

What Went Right in Japan

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Summary of Outlook

Japan’s recovery is strong. Real GDP growth will exceed 4 percent this year and likely be 3 percent or higher in 2005 and perhaps even 2006. The Japanese economy has been growing solidly for the last five quarters (average real 3.2 percent annualized rate), and the pace is sustainable, given Japan’s underlying potential growth rate (which has *risen* to 2 to 2.5 percent per year) and the combination of catch-up growth closing the current output gap and some reforms that will raise the growth rate for quarters to come (though not permanently). Indicators of domestic demand beyond capital investment are increasingly positive, including housing starts bottoming out, inventories drawing down, and diminished deflation. Moreover, on the external side, while China was the main source of export growth in 2003, the composition of exports has become more balanced this year and is widening beyond that seen in other recoveries. Just as in the United States and other developed economies, a sharp slowdown in Chinese growth and a sustained further increase in energy prices represent the primary risks to the outlook.

Improved Policy Underlies the Recovery

Japan’s Great Recession of the 1990s was the result of fiscal, financial, and monetary policy mistakes cutting off the economy’s naturally occurring recoveries. For the last 18 months, however, the Japanese government has gotten out of the Japanese economy’s way. The banking system has responded to better incentives since end FY2002 due to improved supervision and enforcement led by Financial Services Minister Heizo Takenaka, particularly for the merged city and major regional banks. Since Governor Toshihiko Fukui took office in March 2003, the Bank of Japan (BOJ) has credibly committed to keeping interest rates at zero until deflation ends, thereby also improving incentives for consumption and investment. Fiscal policy under Prime Minister Junichiro Koizumi has resisted political pressures for a premature increase in taxation. This sustained recovery in the absence of radical transformation of the Japanese economy bears out the argument in Posen (1998) that the source of Japan’s difficulties was misguided macroeconomic and financial policy, based on an underestimate of potential, and not a fundamental decline of the economy.

The Sources of Current Japanese Recovery

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Economies have a natural tendency towards recovery from downturns. That is why we speak of business cycles and why Japan's persistent stagnation attracted so much interest from macroeconomic researchers. Analysis of the post-bubble period in Japan indicates that prior recoveries were killed off in 1997 and 2000 by varying combinations of fiscal contractions, lack of financial supervision, and excessive monetary tightness. At least as importantly, the overwhelming accumulation of nonperforming loans (NPL) in the Japanese banking system and the behind-the-curve response of monetary policy to recessionary forces (ending with monetary policy constrained by the zero bound on nominal interest rates while deflation began) throughout the decade 1992–2002 were an ongoing drag on the Japanese economy.¹

It is therefore a pleasure to note how normal the current Japanese recovery of eight positive quarters of growth since 2002Q2 is by both international and historical standards. Most importantly, as one would expect, capital expenditure (business investment) has been the leading contributor to growth in the early stages of the recovery, while public expenditure has been on net contractionary (see figure 1).

- The global cycle with a pick-up of manufacturing, particularly in electronics, and ongoing growth in Japanese exports to China and emerging Asia motivated much of the investment at the start. This is fed by a long-term shift of production abroad by Japanese multinationals, as well as demand from China for energy-saving manufacturing equipment from Japan.
- Improved economic expectations and financial-market conditions have finally released pent-up investment demand—while Japan's capital-output ratio remains high, years of underinvestment have made the capital stock antiquated and aided corporate balance sheets. The net growth in capital stock is low, since old capital is being retired at record rates.
- A financial accelerator has generated a two-way improvement in corporate balance sheets and equity prices. The inflow of funds from abroad, who viewed Japan as underweight (and a way to play into China) has also driven up the stock market. Therefore both bank capital and borrower creditworthiness have improved, as well as interest rates have stayed low.
- Some slackening of deflationary pressures has occurred, both as cause and effect of the recovery. While movements in inflation expectations tend to be correlated with future consumption, it is difficult to make too much of this change as yet:
 - On the positive side, Japanese savings rate has declined steadily in recent years. Since demographics had always pushed towards declining Japanese saving over the long term, the recent development should be seen as the removal of precautionary savings motives for households as recovery occurs.
 - On the negative side, much of the decrease in the rate of deflation the past year is due to one-time increases in fees, taxes, and healthcare copayments.
 - The data diverge between CPI-ex fresh food (the BOJ's *de facto* target) and GDP deflator. Both indicate a slowing of deflation, but the GDP deflator shows a greater level/degree of continuing deflation. (The OECD notes that the GDP deflator is heavily distorted in its treatment of investment goods.)

Steady Fiscal Policy

Japanese fiscal policy remains widely, and occasionally wildly, mischaracterized. While the fiscal contraction of 1997 (including but not limited to the famous consumption tax increase) has not been repeated, neither has the record been one of unremitting profligacy and stimulus. As figure 2 shows, the net contribution of fiscal policy (public consumption plus investment, excluding social security

¹ See Hoshi and Kashyap (1999), Kuttner and Posen (2002, 2003, 2004), Posen (1998, 2003), and the chapters by Bernanke, Blanchard, Jinushi et al., Mikitani, and Posen in Mikitani and Posen (2000).

entitlements) has been negative in 15 of the last 18 quarters, and all but one quarter since 2001Q2. Spending on public pensions and social security has risen markedly, doubling over the past decade in response to the aging Japanese population, but that is not what people consider when usually discussing fiscal stimulus.²

Thus fiscal policy has remained a small drag on the Japanese economy throughout the current recovery and has not been the source of unsustainable stimulus (as might account for some recent growth in the United States, for example). There remains, however, no statistically significant correlation between movements in the Japanese household and government balance sheets—the savings decline in recent years can be explained by movements in disposable income, inflation expectations, and real interest rates, supplemented with long-term demographics. There is no explanatory power from adding a term for government debt however measured (see Kuttner and Posen [2003]).

This apparent absence of Ricardian savings behavior justifies the reluctance of the Koizumi government to prematurely raise taxes before the recovery takes hold. Koizumi has recently reaffirmed his pledge not to raise the consumption tax for the remainder of his term in office (which may be until 2007). It also raises a longer-term question as to whether the ongoing cutbacks in public investment, even if mostly directed at wasteful rural and highway construction projects, might be better replaced by cuts in public consumption. Either way, such consolidation will not offer immediate growth benefits.

Towards Reflationary Monetary Policy

BOJ monetary policy has definitely moved back towards the mainstream of central banking over the last 18 months from where it had been previously. Given the BOJ's independence, a change in the membership of its Policy Board had the potential to make a large difference in policy—and the new leadership team (since March 20, 2003) at the BOJ has been associated with a rise in inflation expectations, and a policymaking approach that is more flexible, more cooperative with the Ministry of Finance (MOF) and markets, more transparent, and over time increasingly expansionary. Governor Fukui has been supported in these efforts by Deputy Governors Kazumasa Iwata (a former Cabinet Office economist) and Toshiro Muto (a former MOF official), who were appointed simultaneously with Fukui and who arguably aided in informal coordination with their former agencies.

The key policy change was announced on October 10, 2003, when three significant steps were taken:

- It was stated that cyclical recovery and structural reform should be pursued at the same time (directly reversing former BOJ Governor Masaru Hayami's oft-stated intent to keep monetary policy tight until reform was undertaken);
- The BOJ committed to not raising interest rates again until core CPI shows a forecast (in a majority of the Board members' opinions) of sustained year-over-year positive inflation and the 'most recently published core CPI should register zero percent or above' for at least a few months. They explicitly retained the right to not raise rates even should that occur;
- The quantitative targets for current account balances of banks and for direct purchases of government bonds were increased, allowing the BOJ to leave massive foreign exchange interventions largely unsterilized.

This forward-looking policy commitment reduces significantly the risk of any policy mistakes out of the BOJ or premature interest rate increases. There is some concern about the 'exit strategy' for the BOJ, for when it has to start raising rates if inflation does rise, and how to unwind the liquidity it has been pumping into the banking system. After five-plus years of deflation, the BOJ should be so lucky as to

² And, as Broda and Weinstein (2004) persuasively argue, even this trend is misleading with regard to the overall Japanese debt and fiscal obligation picture.

have this problem, which in any event is well within normal bounds as an operational matter when it arises, rather than being an existential question of how to affect the economy when the interest rate is zero. Also, as deflation eases and investment demand rises for whatever reasons, the zero nominal interest rate becomes *de facto* a looser monetary condition, if accommodated, which it has been. As discussed in Kuttner and Posen (2004), it is difficult to determine the stance and effectiveness of monetary policy once the zero lower bound on nominal interest rates has been reached. One way of making this assessment is to look for evidence of “deflation scares,” where long-term interest rates move without a change in the monetary policy instrument. In Japan, with the call rate held at zero since February 2001, this kind of event is relatively easy to discern. The idea is that since long-term interest rates respond to long-term inflation expectations, a decline in the long-term rate absent a change in the call rate would indicate a market assessment that monetary policy is too tight, given deflationary pressures.³

We found that a deflation scare fit almost precisely the period between the BOJ’s last interest rate increase and its reversal (September 2000–February 2001). Extending that work, as shown in figure 3, another deflation scare occurred during Hayami’s last year at the BOJ, seen in falling long-term JGB yields while the call rate did not move, starting in March 2002. The scare was lifted in the first monthly data available after the BOJ’s new leadership team’s appointment in April 2003, and long-rates and inflation expectations have remained higher since then.⁴ This is strikingly consistent with the change in BOJ leadership being seen by the markets as a regime shift towards a credible commitment to counter deflation.

A More Functional and Sound Financial System

Had the NPL and other problems of the Japanese banking system been dealt with forthrightly, or even with just the delayed recognition and resolution typical of such banking crises (such as the seven years of the US savings and loan crisis), the effect on the Japanese economy’s overall macroeconomic performance would have been limited.⁵ From the time of Japan’s partial financial deregulation beginning in 1984, bad loans began to accumulate and bank supervisors did not adapt to the new environment. As late as 1996, after the Jusen failures but before the autumn collapses of Yamaichi Securities and of Hokkaido Takushoku Bank, the situation urgently required a response, but was not yet a major drag on the Japanese economy of its own accord.

By 1998, however, following the aborted recovery of 1997, the NPL problem had become a major macroeconomic problem in its own right, if not the dominant problem of the Japanese economy, and its size grew markedly through 2002. The ongoing political pressures for the rollover (evergreening) of loans to politically favored but bankrupt enterprises, in hopes of preserving jobs, and the near total erosion of bank capital between loan and equity losses, created incentives for the problem to keep growing.

In this light, the last several quarters’ pick-up in Japanese private investment is of great importance, not only as a source of growth but also as a sign of positive developments in both the nonfinancial and financial sectors. Among the nonfinancial firms, this is a strong indication of the restructuring that has occurred, particularly in the manufacturing and export sectors, but to a lesser degree

³ Goodfriend (1993) created this approach and the idea of ‘inflation scares’ in the United States.

⁴ This is not due to any movements in US long-rates or monetary policy. Work in progress with Daniel Gould indicates that variation in the Japanese long-bond rate Granger causes movements in the US long-bond rate—which has an intuitive appeal since it is capital flows from Japan (and elsewhere) that have made up the bulk of Treasuries purchased in recent years.

⁵ See Hoshi and Kashyap (1999), Posen (2003), and the chapters by Friedman, Glauber, Kashyap, and Shimizu in Mikitani and Posen (2000).

through much of the Japanese economy. Debt levels and costs are down significantly in many companies, and some notable industries have consolidated (steel, semiconductors). This makes firms ready to replace their aged capital stock and to show greater profitability as recovery takes place, and that is what we have seen in 2003–04.

On the financial side, the fact that investment has picked up despite a less than wholesale bank restructuring and the absence of growth in bank lending shows the impact of financial deregulation implemented in recent years—that is, the banks’ refusal to lend to new firms or low-risk projects (due to capital impairment) has not provoked a true credit crunch this time when investment demand rose. Instead, medium and large companies have been increasingly able to raise capital through securities, trade credits, and other means, as well as their own retained earnings. Small companies have been credit rationed, but that is a good thing in Japan.

Meanwhile, the major banks (the four merged city banks, minus the now nationalized Resona, plus the larger regional banks) have had injections of capital through private means and the rise in the stock market. The Resona nationalization example set by Takenaka and related policies do seem to have had some demonstration effect on these banks that they should seek to recapitalize and reduce bad loans due to fear of supervisory intervention. Their lending behavior has improved accordingly over the last 18 months. They are throwing less good money after bad in terms of either rolling over or increasing loans to distressed firms, to the degree this can be measured, and the shares of lending and the Japanese economy allocated to high-debt/low-efficiency sectors has finally been declining.

For this part of the banking sector comprising more than half of all bank assets, NPLs as compared with balance sheets have declined (see figure 4). These official figures probably understate the degree of improvement because, by common assent of market observers, these figures are now close to accurate representations of the size of the problem, whereas in the mid- and late-1990s the official figures were widely believed to be only half as great as (or an even smaller fraction of) the actual numbers. Even some public capital injections are being repaid by the various private banks that received them without sufficient conditionality in the late 1990s. This recapitalization and improvement in regulatory oversight has not proceeded as quickly as the United States or the IMF would have wanted, but there has been real progress since FY2002.

The insurance sector, especially life insurers but also including underprovisioned casualty/property insurers, remains an accident waiting to happen. There is no capital there, but around 30 percent of Japanese household savings remains there amid expectations of an implicit government guarantee. There also remains extensive double-gearing between insurers and banks via subordinated debt. Any difficulties will show up here or in the local/smaller banks that have not yet been subjected to full regulatory scrutiny. The hope is that with half of the Japanese banking system recapitalized, there will be more willingness to let these fail as needed, especially with limits to deposit insurance guarantees finally coming into place in 2005.

Along with some other observers, I had expressed concern during 2002 about the possibility of a financial crisis in Japan (Posen 2002a). Underlying that concern were two assumptions: first, that there would be no change in financial supervision or monetary policy, so the NPL problem would continue to worsen in a vicious cycle with deflation; second, that there would be a liquidity (not a solvency) problem for the Japanese government when important local governments, banks, or life-insurers failed, requested bailouts, and prompted flight of capital from the Japanese financial system. Thankfully, these dire events did not occur.

One clear reason for the ongoing stability was the change in policy for the better described above beginning in spring 2003, which removed the main source of the risk. The other reason, as some Japanese officials counted upon, was that no money would leave Japan until there was outright renegeing on

government obligations/savings accounts.⁶ Given ample Japanese national (as opposed to public) savings, I was in agreement there could be no crisis until money actually left Japan or at least the financial system (Posen 2000), but I expected too much forward-looking behavior of Japanese investors. This illustrates once again that no one has ever lost money overestimating the passivity of Japanese savers.

High and Rising Potential Growth

Once the Japanese government got out of the economy's way and did something to recapitalize the banking system, the current strong recovery emerged and has a chance to be ongoing. Structural tales about the decline of the Japanese system, et al., are unnecessary, since most of the structural problems are the same as were always present in postwar Japan, and the world has not changed fundamentally. All anecdotal evidence, however, is in the direction of structural improvements over the last 20 years, which should raise productivity. These are partial even within sectors and do not represent the kind of structural transformation and rebirth that some commentators on the Japanese economy have deemed a prerequisite for sustained recovery in the absence of fiscal stimulus—they are nonetheless positive steps and should be taken into account when assessing Japan's potential growth rate (Posen 2001).

A short list would include financial deregulation (albeit initially mismanaged when drawn out), energy price deregulation, retail restructuring, and entry of international competition in some areas. Corporate governance has begun to shift towards tighter control of managerial abuse of free cash, and even occasionally contests for corporate control. Additional deregulation since February 2003 of the minimum capital/size needed to legally found a company has released a mini-boom in pent-up demand of small start-ups that had previously not been allowed to form. Labor market change and reform is ongoing at present, with METI and the Ministry of Labor making proposals for retraining and placement programs to assist those workers who have left their old jobs, as well as to improve job matching and investment in human resources. The realization by many unemployed, underemployed, and out-of-the-workforce Japanese—especially women and recent college graduates—that they must take more initiative and show more flexibility to get the best opportunities in today's Japan will have lasting beneficial effects.

Potential output growth for an economy comprises the sum of its labor force growth and its growth in productivity. For Japan, with a declining workforce age population, albeit with some possibility of increased female participation and/or increased retirement age, the contribution from labor force growth is zero or -0.1 percent per annum for the next several years. Thus, potential output growth in Japan over that period will be essentially equal to the rate of productivity growth. If Japan's technological and productive capabilities remain as advanced as they were in the 1980s, and as capable of keeping up with and generating innovation, which I argue in Posen (2002b) they have, then there is no reason to think that Japanese average productivity growth has declined from the underlying growth rate before the 1990s.

Taking into account the positive developments listed above, and putting a value on them in line with OECD estimates of how much comparable reform has paid off elsewhere, Japanese potential growth should have risen to over 2 percent a year, perhaps 2.5 percent, which is significantly higher than the estimates of 1 to 1.5 percent utilized by the Japanese government and many forecasters.⁷ As can be seen

⁶ At the time, my IIE colleagues, Morris Goldstein and Michael Mussa, IMF veterans of many crises, made a similar point that the money would not leave until there was real direct pain for average savers, and thus there was plenty of money available for the Japanese government to hold off crises.

⁷ Not all reforms result in permanent increases in the trend productivity growth rate. Some, however, such as labor market restructuring and financial market rationalization will have positive effects on growth every year for several years as resources are reallocated from less rewarding uses and/or returns rise on productive factors. After this transition

in figure 5, this is also the rate of productivity growth averaged by Japan over the last two years and in previous recent recoveries.

Downside Risk from China

Japanese growth remains vulnerable to a sharp slowdown in China, given China's role in its export picture, and the knock-on effects a Chinese contraction would have on the rest of Asia. The vulnerability of Japan to a decline in Chinese growth should not be exaggerated for four reasons, the need for an investment slowdown there (as called for by Nicholas Lardy) notwithstanding. First, Japanese export growth in 2003 was mostly driven by increasing demand from China, but that pattern has shifted over the course of 2004 to other trading partners in Asia. Figure 6 shows that even after the boom in exports to China of late, that demand has leveled off at around an 18 percent share of total Japanese exports, less than the 24 percent sent to the US (even after a multiyear decline) and the 29 percent exported to Asia ex-China. Should the Chinese government revalue the yuan, with other Asian currencies following it up against the dollar, even an appreciated yen would still leave the Japanese economy quite competitive in China and the rest of Asia, so this pattern should continue.

Second, there is some evidence from the composition of exports to China that Japanese firms are selling a disproportionate amount of their capital and higher-end goods to the market-driven and coastal sectors of the Chinese economy. A credit quality crackdown in China, as has already begun, would focus on the still state-owned/funded and inland sectors of the Chinese economy, not the internationally oriented parts, and a revaluation of the yuan would increase the purchasing power of the entrepreneurs and businesses in this region.

Third, to the degree that Japan is moving production into China and out of the Japanese home islands, it will be sustaining these relationships. On the one hand, this is because Japan will be shipping out parts and inputs to China and then reexporting the finished products to the advanced economies. Umetsu and Asher (2004) find in a decomposition of Japanese exports to China a predominance of "raw materials and parts for the production process, not finished goods to be consumed by end users." On the other hand, the Japanese commitment to production in China has exploded, with the flow of Japanese FDI into China up fourfold since 1999, from ¥85 billion to ¥355 billion in 2003 (see figure 7). As Keidanren, the Japanese business association has advocated, there is a shift underway in Japanese manufacturing strategy from "Made in Japan" to "Made by Japan," and China is the primary location of that trend.

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period, the growth rate would then go back to some underlying growth rate. For more extensive discussions of the challenges in estimating potential and the range of estimates, see Posen (2001) and Kuttner and Posen (2004).

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Figure 1 Contributions to Japanese GDP

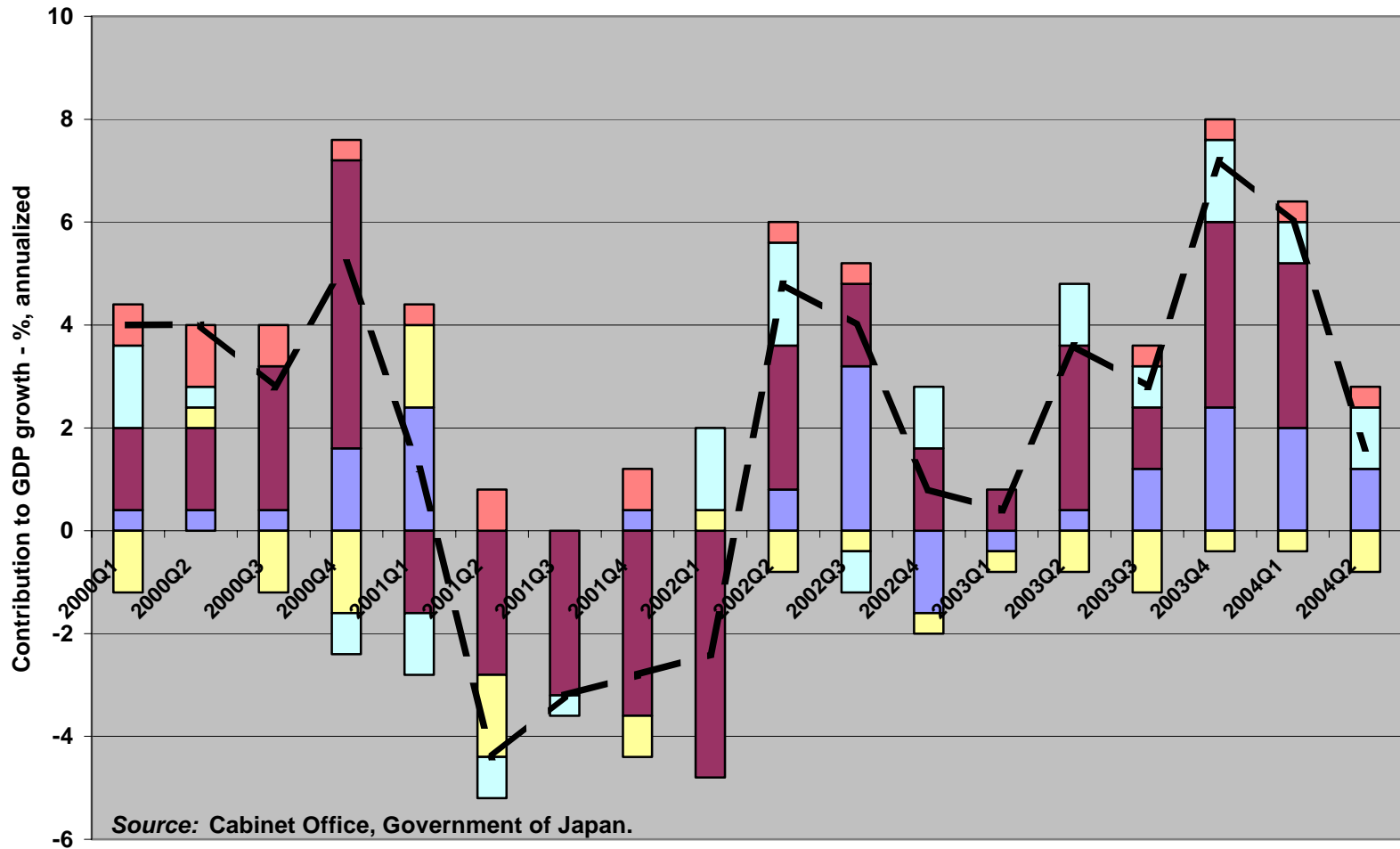


Figure 2 Japanese public stimulus

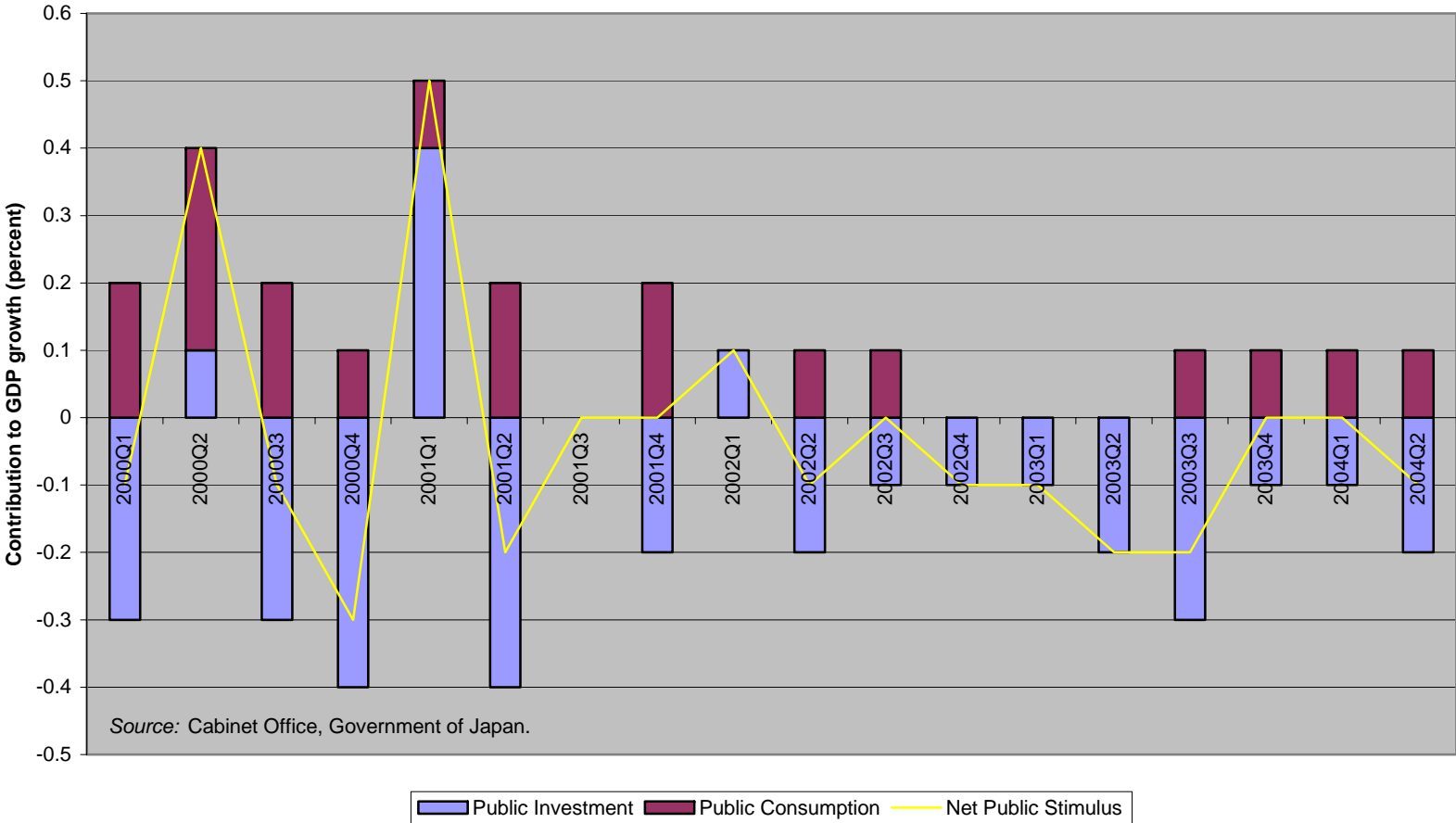
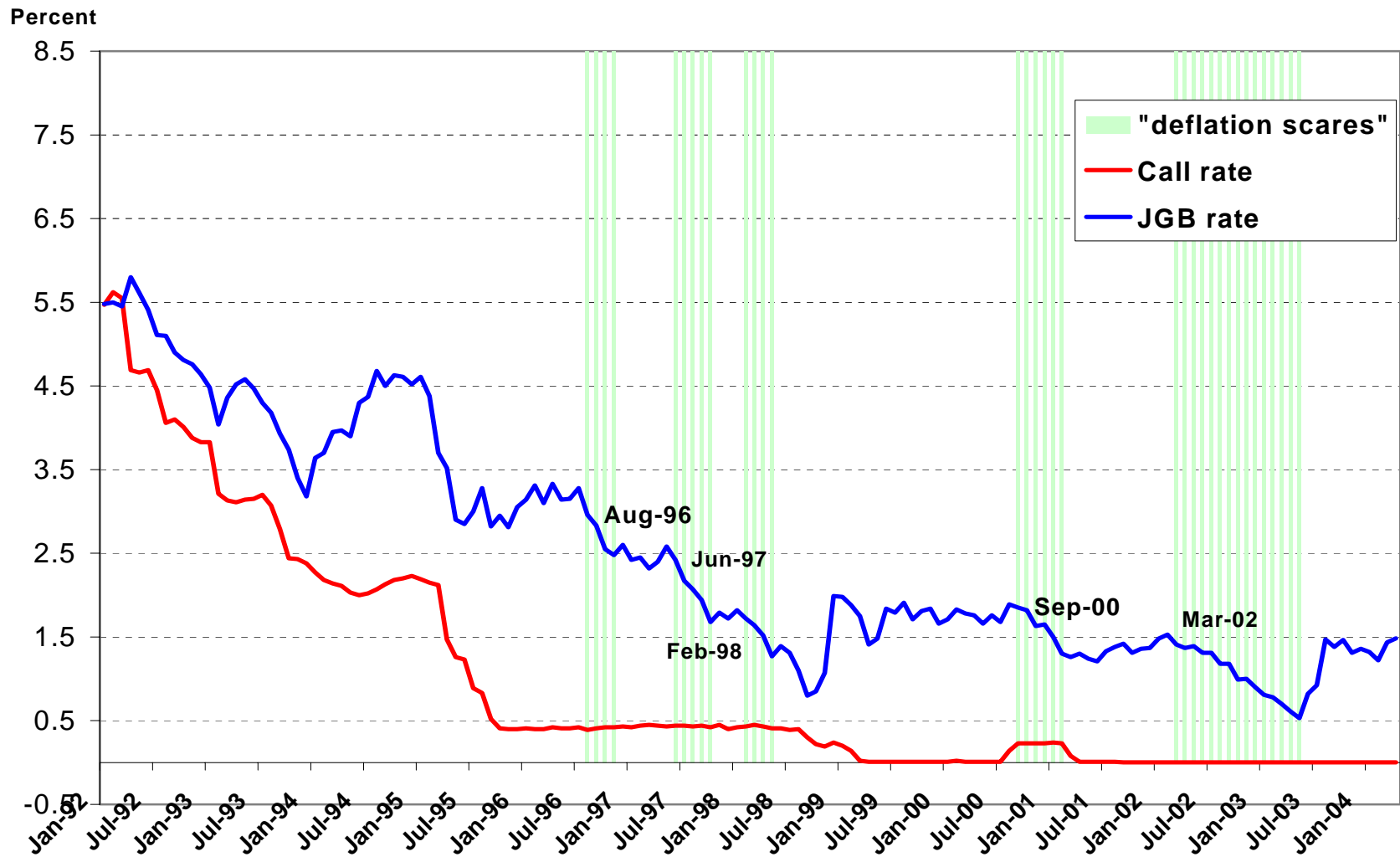


Figure 3 Japanese deflation scares episodes



Note: Updated from Kuttner and Posen (2003), "The Difficulty of Discerning What's Too Tight"

FIGURE 4
NPL Status of Japanese Banks

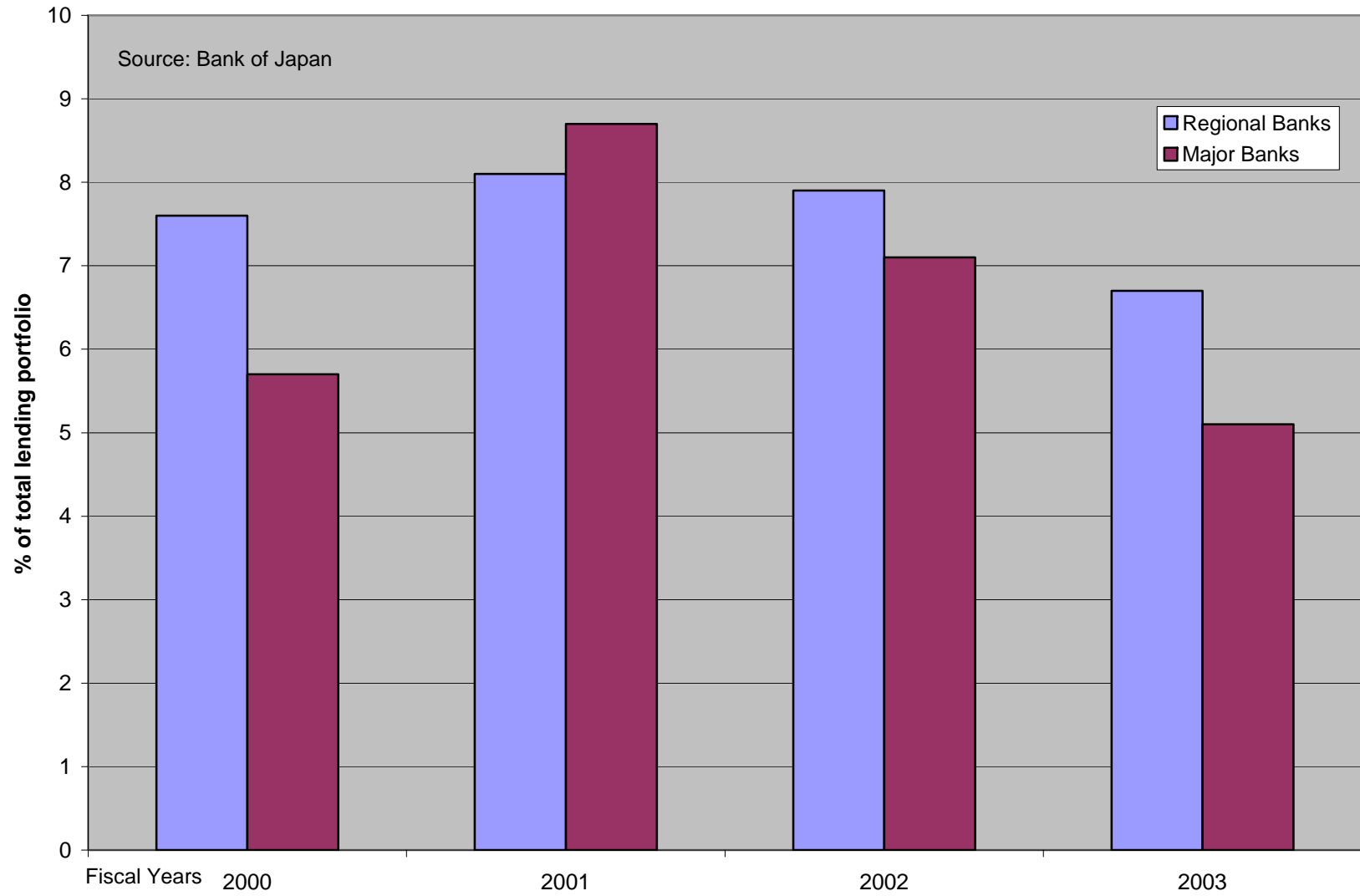


Figure 5 Japanese labor productivity growth

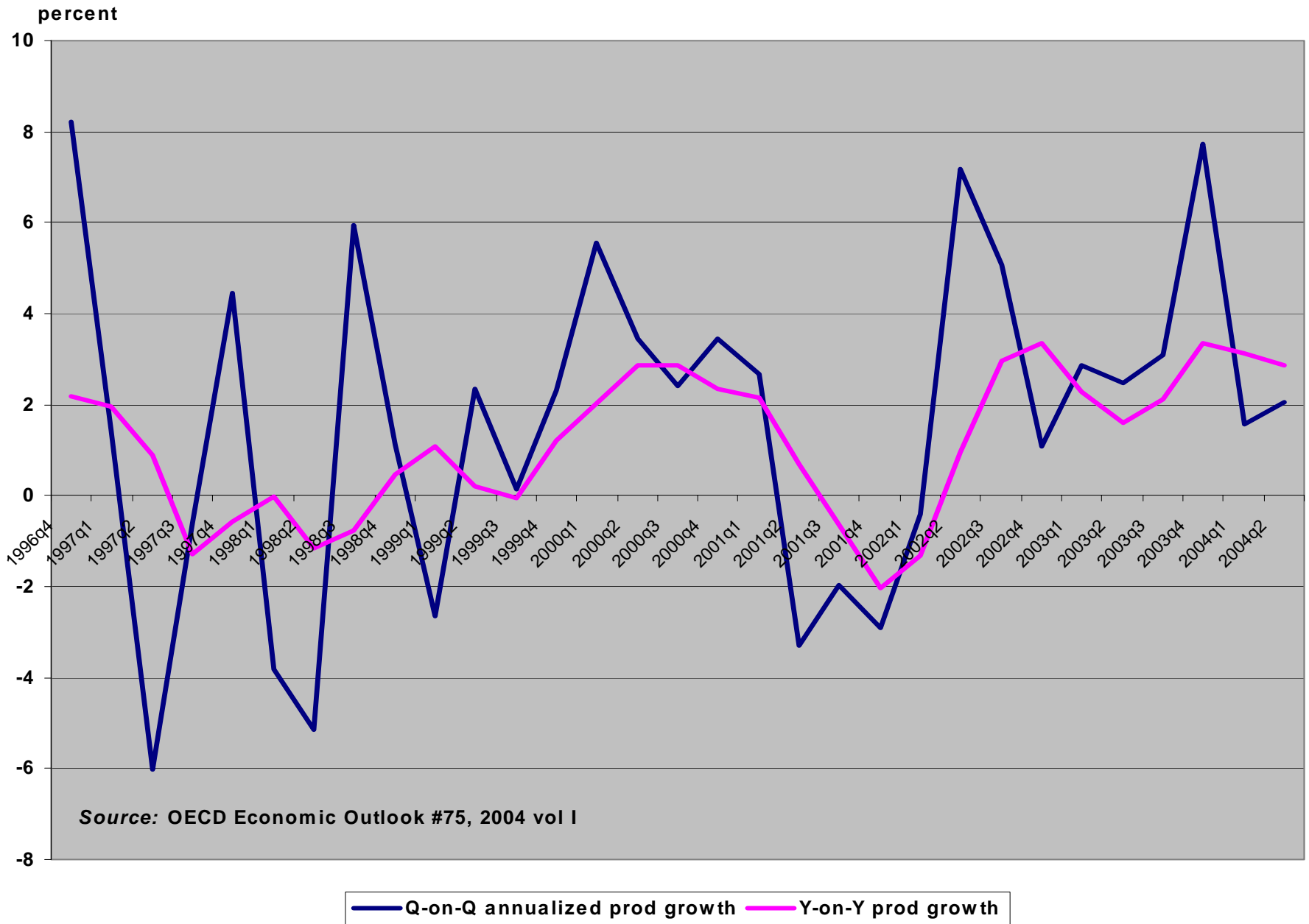


FIGURE 6
Share of total Japanese Exports (% GDP) to Selected Regions

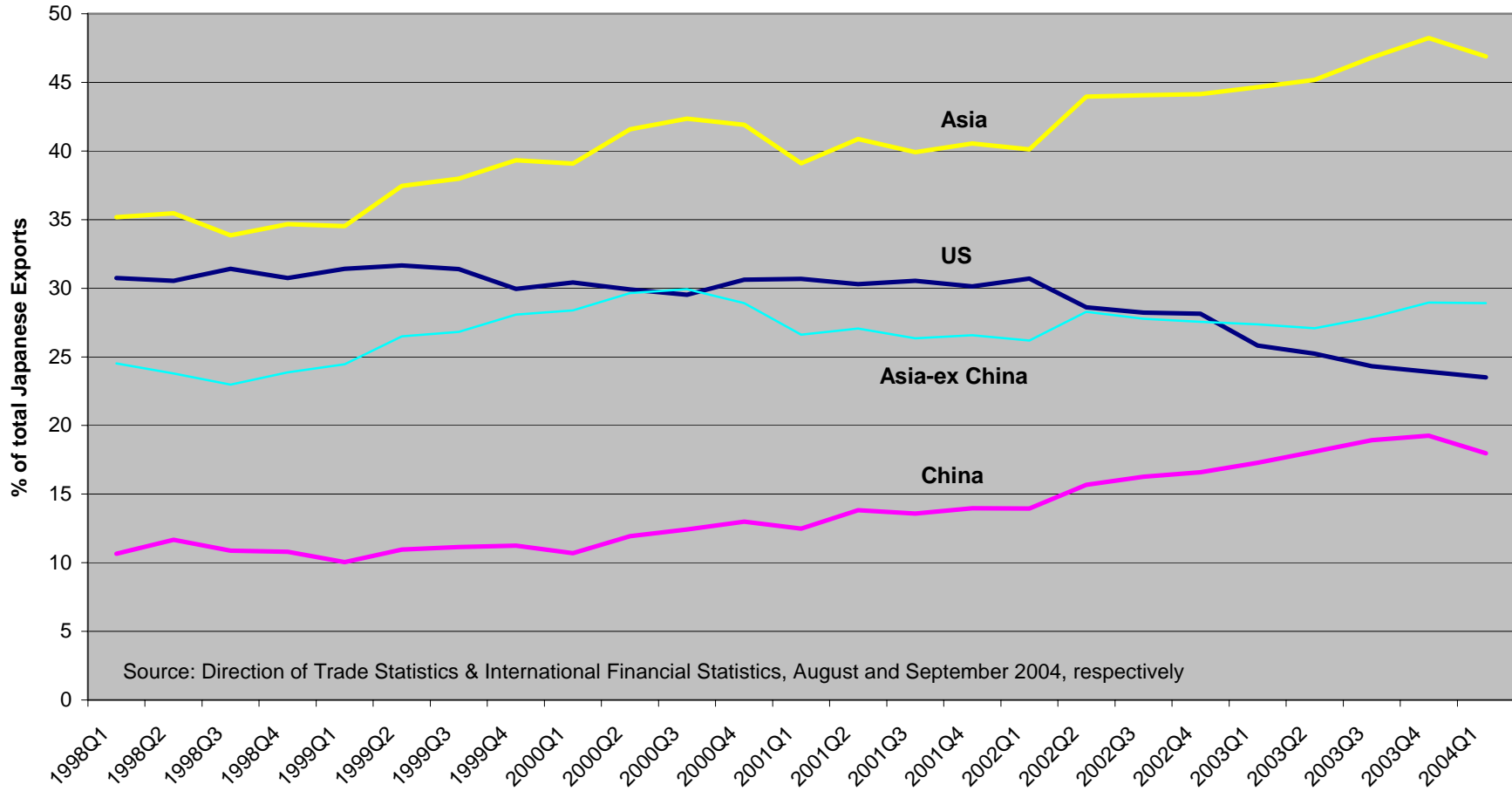


FIGURE 7
Japanese FDI in China

