IIMA
Institute for International Monetary Affairs
NEWSLETTER
財団法人 国際通貨研究所
2001. 8. 29.
(No. 6, 2001)

Structural reforms must be carried out resolutely

Toyoo Gyohten
President
Institute for International Monetary Affairs

Reform and revitalization can go together

Absurd and difficult-to-understand arguments have been propounded both at home and abroad concerning the current state of the Japanese economy. Too often, the focus seems to be on a somewhat irrelevant question, namely, whether Japan should prioritize structural reforms or measures to stimulate business recovery.

Asking such a question puts us in a dilemma in which there is no solution.

When the administration of Prime Minister Junichiro Koizumi was inaugurated in April, the public responded positively to his message of the need for reforms, his candid manner of speech and his hands-on style of governing. The result was extraordinarily high public approval ratings for the Koizumi Cabinet. Overseas analysts — who failed to anticipate such a development in Japanese politics, believing Japan would be incapable of reforming itself without outside pressure — were pleasantly surprised. However, as soon as three months after the new administration was launched, questions were raised shortly before the July 29 House of Councillors election about the impact of Koizumi's planned reforms.

Problems difficult to grasp

Koizumi's structural reform plans have triggered criticism on two fronts shortly after they were announced. Some people believe the reforms are nothing more than a political slogan, unaccompanied by any specific measures. Others say that the Koizumi administration has yet to take any steps to alleviate the faltering economy, and therefore forcing banks to dispose of bad loans quickly would inflict serious consequences on the general public.

The former argument is not a major point of contention, as it is only natural politically for the Koizumi Cabinet to avoid providing details of its planned reforms before the upper house election. The latter, however, is a problem worthy of note. With the economy slipping into negative growth, prices continuing to fall and business confidence rapidly eroding, the media and economists both at home and abroad seem to be confused about what needs to be done to alleviate the situation.

Certain questions have been raised, such as: Can't an economic recovery be compatible with structural reforms? Is it impossible for the two to be supplementary? Is it necessary for the government to clarify which of the two should be prioritized? How can the government pursue both these goals at the same time? It seems that most of the views expressed, both at home and abroad, fail to offer any persuasive arguments regarding these questions. In my opinion, this is mainly because these arguments have failed to grasp in a comprehensive manner a couple of major problems confronting the Japanese economy: the nature of the problems the economy has been suffering from and the reasons why structural reforms are necessary.

U.S. triggered economic slump

There are two things of essential importance in assessing the current state of the economy. First, we should be well aware that the current economic downturn is due largely to a slump in the global business cycle that was triggered by a plunge in capital investment in the United States. During the latter half of the 1990s, the United States experienced an investment boom, with the information technology and communications industries playing a leading role. The U.S. boom rapidly became an economic bubble in and after 1998, causing surges in capital spending in Asia, including Japan, and Europe. However, the excessive capital spending in the United States inevitably peaked and it subsequently entered an adjustment phase in the spring of 2000, a process that is continuing. Indications are that the downturn is likely to continue until 2002. Judging from the business indicators available, the economies of the rest of the world have entered an adjustment phase similar to that of the United States. The cycle of capital investment in the United States this time can be characterized by the surprisingly fast upturn in the latter half of the 1990s, due mainly to the Internet and other technological innovations. The flip side, though, is that once the cycle has entered a downturn phase, it is difficult to reverse the process through demand-stimulating measures. For one thing, cuts in interest rates in the United States — seven times during first eight months of the year — have failed to yield tangible results. The current state of the Japanese economy must be viewed in this context.

Reforms not understood

Second, it should be noted that Japan's entry into the adjustment phase has taken place prior to reform of its economic structure. Not many people seem to understand what structural reforms mean. As Keio University Prof. Eisuke Sakakibara points out in his discourse in the July edition of the Chuokoron monthly magazine, structural reforms can be defined as changing statutory arrangements, tax and budgetary systems as well as a wide range of other institutions and practices that would eliminate the conventional dual structure of the nation's economy and politics. Specifically, the reforms should focus on the manufacturing and service industries, which account for 90 percent of Japan's overall business activities, subject to market economy principles, while shifting the political system away from partisan politicking to political leadership of a responsible government. The problem is that these structural reforms have yet to be accomplished, so that supply-demand imbalances in business cycles are likely to be distorted amplified.

Although the issue of disposing of bad loans has been played up by the media, it is a different issue from structural reforms. Bad loans can result in any country, at any time, in the business cycle. That bad loans have currently taken on such massive and grave proportions is attributable primarily to the indecisiveness of corporate executives and government authorities concerned. However, what made such indecisiveness inevitable were the structural problems involving companies and industries that have turned into nonperforming borrowers on the one hand and the weak earning capabilities on the part of financial institutions on the other. The problem of bad loans, if left untended, would inevitably be dealt with through information disclosure of the finances of banks involved and subsequent liquidation of the debts at issue by market forces. The cost in this case would be so enormous that this kind of scenario is hardly advisable.

Economic stimulus

Those championing an economic-stimulation package over structural reforms have put forth two proposals: so-called quantitative monetary easing, as represented by inflation targeting, and allowing the yen to weaken.

The first proposal is based on the idea that the Japanese economy has been plagued with deflation and since deflation is a financial phenomenon, financial measures must be used to combat it. While this theory may be rhetorically correct, it fails to take into account the reasons why prices keep falling and why there are no signs of an increase in demand for goods and services. In other words, it fails to explain why lending by banks has failed to increase despite their expanded monetary base. Nor does it take into account the fact that huge amounts of surplus funds held by banks have been used to purchase government bonds, so that the risk to financial institutions from excessive government bond holdings has risen to a critical level. Arguments that the economy will pick up if more money is pumped into the financial system by setting and sticking to an inflation target are extremely unconvincing. Such claims disregard whether inflation targeting is feasible and if such an action would prove useful or harmful to the national economy.

Two reasons have been cited in favor of allowing the yen to weaken. One is that a weak yen would improve the profitability of Japanese companies. The other is that the current exchange value of the yen, when viewed in terms of what is called purchasing parity, is unreasonably high. If the yen weakens, yen-denominated profits of export-oriented companies will increase. Such an increase, however, would not lead directly to rises in capital investment and employment in the overall Japanese economy. It is not really known whether the weakening of the yen from 1995 to 1997 helped improve the economy. Despite what those calling for a weaker yen consider an appropriate rate, export-oriented companies that have been trying to enhance their competitiveness are not seeking a weaker yen. What they want is a stable yen and a more predictable range of fluctuations. The yen's current value is undoubtedly high in terms of its purchasing parity on the basis of prices in the domestic market. However, this is simply because the productivity of Japan's domestic manufacturing and service industries has remained markedly low, so that domestic prices are much higher than those in the international market. This gap must be corrected by enhancing the productivity of domestic manufacturing and service industries. Attempts to do this by weakening the yen put the cart before the horse.

In a nutshell, it is wrong to argue that deflationary pressures are the only cause of the economy's current problems and that they can be overcome through short-term remedies. These remedies cannot be put into practice. Demand-side improvements are inseparably intertwined with improvements on the supply side.

Common questions

Two key questions are being asked about structural reforms: how the "pain" that will accompany the reforms will be dealt with and what will happen if the reforms are not carried out.

By pain, people refer mainly to the inevitable increase in unemployment following corporate restructuring. Some people talk about restructuring in bitter terms, arguing that it will "weaken those already socially weak." But it must be remembered that helping the socially weak who have suffered hardship due to circumstances out of their control is one thing and taking countermeasures to protect those who lose their jobs in the process of cutting back on excess workers is quite another. People in the former category exist irrespective of structural reforms, and the task of solving or alleviating their problems is an obligation of every society. Regarding the reduction of excess workers, widely accepted measures should be put in place to solve the jobless problem, such as boosting the efficiency of the labor market, increasing the number of start-up businesses, and improving job-training programs and employment insurance plans.

No reforms, no change

What would happen if no reforms were carried out? Even if the reforms were put off, there would be no immediate danger of Japan's economy collapsing. But the economy would continue to stagnate in a repetition of the 1990s, the period often referred to as Japan's "lost decade." The strength of Japan's economy would certainly deteriorate, and Japan's stature in the international community would weaken. Of course, the longer the economy stagnates, the more difficult it will be for it to bounce back, exacerbating the risk that the country would be on the wane for a considerable time in the future. Structural reforms are needed as they are the only means to enhance the economy's productivity and competitiveness. I would have nothing to say if public opinion opposed the reforms, but since the inauguration of the Koizumi Cabinet, opinion polls have indicated the people have not lost hope for change. The tasks to be addressed in carrying out structural reforms — reform of party politics, early disposal of bad loans, a review of public works projects, reform of local government finances and restructuring of public corporations — an all be specific policy objectives. There may be some who are skeptical that reforms may come to nothing as happened in 1993 under Prime Minister Morihiro Hosokawa. The reform initiative this time, however, is decisively different from that of the Hosokawa administration, which lacked any clear-cut, feasible plans. Eight years on, the Japanese people are now more aware of what needs to be pursued in the name of reform.

There should be no turning back. As the reform objectives materialize, the supply-demand structure will be transformed, providing the market with confidence and hope.

Address: 3-2, Nihombashi Hongokucho 1-chome, Chuo-ku, Tokyo 103-0021, Japan
Telephone: 81-3-3245-6934, Facsimile: 81-3-3231-5422

〒103-0021　東京都中央区日本橋本石町1-3-2
電話：03-3245-6934(代)ファックス：03-3231-5422
e-mail: admin@iima.or.jp
URL: http://www.iima.or.jp/