Japan's Growth Challenge

Yutaka Imai*

To anybody's eyes, the Japanese economic situation is improving. Output has been growing since the beginning of 2002, the unemployment rate has started to fall, and a large amount of bad loans has been removed from bank balance sheets. Thus, the Japanese economy is not in crisis by any reasonable standard. Yet, the on-going economic recovery is not solid-based, deflation persists, and the risk of future crisis continues to be non-negligible. To put the economy on a firmer growth path and minimise the risk of future crisis Japan must meet two daunting challenges. One is to revitalise the economy by reallocating public spending towards activities that favour future growth, remobilising resources that are locked into moribund companies, and instilling competitive forces throughout the economy. Another is to manage the reversal of the expansionary macroeconomic policies pursued since the early 1990s which resulted in the level of government debt that is 150 percent of GDP as well as in a massive increase in the stock of base money.

The nature of the current economic recovery

Over the last seven quarters, the Japanese economy grew at an average annual rate of some 2.5 percent, well above the potential growth rate of just over 1 percent so that the output gap has been shrinking. But the base of the economic recovery has been narrow, driven by business fixed investment and exports in certain manufacturing sectors producing cars and IT-related consumer electronics such as digital cameras and plasma TVs and their parts, and raw materials. Investment in these sectors cannot be expected to continue to grow at the very high pace seen so far, and that in other manufacturing sectors is likely to be made outside Japan. At the same time, a large part of non-manufacturing sectors is still holding excess capital stock. In these circumstances, the pace of economic expansion is bound to slow, from the end of next year, according to most forecasters. Moreover, dependent on exports, the current recovery is vulnerable to the exchange rate appreciation and deterioration in the external environment.

Continued weakness of business and residential investment

A key aspect of the on-going recovery is continued weakness of fixed investment other than that in a limited number of manufacturing sectors. Public investment keeps falling at an average annual rate of some 5 percent because of a tight purse. Residential construction, too, continues to fall, reflecting underlying demographic changes, though the pace of decline is being attenuated by very low long-term interest rates and lower land prices. Business fixed investment outside the booming manufacturing sectors remains sluggish, as the labour-intensive production base is shifting abroad, particularly to the rest of Asia, and the non-manufacturing sectors on balance are still suffering from a conundrum of excessive capacity, over-indebtedness, lack of entrepreneurship and too much regulation.

Another key aspect of the current recovery is continuing deflation. Deflation weighs on debtors by preventing real interest rates to become negative – because of zero-bound nominal interest rates and by raising the real value of liabilities. Concerns have often been raised about the possibility of the Japanese economy entering a spiral of falling output and prices through the mechanism of debt deflation. Such risk could materialise if Japan is hit by a big negative shock.

One should not, however, lose sight of the fact that the current deflation is rather mild and steady. It can be seen as a (mechanical) reflection of relative price changes on overall price indices, rather than a generalised fall in all prices. The weight of items with falling prices in the consumer price index (CPI) is now about 60 percent. Furthermore, analy-

* Graduate School of Economics, Osaka University.

sis reported in the last *OECD Survey of Japan* has shown that about one third of the CPI deflation since 1998 can be explained by demand-side factors, and the rest by supply-side factors such as greater import penetration and deregulation. The importance of domestic supply-side factors in explaining deflation is consistent with the fact that real GDP and the GDP deflator have moved in the opposite direction, because if demand factors dominated, then both should move in the same direction. It should also be noted that deflation is greater when measured by the GDP deflator than by the CPI because of a rather sharp fall in the investment deflator, which is likely to be exaggerated by the particular method used to derive this deflator.

Finally, the current recovery is taking place against the backdrop of improving but still fragile balance sheets of banks. In part, improvement has reflected the rebound in stock markets since last April. Banks benefited from capital gains from higher share prices, which more than compensated for capital losses resulting from the correction in bond prices in September. But it has also reflected some genuine efforts by banks to rationalise their operations, more strictly assess asset quality and write off bad loans, though prodded by the Financial Services Agency, the financial regulator. Despite such efforts, at some 7 percent, the ratio of non-performing loans to total loans in major banks remains high and their capital base weak because it relies excessively on deferred-tax assets. The situation is on balance worse in regional banks and smaller banking institutions, though it varies much across individual houses. The scheduled re-introduction of a 10 million yen limit on the protection of ordinary savings accounts in April 2005, in the face of continuing banking sector fragility, could result in bank failure. And, this is the proximate reason why the Japanese authorities are preparing a law that would allow public fund injection in a preventive manner.

Revitalisation of the economy

The underlying problem of the Japanese economy is a misallocation of resources both in public and private sectors. To put the economy on to a higher and more solid growth path it is necessary to reallocate its resources away from activities that preserve inefficiency towards those that contribute to future growth. In the budgetary sphere there has been some progress in this regard since the adoption of a top-down approach by the current government. Spending on public works has been cut and its composition changed in favour of urban infrastructure yielding higher social returns. At the same time, budget allocation to R&D, education and social protection has been increased. The scope for further reallocation of public spending appears to be large in view of the still very high share of public investment in GDP by international comparison.

In the private sector a trend decline in the rate of return on capital is symptomatic of the problem of resource misallocation. With a certain number of exceptions, Japanese companies have failed to adapt to, or seize the opportunities opened up by, a change in environment in which they operate, be it globalisation, development of new technologies or evolving changes in the pattern of demand. To a large extent the determining factor has been the strength of competitive forces facing the companies. Those facing international competition have had no choice but to respond to new challenges, or else disappear. In contrast, those mostly operating in domestic markets and not exposed to severe competitive pressures have not done serious restructuring but have been kept alive by lenient bank attitudes. Resources are thus stuck in such moribund companies that are behind the non-performing loans. Progress has been made in remobilising these resources along with the writing off of bad loans from bank balance sheets, but much remains to be done. On this diagnosis, instilling competitive forces throughout the economy is essential to its revitalisation and requires policies of deregulation/privatisation, promotion of inward foreign direct investment and fight against anti-competition practices.

Failure to adept to changed economic environment

Deregulation has much advanced in Japan since the mid-1980s, though it has been largely limited to economic regulation, and its extent varies across different areas. Where it went further, such as in telecommunications and retail distribution, it has resulted in both a large fall in prices and strong expansion of service volumes. A more recent initiative of urban deregulation, along with lower land prices and increased supply of land in city centres resulting from corporate restructuring, has allowed urban redevelopment on a massive scale, which has helped attenuate the decline in construction activity. Much progress is necessary in putting in place an appropriate regulatory framework in network sectors, a framework that would ensure impartial and independent regulation. Much scope also remains in deregulating public utilities, agriculture, education and social welfare services, but efforts in most of these areas have met strong resistance from respective ministries and vested interest groups. As a way of combating the opposition, the government introduced last spring special structural reform zones which are free of specific regulation requested by local authorities. This initiative made a promising start and could have a substantial impact on nation-wide regulation with the accumulation of successful experience.

Japan has also privatised quite a few public corporations, and reform including privatisation of remaining public corporations is on the policy agenda of the current government. Public corporations deprive private companies of profit opportunities and/or raise the cost of intermediate inputs. Postal savings and postal life insurance are examples of the former, and the notoriously inefficient Japan Highway Corporation is an example of the latter. Privatisation of the Postal Corporation and the Japan Highway Corporation is the top priority of the Koizumi government, though the relevant ministries and vested interest groups are attempting to shape the implementation process to suite their needs. Reform of the Highway Corporation must be carried out in ways which would lead to a reduction of the high costs of transportation, an obstacle to expansion of domestic markets.

Deregulation and privatisation, but too little inward FDI

Introducing foreign competition in the form of direct investment has a large potential in fostering dynamism in domestic markets, as demonstrated by the omni-presence of multinational fast food chains and the dramatic turnaround of Nissan by Renault. But the level of foreign direct investment in Japan remains miniscule at about one percent of GDP. While there is no formal obstacle to the entry of foreign capital, poor quality of regulation and weak enforcement of competition policy in certain respects are often cited as major impediments.

There is considerable room for strengthening the role of the Fair Trade Commission (FTC) as a competition fighter. Sanctions are currently too low to discourage the violation of law; human resources of the FTC are insufficient for the desired task both in quantity and quality; and the selection of the commissioners is not always based on professional competence. A new law is under preparation, notably to raise sanctions and introduce a leniency programme. This, together with the whistleblower protection just enacted, would help counter widespread anti-competitive practice often linked to trade associations.

Managing the macroeconomic policy re-direction

Over the decade to 2001, the Japanese economy grew by 14.5 percent cumulatively. It seems quite likely, however, that without the support of fiscal policy the Japanese economy would have recorded no growth at best in the 1990s. The change in the structural deficit of the general government as a share of GDP (a broad measure of fiscal stimulus) over the same decade corresponds to about two thirds of this cumulative growth of real GDP, and once the multiplier effect is taken into account, the contribution of fiscal policy could arguably be 100 percent. This also suggests that repeated fiscal stimulus failed to spark off a self-sustained growth of the economy. At the same time, this left a legacy of large deficits, rapidly growing public debt and misallocated public spending, notably towards unproductive public works.

The contribution of monetary policy over this period is much harder to evaluate, since monetary conditions are also influenced by exchange rate developments which are difficult to control. Short-term interest rates continued to fall, but with disinflation and deflation, real rates remained between 1 and 2 percent, while the real effective exchange rate of the yen showed a significant swing. Overall, monetary conditions have fluctuated with the movement of the exchange rate but with no obvious trend. On this basis, one could conclude that monetary policy was on balance neutral over the decade to 2001. It should be noted, however, that the Bank of Japan (BOJ) has adopted a new policy approach of quantitative easing under zero policy rate since March 2001, after the historical decision in February 1999 to set the policy rate at zero and a controversial reversal in August 2000 to raise it to 0.25 percent.

The new policy of quantitative easing has been pursued through open-market purchases of securities of longer maturity, notably the 10-year Japanese government bonds. At the same time, the BOJ announced that it would continue this new policy until deflation ends and the risk of relapsing into deflation is virtually eliminated. This resulted in a significant decrease in long-term interest rates as well as the drying out of short-term money markets. The former can be seen as a sort of financial bubble which could exacerbate the eventual fall in bond prices. The latter has resulted in the need of the private sector to hold increased liquidity balances because it cannot rely on the call market, a need which has been accommodated by the BOJ in the name of target for current account balances held at the BOJ.

Reversing the policy stance will become necessary sooner or later and raises difficult issues on both fiscal and monetary fronts, though their nature differs across policies. On the fiscal side, the policy reversal should start as soon as possible. Indeed, the stance for next year is likely to be tightened slightly in the absence of a supplementary budget for the current fiscal year, a plausible assumption given the lack of a call for one typical in a recessionary situation. But the magnitude of fiscal consolidation that would be required to merely stabilise the ratio of public debt to GDP at, say, 180 percent by 2010 is huge (about 10 percent of GDP on a set of reasonable assumptions about output growth and real interest rate). At the same time, spending pressures stemming from the ageing of the population and the realisation of contingent liabilities associated with bank restructuring and loan guarantees will be strong. There is therefore no escaping from implementing some combination of cutting discretionary spending, designing a more parsimonious social security system and raising taxes and social contributions, none of which is popular. While it is desirable to put in place a credible medium-term consolidation programme which spells out concrete measures to achieve a goal, this would be politically difficult since any government that does this would become vulnerable to attack by opposition parties and risks losing the future election. The actual pace of fiscal consolidation is hence likely to be determined by a gradual and sequential implementation of relevant reform as well as by the path of nominal income growth. But the resulting pace of consolidation may be seen as insufficient to ensure public finance sustainability. In that event, the risk premium on government bonds may rise, and this would make fiscal consolidation more difficult.

On the monetary side, the issue is more complicated since the Bank of Japan must convince the market participants that it will unfailingly stick to the policy of quantitative easing even after prices begin to rise, and that it will change its policy only when the risk of relapsing back into deflation becomes infinitestimal. For otherwise long-term interest rates, which are a function of expected future short-term rates, would rise, impeding the economic upswing. The BOJ announced in October a clarification of specific criteria by which the appropriateness of changing policy is assessed. But this still leaves the timing of an actual policy reversal uncertain.

Furthermore, if policy were to change, the required magnitude of tightening would also remain uncertain. The longer the policy of quantitative easing is maintained, the greater the amount of liquidity injected into the economy. Given the currently very low velocity of circulation of base money, it might become difficult to control inflation once prices start to rise. A radical tightening of policy might then become necessary. As markets speculate on both the timing and the size of policy tightening, the risk of financial turbulence may increase.

Policy reversal will be difficult

Prospects

Pulling different threads together, the road ahead for the Japanese economy seems to be rough even in the absence of large negative shocks coming from abroad. Macroeconomic policy reversal could entail financial turbulence if not pursued skillfully and with vigour. Fiscal policy should make consolidation a top priority, while focussing on altering spending allocation in favour of future growth. But such efforts are politically constrained so that progress in both regards may not satisfy the markets. Monetary policy is faced with a delicate task of convincing the markets that there would be no premature tightening, while minimising the extent of tightening required when the risk of falling back to deflation becomes virtually zero. In these circumstances the best insurance policy is to accelerate reform efforts so that growth becomes stronger and more solidly based. The competition-enhancing nature of reform would also help to attenuate eventual inflationary pressures and hence reduce the required amount of monetary tightening.