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Address by Edward Lincoln
Senior Fellow, Foreign Policy Studies
Brookings Institution
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An American View of the Japanese Economy
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Edward J. Lincoln
The Brookings Institution
Washington, DC

The first country in Asia to experience economic difficulties in the 1990s was Japan, and those problems have been far more severe than anticipated. Because of the lengthy Japanese stagnation, American views of Japan have become more pessimistic. I would like to sketch out some of the reasons Americans have become more pessimistic about Japan and its role in Asia.

The collapse of the bubble at the beginning of the 1990s brought severe asset deflation, and the resulting bad debts in the financial system and overall economic stagnation was no surprise. Given the severity of the drop in asset prices, Japan did well to escape with stagnation rather than a contracting economy. The macroeconomic packages of 1994 and 1995 did have a positive impact--cutting taxes and raising expenditures helped to push the economy back toward recovery. By the time I left the American Embassy in the summer of 1996, the economy appeared to be entering a phase of self-sustaining growth. But several things have happened since then to produce a much more pessimistic view:

First, the decision to raise taxes and medical fees in the spring of 1997 was a major mistake. Many of us sympathize with the long-term need of Japan to control its fiscal deficit, but the moves in 1997 were too much too soon. The tax increases had negative real impact on the economy as well as a negative psychological impact. Having created a pessimistic public psychology, the government then faced a difficult task of reversing those attitudes.

Second, the government was slow to recognize the real and psychological damage done to economic recovery. While American analysts were becoming concerned by the summer of 1997 that the damage would last longer than just one or two quarters, the government did not respond until December.

Third, even when the government began to respond, the decisions were small and taken one at a time. The initial tax cut was in place for only two months, and accompanied by public statements about no consideration of any further tax cut. The stimulus package then took over four months to develop, with new rumors every week or two, while all economic indicators implied the situation was worsening rapidly. Even now, the government is sending signals that additional measures on the tax side might be considered after the summer. This drawn-out process did not inspire any confidence among Japanese or foreign observers, especially since each step was accompanied by optimistic government statements widely believed by outside observers to be unrealistic. Speeches by government visitors to Washington over the past six months have been greeted by skepticism by their audiences.

Fourth, Americans have been listening to Japanese complaints concerning the inefficiency and corruption associated with public works spending for two to three years. This leaves people puzzled as to why the new stimulus package would rely mainly on public works. Even the notion of a different approach emphasizing new technology rather than traditional public works is not convincing because the largest new item is acceleration of construction of a fiber optic network--which is essentially a construction project (and one that should not be subsidized by government spending in the view of most Americans).

Finally, Americans have been hearing for five years statements from Japan concerning the need to accompany macroeconomic stimulus with extensive deregulation of the economy to enable a more robust, self-sustaining recovery. But the view of most observers is that general deregulation and administrative reform has been slow and weak. This leaves people worried that the current macroeconomic stimulus package will only have a temporary effect on the economy.

Besides these concerns about the macroeconomic situation, American observers are worried about the continuing problems in the financial sector, and worried that Japan is repeating mistakes we made in the 1980s. On the positive side, restoring confidence through refinancing the Deposit Insurance Corporation to protect depositors was a good decision. Depositors need to be reassured that their money is safe even if the bank into which they have put deposits were to fail. This should be sufficient to restore depositor confidence.

But restoration of a healthy financial system also requires weeding out weak institutions that are a drag on the economy. In both the 1930s and late 1980s, many American banks or savings and loan institutions went bankrupt as part of the solution to solving bad debt problems. Rather than weeding out weak institutions, though, the collapse of Yamaichi Securities and Hokkaido Takushoku Bank appears to have driven policy back to protection of all (or virtually all) financial institutions. This could prolong the recovery of the financial sector and damage public confidence in the system.

To prop up financial institutions, the government has implemented a series of accounting measures and other government actions that permit weak or insolvent banks to appear stronger than they really are. These additional moves do not restore public confidence. In fact, some foreign observers in the financial community believe that the government will eventually fail in this attempt to support very weak institutions, and having implicitly promised that additional bankruptcies would not occur, these additional bankruptcies would further undermine public confidence in both the financial system and the government.

What should be done about the macroeconomic and financial situation? The current ¥16 trillion stimulus package will certainly have a positive effect on the economy over the next year, sufficient to keep the economy expanding slowly. Government policies toward the financial sector will prevent any disastrous collapse of financial flows. Nevertheless, I believe that a somewhat different set of policies could help Japan recover from its problems faster. If I were dictator of Japan, I would adopt the following policies:

1. Announce an economic emergency to the public to convince them that the government understands the severity of the economic situation.

2. Proclaim a substantial, permanent income tax cut. This might include both the increased personal exemption method of the current tax cut, but also a sharp drop in the top marginal tax rates. And this would be accompanied by a promise that any future need to dampen fiscal deficits would take the form of decreased government spending rather than a reversal of the tax cuts.

3. Mobilize all Ministry of Finance and Bank of Japan officials with expertise in accounting to begin a systematic inspection of all banks, securities firms, and insurance companies. These inspectors would be empowered to shut all institutions considered too weak to save.

4. Move forward dramatically with deregulation, including action on the many zoning and tax problems concerning real estate so that it would be easier to actually sell the real estate collateral behind bad debts. Other actions should include accelerating and strengthening the "big bang" reforms, as well as substantial deregulation of telecommunications, construction, domestic transportation, agriculture, and other areas.

In the short run, my policy might cause considerable pain, and is obviously easier for a dictator than a democracy. But I have confidence in the entrepreneurial spirit of Japan. While the weak and inefficient enterprises in finance and construction suffer, others freed from regulatory restraints will grow and bring Japan into a new era of expansion.

This set of proposals leads to a final question--the role of Japan in restoring Asian economic growth. The trigger for problems elsewhere in Asia was a currency crisis as foreign investors withdrew funds from Asian currencies. But this broader Asian problem is only partly a currency crisis. The currency crisis was caused by internal economic problems in several countries, and foreign investors were reacting to the lack of effort by governments to deal with these problems. Although the nature of those problems varied--corruption in an aging political regime in Indonesia, a real estate bubble in Thailand, and imprudent investment decisions in manufacturing in South Korea--they do have a common theme: weak financial systems. Many Asian countries have relied heavily on banking to mediate the flow of funds from savers to real investments. Within banking these countries have relied heavily on either personal relationships with borrowers or informal signaling from government to allocate loans. As was the case in Japan from 1950 to the early 1980s, such a system can work. But there are dangers, which have now disrupted Asian economic growth.

Obviously economic systems must be compatible with underlying cultural characteristics of a society. The reliance on personal relationships in business has been one feature of Asian economies that may have some cultural basis. But even with this social background, careful financial analysis remains important. Therefore, a critical component of Asian recovery lies in reform of financial systems to inject greater emphasis on financial analysis, accompanied by stronger rules on disclosure to convince outsiders that such analysis and prudent lending decisions are occurring.

Japan could set a good example by bringing about reform of its own financial sector, thereby encouraging others to do the same. Unfortunately, this is not the signal that Japan has sent to the rest of Asia so far. Japan's emphasis has been more on the supply of financial credits to debtor countries to help bail out their bad debt problems. Because the bad debt problems in Asia are primarily in the private sector, this response is controversial in the United States. Some financial support (by the IMF or individual creditor countries) may be necessary to prevent severe economic and political problems in Asia, but experts in the United States generally believe that both debtors and the foreign financial institutions lending to them should bear much of the loss because this is the essence of private markets. This view also emphasizes the need for reform, because reform would create financial sectors in these countries less prone to the kind of imprudent lending that created the current problems.

In conclusion, economic problems in Japan and elsewhere in the Asian region are serious. But many of the economic fundamentals--high levels of education, strong work ethic, entrepreneurial spirit--remain. If Japan and other countries successfully address their current problems, they should be able to return to a path of healthy economic growth.