

Japan's Economy Still Looks Recessionary

Last March, Japan's central bank made a significant qualitative change in monetary policy. It switched the operating target for monetary policy from the overnight call rate to the level of current account balances held by financial institutions, paving the way to inject more money into the nation's worsening economy.

However, this monetary policy adjustment has yet to create the conditions for recovery. Although the Japanese economy has been suffering for a decade from stagnant growth—in which the economy expands at significantly below trend—new evidence suggests an absolute recession in recent months. If a recession is defined as two consecutive quarterly declines in GDP, Japan is already halfway there with its negative first quarter (*Chart 1*).

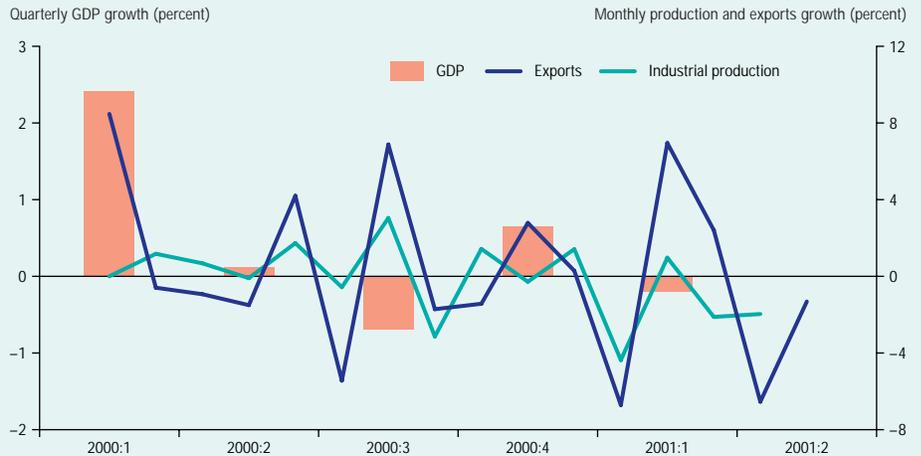
Moreover, Japanese industrial production and other indicators have fallen so significantly since the first quarter that many observers believe the second quarter will also show negative GDP growth. A quarterly survey of manufacturers' sentiments by the Bank of Japan, taken in mid-June, also suggests more negative conditions than in the first quarter.

This continuing weakness places Japanese policymakers in a quandary. While both monetary and fiscal policy have been thought useful in addressing an economic downturn, attacking the Japanese economy's recessionary impulses by means of fiscal deficits has been tried often in the past decade without success. Because of these efforts, Japan's debt-to-GDP ratio has ballooned to levels considerably higher than those of other developed countries and its Asian neighbors (*Chart 2*).

With Japan's nominal interest rates near zero, the cost of carrying even its current debt load is not overwhelming. But the budgetary implications of potentially higher interest rates in the future have some policymakers nervous about additional deficit financing. And because past deficit spending was insufficient to

Chart 1

Growth Indicators Looking Down



SOURCES: Economic and Social Research Institute (GDP); Ministry of Finance (exports); Ministry of the Economy, Trade, and Industry (Industrial production).

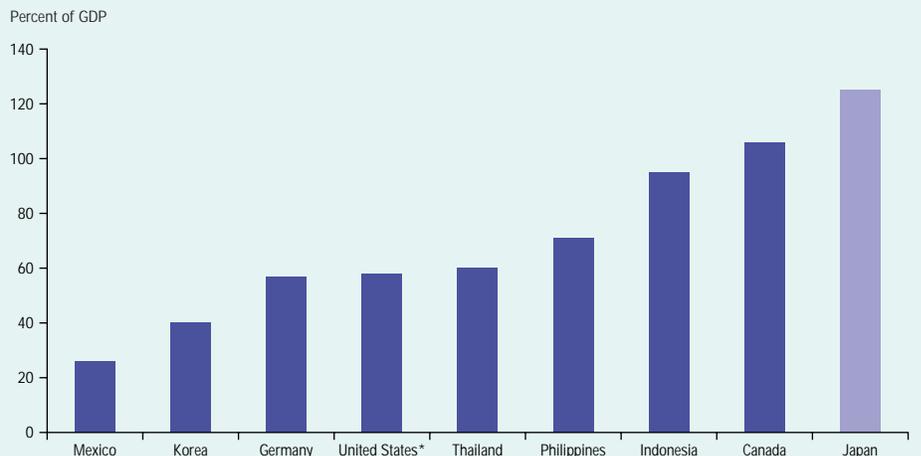
kick-start the economy, some policymakers are pessimistic about the effects of such spending as future policy.

Junichiro Koizumi, the new Japanese prime minister, wishes to refocus antirecessionary efforts away from fiscal and monetary policies and toward structural reforms. He wants to resolve Japa-

nese banks' huge inventory of bad debts, much as the Resolution Trust Corp. (RTC) did for U.S. financial institutions in the 1990s. Koizumi also would slow expansion of the government's budget deficit and deregulate and privatize the economy. He believes private industrial reorganization would bring greater long-

Chart 2

Japanese Debt Looms

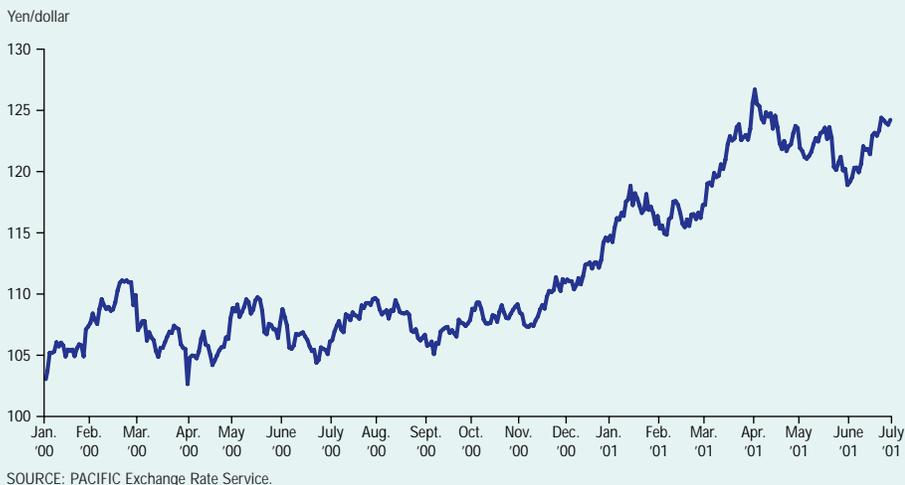


* Federal government debt only.

SOURCES: Secretaria de Hacienda y Crédito Público (Mexico); Goldman Sachs (Korea, Thailand, Philippines, Indonesia, Japan); Federal Statistical Office (Germany); Department of the Treasury (United States); Department of Finance and Statistics Canada (Canada).

Chart 3

Yen Depreciates Against the Dollar



run efficiencies, as has been demonstrated repeatedly over the last decade in Latin America, and ultimately revive the economy.

However, while the RTC's restructuring allowed U.S. financial institutions to resume lending, government critics wonder if the same stimulation can occur in Japan. That is, in an environment where private credit demand is so low, the negative effects of foreclosures and write-downs of bad debt may not be offset by the positive effects of freeing banks to make new loans.

Similarly, some observers who support more deficit spending question whether budget tightening will get Koizumi what he wants. After all, they argue, the United States is cutting taxes to prime the pump in economic circumstances far less serious than Japan's. Nevertheless, Koizumi has shown his determination to pursue structural reform. He has said that his reforms should have positive economic effects in two or three years—a timetable that may require the Japanese to fasten their seat belts.

Despite Koizumi's reformist political image, some analysts claim that his reform agenda lacks a clear action plan. They argue that his pledge to cap new government bond issuance at \$246 billion will create more short-term economic and political pressure than his government can endure. Recent data show that outstanding bonds jumped 10 percent from March 2000 to March 2001, to \$3 trillion.

Even though deficit spending has not spurred growth, keeping the deficit below \$246 billion may allow regional economic conditions to weaken more than they already have. Economics Minister Heizo Takenaka recently estimated that liquidating bad debt could cost 100,000 to 200,000 jobs as banks pull the plug on unprofitable companies.

The unemployment estimate hints at the extent of reform Japanese policymakers have in mind. It is estimated that nonperforming loans in Japan are equivalent to 8 to 30 percent of GDP and that an amount equal to 4 percent of GDP needs to be written off. In such an environment, Takenaka's estimate of 200,000 jobs lost—a 0.3 percent increase in the unemployment rate—may reflect the government's positive expectations concerning the ultimate effects not only of reform, but also of other policies.

In this context, looser monetary policy, including the direct purchase of government bonds by the Bank of Japan, is anticipated. So is the depreciation of the yen, as can be seen by the recent currency market reaction (*Chart 3*). Some U.S. academics feel that the Japanese economy cannot resuscitate without some kind of demand-side policies.

The effects of monetary and fiscal policy in Japan have been small and short-lived for the last decade, mainly because many Japanese companies could not make profits in response to them. Easy monetary policy did not spur in-

vestment because companies did not want to borrow, even at virtually zero nominal interest rates. Nor have consumers increased their consumption. With low expectations of corporate profits, they could not foresee increases in their own incomes and thus remain cautious spenders. The effects of fiscal expenditure evaporated as soon as the government money was gone.

Koizumi's proposals are based on the idea that economic reform should create the conditions necessary for private companies to become profitable through organizational and product innovations. The concern of some Japanese policymakers about employment suggests they are still reluctant to change the legal and institutional structures that have made it difficult in the past for the Japanese labor market to adjust to change. However, the idea of steps toward labor market flexibility and the consistency of these moves with the expressed intentions of the Koizumi administration are said to be gaining ground among Japanese politicians. Such changes in Japan's labor market would not be easy, but similar adjustments in recent years have helped make the difference between recovery and its antithesis in some other Asian economies.

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