Volume 7 | Issue 7 | Number 3 | Article ID 3049 | Feb 09, 2009

Japan's Twenty Year Response to Economic Crisis

Andrew DeWit, T. Harris

Japan’s Twenty Year Response to Economic Crisis

Andrew DeWit and Tobias Harris

We have some good news, and we have some bad news.

First the good news. A little common sense is breaking out both within and about Japan. Within Japan, an election seems almost certain for the month of May. Comfy in his captain's chair, Prime Minister Aso is at present testing his 19% level of public support and -- with helpful advice from Mr. "structural reform" Takenaka Heizo -- is hoping to ride out the storm and his legal tenure. Japanese constitutional law requires that an election be called by September, and both Aso and Takenaka apparently believe that by then there will be some kind of recovery of the economy both globally and within Japan. They also seem to be betting that Aso’s YEN 2 trillion cash payout to residents (about YEN 12,000 per taxpayer) will boost support, even though upwards of 70 percent of poll respondents apparently see it as wasteful (which it is).

Aso’s wishful thinking is not shared by the LDP elders. They are, therefore, pressing him to call an election shortly after the budget is passed by the Diet. They understand that, following a 35% drop in exports in December (year on year), a 2009 recovery is unlikely. And they show signs of grasping that the current crisis is almost certain to be far worse come September.



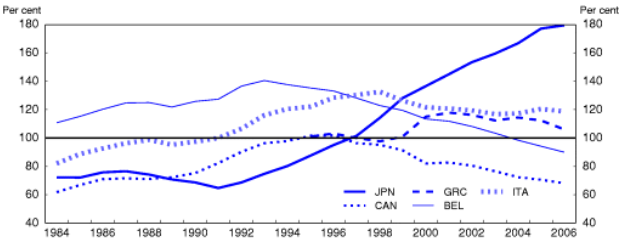
Cars accumulating with no buyers in sight

The LDP clearly worry that an electoral loss is almost certain at present, and could turn into a perfect storm, particularly if Aso's "straight on till September" obstinacy holds sway. The February 8 Nikkei makes note of their pressure on Aso, adding that if he ignores it he risks being thrown overboard. So one bit of good news is that the LDP elite know they have no choice but to go to the people quickly. This could mean that Japan’s weak and unimaginative leadership, confronting an historic crisis with a paucity of ideas, may come to an end. If so, one can only hope that the LDP will not simply be followed by more old boys bereft of ideas and leadership skills.

Another note of good news is found in Martin Fackler’s February 6 New York Times article, proclaiming that "Japan's big-works stimulus is lesson." There has been a great deal of discussion about what the United States might learn from Japan's experience of dealing with the collapse of the bubble economy, but most of it has been less than illuminating. Beyond the obvious lesson that the financial and fiscal authorities ought to act much faster than the Japanese did (and note that the Japanese authorities' slowness is often exaggerated), a

https://doi.org/10.1017/S1557466009023432 Published online by Cambridge University Press

few pertinent lessons have made it into the public debate. The article notes one of the major lessons is that the size of the fiscal stimulus needs to be huge, and that the spending needs to be sustained "until recovery takes firm root." Moreover, another lesson is that spending should not be willy-nilly. Japan bought itself numerous failed resorts, empty airports, and silent concert halls, in addition to the so-called roads and bridges to nowhere. The huge fiscal stimulus packages of the 1990s not only helped raise the public debt to 180% of Japan's GDP (by far the largest of any big OECD country), but they also imposed onerous burdens on local governments for projects that provided little basis for new economic growth.



Japan’s public debt ratio in comparative perspective

The New York Times article points out that spending on education and social services would have delivered far more "bang for the buck than infrastructure spending," but that is not all. Imagine the benefits Japan would be enjoying now had it invested heavily in renewable energy projects, where it sadly lags behind countries such as Germany as well as -- surprise, surprise -- the United States. Indeed, under the Koizumi regime, in 2004, the subsidy for solar power purchases was axed in a striking display of market fundamentalist overreaction to the state's misguided stimulus policies of the 1990s. Japan's focus on old-style infrastructure also bolstered political lobbying for more of the same. All those skewed incentives contributed to the severity of the current downturn, since the workforce and domestic economy were not retrained and focused towards sustainable growth areas. As the article notes, citing an emeritus professor of public finance at Shimane University, "in hindsight, Japan should have built public works that address the problems it faces today, like aging, energy and food sources... This obsession with building roads is a holdover from an earlier era."

So the good news is that we may be approaching the end of an era, both in the governance of Japan as well as in the notions of how the state can most effectively stimulate the economy. The latter is a particularly important lesson for the United States, which at present is embroiled in a debate over whether to use tax cuts to try and resuscitate the unsustainable economy that collapsed, or to emphasize smart spending to stimulate the economy and shift its industrial base. If the smart emphasis becomes common sense in Washington, it will become common sense in Tokyo as well, as it is already emerging among the Japanese Democrats. Even PM Aso has of late been paying lip service to the idea of a Japanese-style “green new deal.” The real deal in Washington, centering on support for renewables, the “smart grid,” and other modern infrastructure, will encourage the same in Tokyo. This could mean that Japan will have to learn from the Americans the right lessons from its own policy failures during the years of waste as well as its “structural reform” road to unsustainable export dependence.

But now the bad news. As the very astute blogger Tobias Harris notes in his February 8 comments entitled "twenty years of crisis," Japan might be on the edge of some desperate and potentially dangerous measures. After the collapse of the asset bubble and the descent into deflation, Paul Krugman argued that the Japanese central bank ought to "credibly promise to be irresponsible." Krugman's advice was that Japan needed to adopt an inflationary target in order to pull itself free of deflation and a liquidity trap (the latter obtains when nominal interest rates are already close to or equal to zero, in order to counter a recession, but the

https://doi.org/10.1017/S1557466009023432 Published online by Cambridge University Press

financial system and actors in the real economy do not respond with increased lending as well as increased investment and consumption). Krugman's advice to aim at inflation, even recklessly so, has been deeply controversial within Japan. Advising that the present regime, not particularly renowned for fiscal and financial probity, be let loose seems a recipe for disaster to many observers.

Notwithstanding these concerns, Krugman's advice remains attractive to some domestic actors. As Harris notes, the failure of Japan to escape its "lost decade" (indeed, its "lost twenty years") has seen a group of 15 LDP Diet members form "the Diet members league to consider the issuance of interest-free government bonds and government money." They want the government expand the money supply by a whopping ¥50 trillion, bypassing the Bank of Japan, so as to fund new rounds of economic stimulus. The group understands that there is a risk of hyperinflation, but they argue "we are facing hyper-deflation, so we need a policy to create hyper-inflation. We have to do something to undermine the central bank and government's credibility or else we won't be able to halt the yen's rise. So, while we know this is drastic medicine, we will do it."

As Harris notes, these people have clearly read Krugman. But have they read the more recent contributions from Krugman? In his February 6 opinion column for the New York Times, entitled "On the Edge," Krugman argues for smart public spending. He goes on the attack against the absurd proposals for tax cuts coming from Senate and House Republicans in Washington. The defeated presidential candidate, John McCain, went so far as to propose the fiscal stimulus be scaled back to $420 billion and be focused on tax cuts. This is in contrast to the advice of his unofficial economic adviser during the campaign, Mark Zandi of Moody's Economy.com, who of late has argued before congressional committees for a stimulus in excess of $1 trillion with a focus on such items as food stamps, aid to the states, and other spending. Like Zandi, Krugman warns that "even if a major stimulus bill does pass the Senate, there is a real risk that important parts of the original plan, especially aid to state and local governments, will have been emasculated." Krugman derides the Republicans' focus on tax cuts as "hackneyed political theater" and warns that "Washington has lost any sense of what's at stake -- the reality that we may well be falling into an economic abyss, and if we do it will be very hard to get out again."

In short, Krugman is arguing for smart spending, and nowhere does he urge the financial authorities to, as it were, whip up inflation now. Let's cross our fingers, and hope for a whole lot of learning, fast in Tokyo and Washington.
Andrew DeWit

Tobias Harris

A twenty years' crisis

"Japan is an economy that is almost certainly producing well below its productive capacity - that is, the immediate problem facing Japan is one of demand, not supply. And it gives every appearance of being in a liquidity trap - that is, conventional monetary policy appears to have been pushed to its limits, yet the economy remains depressed. What can be done?"

So wrote Paul Krugman in his 1998 analysis of Japan's prolonged economic crisis, in which he argued that to escape its liquidity trap, it was necessary for "the central bank to *credibly promise to be irresponsible* - to make a persuasive case that it *will* permit inflation to occur, thereby producing the negative real interest rates the economy needs."

Four years later, then-Fed governor Ben Bernanke, in his noteworthy speech on deflation, echoed Krugman, arguing "We

https://doi.org/10.1017/S1557466009023432 Published online by Cambridge University Press

conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation" — but then concluded that Japan's prolonged crisis was not the result of ineffective monetary policy but reluctance on the part of political actors to implement structural reforms, reforms that, Krugman argued, may be necessary but would do little to "induce people to spend more."

A decade after Krugman, Japanese authorities are once again stuck trying to stimulate aggregate demand.

Economist Ikeda Nobuo, in considering Japan's sluggish aggregate demand, concludes, like Bernanke, that the high liquidity preference of Japanese households — nearly half of Japanese household assets are held in cash or low-risk, low-return bank accounts — is a response to inefficient Japanese companies. Pessimistic that the Japanese government is capable of stimulating Japanese demand in the absence of foreign demand for Japanese goods, Ikeda concludes that the lost decade never ended: Japan is in the midst of a "lost twenty years."

A group of fifteen LDP lawmakers, however, has decided to embrace Krugman's solution, calling for the government to run the printing presses, expanding the money supply by 50,000 billion yen independently of the Bank of Japan in order to finance further economic stimulus. The "Diet Members League to consider the issuance of interest-free government bonds and government money" will hold its first meeting on Tuesday, with upper house member Tamura Kotaro chairing. Former finance ministry official Takahashi Yoichi will address the inaugural meeting.

The group's motto is essentially "desperate times call for desperate measures." Acknowledging that running the presses has positive and negative consequences, the group believes that the economic situation is sufficiently dire to merit the risk of hyperinflation. Quoted in an FT article, Mr. Tamura clearly has read his Krugman: "We are facing hyper-deflation, so we need a policy to create hyper-inflation. We have to do something to undermine the central bank and government's credibility or else we won't be able to halt the yen's rise. So, while we know this is drastic medicine, we will do it."

The new study group has drawn the opposition of senior LDP and cabinet officials. Yosano Kaoru, minister without portfolio for economic and fiscal policy, suggested that the government should issue more bonds instead of printing currency. Shirakawa Masaaki, president of the BOJ, insisted that the policy would do precisely what its proponents intend, namely undermine the credibility of his bank and the health of the currency. The heads of the LDP's factions were equally critical of the proposal, with Tsushima Yuji, the eponymous head of the Tsushima faction, likening the proposal to the *enten* ponzi scheme.

In other words, this is yet another policy upon which the LDP is divided and unsure of how to proceed, yet another sign of the governing party's flailing about in hope of finding some way to save itself (and Japan).

Not being an economist, I cannot say whether this group's proposal is appropriate. After years of weak domestic aggregate demand, it may be that only drastic inflation may be the only way to make Japanese spend at home — or demand less liquid assets with higher returns — no matter how politically risky it is for the LDP. Pensioners, already angry at the government, will presumably be no less angry as they watch inflation erode their fixed incomes.

But however appropriate the inflationary proposal, it may be beyond the power of the Aso government to implement. Whatever legitimacy the LDP-Komeito government had is now in tatters. The prime minister's latest

https://doi.org/10.1017/S1557466009023432 Published online by Cambridge University Press

misstep is to call for the revision of the postal privatization scheme, the very basis of the government's parliamentary supermajority. Mr. Aso questioned whether it is appropriate to divide the postal system into four companies, and stated that now is the time to revise the privatization scheme. He blithely stated that this position is wholly unrelated to the 2005 election that gave the government its mandate. Public opinion may have changed since 2005, but to backtrack now makes a mockery of democratic legitimation. If the government wants to revert from a policy that was critical to returning the coalition to power, it should have to go to the people and ask for approval to change course. (Nakagawa Hidenao made this argument at his blog, as did DPJ member Nagashima Akihisa.)

Naturally LDP proponents of postal reform have been quick to criticize the prime minister for his naked appeal to find some issue that will rescue his sinking government. (It bears noting that Mr. Aso has spoken of preserving the quality of postal services, a major concern of the public when it comes to privatization.) Koizumi confidante Takebe Tsutomu was perhaps the most succinct in his criticism: "What nonsense! I wish he would be more discrete in his speech."

In short, the prime minister is gradually losing whatever ability he has to rally his party and the public to an agenda. He is incapable of setting priorities or taking decisive action. The halls of power echo with rumors of plots to unseat him.

It is unlikely that this shiftless prime minister is capable of deciding on so risky and decisive a policy as proposed by the new league.

This prime minister, his party, and his government are bereft of authority and legitimacy — and they appear determined to drag Japan into the abyss with them.
As MTC so eloquently observes, hopefully Secretary Clinton will take heed of the stench of decay when she visits Japan later this month.

Andrew DeWit is Professor of the Political Economy of Public Finance, Rikkyo University and an Asia-Pacific Journal coordinator. With Kaneko Masaru, he is the coauthor of Global Financial Crisis published by Iwanami in 2008.

Tobias Harris is a fledgling Japan/East Asia specialist — who worked for a DPJ member of the upper house of the Diet 2006-2007. He is presently a Ph.D. graduate student in political science at MIT. He has been published in the Wall Street Journal Asia, the Far Eastern Economic Review, and the Japan Times. He can be contacted at observingjapan@gmail.com.

Andrew DeWit's commentary was written for The Asia-Pacific Journal and posted on February . Tobias Harris' blog entry was posted at Observing Japan on February 8, 2009.

Recommended citation: Andrew DeWit and Tobias Harris, "Japan's Twenty Year Response to Economic Crisis" The Asia-Pacific Journal, Vol. 7-3-09, February 12, 2009.

https://doi.org/10.1017/S1557466009023432 Published online by Cambridge University Press