

Why Japan Can't Reform Its Economy

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Japan's economic policy decision-making is coming under increasing scrutiny worldwide, particularly in light of the instability prevailing on Asian financial markets. (For purposes of this paper, Asia refers to the countries of East and Southeast Asia excluding Japan.) Until quite recently, Asian countries formed the world's fastest growing region and had become a focus of attention by businesses and investors worldwide. The story of what happened in that region is essentially a by-product of events in Japan. And as this becomes more and more obvious, global attention will, for better or for worse, increasingly focus on Japan. Indeed, this is already happening.

Much of this attention is directed at the issue of reform. Why can't Japan reform itself? Why does Japan continue to run its economy as if it were a developing nation just climbing out of poverty? As if shortages of precious foreign exchange and essential commodities were right around the corner? The reality, of course, is completely different. Japan is the world's largest net creditor nation and runs chronic current account surpluses. From a strictly economic point of view, Japan could easily afford to run current account deficits without causing significant turmoil in currency markets or triggering a destabilizing round of yen weakness—indeed one can argue the reverse. It is only when large quantities of yen are in circulation outside Japan and when yen interest rates rise to reasonable levels that investors worldwide will wish to hold yen, providing a stable floor for the currency. For these things to happen, Japan must run current account deficits. Indeed, little benefit accrues to a net creditor nation unless that nation is prepared to run current account deficits. No theoretical economic reason exists to prevent Japan from absorbing large quantities of imports, thereby becoming a locomotive for the global economy.

But by reversing its exchange rate policy in 1995 with American cooperation, Japan instead tried to export its way out of its economic doldrums. This policy has failed so far to ignite a strong boom in capital outlays. Japanese government officials seem not to have understood that Japan is burdened with production capacity far in excess of any

* *Anm. der Redaktion:* Der folgende Aufsatz ist erstmals im Working Paper No. 44 des *Japan Policy Research Institute* (JPRI), Cardiff, CA, erschienen. Wir danken dem JPRI und seinem Präsidenten, Herrn Prof. *Chalmers Johnson* herzlich für die freundliche Genehmigung zum Abdruck.

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conceivable domestic demand. Thus, any recoveries in external demand simply result in an expansion of the trade surplus.

Meanwhile, the United States, which has functioned as the world's locomotive during the postwar era, has also become its largest debtor nation. Following the 1985 Plaza Accord, which resulted in the near-halving of the dollar's value, American companies regained competitiveness in a number of industries as well as further entrenching American dominance of the high-technology and information sectors. But the restoration of American competitiveness is directly threatened by the devaluation of virtually all of Asia's currencies, as well as the present weakness of the yen. The region's trade surpluses with the United States are already mounting quickly. The truth of the matter is that the only way out of the region's difficulties is external demand. The alternative is continued economic turmoil, leading almost certainly to political unrest.

The world's only significant source of external demand today is, of course, the United States. It is by no means clear, however, that adding exploding external deficits to America's huge net debtor position is compatible with continued dollar strength. At some point, it appears inevitable that either the foreign currency markets or the bond markets—or, more likely, both—will force a reduction in the level of American external deficits. And it should be understood that the primary pillar that undergirds the strength of the dollar—and thus the ability of the United States to run external deficits—is the Japanese financial system—the same system that is depriving central bankers and investors worldwide of sleep. While maintaining external demand for Asia's products is essential from both an economic and security point of view, the United States at the same time will probably soon face the need to reduce its own current account deficits. If it does not do so it risks a sharp weakening of the dollar and possibly a severe recession as dollar interest rates rise to finance American external deficits. And the only alternative to the American market is, of course, Japan. But not only is Japan running substantial current account surpluses; its gross domestic product (GDP) measured in dollars—and thus its ability to absorb imports—has sunk by a full 1/3 since the currency realignment of 1995.

Given these circumstances, the pressure on Japan is becoming overwhelming to overhaul the structure of its economy in order to put domestic demand in the driver's seat. Of course Japan should be running a current account deficit anyway, given its stature as the world's leading net creditor country. Such a deficit would not only benefit the Japanese population but forms the key to resolving the Asian crisis. So why is Japan's economy so stubbornly resistant to the overhaul that would lead to its running a current account deficit? And how might such an overhaul conceivably take place some day?

HOW THE SYSTEM WORKS

The two outstanding characteristics of the Japanese economy are, first, a very high savings rate, and second, a comprehensive productive capacity that is both vertically and horizontally integrated. It was the high savings rate that financed Japan's integrated production facilities, and the high savings in turn resulted to a very large extent from a tax code structured to induce them. Historically, interest income was not taxed at all for all practical purposes; today it is taxed separately from ordinary income at a modest 20 percent rate. Thus, for Japan's better off households, bank deposits are the equivalent of tax-exempt municipals for their American counterparts. Since the top marginal tax rate in Japan is 65 percent, savings deposits, with their 20 percent tax, look awfully attractive when contrasted with other potential uses for funds.

Meanwhile, Japan's corporations likewise paid what were effectively tax-exempt rates for these funds. Indeed one can argue that in a sense the entire Japanese financial system functions as a huge tax-exempt market, except that no fully taxable investment alternative paying higher interest rates has been available to Japan's investors. The benefits from this set-up flow directly to well-connected companies who can deduct already low tax-exempt interest rates from taxable income. That, moreover, was the intention behind the system: to ensure that companies in so-called "strategic industries" enjoyed financing at costs that gave them a competitive edge over foreign rivals. Banks were the vehicles by which companies obtained access to household savings; in turn the Ministry of Finance so thoroughly dominated the banks that they were in effect little more than MOF franchisees. The savings thus collected were deployed in the construction of a productive capacity far in excess of domestic demand. Both the savings themselves and the productive capacity they financed were protected from the risk of failure by every tool the government could command. Any failures were spread throughout the economy, rather than falling on the shoulders of individual savers, banks, or companies—a phenomenon I have labelled the "socialization of risk."

The system worked well until Japan replaced the United States as the world's largest net creditor nation. By becoming the world's largest net debtor instead of its largest creditor, the United States could no longer act as a very good customer for Japan. Japan can still sell goods to the United States, but it cannot convert the proceeds of these sales into yen without driving down the yen/dollar exchange rate. Meanwhile, Japanese banks loaded with household savings cannot find borrowers looking to finance further productive capacity. The money instead goes to dubious borrowers and thus ends up as "problem" loans, or it flows overseas where the risks from exchange losses far exceed the potential returns. This is the current state of the Japanese economy and it is leading directly into a deep and intractable recession—something that becomes clearer every day as economic activity slows while the current account surplus continues to expand.

Changing this economy into one that will generate current account deficits means, inevitably, that some portion of Japan's production capacity will be shut down. Its

financial infrastructure will likewise be slimmed down. In other words, the Japanese economy will need to become sensitive to risk and return. But any move in that direction encounters enormous obstacles. One of the biggest is that few bankers, policy makers, or even businessmen in Japan genuinely understand the function and needs of equity capital. They have never had to worry about it in the past. Individual players in the Japanese system took capital for granted. The government subsidized banks and important industrial companies in a variety of ways, and deliberately created hospitable environments to encourage revenue and capacity growth. But it was not only the government per se that was so helpful. Companies in virtually all industries in Japan are organized into industrial associations that help set prices and allocate production volume in a manner that would be flatly illegal in the United States. If such colluding arrangements prove insufficient to maintain profitability, the government has since prewar times been expected to intervene to bring this about.

These industrial associations and the implied promise of government intervention have helped maintain the viability of member companies, thus obviating the need for individual companies to accumulate sufficient capital on their own to withstand downturns. Anti-cut laws do exist, but they are largely empty. Whatever the negative effects the collusion on prices and production volumes has on the hapless Japanese consumer and on the foreign business seeking to enter the Japanese market, the socialization of credit risk would have been impossible without it.

THE SOCIALIZATION OF CREDIT RISK

Socialization of credit risk protected banks from the consequences of credit mistakes, but as a result the banks do not grasp the role of equity capital. The Bank for International Settlements (BIS) capital adequacy guidelines are, to them, simply a matter of presentation, not of substance. Japan's Ministry of Finance, which oversees accounting standards and disclosure requirements, is far more concerned about maintaining the viability of the institutions it supervises than it is about ensuring that outside investors have the information they need to understand what is going on inside those institutions. The MOF is determined that publicly disclosed information will never trigger the failure of a licensed Japanese financial institution—or a major Japanese company for that matter. The MOF wishes to ensure that any decisions to cut off life support to companies or banks that may be terminally ill continue to be made by bureaucrats behind closed doors, and not by the credit markets.

For the past three decades, thanks to this system, Japanese banks could operate with zero or even negative equity without any problem. Problem loans were either not recognized on the books, or explained away via supposedly huge unrealized capital gains. The government did whatever necessary to keep high the growth rate of nominal GDP—that is to say, real GDP plus the rate of inflation—since a constantly rising nominal GDP melts away bad loans as they occupy an ever diminishing share of bank

balance sheets. Indeed, propping up nominal GDP has been perhaps the overriding macroeconomic policy goal of the Japanese government. In the late 1980s, with MOF encouragement, the Japanese financial system created the largest bubble in history with excessive credit expansion. In the early 1990s, the government launched some \$600 billion in fiscal stimulus packages, much of it in the form of public construction of questionable merit. In 1995, the government poured resources into the foreign exchange market to prop up the dollar, thus providing a boost to exports that it was hoped would translate into broader GDP growth. Interest rates were also cut to historic lows.

None of it worked, however. The economy has hovered on the edge of deflation and recession for six years now. The failure to induce growth in nominal GDP has made it impossible to dissolve the problem loans that burden Japan's banks. And it made glaringly obvious the Achilles' heel of the Japanese banking system: the lack of equity. It is inadequate equity that has put the entire system into crisis. In the absence of sufficient equity, problem loans cannot be written off without bringing down the banks that made them. Banks are responding by liquidating their equity holdings and calling in loans.

A number of economists and other friends of mine outside Japan have asked why the Bank of Japan doesn't simply print more money in order to trigger inflation and thus boost nominal GDP. The fact is that the BOJ is actually trying to do this—its printing of notes in circulation is rising at an annual rate of more than 10 percent. But much of this currency is simply being hoarded by households scared by the news reports of failing banks; much of the rest of it leaks abroad as households chase foreign investments with higher returns and supposedly greater security. The banking system, particularly weaker banks, is actually suffering deposit withdrawals. As banks seek to reduce their leverage ratios, a deflationary cycle is put in motion. Unless the bad loan problem is solved, permitting a recovery of confidence in the banks, the Bank of Japan's monetary policy cannot stimulate nominal GDP, no matter how inflationary it may seem on the surface.

THE PROPOSED CURE

The widely advertised cure is to turn Japan into a more risk-sensitive economy, thereby forcing the shutdown of unprofitable productive capacity. But such a shutdown would injure many domestic interest groups, as well as undermine the power of Japan's permanent bureaucracy. The entrenched domestic opposition to any genuine transformation of the Japanese economy is thus very great. Some look to political pressure applied by the United States to overcome the opposition. And it is certainly true that such pressure—so-called *gaiatsu* in Japanese, or foreign pressure—has historically played a very important role in bringing about policy shifts in Japan.

To see why this is so, it is important to understand that whatever appearances may be, politicians in Japan do not originate policy. Their role is to formalize what is decided by the bureaucracy. Bureaucrats in turn follow precedent. Outside influence on the

bureaucracy has been the exception, not the rule, in modern Japanese history. One such exception occurred in the late 19th century when the so-called Meiji oligarchs created the modern Japanese state. Occupation authorities in the early post-war years were also able to impose some direction on the bureaucracy. And from time to time the United States government has succeeded in doing so, partly as a legacy of the Occupation and partly because the United States plays an essential role in the Japanese power structure thanks to its market, its currency, and the security umbrella it provides.

The United States has on a few occasions imposed a change of direction on Japan—the delinking of the yen from the dollar in 1971 comes to mind. Given Japan's pivotal role in the Asian crisis and the danger to both global finance and regional security stemming from that crisis, the United States may again muster the stamina to impose a change of direction on Japan. And indeed, recent comments by the likes of Robert Rubin suggest that this could be happening. But there is an inherent conflict of interest for the United States in any overhaul of the Japanese economy that turns Japan into a genuine market economy. The United States has benefited enormously from the current Japanese system. Cheap Japanese products and low-cost Japanese financing permit the United States to run huge external deficits without paying any of the usual costs while keeping inflation low and American financial markets buoyant. Any serious overhaul of the Japanese economy would raise the price to Americans of both Japanese goods and Japanese money, leading almost surely to a significant slowdown in the American economy. To the extent that Washington understands this, pressure on Japan for reform coupled with Japanese officialdom's ostensible embrace thereof may be little more than a species of Kabuki.

Thus, while American pressure might conceivably bring about reform, given the unacknowledged American stake in the present system, genuine reform is more likely to happen when a sufficient coalition of forces in Japan decides the alternative is disaster. Only when that is manifestly obvious, however, can we expect such a coalition to appear. The normal institutions of advanced democratic countries that could be expected to force reform exist in only truncated or superficial forms in Japan. I am thinking of such institutions as a fully independent judiciary with the resources necessary to play the role of final arbiter in economic disputes; an investigative press that defines its mission as uncovering the truth rather than supporting the social order; a genuine opposition with the resources and the will to govern that could and would impose political control over the bureaucracy; shareholders able to discipline management; banks that extend credit on the basis of their assessment of a borrower's ability to turn a profit; a disinterested accounting profession; economists and other intellectuals who do not depend on government bureaucracies for their livelihoods.

THE REAL CURE

Beginning in the Meiji period and continuing throughout the post-war era, Japan's elite imported many of the just-named institutions not because it wanted or felt it needed them. Nor were they forced on the elite by popular demand. Rather, they were imported in order to demonstrate that Japan was a modern, developed country. But these institutions were never really allowed to take root. They have essentially remained window-dressing for an older social order. And only when that order is convinced that the alternative to change is its own destruction can we expect real reform initiatives.

Instead, Japan's ruling bureaucracy has avoided the pressures for reform by extending a blanket safety net that co-opts any genuine opposition to its continued control of economic events. But as the government simply picks up the tab for any and all losses, a moral hazard problem of horrendous proportions has arisen. As it becomes clear that the safety net can continue to function only if taxes rise to ruinous levels, bankruptcies will simply have to be allowed to take place. Indeed, we have begun to see this happening in the past year as what had once been unthinkable—bankruptcies by well-connected Japanese firms—is becoming more common.

Meanwhile, since 1995, when Japan and the United States worked together to push down the yen, Japan's current account surplus has soared. But as already noted, this has not provided a sufficient stimulus for capital outlays to put the economy back on the growth track. Indeed, Japan appears at present to be falling again into recession. Instead of boosting the Japanese economy, the weakened yen has badly damaged the competitiveness of Asian industries, leading directly to the present crisis in those countries, and creating a boomerang effect in Japan. Japanese banks hold hundreds of billions of yen worth of questionable Asian loans and Japanese companies find a principal outlet for their exports shrinking fast.

Instead of fearing a stronger yen, Japan should welcome it. If the yen were to appreciate against the dollar, many countries would find their competitiveness in the U.S. market enhanced vis-à-vis Japan, as well as improving their sales in Japan. While this would cause some pain to some players in Japan, Japanese investors in the region would at the same time see their investments recover. With a recovery in the region, imports of American goods would increase, easing the pressure on America's external deficits.

Ultimately, instead of the endless accumulation of dollars necessary to depress the yen, the Japanese economy must be overhauled through redefining the economic role of households from that of passive savers at depository institutions into active spenders and investors. This, in turn, for the reasons mentioned earlier, can only happen with a complete overhaul of the Japanese tax code. Interest income would need to be subject to comprehensive and progressive taxation, while interest expenses—particularly those expenses incurred in financing home purchases—must be made deductible from taxable income.

Without tax reform, the ending of controls on individual Japanese making investments abroad will have no effect. Interest income that Japanese savers receive directly from abroad is subject to progressive taxation as part of regular taxable income. However, interest income received within Japan from Japanese financial institutions or Japanese entities through Japanese financial institutions are subject to only 20 percent withholding tax and is separated from taxable income. In investing in overseas assets, Japanese who transfer money in excess of ¥ 2,000,000 (\$ 15,625 at ¥ 128=US\$) abroad are legally required to report this to the tax authorities. All transfers of any money from abroad must also be reported. This means that interest income from abroad will be taxed at progressive rates while domestic interest income will be taxed at only 20 percent. Equally important, anonymity is available to domestic owners of financial products but not to owners of foreign financial products. The current tax system as a whole discourages the outflow of money from Japan.

The benefits of tax reform would be many. Better-off families would spark a housing boom as they borrowed money to buy bigger houses, increasing their interest expenses to offset the increase in taxable income that would come from taxing interest income as if it were regular income. Less well-off families, with smaller deposit holdings and in tax brackets lower than 20 percent, would see a rise in their after-tax interest income. Financial institutions would see an expansion in lending opportunities to better-off households. The corporate sector could anticipate an increase in economic activities centering on housing that would help offset the burden of higher interest rates. Tax revenues stemming from the application of progressive taxation on higher interest rates would help offset losses flowing from making mortgage payments tax deductible. Furthermore, foreign investors could find yen assets more attractively priced with elimination of the withholding tax system.

Following an overhaul of the tax code, the next step needed in reforming the Japanese economy is an end to the "socialization of credit risk". Mechanisms are needed that would permit inefficient industries and companies to be closed or absorbed by their more efficient competitors. Since no market in corporate control has ever been allowed to take root in Japan, management not only has no fear of bankruptcy; it also does not have to worry about either takeovers or pressure from disgruntled outside shareholders. The result of course is now plain for all to see: Japan is afflicted with enormous overcapacity that can only be maintained by depressing both interest rates and the value of the yen, thereby shifting the costs outside of Japan to the other countries of Asia. Real reform will require a complete overhaul of existing accounting and legal systems so that those responsible for asset deployment can be made accountable for their performance, so that risk can be properly assessed and brought into line with return.

It is late in the day. Japan's mandarins in the economic ministries, the great banks, and the federations of industrial associations do not want to see reform, not so much because it will deprive them of the power to allocate managerial resources at their own discretion but simply because they do not understand the alternative system, a genuine

market economy. But events are moving fast. The deposits draining from Japanese banks have become a torrent, as they flood into currency in circulation and overseas assets, causing a rundown in reserve deposits. Japanese banks in turn are facing a liquidity shortage, resultant callback of their loans, and liquidation of investments. Principal among the investments to be liquidated are dollar assets. And as Japanese financing for the U.S.'s external deficits contracts, the pillars of American economic prosperity—a strong dollar, low inflation, and buoyant financial markets—will come under great strain. If the world's principal engine of demand falters, then we truly enter uncharted economic waters. And the country that is likely to be hurt the most is Japan itself.