Japan's lost decade

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Japan is not so much in a cycle as in a rut

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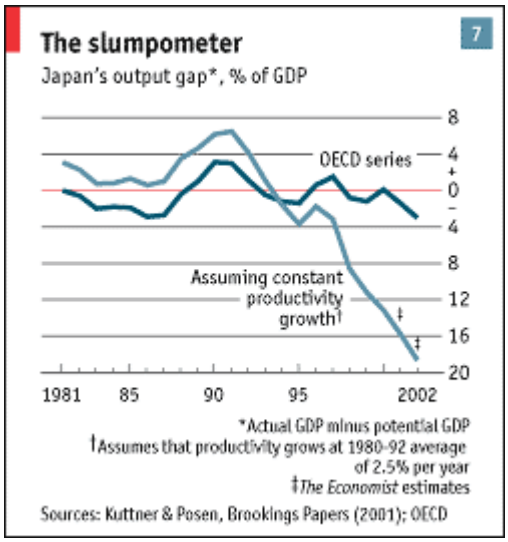

THE annual growth rate in Japan has averaged less than 1% over the past ten years, compared with over 4% in the previous decade. The OECD estimates that Japan's output gap, a measure of spare capacity, is a modest 3% of GDP, but this assumes that its potential growth rate has fallen sharply along with its actual growth. If productivity growth had remained constant at its 1980-92 average, then Japan's output gap would now be a huge 18% of GDP (see chart 7). Assuming that the truth lies somewhere in-between, Japan has suffered the deepest slump in any developed economy since the Great Depression.

Japan's policymakers, unlike America's in the 1930s, appear to have followed the Keynesian textbook: the government's budget has swung from a surplus of 2% of GDP in 1990 to a deficit of 8% of GDP. Yet the economy is still flat on its back. Is this more evidence, as argued in the previous section, that fiscal policy is becoming less effective? Some economists conclude that fiscal policy simply does not work in Japan. The government's debt of 140% of GDP is unsustainable, especially considering the future burden of a rapidly ageing population. Households know that taxes will need to rise, it is argued, so they save more, neutralising the fiscal stimulus.

Kenneth Kuttner, of the New York Fed, and Adam Posen, of the Institute for International Economics, disagree. They argue that fiscal stimuli in Japan in the past decade have been successful in boosting demand. Without them, Japan's economy would have been even weaker. However, the government's fiscal stimulus has been more modest than generally thought. The endless packages announced by the government did not contain as much new money as they appeared to. Most of the increase in the budget deficit has been caused not by public-spending increases or tax cuts, but because tax revenue has automatically shrunk as output has fallen.

Watch that output gap

Widely quoted OECD figures show a big increase in Japan's structural budget deficit during the 1990s. But if, as suggested above, Japan's output gap is really much bigger than the OECD estimates, the discretionary fiscal stimulus must have been smaller. Messrs Kuttner and Posen reckon that since 1997 fiscal policy has been causing output to contract. But in earlier years, when there were genuine tax cuts or spending increases, they did boost GDP.

Far from being ineffective in Japan, fiscal policy might actually work better there than in some other countries, because Japan is relatively closed to international trade and capital. Imports account for only 10% of GDP, the lowest proportion in any OECD country, and capital is still not fully mobile: Japanese savers remain reluctant to move their money abroad in search of higher returns. This captive pool of saving makes it easier to finance debt without pushing up interest rates.

The alarming increase in Japan's public debt has prompted talk in Tokyo about cutting government borrowing. Now is not the time. A rise in taxes would reduce growth and hence tax revenues, thereby increasing the

government's deficit even further. Mr Posen argues that even now it is neither too late nor too costly for Japan to revive its economy by pursuing proper fiscal reflation, financed by the Bank of Japan buying government bonds.

But the shape of any fiscal stimulus is as important as its size. Japan's earlier packages were never designed for maximum macroeconomic effect, but often to help out politically well-connected firms. During the past decade, tax cuts have done much more to stimulate demand than increases in public spending, partly because public works were widely regarded as wasteful. This suggests that a reduction in public works accompanied by an identical cut in taxes would boost GDP.

Martin Feldstein, the president of America's NBER, suggests the use of targeted fiscal incentives. For example, the government could announce that the rate of sales tax was to be cut immediately from 5% to zero for a limited period, after which it would increase gradually to 10% once the economy was growing again. That would give consumers an incentive to buy goods now. It would, in effect, offset deflation, by creating an expectation of rising prices. The immediate revenue loss could be made up by cutting public works, and the future tax increase would put Japan's finances on a sounder path.

Demand or supply?

Some economists think this emphasis on boosting demand is misplaced. Echoing the Austrian economists, they argue that monetary and fiscal stimulus is a narcotic that prevents structural adjustments. Japan's real problem, they say, is the failure of the government to clean up the banking system. Banks keep rolling over bad loans rather than writing them off. This sustains overcapacity as unprofitable firms are kept alive, and locks resources into low-return sectors such as construction and retailing.

In a provocative paper, Robert Dugger and Angel Ubide, economists at Tudor Investments, an American fund-management company, argue that Japan is not in a “liquidity trap” but a “structural trap”, meaning that political and economic obstacles are preventing the reallocation of capital from low-return to higher-return firms. The symptoms—slow growth and deflation—are the same as those of a liquidity trap, but the condition calls for a different policy response.

In a structural trap, loose monetary and fiscal policy can exacerbate deflation and sluggish growth because unproductive but politically important firms are allowed to survive. In Japan public works have propped up inefficient construction firms; subsidies and zero interest rates help troubled firms to stay in business. By perpetuating excess capacity, this feeds deflation.

Messrs Dugger and Ubide argue that if there is strong political resistance to reallocating capital, as in Japan, monetary policy needs to be tighter than if the government were actively attacking the economy's structural rigidities. Higher interest rates, they argue, would force unprofitable firms out of business, eliminate excess capacity and release labour and capital for more productive uses.

However, raising interest rates to eliminate inefficient firms goes well beyond the mandate of any central bank. Moreover, although scrapping excess capacity would improve the return on capital and eventually help to boost growth, in the short term it would worsen deflation as unemployment rose. Much better that the government should clean up the banking sector, forcing banks to write off bad loans, which would cause unprofitable firms to close down. Monetary and fiscal policy could then be used to cushion, not prevent, the painful consequences.

Market rigidities may well blunt the effectiveness of monetary and fiscal policies. For Japan, macroeconomic stimulus and microeconomic reforms are not alternatives: they should be used to complement each other.