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A global solution needed to deal with the "Japan problem"

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The Japanese economy has been in a protracted phase of deflation with a large unused production capacity despite monetary policy geared to virtually zero nominal short-term market interest rates and huge increases in the monetary base over a sustained period. Accelerated bank restructuring or further fiscal expansion alone would not correct this situation.

As pointed out by myself as OECD chief economist in the 1994-95 period of yen's sharp appreciation and argued also by some prominent US and European economists including Profs. Allan Meltzer, Jeff Sachs, Joseph Stiglitz and Lars Svensson, an effective way to jump start the economy after the burst of a bubble is aggressive easing of domestic monetary conditions to ward off a deflationary spiral; and once the zero bound to nominal interest rates is reached, it is essential for an open economy in a liquidity trap and recession to resort to another effective stimulative mechanism, namely currency depreciation with the understanding and support of its trade partners.

Between 1993 (a year or so after the burst of a bubble economy) and last year, Japan's share in world merchandise exports declined sharply from 10.0 per cent to 6.6 per cent. During the same period, US share was remarkably stable at around 11 percent and Germany's remained close to 10 percent. Japan's poor export performance in the face of weak domestic demand is largely a result of weaker international price competitiveness associated with the excessively high yen value. This export behaviour of Japan is in sharp contrast to that of countries such as the United Kingdom, Australia and Nordic countries which managed to get out of recessions and to solve balance-sheet problems resulting from sharp declines in domestic real estate and other asset market prices through export-led recovery induced by sharp currency depreciation. The role of monetary policy in many of these countries was to contain inflationary pressure associated with currency depreciation by adoption of numerical inflation targets together with fiscal tightening to improve budget positions and prevent the collapse of the government bond market.

In Japan, instead, a series of expansionary fiscal measures were introduced in vain to reflate the economy battered by the burst of a bubble and turned its fiscal position into the worst among advanced countries. Moreover, despite some short-run ups and downs in the yen exchange rate, international capital market forces, often unrelated to developments in price and wage differentials across countries, tended to exert upward pressure on the yen exchange rate and it continued to follow an uptrend. Sure, from time to time, the Bank of Japan as the agent of the ministry of finance conducted forceful intervention in the foreign exchange market in an attempt to avoid the yen's sharp upswings. But, domestic monetary policy management and foreign exchange market operations remained un-coordinated and the yen exchange rate has remained out of line with international price and wage differentials. Higher nominal wages and other production costs in Japan than in its partner countries have deterred foreign direct investment inflows into Japan and encouraged Japanese direct investment abroad with a result of "hollowing" of Japanese manufacturing industries.

In theory, at unchanged levels of nominal exchange rates, shaper wage cuts and other cost deductions in Japan than in its trade partner countries should help Japanese industries regain international competitiveness and increase foreign demands for Japanese products, inducing a rise in business investment which may in turn raise domestic consumer demand in real terms, if not in nominal terms, over time. But given a low inflation environment in a growing number of competing countries abroad and a certain degree of downward rigidity of nominal wages and prices in Japan, restoration of international competitive positions by undergoing a protracted period of sharper wage cuts and price deflation in Japan is costly. Moreover, continued deflation and lower nominal income will aggravate debtors' balance-sheet positions and increase banks' new bad loans. Currency weakening is a less costly way of adjustment in particular if supported by actions of Japan's trade partners which have room for manoeuvre of conventional macroeconomic policy instruments to offset any undesirable short-run negative demand effects of Japan’s currency adjustment on their economies.

The net effects of a currency depreciation on trade and current account balances of Japan’s trading partners can be very small over time with higher export growth jump-starting Japan’s domestic economic recovery and later increasing its import demand. But, yen exchange adjustment can reduce export volumes and hence aggregate demands in Japan’s trading partners and have adverse consequences on their external accounts at least in the short run. Therefore, they might not extend help to Japan unless they were fully convinced that Japan’s new package deal included measures which would help increase their own economic benefits over the longer term.

With these basic domestic and international considerations in mind, I would propose the following set of policy actions to be jointly taken immediately by the Bank of Japan and the government of Japan.

First, the Bank of Japan should set an operating target in terms of total bank reserves and aim at its annual growth in line with desirable growth of nominal GDP, say 5 percent, with a proviso that an unforeseen increase in demand for bank reserves will be accommodated so that nominal short-term market rates should remain close to zero (endnote). The target level should also be adjusted for foreign exchange market operations, as I shall discuss below.

In the current framework of the Bank of Japan’s policy setting, the role of monetary base is not clearly determined. Its role as a policy indicator should be downgraded in a situation where the general public’s demand for currency, a dominant part of the monetary base, can remain volatile as weakening in the credibility of a number of financial institutions may trigger an un-anticipated shift from bank deposits to currency holdings at a time when interest rates on bank deposits are virtually zero and risks of holding currencies are fairly small (given still low crime rates in Japan). Indeed, slower growth of the monetary base this year relative to last year basically reflects some weakening in the demand for currency after the postponement of the capping of deposit protection, and does not represent a tightening of the stance of monetary policy.

The monetary base should be disaggregated with its currency component used as an indicator and another component, and bank reserves as an operating target if a quantity variable is needed as an operating variable.

Second, the ministry of finance of the Japanese government and the Bank of Japan should jointly announce the target range of the yen exchange rate, say 150 to 160 yen per US dollar. The Japanese authorities should also make it clear that they will intervene in the foreign exchange market openly to prevent the yen rising above the 150 level. Another option would be, as argued by Lars Svensson in his NBER working paper of February this year*, pegging of the yen at 150 or 160 per dollar. In addition, the Bank of Japan should announce its intention to follow a new practice of keeping yen proceeds of foreign exchange market operations in the money market by automatically raising the targeted level of bank reserves by equivalent amounts.

In his first testimony in Japanese parliament, Mr. Fukui, new governor of the Bank of Japan, reportedly said that he would accept a weaker yen to the extent it is a natural reflection of easy domestic monetary conditions. The monetary base rose by more than 30 percent in the course of 2001 and by 20 percent or more over the past year. But such huge increases in monetary base have not been associated with weaker yen. Direct exchange rate targeting was a useful device for domestic economic stabilization in member countries of the European Exchange Rate Mechanism (ERM). In the case of Japan, a mutual support mechanism would not be needed. At least in technical terms, unilateral action by the Japanese authorities to support the US dollar in the foreign exchange market, with agreement with the US authorities, would suffice.

Third, the government should impose a special exchange rate adjustment tax on the marginal corporate profits arising from “wind-fall” increases in incomes associated with yen weakening from the level of say 120 yen to the dollar. This special tax, designed to avoid tensions with foreign producers competing with Japanese firms, would be applied to super-competitive large companies having access to domestic and international capital markets and enjoying financial advantages relative to smaller and medium-sized companies with credit access virtually limited only to borrowings from domestic banks constrained by weak capital bases and not enjoying very low capital market borrowing costs realized by the easy stance of monetary policy.

Fourth, the government should accelerate domestic structural reform and further encourage competition among Japanese and foreign firms in services and other formerly protected sectors of the Japanese economy. Industries and firms not viable in a competitive environment even at an exchange rate remaining within the targeted range should not be protected by overt or covert subsidies.

Fifth, those workers who may lose jobs as a result of their exit from the market should receive government supports for re-training. The programmes should be financed from revenues arising from the special export adjustment tax mentioned above. Part of these revenues may also have to be used for income support of those elder workers who may find it difficult to follow re-training courses.

Sixth, the government should announce a credible medium-term plan for reducing cyclically adjusted fiscal deficits, namely “structural” deficits adjusted for the effects of cyclical changes on tax revenues and expenditures. Automatic stabilizers should be allowed to work, but every effort should be made to cut inefficient government subsidies and to make more “productive” use of budget funds.

Seventh, once these government policies are in place, the Bank of Japan should adopt the price level target to be achieved in a two-year time horizon and announce its intention to move to a regime of inflation targeting once the level target is achieved. Forecasts of general price performance should be published with certain assumptions about the stance of fiscal policy and the yen’s nominal effective exchange rate which is influenced not only by the yen-dollar rate but also by the dollar rates of the Euro and other currencies beyond the control of the Japanese authorities, having implications for Japan’s import prices together with changes in international commodity prices. As price performance particularly over a time horizon of two years or less can be influenced significantly by non-monetary factors as well, factors both monetary and non-monetary, causing discrepancies of outcomes from forecasts should be analyzed in quantitative terms as precisely as possible and the results of such work should be published. In this exercise, the research wing of the Bank of Japan should compete with government and private research institutions.

Eighth Japan should advise Asian partner countries to adopt currency baskets in which the yen's weight should be raised to absorb part of shocks associated with yen exchange adjustment.

Ninth, in the context of preparing the forthcoming economic summit at Evian, France, the Japanese government should argue that like in the United States, some fiscal flexibility be allowed in the European Community countries. In particular, fiscal disciplines imbedded in the growth and stability pact must be adjusted so that targets for budget deficit cuts should be based on structural balances allowing for the working of automatic stabilizers. This would help prevent the euro zone economy from getting into recession in part arising from weaker exports associated with the recent firming of the euro against the US dollar and the yen.

And finally, the Japanese government should take a leading role in the post-Uruguay round of trade liberalization including agricultural products and services. Further opening of Japanese markets should increase the import content of Japanese domestic demand and induce faster growth of Japanese imports relative to the expansion of the size of the domestic market which should grow more rapidly after a jump-start of the Japanese economy triggered by yen exchange rate adjustment.

Some of these policies may be painful to implement. But they are the only way Japan can secure vital support from its trade partners in its efforts to achieve economic recovery through exchange rate and monetary policies.

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* Lars E. O. Svensson, "Monetary Policy and Real Stabilization", NBER Working Paper 9486, February 2003, http://www.uber.org/papers/w9486. See also Kumiharu Shigehara, "Developments in International Policy Co-operation and Japan's Tasks: An Insider's Views", Research Institute of Economy, Trade and Industry, Tokyo, 3 July 2002, http://www.rieti.go.jp/en/events/bbl/02072301.html.