

**Towards Sustainable Economic Growth in Japan:  
The New Mix of Monetary & Fiscal Policy**

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**Overview of Japan's present situation**

The Japanese economy is again facing turbulent times. The upturn that started in 2002 has faltered, leaving Japan at risk of its fourth recession since the collapse of the bubble. The unemployment rate is at a record high 5.4 per cent, while the rate for young people has reached double-digit levels. Deflation<sup>1</sup>, has persisted for eight years, and poses both a constraint on growth and a risk of a deflationary spiral.

In such a situation, policymakers naturally turn to macroeconomic policies to sustain growth and restore price stability. But beyond their contribution to conjunctural stabilisation, macro policies should also be framed into a long-term perspective. They have to contribute to long-run objectives such as strong and sustainable growth as well as sound public finances. To regain their effectiveness, which is currently hampered by the structural weaknesses of the Japanese economy, they also need the support of good structural policies and courageous economic reforms.

As you all know, economists used to establish a clear-cut distinction between short and long-run policies. But in Japan, as in many other OECD countries, this distinction is now largely blurred and ineffective: structural policies play an important role in short-run stabilisation and fiscal and monetary policies play a crucial role in the long run. So, before engaging into a discussion of monetary and fiscal policies, it may be useful to say a few words about some of the long-term challenges facing Japan.

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<sup>1</sup> As measured by the GDP deflator.

## The long-term problems

Japan's performance has been disappointing over the last decade as its *GDP per capita* fell relative to other OECD countries (Figure 2)<sup>2</sup>. It declined markedly from 84 per cent of the US level in the mid-1990s to 75 per cent today. Japan has thus gone from being one of the richest OECD countries to around the average.

Looking back at the past decade, what has been indeed striking is the sharp deceleration of growth. Japan's rate of potential growth has slowed from 4 per cent in the second half of the 1980s to only around 1 per cent at present (Figure 3).

The key factor explaining the slowdown in potential growth is the deceleration in total factor productivity (TFP) growth<sup>3</sup>. In addition, the contribution of labour has swung from positive to negative, as the secular decline in working hours has outweighed the growth of employment.

The problem is not only that potential growth has weakened. But also that it is still relying too much on capital accumulation, a long time after the collapse of the bubble. In spite of its declining trend over the past decade, the level of business investment remains indeed so high that the capital stock is still outpacing GDP. This continuous increase in the capital to output ratio is a clear sign of over-investment conducive to depressed returns on capital and financial fragility.

To restore potential growth, Japan will have to rely less on production factors such as labour and capital and more on productivity gains. There is little scope indeed for a positive contribution from employment, given the working-age population is now shrinking. The impact of capital accumulation is likely to diminish, as investment continues to drop in a context of persistent "capital overhang".

Making productivity the main source for growth will require audacious economic reforms. Many sectors of the Japanese economy are characterised by weak innovative activity, low productivity and comparatively high prices (Figure 4). Indeed, in many cases the prices of goods and services are more than 50 per cent above the OECD average, suggesting a lack of competition in various sectors. Overall, the

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<sup>2</sup> Measured in purchasing power parity terms.

<sup>3</sup> The TFP contribution shown in the figure -- the smoothed residual in a production function -- essentially reflects efficiency gains.

price level in Japan is 30 per cent above the United States. In this context, the potential gains from increased competition are probably quite large. For Japan, strengthening competition is indeed a top priority.

Given the structural roots of Japan's slowdown, what should be the role of monetary and fiscal policies? Here policy-makers are in a difficult conundrum. The use of fiscal policy is constrained by the rise in public debt to extremely high levels. With high debt comes the risk of a sharp hike in interest rates and/or increased household savings via the Ricardian effect.

The Bank of Japan has lowered short-term interest rates to zero and introduced a policy of quantitative easing. However, this approach has not had a marked impact on monetary aggregates or on the real economy, with bank credit still on the decline. In practice, the impact of monetary policy has been blocked for quite a long time by structural problems in the banking and corporate sectors.

In short, macroeconomic policies are unlikely to get Japan out of its current situation just on their own. What is needed, instead, is a broad-based approach that includes structural reforms to revitalise the business sector and restore the effectiveness of the credit channel, as well as a carefully thought out macro policy mix.

The policy mix I would offer for Japan bears some similarity with what is currently needed in Europe. I do not forget, of course, that the challenges facing the Japanese economy are of a larger magnitude. Curing deflation is much more demanding than preventing it.

Starting with the short-run policy-mix, the task of engineering the recovery should be left to a combination of aggressive structural reforms and very supportive monetary policy, with fiscal policy playing only an auxiliary role, through the free play of automatic stabilisers. In the fiscal area, Japan should give up completely on fine-tuning with its associated paraphernalia of public works supposed to boost domestic demand.

Fiscal policy should be geared, in earnest, to the medium-term with a view to restoring the sustainability of public finances. In combination with vigorous economic reforms, it could also contribute to achieving strong and sustainable economic growth. This means working on the allocation of public spending and the structure of taxation to make them more growth friendly.

Whatever the efforts made on the fiscal front, it will be next to impossible however to restore the sustainability of public finances if, in parallel, deflation is not ended and potential growth is not boosted. That is why the fiscal cost associated to the restructuring of the banking sector should be sheltered from the general consolidation effort.

So, to sum up, Japan needs indeed to implement a new policy mix of monetary and fiscal policies with the crucial help of structural policies, both in the short- and mid-term.

I fully realise all this is easier said than done. In a context where the weight of vested interest and conservatism should never be underestimated. But as a good OECD staff member, I have to make a plea for reforms. That being done, let me get back in more detail into monetary policy and deflation.

It is important to distinguish the current deflationary trend from that which occurred in the 1930s. The current episode is rather mild, with the GDP deflator falling by a cumulative 10 per cent since 1994 and the CPI by 4 per cent since 1998. Gradual price declines of this magnitude are certainly not the underlying cause of Japan's current stagnation but rather a symptom of it.

That is not to say that we should be unconcerned about deflation. Indeed, allowing deflation to continue could be very risky and costly:

- Persistent deflation may degenerate into a deflationary spiral of falling prices, output, profits and employment.
- Deflation will frustrate progress in fiscal consolidation and worsen the non-performing loan problem. Why is deflation potentially so dangerous? Because it acts in several pernicious ways:
  - First, it transfers income from debtors to creditors, who generally have lower marginal propensities to spend. The increased burden on debtors also tends to boost defaults, weakening in the process the financial sector.
  - Second, falling prices provide an incentive to delay spending in anticipation of further price decreases.

- Third, the zero bound on nominal interest rates is keeping real rates too high. Indeed, the real short-term rate in Japan<sup>4</sup> was the third highest in the G-7 in 2002 at 1.6 per cent. Despite the fact that growth itself was one of the lowest at 0.3 per cent. Negative real interest rates are a common monetary policy response to recession. But they are not possible during periods of deflation.
  
- The high real interest rate on government bonds tends to discourage investment in more risky assets.

Given the negative implications of deflation, it is important to take action. And indeed commendable efforts are under way which need to be pursued unflinchingly regardless of political difficulties. In September 2001, the Bank of Japan introduced a policy of quantitative easing that is targeting the current balances of commercial banks. As you all know the target has been raised from 5 trillion yen to a range of 27 to 30 trillion yen most recently. The central bank which finances this operation by purchasing government bonds has promised to continue the policy until deflation ends.

The quantitative approach has been successful in reducing long-term interest rates (Figure 6). Indeed, the yield on ten-year government bonds has fallen from 135 basis points before the introduction of the new policy to less than 50 basis points today. Such a low rate does suggest however there is a bubble in the government bond market. This bubble will unwind quickly once deflation comes to an end and interest rates are again on the rise. A sharp decline in government bond prices will then take place, hurting in the process the balance sheet of the Bank of Japan as well as other institutions, particularly banks.

The quantitative approach has succeeded in boosting base money by 43 per cent since the end of 2000 (Figure 7). However it has failed to lift either the money supply or bank lending, which has continued to decline at a 2½ per cent pace. What has been observed instead is a decrease in the velocity of money. This failure is largely due to weak bank balance sheets and the associated disruption of the credit channel.

The problems in Japan's banking sector are well-known. Non-performing loans amount to 8 per cent of total loans of the major banks or more (Figure 8). Although the banks earn some modest operating profits, the costs stemming from bad loans have undermined their profitability and their capital base.

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<sup>4</sup> Deflated by the private consumption deflator.

According to the FSA, their capital adequacy ratio is indeed very small once we exclude the hypothetical “deferred tax assets”.

To remedy these deficiencies the government has established a goal of reducing the major banks’ stock of NPLs by half to 4 per cent of total lending by March 2005 (Figure 9). I will not dwell on institutional details but it seems that some progress has already been achieved with the stock of NPLs falling from 8.1 per cent to an estimated 7¼ per cent during the six months to March 2003. Maintaining this accelerated pace of bad asset disposal will be key. But it is likely to reduce banks’ capital base, thus creating a need for public funds. A new framework governing the injections of such funds is under development.

At the same time, it is important to enhance bank profitability by reducing the size of a Japanese banking sector suffering from endemic over-capacity. Other priorities should include reducing the role of public financial institutions and upgrading the governance of banks.

In summary, to bring deflation to an end, it is necessary that (Figure 10):

- The Bank of Japan should continue an aggressive approach of supplying liquidity. However, establishing specific targets for current balances of banks does not seem to be a useful element in this strategy. It is important for the Bank to diversify asset purchases as a way to limit the distortions associated with the quantitative approach. The plan to include asset-backed securities is a step in the right direction.
- Improving the health of the banking sector is essential to re-establish the transmission mechanism of monetary policy. The FSA should tackle the NPL aggressively to achieve the March 2005 target.
- To revitalise the business sector, further progress on structural reform – such as the creation of special zones – is essential.

### **The role of fiscal policy: restoring sound public finances**

As you all know, there is a huge problem in Japan with the sustainability of public finances. With a budget deficit of more than 7 per cent of GDP last year, the stock of public debt continues to rise,

surpassing 150 per cent of GDP this year (Figure 11). This is the highest ratio in the OECD area and things could be worse without these exceptionally low interest rates you currently enjoy. Indeed, interest payments on the public debt are less than 10 per cent of total government expenditures (Figure 12).

Recognising the threat posed by the large deficit and growing debt, the Ministry of Finance has set a medium-term objective of reducing the primary budget deficit. To stabilise public debt relative to GDP, the primary deficit, currently at 6 per cent of GDP, should fall to 1.3 per cent by 2010. This objective is ambitious although maybe not ambitious enough. It relies in addition on a quick reversal of deflation. Should this reversal fail to materialise, the amount of fiscal consolidation needed would become truly daunting (Figure 14)<sup>5</sup>.

Achieving a positive rate of inflation is indeed a key part to success in fiscal consolidation. Deflation has been associated with a declining share of taxes in GDP, with the impact particularly marked in corporate tax revenue, as the number of firms making profits and paying taxes has fallen. It has also put downward pressure on personal income tax revenue in a context of falling nominal wages.

The government's perspective assumes public expenditures will be frozen at 37 per cent of GDP. Given the unavoidable increases in interest payments and transfers to local governments, this means general expenditures should remain unchanged in real terms. Achieving zero growth in general expenditures is a big challenge. And things will be complicated further by the pressure of population ageing on public spending. Indeed, social security outlays are slated to rise 3.9 per cent in this fiscal year (Figure 16). To offset this increase, spending declines are planned for virtually every other spending category.

Over the medium term, it is officially projected that health and pension outlays will rise by 4 per cent of GDP between 2002 and 2007 (Figure 17). That is to say, strong increases in pension and health

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<sup>5</sup> This target is based on real growth averaging about 1½ per cent a year and deflation ending in FY 2005, replaced by inflation of around 1 per cent. However, if nominal output growth were around 1 per cent a year, a primary budget surplus of 1¾ per cent of GDP would be required to stabilise public debt relative to GDP. An OECD simulation reported in last year's *Economic Survey* showed that if deflation were to continue at a 1¼ to 1½ per cent rate through 2010, the primary budget balance would widen to 8 per cent of GDP, even if the same amount of budget saving as assumed in the government's perspective is achieved (Figure 15). Under this scenario, public debt would rise to 215 per cent of GDP by the end of the decade.

spending will have to be offset by very significant cuts in most discretionary spending categories. We would certainly be on safer grounds if social spending could be curbed through pension and health reforms.

The financial sector is another area that may put upward pressure on government spending. In 1999 and 2000, such expenditures amounted to 1 per cent of GDP (Figure 18). Given the increase in the number of failed institutions and the priority attached to accelerating the disposal of non-performing loans, there may be a need for additional public funds. As I said, such a strategy would be worth a temporary delay in progress toward fiscal consolidation if it were able to restore the monetary transmission channel and allow faster growth.

In the case of Korea, outlays amounting to 27 per cent of GDP were used to restructure the financial system in the wake of the 1997 crisis. This is an enormous sum. However, the restoration of financial health has led to economic growth averaging 7 per cent a year since 1998. The opportunity cost of not repairing the financial sector would have been very high.

Given the commitment to keep government spending constant as a share of GDP, it is essential to improve the allocation of expenditures in ways that will enhance growth prospects. The Ministry of Finance has been granted additional powers that should facilitate the shift of funds into priority areas. One positive sign is the 20 per cent decline in public works spending over the past two years. Moreover, it is important to reduce the reliance on supplementary budgets, which continued last year. Spending in such budgets tends to be less well scrutinised than that in the main budgets.

Given the considerable pressure for more spending, achieving a surplus in the primary budget will certainly mean reversing the downward trend in tax revenues (Figure 19). Tax revenue has fallen from a peak of 22 per cent of GDP in the early 1990s to around 17 per cent. In light of the weak economy, moves to increase tax rates would be premature at this point. Instead, the priority should be to broaden the base, and cut marginal income tax rates to improve incentives. Over the medium-term, the need for higher revenue would require increases in the consumption tax from its current level of 5 per cent.

All in all, I think there is a wide agreement on what should be done on the fiscal side (Figure 20). The problem is now to deliver on these promises to avoid a so-called “implementation gap”. To avoid such a gap, fiscal strategy should be spelled out in much more detail, with specific real spending targets and well specified sets of measures to achieve them.

A few words to conclude this presentation. Japan has been for many years and decades the wonder boy of the OECD. Now some naysayers are presenting Japan as a lost cause. I do not share this point of view. I am convinced that through adequate reforms and stronger momentum Japan has indeed the capacity to become again the envy of the rest of the world.