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Japan's Mediocre Economic Performance Persists and Fundamental Problems Remain Unresolved [*]

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Introduction

Japan's economic performance and economic policy actions since summer 2001 have once again been disappointing. The economy slid into mild recession, its third in the past decade; and unemployment rose and deflation has persisted. The economy bottomed out in early 2002 and apparently began a moderately good recovery, but that now appears to be slowing, perhaps even stalling. The prospects for 2003 are not good.

Basically Japan's mediocre economic performance continues. Even more dismaying has been the persistence of the same major macro, financial, and structural problems that have plagued Japan for some years now – inadequate aggregate demand, huge non-performing loans, corporate excess capacity and low profitability, unemployment, slowness to engage in substantial structural reforms, and so on.

Perhaps the greatest disappointment has been in the hope that Prime Minister Koizumi would successfully address these and other major economic issues. While the Koizumi

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government has made modest progress in some structural reforms, such as public corporations and the postal service system, the overall results have been disappointingly limited.

Nonetheless, Japan is very different than it was a decade ago – institutionally, politically, and even in its mindset. My colleague Gerald Curtis has characterized the 1990s not as the lost decade but as the watershed decade, in which the cumulative effect of many changes, some seemingly small, will be profound over the longer run.

However, the economic cost of the 1990s has been substantial in terms of gross domestic product (GDP) foregone. If the economy had grown over the past decade at the 1980s annual average growth rate (3.7 percent) rather than its actual eleven year average for 1992-2002 of 0.7 percent, Japan's GDP would be 43 percent higher today. Even at 2.5 percent growth, GDP would be 24 percent higher. The only industrialized economy with a worse growth performance in an eleven-year period since 1945 is Switzerland.

<u>Ongoing Transformation</u>

The Japanese economy is in the process of fundamental transformation which will take at least two decades. Such transformations are never smooth. Japan is moving fundamentally from its more regulated and particularistic postwar economic system to one which is much more competitive and market-based. The transformation has various dimensions.

Agriculture has long been a neglible share of output and employment, manufacturing is declining gradually, and services are steadily increasing. Production continues to shift from labor-intensive to capital and skilled labor-intensive, high-tech activities in manufacturing and especially in services, where Japanese relative productivity has been extraordinarily low compared to other OECD countries.

As domestic investment opportunities weaken over time, Japan is evolving from a high saving, high investing, and low consuming economy to a medium investing economy in which the share of saving must decrease and the share of consumption rise. Eventually, Japan's financial system will evolve from its bank deposit and lending base to a more diversified financial structure in which commercial paper, bonds, mutual funds, and other capital market financial instruments will become more important. Labor markets, adjusting most slowly of all, will become less segmented and more flexible. Demographic change may not have much economic impact for the next ten years, but after that it will become increasingly important. Those over 65 are becoming a steadily larger share of the population. On the other hand, the younger generation will embody new lifestyles, values, and technological capabilities to utilize the Internet and other attributes of information technology. The government's unwillingness to address Japan's fundamental economic problems means that growth in 2003, and probably for several years to come, will continue to be substantially below its potential rate.

Financial System Fragility Persists

One of the biggest disappointments has been the government's lack of political will to tackle financial system problems. The most important instance, both substantively and symbolically, is the bank non-performing loan (NPL) problem. The government was able to avoid a financial crisis prior to the March 31, 2002 annual settling of accounts and the September interim settling for financial institutions and most corporations, but fundamental problems persist. These include the fragility of bank capital; the steady weakening of life insurance companies, coupled with their double gearing with related major banks (each provides capital and lends to the other); and the delay to 2005 in the scheduled final termination of the government unlimited guarantee of bank demand deposits.

The government's three basic financial system principles, implemented by the Financial Services Agency (FSA), are to continue to pursue financial reform, to avoid financial crises, and to refrain from injecting any further government funds as bank capital. In normal times these principles are compatible, but these are not normal times. The government cannot solve the NPL problem, the key to bank reform, without providing more funds, directly or indirectly.

While technically well meeting the risk-weighted minimum 8 percent capital adequacy requirements, the quality of bank capital is problematic even if their non-performing loan projections and loss provisions are accurate. Of the major bank core capital base of ¥17.5 trillion ($152 billion, 115 yen per dollar), ¥8.4 trillion is based on deferred tax assets against presumed future profits and ¥6 trillion on preferred shares owned by the government and supposed to be redeemed. The huge surge of the deferred tax assets is fundamentally a consequence of quite restrictive Japanese tax treatment of bank loan loss reserves. Unlike the United States or other countries, Japanese banks cannot deduct as an expense additions to loan loss reserves until the borrower has essentially declared bankruptcy. Inevitably, in such a tax system, not desirable in my view, banks build up deferred tax credits that can be realized against operating profits (which in fact banks do have) only after the loan write-off procedures are completed, while the government collects taxes currently rather than later.

Even so, the greatest problem continues to lie in the estimates and projections of non-performing loans. Furthermore, this is after the massive bank write-offs of some ¥81.5 trillion ($709 billion) since 1992, including ¥9.7 trillion ($84 billion) this past year (fiscal 2001); the major bank write-offs alone amounted to ¥7.7 billion, almost double their previous year's write-offs of ¥ 4.3 trillion. Significantly, bank estimated cumulative new NPLs since 1993 are even greater than loan losses taken or provisioned against.

The estimates of bank non-performing loans continue to be controversial. As of March 30, 2002 bank estimates of their NPLs totaled ¥43.2 trillion ($376 billion); the major bank NPLs stood at ¥28.4 trillion. FSA estimation procedures have tightened, and on November 10 Minister Takenaka announced that the major bank NPLs amounted to ¥47 trillion, rather than the end September interim estimate of ¥34 trillion. Even this revision is a lower bound. While substandard, most NPLs are backed by collateral to some degree; nonetheless potential losses could devastate bank capital, and eventually almost surely will, unless new capital is injected. In economic terms, the capital of most banks is far below the minimum adequacy requirements.

Bank capital is subject to two further risks. One is a decline in the market value of the shares banks hold in other companies, an amount considerably larger than their own capital. Under the mark-to-market rule, banks have to subtract from capital any losses over the yearly period (and of course add any gains). Banks have been selling shares in the market, and soon will be selling some shares directly to the Bank of Japan, so they have reduced their risk exposure. While last summer a Topix stock index of 800 was the point at which bank capital would be below 8 percent, a recent estimate is that the banks can cope with stock price declines to a Topix of 650. Nonetheless, stock price levels will be one danger signal for banks at fiscal year-end (March 2003).

The second is the danger of possible further life insurance company collapses. The life insurance companies have been caught in a squeeze between the interest rates earlier guaranteed to policyholders and the much lower yields they are able to earn on their assets. Seven companies have already been forced into bankruptcy. Major banks have provided the equivalent of capital and made loans to affiliated life insurance companies, which in turn have subscribed to bank preferred shares and subordinated bonds. Each is at risk of the failure of the other. The government's Financial System Council is now studying the possibility of reducing guaranteed yields on existing insurance contracts, essential for the survival of many of the remaining life insurance companies.

The future of Japanese banks appears bleak even in the near-term. Operating profits for fiscal 2002 will almost surely be lower than bad loan disposals. So long as deflation and very slow economic growth persist, bank profits probably will not be sufficient to cover loan losses, and banks will weaken further. Even when deflation ends, until interest rate spreads widen banks cannot generate substantial profits. More importantly, banks still lack a strong credit culture, i.e. the ability and willingness to differentiate interest rates on loans by borrower creditworthiness. At the operating level, loan officers presently seem to be risk averse, preferring not to make loans rather than to raise interest rates for small and medium-sized corporate borrowers. Bank management has a strong personal incentive not to dispose of NPLs at the pace and in the amounts needed because that will require the injection of government funds, the political quid pro quo for which they will lose their jobs.

The other side of the NPL coin is what to do about the borrowers, namely the weak but very large companies unable to service their bank loans. In many respects their restructuring or liquidation, while essential, creates more fundamental problems: laid off workers; disposal of assets; and the writing off of the NPLs (debt forgiveness, debt-equity swaps) which will severely hurt the creditor bank balance sheets. The loan exposure of individual banks to certain major clients is huge. Banks cannot afford to finance the restructuring of a half a dozen or so of these clients at the same time, which is why the banks and the FSA have persisted in an incremental, sequential, drawn-out approach.

Prime Minister Koizumi and other politicians faced an unpalatable choice between delaying the pay-off further or facing the real risk of a banking crisis as depositors move funds out of financially weak banks, especially smaller but politically powerful local and regional banking institutions. Koizumi decided to delay the termination of large-sized ordinary deposit guarantees until April 1, 2005, an implicit recognition of the fragility of the financial system and failure of financial reform policies. Worse, the Diet has just passed the government unlimited guarantee, non-interest-bearing deposit accounts for settlement (transactions) purposes on a permanent basis. This opens a potentially huge loophole and creates further moral hazard problems.

The Takenaka Financial Revitalization Program

It is very difficult for an outsider to know and understand well the fundamental strategy, much less the tactics, in announcing and implementing the Takenaka program for financial revival in October. Japanese policymaking is probably even more opaque and complex than in other democracies. Many Americans tend to be somewhat naively optimistic, and expectations were raised that real progress in banking reform would be forthcoming in the September 30 Cabinet reshuffle installing Heizo Takenaka as FSA Minister and his appointment of an independent, strong committee to prepare and report quickly a financial revival program. The complete implementation of the final program as it now stands is key, but that is an ongoing process with many of the specific measures yet to be defined, so one can make only an interim evaluation.

The Takenaka program, as initially leaked, was extraordinarily bold and strong. In as much as Takenaka has no political power base, clearly its implementation required not only Prime Minister Koizumi's initial approval but his ongoing, supportive involvement in the tough political negotiations among the LDP, the government bureaucrats at FSA and other relevant Ministries, and major bank top management. However, follow-up support of his bold policy proposals has not been Koizumi's style, and apparently it did not occur in the intense negotiations over the initial Takenaka proposal. The final result was a substantially weakened version, only further seemingly incremental steps in resolving the bank non-performing loan and capital inadequacy problems. Only time will tell whether the implementation of the new policies announced on October 30 will be effective and adequate.

I derive several lessons from the ongoing evolution of the Takenaka program.

First, the government is not yet prepared to initiate sufficiently strong bank reform measures that government funds would have to be injected directly as bank capital; the provision of government funds would both arouse the ire of the public and require bank top management to resign. Takenaka has recently announced that no banks will be nationalized. The hope, unrealistic in my view, remains among policymakers that the policy of very gradual reforms and improvement will eventually succeed.

Second, nonetheless the FSA is increasing its pressure on the banks. These include stricter guidelines for bank supervision, evaluation of loan riskiness, importantly the application of the discounted cash flow method for such valuations, reduction of inconsistencies among banks in their differential evaluation of loans to the same borrower, and related measures. A key issue is whether the actual implementation of the various new policies will be sufficiently severe as to create conditions requiring government capital injection in order to prevent a financial crisis. That now seems unlikely. As of now, only some financial market crisis is likely to precipitate stronger, more robust financial reform by the government.

Third, the government nonetheless will seek indirect means to help refinance the banks by somehow buying their non-performing loans at higher than present, inevitably low, market prices, namely at net book value (face value minus any loan loss reserves). This will be done through the RCC for NPLs of firms in or near bankruptcy (categories 3 and 4) and by a new agency, the Industrial Revitalization Organization (IRO), which will buy from banks the dubious (category 2) loans of major industrial corporations that are deemed to be viable.

Fourth, the establishment of the IRO represents an explicit recognition that even more serious than the bank NPL problem is the restructuring of those companies with non-performing assets unable to generate sufficient cash flow to repay their borrowings on schedule. The IRO is potentially a major positive step, but at the same time potentially dangerous if political intervention and moral hazard issues seriously impede its effectiveness. Key issues are whether the public will accept this indirect infusion of government funds into banks, and more importantly, determination of the criteria and procedures by which companies are deemed viable and hence worthy of joint IRO – main bank assistance. The conditions necessary to make effective are tough, and it is premature to judge whether the IRO will be effective.

Fifth, the Takenaka plan episode has nonetheless significantly changed the nature of the policy debate within Japan and moved it forward. With the more widespread recognition of the size and importance of deferred tax credits as a major component of bank capital has come increased understanding that the banks really are in deep trouble. When the time comes the public may be more receptive to the infusion of government capital funds by one means or another.

Sixth, for the first time a potentially effective coalition of major economic policymaking government institutions seems to be coalescing. That is essential, since the implementation of a coordinated combination of financial and economic reform policies is necessary. These include the FSA, the Bank of Japan, the Council for Economic and Fiscal Policy, the Ministry of Finance, the Ministry of Land, Infrastructure, and Transport, and especially the Ministry of Economy, Trade, and Industry (METI), which apparently is sending some of its most able staff to the Industrial Revitalization Organization. The Bank of Japan deserves major credit for initiating this process with its September 18 announcement that it would purchase excess equities directly from banks for purposes of financial system stability. This had a significant psychological and political impact that set the current policy process in motion, even though the direct economic impact of such purchases will be modest.

The set of Takenaka proposals finally agreed upon have set in motion a process that in principle is gradual in approach. However, given the fragile condition of the banking system, it may well turn out that a crisis, or a sense of crisis, erupts before the fiscal year end (March 30, 2003), which will require more forceful government action.

This episode has reinforced my view that the ending of deflationary expectations and near-term aggressive aggregate demand stimulus are more essential than ever, and should now be the highest priority. Restructuring and readjustment and its costs will be substantially less severe if the economy were to grow fairly well over the next two years, and deflationary expectations replaced by modest reflationary expectations. Since the 2002 economic recovery is now slowing down, and the world economic outlook is somewhat cautious, policymakers will have to be even more vigorous in aggregate demand stimulus. The proposed fiscal 2002 supplementary budget of ¥6.2 trillion, of which ¥4.2 trillion is in expenditures, is only a modest step forward; it should be substantially larger since this direct stimulus effect will be less than one percent of GDP. However, I am not optimistic that policymakers will take sufficiently stimulative aggregate demand policies in the near future.

The next few months will be witness to increased pressures on the banking system and on government policies, with fiscal year-end March 30, 2003 looming. Governor Hayami's term expires by then, and soon the Prime Minister will have to decide upon a new Bank of Japan governor. By March the concrete policies, rules, and programs of the newly-established Industrial Revitalization Commission will have to be determined. While initial financial market reactions have been somewhat positive (almost everyone prefers policy postponement to hard landings), it is unclear how markets will react in the months ahead as the Takenaka reform process unfolds.

Japan's Fundamental Macro Problem: Excess Saving

Put simply, excess private saving is the fundamental cause of Japan's current extraordinary macroeconomic situation of inadequate aggregate demand, deflation, unprecedented monetary ease with zero short-term interest rates and excess liquidity, a continuing general government budget deficit on the order of 6 percent annually, and a gross government debt in excess of 140 percent of GDP (though most is held by the government, government-related institutions, and the Bank of Japan). The excess of private domestic saving over private domestic investment is one of Japan's most important structural problems; it shows up as lack of aggregate demand and a huge saving-investment gap. Once this gap ends, all other macroeconomic difficulties will substantially ease.

Unfortunately, Japan's stimulative monetary and fiscal policies have been insufficient; the gap has simply been too large. And, given the decline in profitability (return on assets) and future growth prospects, business investment is likely to be a substantially smaller share of GDP – a share more like that seen in comparably wealthy industrial countries in the West. The Japanese GDP structure has to shift from its high saving, high investment, and low consumption pattern to moderate saving and a higher share of consumption to accommodate a more moderate investment rate. Reduction of barriers that currently inhibit effective competition, greater market flexibility, and other deregulatory and structural reforms will increase business investment opportunities, and in the long run the household saving rate will continue to decline. However, all that takes time; it is one important element of Japan's ongoing economic transformation.

How can a country save too much? After all, saving is a constructive, beneficial activity. It finances investment, a basic source of wealth creation. Individuals and household save out of income to buy a house, to finance their consumption in retirement and old age, and for a variety of other specific needs. Corporations save out of profits to invest in profitable new projects and other productive activities. In an expanding economy corporations typically invest more than they save, utilizing the savings of individuals transferred though banks and the capital markets.

These are all good activities, so why and when can a nation's saving be excessive? The answer: when the nation's savings become so large relative to investment opportunities that the saving cannot be utilized productively. How can an economy close this saving – investment gap? The first way is to increase profitable investment opportunities by deregulation, structural reforms and ongoing R & D. Structural reform is essential for long-run growth, but it does not provide the necessary quick fix for recovery from recession, and will not soon end the now-huge gap between potential demand and actual supply capacity, and probably never can.

A second approach is for the government to provide aggregate demand stimulus through fiscal expansion and easy monetary policy. This is the route Japan has quite naturally pursued over the past decade, although somewhat reluctantly, slowly and awkwardly, with various policy errors. It is noteworthy that, since 1998, government expenditures as a share of GDP have remained flat, and government public work and other investment activities have actually decreased. The budget deficit is due to a decrease in revenues, not an increase in expenditures. Nonetheless, the gap between saving and investment has become so large that this aggregate demand stimulus, while substantial, has been inadequate to do more than ameliorate a very difficult situation. In the very long run, though less soon than some project, continuously increasing government debt will become a severe burden.

In principle, there are two other ways in which an economy may resolve its excess savings dilemma. One is to reduce saving by slowing GDP and income growth. That has been Japan's "solution" for the past decade. This is an unsatisfactory outcome because of its huge economic and social costs. It reflects major misperceptions and unwillingness to tackle real economic problems, by both government and corporate policymakers.

Conceptually, the remaining solution is for Japan to export its savings to countries where they can be better invested. The economic mechanism for this involves an increase in net exports and the balance of payments current account surplus, representing Japan's net investment in foreign assets. Suppose Japan's saving-investment gap is now on the order of 8-10 percent of GDP: the size of the government budget deficit plus the investment (or consumption) required to restore a growth rate of 2-3 percent. If Japan were a small economy, such as Singapore or Taiwan, it could run a current account surplus that large without any political backlash.

However, Japan is not a small economy; it is huge. Its recent current account surplus of 2-3 percent is internationally acceptable, and desirable for Japan both as demand stimulus and as the accumulation of foreign assets to cash in much later when domestic saving rates decline and retirement needs increase. However, to generate a current account surplus of, say, 6 percent of GDP, (much less 8-10 percent), Japan would have to increase sharply exports of its competitive goods (cars, electronics, steel, ships, machinery) and even goods now not particularly competitive; the yen/dollar and yen/euro exchange rates would have to depreciate sharply. Such a huge net export growth would not be politically acceptable to the United States or the European Union; their own industries would suffer too much. So, as a large economy Japan cannot export its way out of its structural problems without generating massive retaliation, even though in the short run, recent net export growth on the order of 3.5 percent has desirably sparked the current economic recovery.

<u>Solutions</u>

What are the solutions to the excess saving gap if healthy growth is to be restored? They combine policies aimed at the immediate twin problems of deflation and insufficient aggregate demand, the intermediate problem of supply-side structural reforms to create better resources allocation and new profitable business investment opportunities, and the long-run problem of increasing the share of consumption in GDP in order to sustain healthy demand.

In the short run, Japan must carry out further aggregate demand stimulus in order to get the economy back on its normal growth path and to restore business, employee, and household confidence. Only sustained economic growth will produce the conditions whereby Japan's long-run economic objectives can be achieved. The Bank of Japan should provide even greater monetary stimulus until deflation has come to an end and growth is restored. However, under present circumstances monetary policy alone is not sufficient. Short-term fiscal stimulus is essential. Given the historic tendency for wasteful, pork-barrel (political) spending on public works, tax cuts will probably be more effective. Over time, as one element in the long run adjustment process, Japan's tax base must be increased.

Structural reforms are essential to enhance business opportunities and create a more competitive environment, but their economic impact takes time. The key to future growth is to make investment more productive and profitable, not simply to raise its share in GDP. For more than a decade Japan has devoted about 15 percent of GDP to business investment, substantially more than the US, but has little to show for it. Japan can generate economic growth of 2-3 percent annually with a much more efficient pattern of business investment that requires a smaller share of GDP.

In the long run the structure of national expenditure will have to shift somewhat from business investment to household consumption, with a reduction in the private saving rate. It is unclear how rapidly the household saving rate, which peaked in the mid-1970s and declined until leveling off in the 1990s, will continue to decline as the population ages. It is also difficult to predict the future corporate saving rate from profits. One implication for tax policy during this adjustment process is that Japan consider shifting from consumption taxes to capital (assets) taxes in order to reduce the incentive for households to save, and to exempt corporate dividend payments from their income taxes in order to encourage greater pay-outs to shareholders, thereby reducing corporate saving and increasing to some degree the consumption of dividend recipients.

Alternate Scenarios for the Coming Decade

All this sounds well and good but probably is unrealistic. What Japanese economic policymakers should do and what they actually will do, given political calculations, has been dramatically different over the past five years. Nonetheless, eventually, perhaps gradually, they will have to confront more directly the macro, structural and political issues looming over them.

I consider here four alternate economic scenarios for the coming decade, of which two assume gradual change, and two assume a sufficiently serious shock as to bring about substantial changes in economic policy and performance much more quickly. They are: the muddling through ("wishful thinking") scenario in which gradual changes eventually lead to improved economic performance and GDP growth of 2 percent or so; the muddling along ("setting sun") scenario, of gradual decline or very little fundamental improvement, with economic growth zero, or 1 percent at best; the constructive shock scenario, in which a shock forces major changes in economic policies so as to promote structural reform and increased aggregate demand, and moves the economy onto a growth path of 2-3 percent; and the disastrous shock scenario, in which a shock leads to policymaking disarray and results in little economic improvement or even decline.

One has to be careful on terminology. The economy will inevitably suffer a series of modest shocks in the gradualist scenarios, but not sufficiently large to substantially alter policy quickly. Analogously, we need to distinguish between small crises and major crises. A major crisis by definition will bring about major policy changes. The media use the term "collapse" too frequently. A bank may collapse, but the banking system will not; and certainly the Japanese economy will not collapse.

This is not the place to go into a detailed consideration of each of these scenarios. Like all projections, any evaluation is to some degree subjective. I rank their likelihood as first, constructive shock, second, muddling through, third, muddling along, and lowest, disastrous shock. My long-term relative optimism is based on Japan's long-term fundamentals, which will eventually reassert themselves. These include a coherent, stable society of ambitious people; high educational attainment; high R&D activities and capabilities; a willingness to sacrifice; a (now too) high saving rate; and good entrepreneurship and management.

Potential Major Shocks

I consider here three likely sources of major shocks: Japanese domestic financial markets; the Japanese political arena; and further dollar depreciation resulting in significant yen appreciation.

Financial Crises

Any of several specific events could trigger a financial crisis sufficient to force the government to break out of its economic policy gridlock and significantly change its economic policies. One would be investor perception that a major bank has become so weak that it is likely to collapse. Bearish selling of its shares would push its stock price down sufficiently that its depositors and other creditors flee. Another cause could be a depositors' shift of funds from weaker banks on a large scale.

To prevent bank runs and a panic, the government would have to activate its crisis management plan to inject capital directly or indirectly, take over bad loans, and possibly nationalize several banks (politically the least attractive alternative). Such events would trigger a comprehensive strong attack on all major bank non-performing loan problems; this in turn would require further government capital injections and, equally importantly, the restructuring or liquidation of the large ailing companies with non-performing loans. As of now, the government is not willing to initiate this process in order to solve the bank non-performing loan problem.

While not likely, another possible financial event would be a sudden shift in public expectations from deflation to unacceptably high rates of inflation. The Bank of Japan has appropriately generated a huge liquidity overhang in the financial system, reflected both in the extraordinarily low interest rate structure (zero interbank overnight rates) and some ¥15 trillion or more in excess reserves held by banks and other financial institutions in addition to their required reserves of some ¥4 trillion. A major policy objective is to overcome persistent deflationary expectations.

Suppose expectations – for whatever reason – shifted suddenly from deflation to inflation. In the short run that would be beneficial. Households and corporations would shift out of cash and deposits. Asset prices would rise, including real estate. The exchange rate would depreciate. Purchases of goods and services would rise dramatically. While this would be wonderfully beneficial if inflationary expectations were small, a shift to high inflation expectations would be very disruptive. Interest rate would rise sharply and impose large capital losses on banks and other private holders of Japanese government bonds and other longer-term fixed interest rate financial assets. Problems could arise from the sudden nature of these changes, the turmoil they produced in financial and other markets, and the slowness and ineptitude of government policy responses.

Another financial event, also not likely, would be widespread and extensive loss of confidence in the yen by Japanese households, financial institutions and foreign institutions which generates a massive flight from the yen into foreign currency-denominated assets or gold. This would precipitate a very large, market-based decline in the yen-dollar exchange rate (say to 180 or 200). Exports would rise sharply. Negative foreign reactions would be very strong. The government would be under great pressure to undertake the necessary economic and other reform measures necessary to restore confidence in the yen, and to placate the US, the EU, China and other Asian economies.

Political Change

Second, public dissatisfaction with the political status quo and the ongoing economic policy gridlock could well manifest itself in a rejection of the Liberal Democratic Party in the summer 2004 Lower House elections, and the likely collapse of the LDP.

In any scenario the political landscape is likely to change a great deal over the next ten years, probably even more than it has in the past decade. But the nature and form of political change is uncertain, and stories can be told to support either “constructive crisis” or “disastrous crisis” scenarios. Various groups of reform-oriented, middle-of-the-road politicians might coalesce into a stable new majority party which would implement the economic, social and political reforms which are so crucial to Japan. This is the political version of the “wishful thinking” scenario. There are (at least) two other possible political outcomes. One would be a shift to more conservative politicians and politics. They might combine continued protection of vested interests and increased government pork barrel expenditures with a major expansion of military expenditures. Another scenario would be political fragmentation into many small, competing political parties resulting in political and policy stasis.

External Shocks

A third possibility is an external shock. The weakening of the dollar and the US stock market in early summer and significantly slower-than-expected recent economic performance (second quarter GDP growth of only 1.1 percent annually) has raised the possibility that the US engine for global growth might stall in coming months, and the US might even undergo a double-dip recession. That would be bad news for all economies including Japan. However, a renewed US recession, and even deflation, is very low growth may be modest in 2003, but accelerate by early 2004.

Japan's most likely external shock is a sharp further depreciation of the dollar and appreciation of the yen. It is important to distinguish between near-term movements and longer-term trends. In late July 2002 the yen had appreciated some 13 percent to about 115 yen/dollar from its spring low; it is now in the 120-125 range, and the Ministry of Finance would like it to be even weaker. Current fundamentals are pushing for both a weak yen and a weak dollar. Market forces weakening the dollar have been global and stronger than those of yen weakening. It is unclear how the yen-dollar exchange rate will move in coming months.

In the longer run, however, it seems unlikely that the US current account deficit in its balance of payments, projected to be above $475 billion (4.5 percent of GDP) in 2002 and to rise further in 2003, is sustainable. As US economic performance moderates and its asset markets remain less attractive, foreigners are likely to become less willing to provide their savings to the

US. A trade-weighted further decline of the dollar of 10-15 percent would probably be necessary to reduce the US current account deficit to 2-2.5 percent of GDP. The trade effects of depreciation lag substantially. The hope is that the dollar will weaken gradually, that the main brunt is borne by the euro, and that the yen will appreciate slowly enough to allow domestic adjustment to occur. Japan cannot rely on export expansion to be a major source of domestic demand over the coming decade.

But suppose the dollar depreciates suddenly and swiftly as foreigners lose confidence in the US market. While the Japanese government would initially continue to resist yen appreciation and buy dollars, at some point it would stop resisting what had become a global phenomenon. Suppose the exchange rate became 100 yen/dollar. This would make it clear that there is no possibility of Japan exporting its way out of undesirably low rates of growth, or even recession. In order to prevent a massive decline in confidence and in foreign demand, the government would be forced to take vigorous aggregate demand stimulus and economic reform measures.

Since all these potential shocks are well known, why don't Japanese policymakers do more now? There are at least three reasons: lack of political will (the stalemate between the reformers and the status quo vested interests, the political costs of difficult decisions); wishful thinking ("in due course the economy will recover and grow normally on its own and deflation will end"); and mistaken perceptions and incorrect analysis of policy issues and policy instruments.

Other shocks are less likely. Some analysts of the muddling along ("setting sun") scenario visualize unemployment eventually reaching double digits. I consider that to be socially and politically unacceptable to Japanese; it would trigger major economic policy changes.

Fundamental changes in the external environment, such as a US retreat into unilateral isolationism, disintegration of the global economic and financial systems, or a heightened Japanese perception of external threat not handled by a reliable US security guarantee, all seem quite unlikely.

In Conclusion

Over the long period of its recorded history, Japan has demonstrated a tremendous capacity to re-invent itself politically, economically, socially, culturally. As in all countries, institutions were created that served the purposes of each particular phase of Japan's history, but these institutions became counterproductive as conditions and circumstances changed. The essential point is that Japan, like all countries today, lives in a world of change. Consider the Meiji transformation from the daimyo-based Tokugawa system; the development of a modern, industrial, autocratic, militaristic state prior to World War II; the emergence of a pacifist, democratic state which became the first postwar "economic miracle"; and the period since 1990 in which Japan is once again in a difficult process of major transformation.

The past few years have not been easy and the next few may well be equally difficult, but in the longer run Japan will once again constructively and productively reinvent itself.