive inflation rate, a depreciated yen, or

both. Incidentally, the foreign currency to be purchased could usefully be euros, rather than dollars.

Microeconomic reforms must include cleaning up the banks, that is, disposing of nonperforming loans. Other important microeconomic reforms include more privatization (e.g., the postal savings system) and more deregulation (e.g., in the construction and retail sectors). As Yoshino and Sakakibara say, no government should guarantee all household bank deposits; the guarantee should only go up to some minimum (e.g., 10 million yen). In addition, Japan should develop better alternative saving vehicles, such as mutual funds, continuing along the lines of the 1997 Big Bang.

Paul Krugman's column in the *New York Times* the day before the conference (25 April 2001) said that Koizumi's restructuring proposals sound like "purging the rottenness from the system," in which case they will be the wrong thing to do. Krugman wants expanding business and lower unemployment, not "companies going bankrupt and increased unemployment." My own advice would be to try everything at once so that both supply and demand are increased. Besides pursuing a more efficient allocation of its spending and the other reforms mentioned by the authors, the government should also implement a temporary cut in the consumption tax, expand the money supply through purchases of JGBs and foreign currency, and announce inflation targets. After a decade of stagnation we are less sure what will work, but that is a reason to try all of the medicines at once.