

# OECD Economies: Japan

## Lecture 4: Economic stagnation in the 1990s

- Recommended Reading:
- Lipsey and Chrystal, *Principles of Economics*, 9<sup>th</sup> ed, pp 596 - 600.
- *Oxford Review of Economic Policy*, 2000, Vol 16, No 2 Special Issue on Japan.
- A Posen, 1998, *Restoring Japan's Economic Growth*, Washington, D.C.:Institute for International Economics.
- Blomstrom, Corbett, Hayashi, Kashyap, (eds), 2003 forthcoming, *Impediments to Japan's Growth*, Chicago U P for NBER, papers available from [www.nber.org](http://www.nber.org)

P. Krugman, 1998, “The Return of Depression Economics”,  
*Foreign Affairs*, Vol 78, No 1, pp 56 - 75

P. Krugman, 1998, “Its baaack! Japan’s slump and the return  
of the liquidity trap”, *Brookings Papers on Economic  
Activity*, 2 (2).

E. Lincoln, 1998, "Japan’s Economic Mess", *Foreign Affairs*,  
Vol 77, No 3, pp 57 - 67.

E. Lincoln, 1998, “Japan’s Financial Problems”, *Brookings  
Papers on Economic Activity*, 2: 1998, pp 347 - 375

# Burst of the Bubble

- What burst the bubble in 1991?
  - deliberate monetary policy.

## OFFICIAL DISCOUNT RATE JAPAN

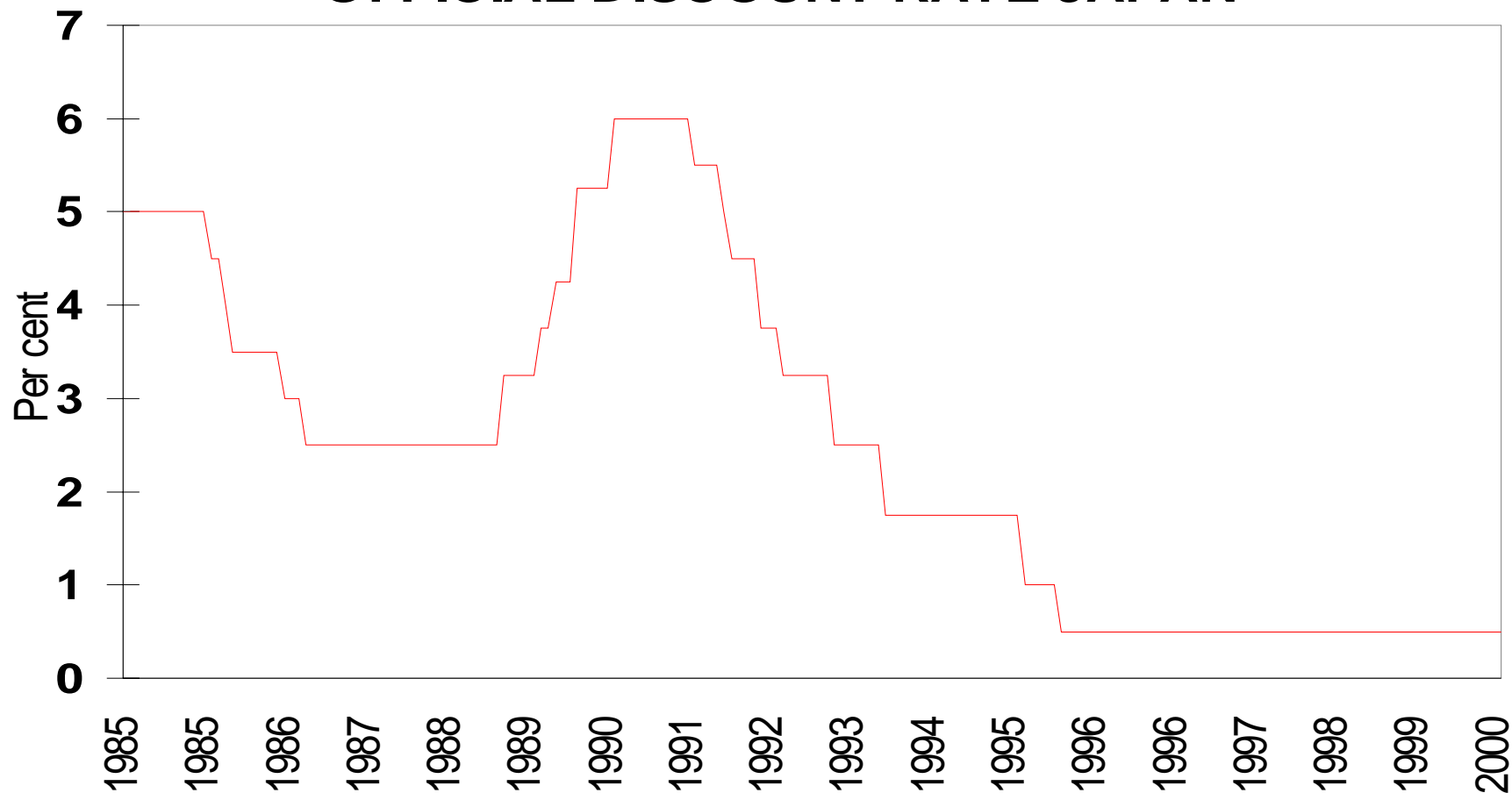
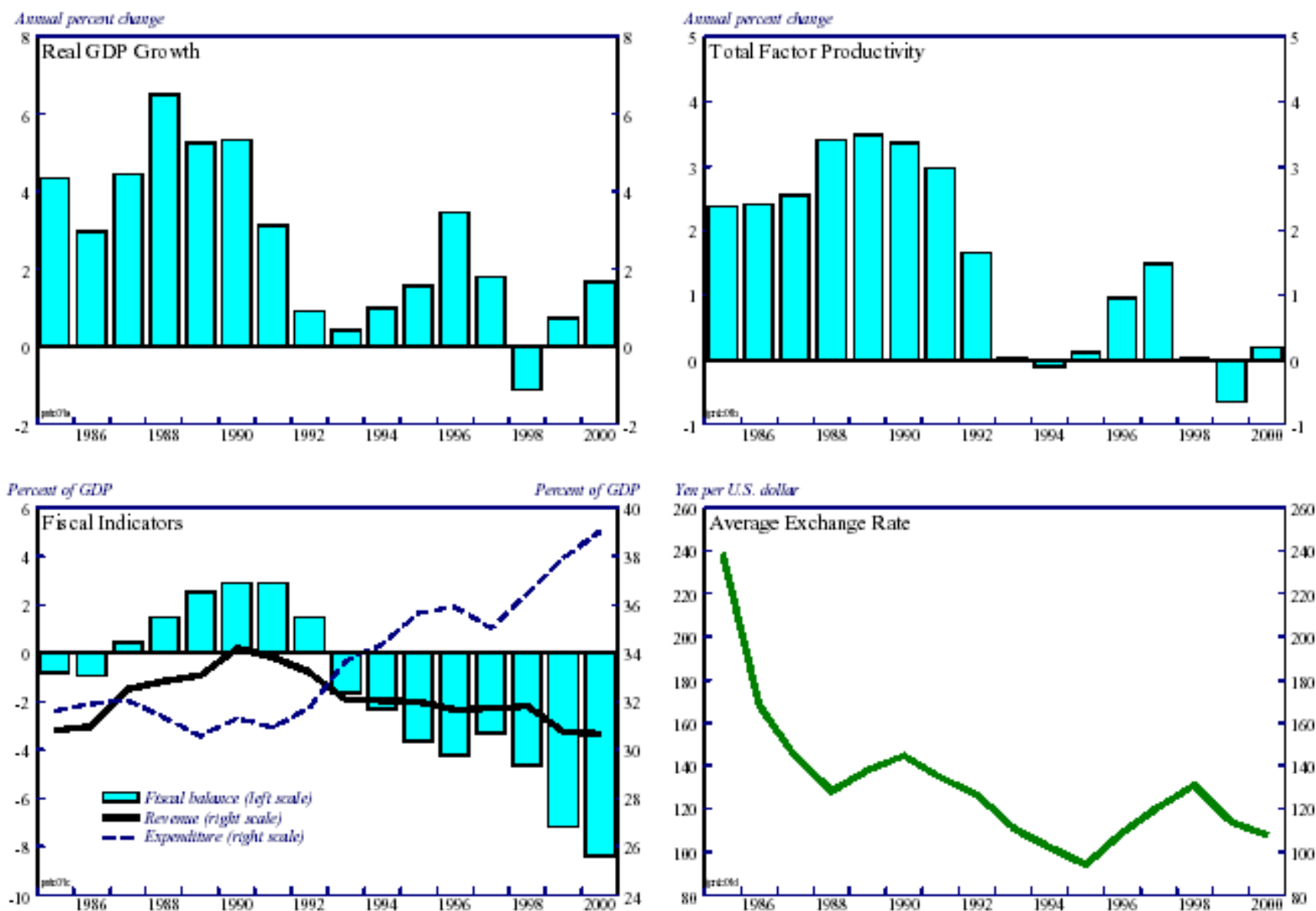


Figure 1. Japan: Selected Economic Indicators, 1985-2000

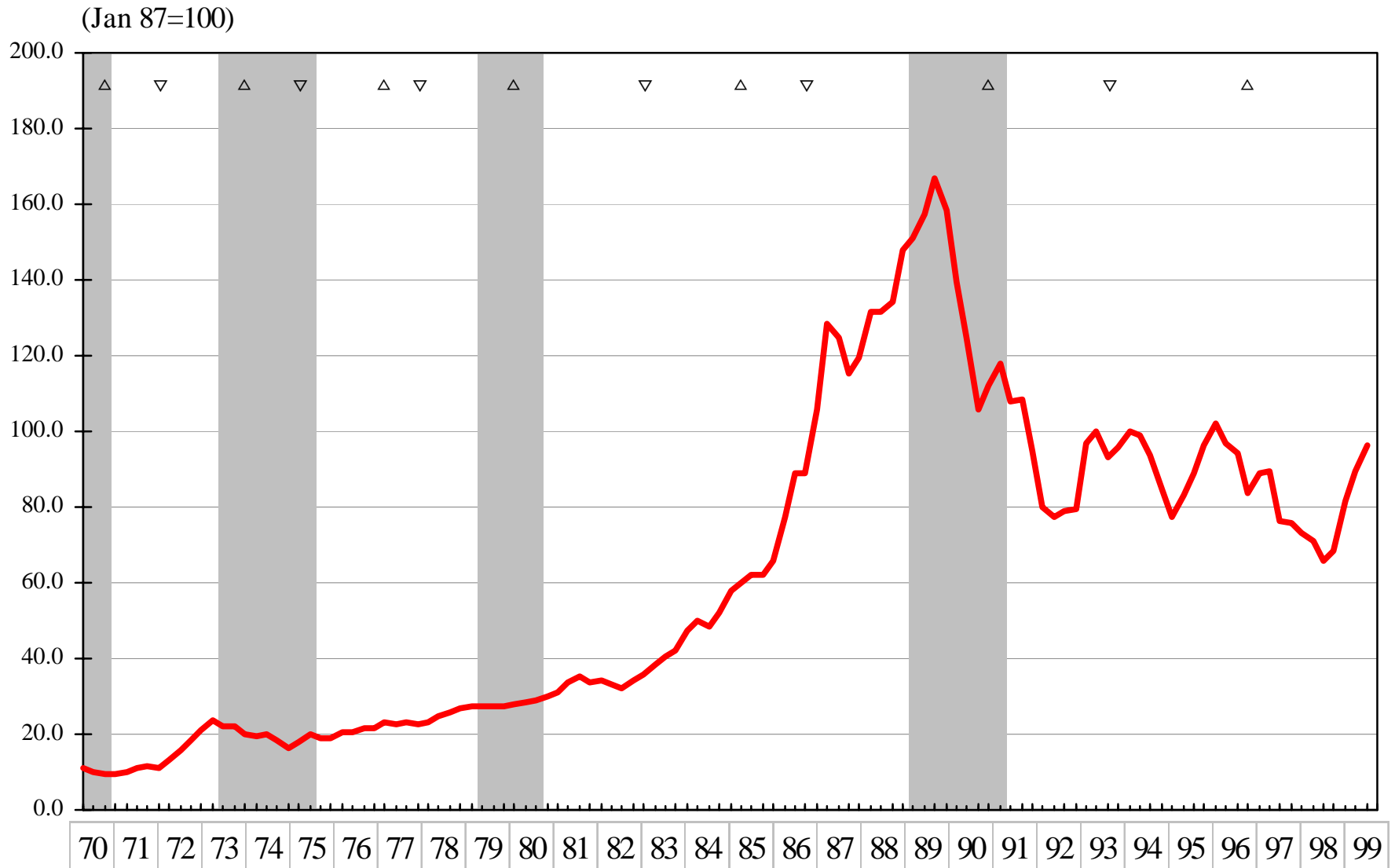


Sources: Nikkei Telecom; and staff estimates.

# Burst of the Bubble

- What burst the bubble in 1991?
  - deliberate monetary policy.
- Compounded by ever stronger yen
- Then asset price deflation had wealth effects
  - on households
  - on firms

# Nikkei Stock Average



# Capital Losses in the 1990s

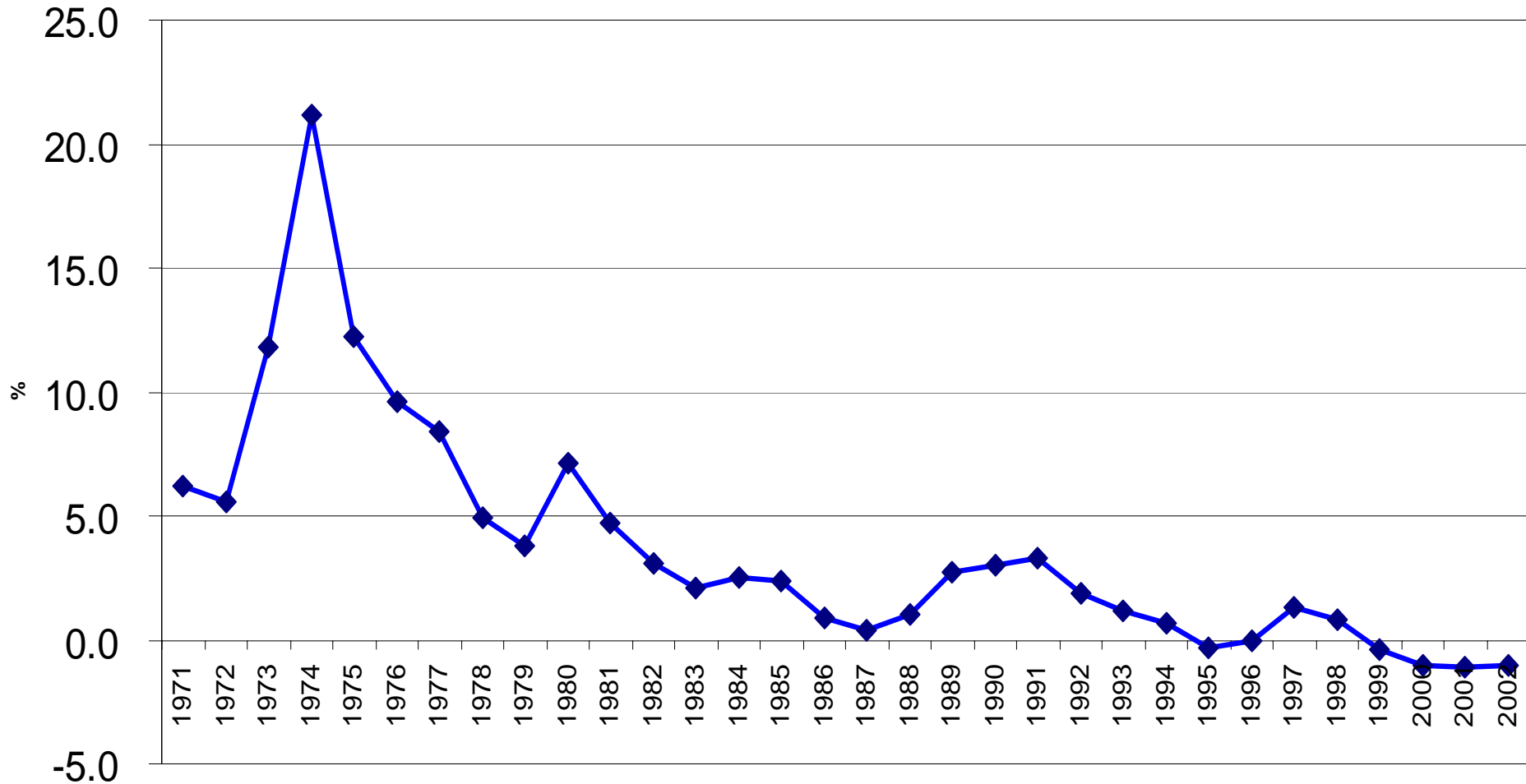
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# Recession in the 1990s

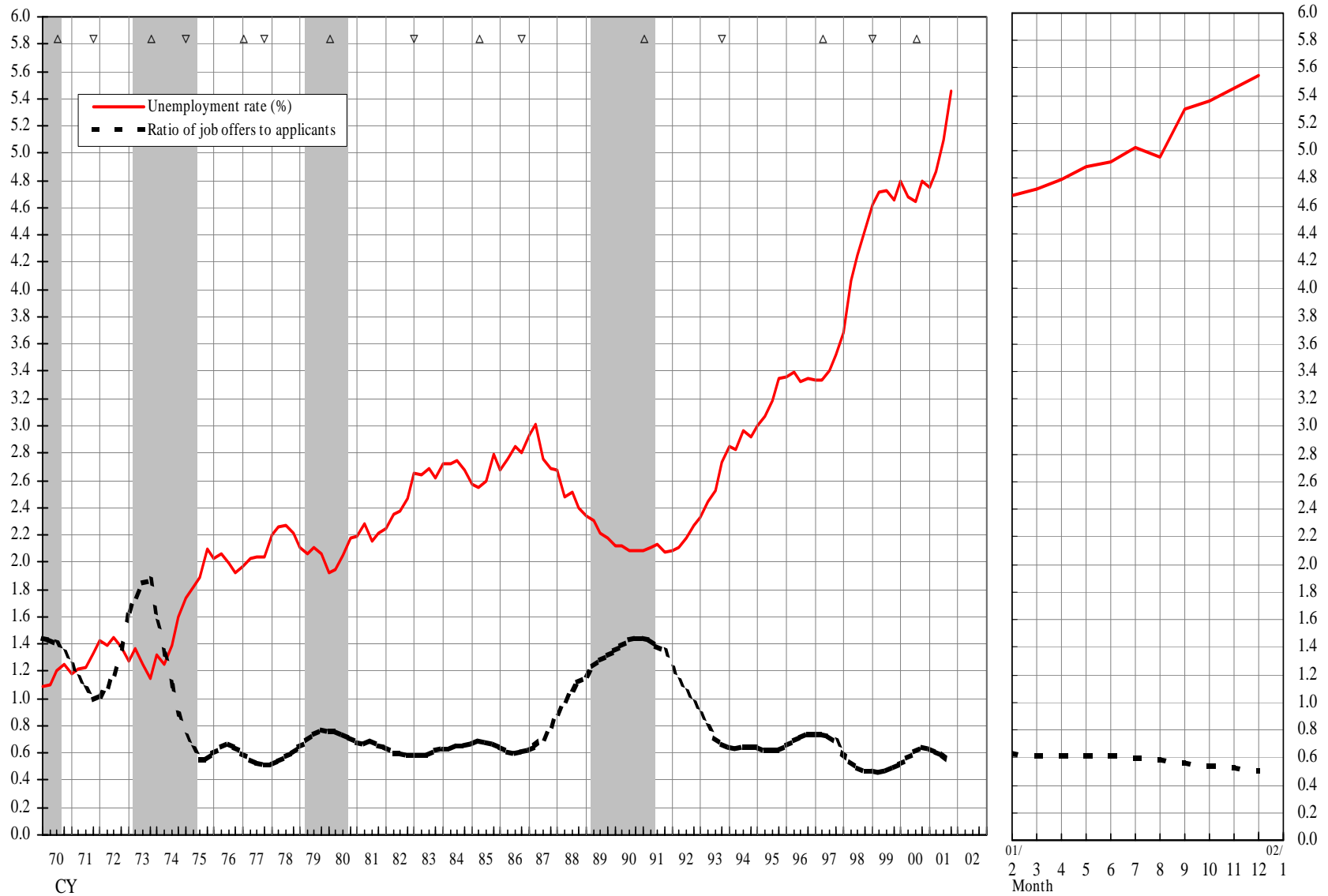
- Double-dip recession
  - 1991-95
  - 1997-99
- Additional Problems:
  - Large and rising government deficits as time went on, debt to GDP ratios huge
  - Ageing population - pension problems
  - Financial market deregulation and demands for further deregulation
  - Growing banking crisis still not resolved

## CPI Inflation



Source: Statistics Bureau, Ministry of Public Management etc, Japan,  
<http://www.stat.go.jp/english/data/cpi/index.htm>

# UNEMPLOYMENT RATE AND JOB OFFER INDEX



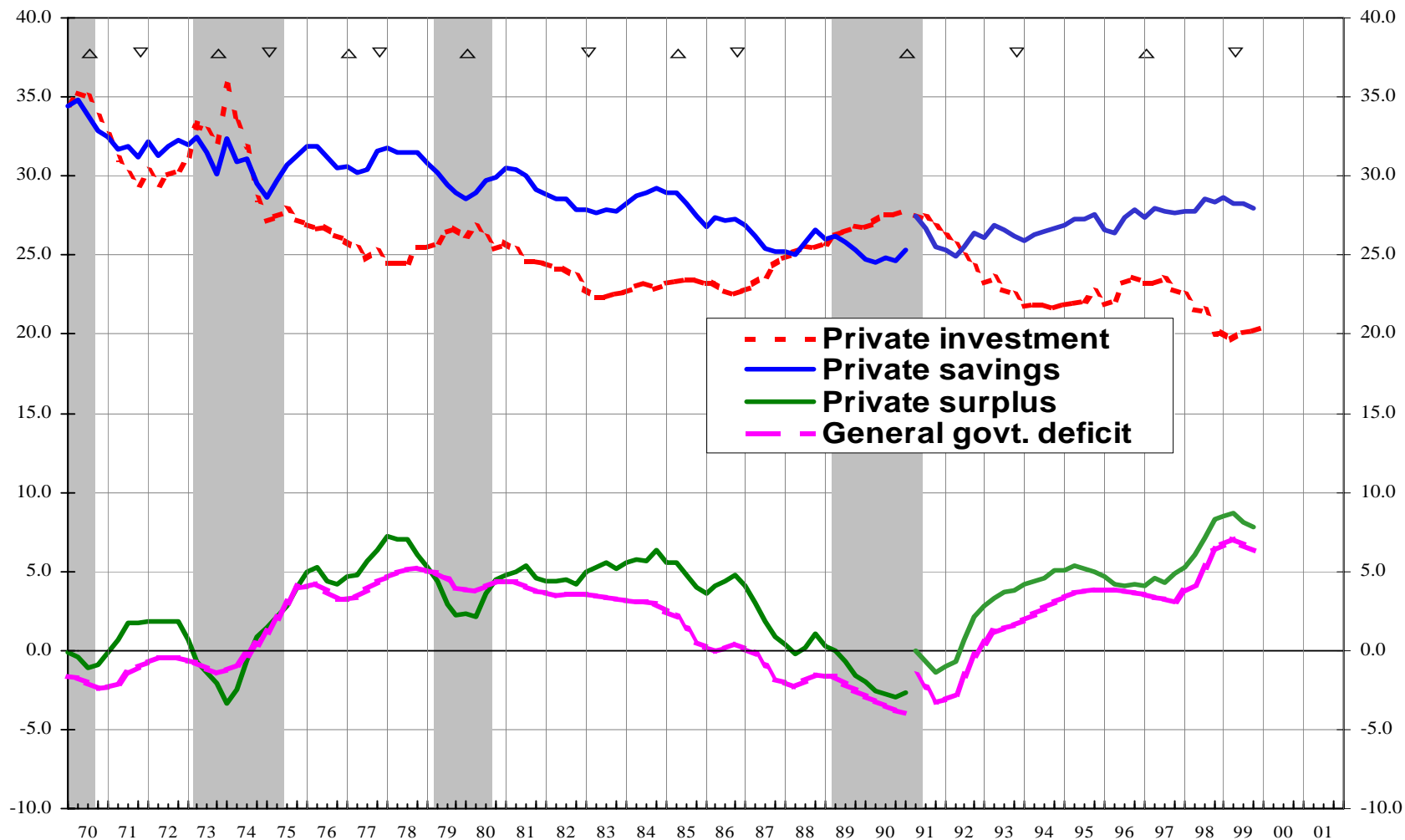
# Three major interpretations

1. Succession of unfavourable shocks
  - debt deflation (Its baaack, Krugman)
  - the ever-rising yen
  - policy mistake of 1997
2. Potential growth has sharply diminished
  - longer term trend of declining productivity
3. Elements of both which interact
  - can't ignore the demand side

# Can't ignore demand side problem

- Savings rate has always been high, for last 10 years higher than domestic investment
  - a Keynesian economy with insufficient demand
- Macro policy tools are the conventional remedy

# SAVING-INVESTMENT BALANCE AS % GDP

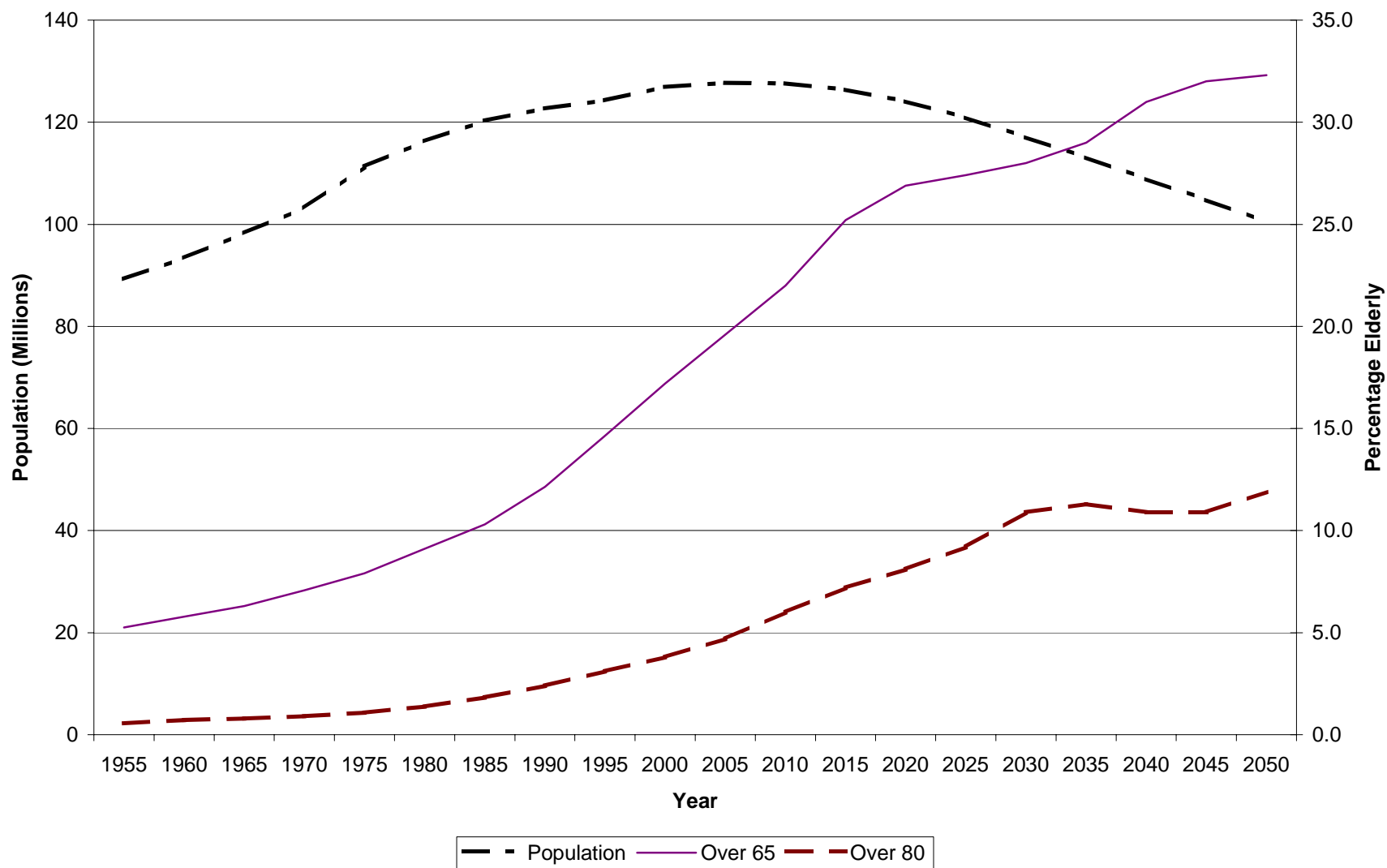


Source: BOJ, Economic and Financial Data on CD 2002

# What **should** macro policy do?

- Environment:
  - Deflation
  - Rising unemployment
  - Balance of payments surplus

Figure 3: Population and Elderly Projections





# What **can** macro policy do?

- Monetary policy
  - May be in a liquidity trap?
  - Problems of deflation
- Fiscal policy
  - Ricardian equivalence
  - Debt dynamics
  - Is the slowdown demand or supply-side?

# What role for Monetary Policy?

- Japan may be in “liquidity trap”
  - Nominal interest rates close to zero: what more can be done?

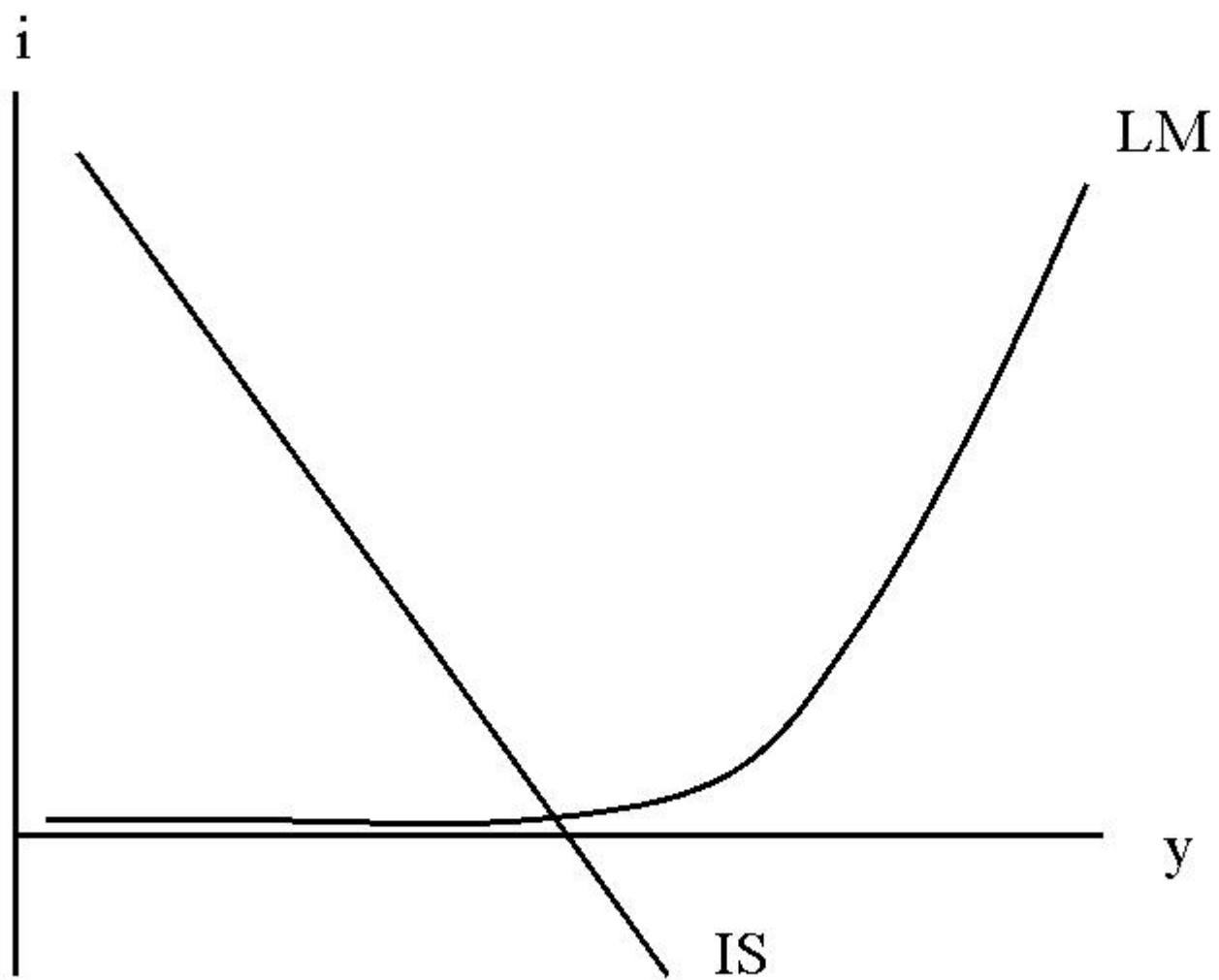


Figure 1

# Monetary Policy at Zero Interest Rates

- In a liquidity trap the demand for money becomes perfectly elastic – the nominal interest rate is already so low that an increase in the supply of money is held as money balances without further falls in the interest rate. Once you've hit the floor (zero interest rate) expansionary monetary policy has no further effect – can't force the interest rate any lower.

# What role for Monetary Policy?

- Nominal interest rates are zero
- But *real* interest rates are still positive (so  $S > I$ )
  - One of the costs of deflation
- What can be done?
  - There are other transmission mechanisms for monetary policy
  - But conventional one via bank lending is not working
  - Expansionary monetary policy will eventually impact prices, expectations would be helped by explicit inflation targets
  - Yen depreciation would be another mechanism but Japan is frequently criticised for weak yen (Sept 2003 meeting of G7)

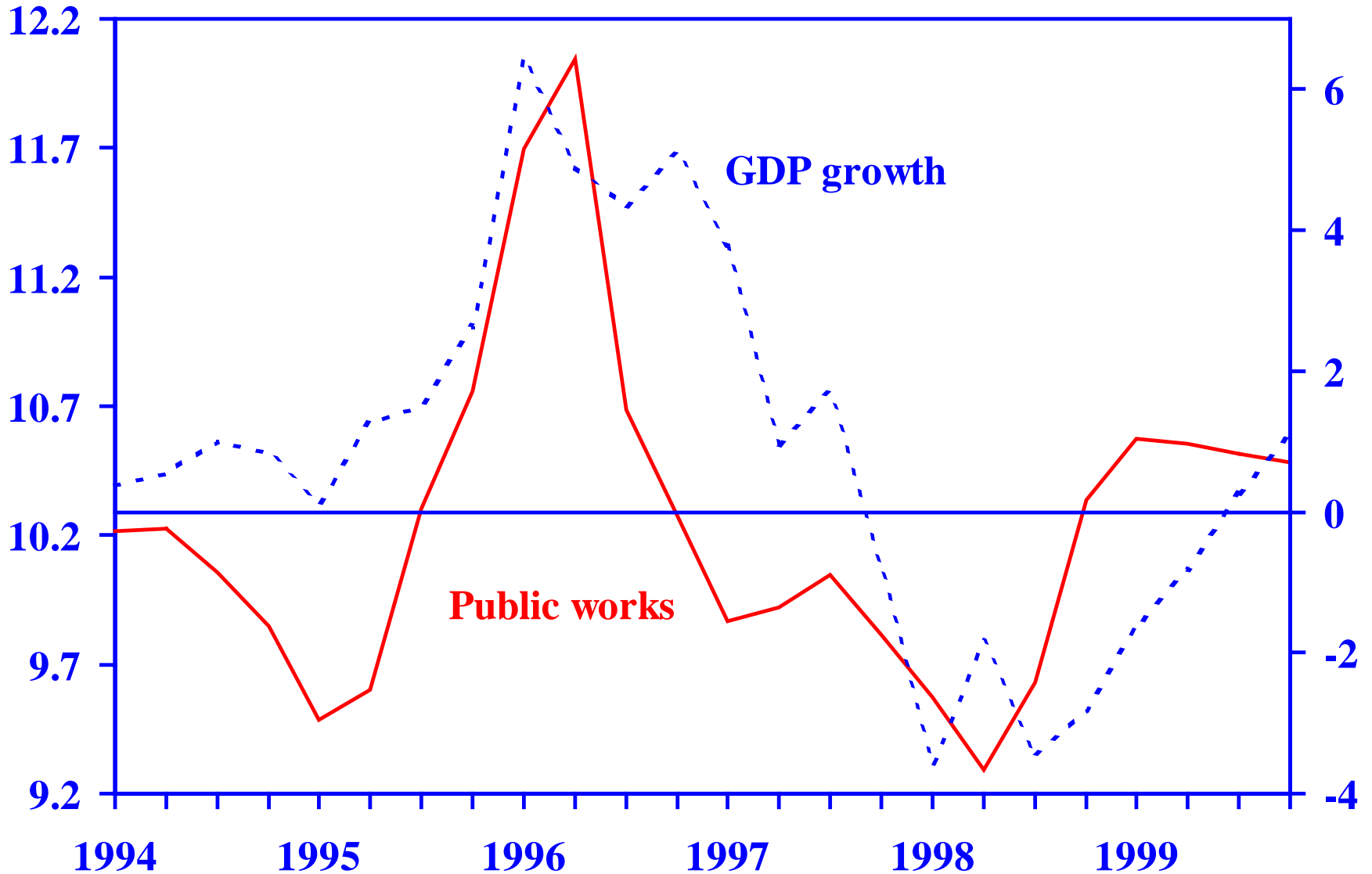
# Does Fiscal Policy Work?

- Why wouldn't it: *Ricardian equivalence*
  - Fears of size of government debt
  - consumer's increase savings to offset government spending
- Interest rates and exchange rates in open economy
  - effects can be undone
- But in fact it has worked when tried
  - 1997 major change of stance
- Sustainability requires confidence – rising doubts about debt dynamics

# Public works and GDP growth cycle

1990 yen trillion

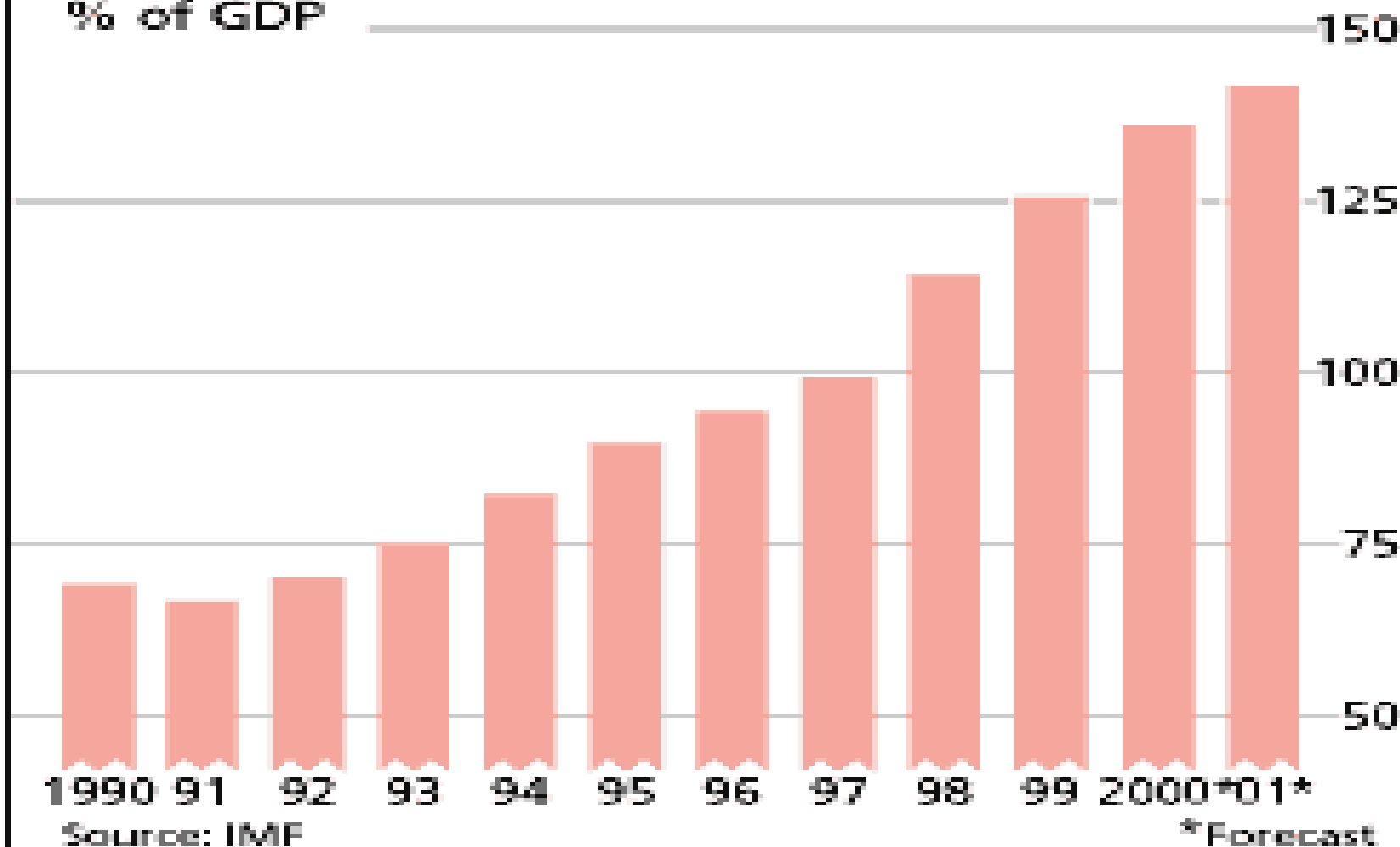
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Source: OEF

# An Olympian achievement

Japan's gross general-government debt as % of GDP



Source: Economist, Sept 30, 2000



# Structural Reform

- Difficulties with macro policy prescription led to focus on supply-side, structural reforms.
- A continuation of past policies – not wholly new idea.
- Despite bad press quite a lot has taken place
- One big issue is whether structural change and deregulation go more quickly in good times or in bad.

# Public Finances: blowout?

- R Dekle: debt dynamics wi real int rates at 3% and age-specific spending patterns at current real levels:
  - Unchanged policy – net debt/GDP by 2020 at 262%
  - Increased tax – net/debt GDP 2020 149% (tax/GDP 40%)- big tax rise required to stabilise and still get very large debt levels far into future
  - Cut in spend and invest – net debt/GDP 2020 74%
- IMF and JCER forecasts also imply savage tax rises and still large net debt/GDP ratios.

# Other sources of public liabilities

- Losses on assets held by public agencies and local govts financed under FILP
  - Doi and Hoshi estimate could be 15.7% GDP
- Implicit guarantees for banks (injections of public money)
  - Fukao estimates banks lost ¥82 trillion (over 16% of GDP) up to March 2002 (and more to come). Current capital levels of banks are over-estimated. Several could be insolvent if stock market falls.

# Cost to taxpayers of FILP liabilities

- Doi and Hoshi: assess solvency of public agencies which borrow from FILP
- Outstanding loans by FILP ¥357 trillion
- Future cost to taxpayer ¥78.9 trillion (15.7% GDP)
  - Total cost of ¥36.4 trillion to recap and support 8 govt financial institutions, 34 Special Public Corporations and 5 special firms
  - ¥35.2 trillion estimated defaults on loans to insolvent local governments
  - ¥7.3 trillion debts assumed from JNR

# Other structural problems: labour & technology

- Branstetter & Nakamura: R&D productivity fell in 1990s, though not in all industries
- Rebick-Ono: mobility of labour hampered by strong legal protection, low portability of pensions, no-hire above 40, penalties and barriers to female participation