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Fukui's Mission Impossible

BY TADASHI NAKAMAE

The gist of my last article for *The International Economy* was as follows: The capital investment bubble of the late 1980s created a glut of supply capacity in the Japanese economy. Protected by ultra-low interest rates, this excess of supply capacity has remained at around 30 percent since the bubble burst. Balance can be restored to the Japanese economy only through market-driven reduction of supply capacity. To this end, interest rates must rise substantially. But this will not happen until the decline of Japan's current account surplus, combined with capital flight from the household sector, triggers a significant depreciation of the yen.

This still represents in a nutshell my view of the Japan problem. I wrote last time of the tragic futility of attempts to solve the problem by boosting demand. In fact, government attempts to boost demand through fiscal expansion, and the Bank of Japan's attempts to boost demand through low interest rates, have not been merely futile; they have been decidedly counterproductive, because they have

Some now argue the Bank of Japan—with a would-be reformer at the helm—is the answer to Japan's economic malaise. Actually, the Central Bank is still part of the problem.

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Reformer Wannabe

New BOJ governor **Toshihiko Fukui**, in order to initiate genuine supply-side reform, would have to stop the BOJ from buying Japanese government bonds, thereby forcing up long-term interest rates. In view of the sharp rise in bankruptcies and unemployment that would follow such action, it is simply not a politically viable course. This illustrates why central bankers—even if they have no intention of being anti-reformist—usually turn out to be anti-reformist in practice. As a general rule, central banks in democracies cannot be reformist, however strong the reformist credentials of their governor may be.

—T. Nakamae

prevented the market from addressing the issue of supply-side reform.

Like central banks the world over, the BOJ is not given to radical new initiatives. Rather, it responds to events in predictable ways. In particular, the BOJ has shown itself capable of vigorous reaction to three stimuli, namely: (1) weakening of the economy; (2) decline of the stock market; and (3) perceived threat to the banking system. And successive reappearance of these stimuli has consistently elicited the same response from the BOJ: lowering of the interest rate. Thus, as a result of the BOJ's plodding reactivity since the bursting of the capital investment bubble, the interest rate has seen a truly drastic decline, from 8 percent in the early 1990s to its current rate of zero percent.

Thus will begin a new era of rising interest rates.

Given that the BOJ has lowered the interest rate in order to revive economic growth, support the stock market, and help the banking system, let us consider whether lower interest rates have in fact brought benefit in each of these areas.

Lowering of the interest rate is the normal reaction of a central bank to a cyclical downturn in the economy. But even reducing the interest rate to zero has not caused Japan's economy to recover. Why not? Because Japan's ills are not cyclical; they are structural.

On the supply side, lower interest rates have made it possible for inefficient corporations to survive on meagre rates of return on capital. This has been the biggest obstacle to the structural supply-side reform upon which overall recovery depends.

Moreover, by absolving weak firms of the need to maintain return on capital up to the international standard, zero interest rates have promoted asset deflation. In view of the global deflationary trend and the pressing need for Japanese companies to cut costs, a degree of what I call 'flow' deflation has become acceptable and in any case inevitable. Asset deflation is a different matter. Even under flow deflation, if return on capital is improving, the price of equities, property, and other assets should increase. The falling price of such assets, because it reflects the deterioration of return on capital, is a sure sign that the supply-side reform that should be happening is not in fact happening.

The bubble years left structural problems to be resolved on the demand side also. In the four years from 1987 to 1991, capital investment increased on average by 11.4 percent per year. Following such extravagance, there was no way that demand for capital equipment could be revived, even by rock-bottom interest rates. Therefore, inevitably, between 1991 and 1997 capital investment decreased, by an average 1.5 percent per year. This was not a cyclical downturn; it was the beginning of a necessary structural adjustment to which lowering of interest rates was not the appropriate response.

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Consumption and housing investment, too, were inflated by the wealth effects of the bubble. They grew by almost 5 percent per year in the four bubble years. In the six subsequent years consumption increased by only 1.5 percent per year while housing investment decreased by 0.8 percent per year. Again, this was part of a structural adjustment to which lowering of interest rates was not the appropriate response.

What made lower interest rates particularly inappropriate, from a demand-side point of view, was the effect they had on interest income in the household sector. In 1992, with the cost of borrowing at 7.6 percent and interest on savings at 5.2 percent, households paid interest totaling ¥22 trillion and received interest totaling ¥37 trillion, for a net gain of ¥15 trillion. In 2001, with the cost of borrowing at 4.4 percent and interest on savings at 0.9 percent, households paid out ¥15 trillion in interest on liabilities of ¥337 trillion. Yet they received only ¥8 trillion on assets of ¥855 trillion, for a net loss of ¥7 trillion. At 1992 interest rates, this net loss of ¥7 trillion would translate into a net gain of ¥19 trillion.

The ¥26 trillion per year that has thus been plundered from the household sector is equivalent to over 5 percent of GDP. This loss of interest income has been a major impediment to the growth of consumption of services, wherein lies Japan's real potential for future growth.

The stock market's reaction to monetary policy has grown more muted with each intervention. Hence, the decline in the interest rate has not halted but has merely mirrored the decline in the stock market. Over the past twelve years, this decline has seen the Nikkei index fall from around 39,000 to under 8,000.

When the non-performing loans problem emerged in the 1990s as a chronic symptom of Japan's structural woes, the BOJ intervened to help the banks by lowering the interest rate and thereby improving banks' profit margins. This was a classic case of putting the cart before the horse.

For the banks, lower funding costs have indeed given rise to ballooning operating surpluses. From 1992 to 2001, accumulated bank operating profits totaled ¥50 trillion. This was heavily outweighed, however, by the costs of disposal of ¥80 trillion of non-performing loans.

Banks' capital has thus been totally consumed, leaving the banks in need of either huge injections of public funds or temporary nationalization. The NPL problem, meanwhile, is no nearer a solution. NPLs have gone on increasing year by year, even as Japan's non-financial corporate sector as a whole has actually become a net saver and begun to repay its debt.

Incidentally, there is little truth in the argument that the burden of NPLs has prevented banks from lending. Japanese banks are not short of liquidity. The Marshallian K (ratio of money supply to nominal GDP) for Japan, at 136 percent, is more than double that for the United States. So-called kashishibori, or banks' unwillingness to lend, arises mainly from a lack of attractive lending opportunities. When supply-side reform causes return on capital to improve, banks will be eager to lend. The obstacle to such reform is not NPLs; the obstacle is zero interest rates.

Neither the BOJ nor the Japanese government can be blamed for failing to attack from the supply side the root problem of oversupply. In a democracy, it is not feasible for the authorities to be seen to be implementing policies that are designed to bring about the scrapping of machinery and the abandonment of factories and office-blocks, with the inevitable concomitant rise in short-term unemployment.

The new BOJ governor, Mr. Fukui, for example, in order to initiate genuine supply-side reform, would have to stop the BOJ from buying Japanese government bonds, thereby forcing up long-term interest rates. In

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The bravest stance a central bank can take is sometimes to do nothing—to resist the impulse to intervene. What happens more often in practice is that, once an undesirable economic trend becomes established, the central bank feels the need to show it is doing something to counter the trend and so it steps in, only to prolong and exaggerate the trend. A typical example of this is how the BOJ's reaction to the weakening of the Japanese economy only weakened the economy further.

A similar pattern may be observed in the way that central banks react to economic bubbles by creating further bubbles. Amid the economic and political fallout that descends when a bubble bursts, it is a valiant central banker who resists the pressure to intervene. The natural reaction is to ease monetary policy aggressively in an effort to boost demand and thereby reduce the fallout from the bubble's bursting. But such intervention only creates another bubble.

In just this way, by aggressively easing monetary policy after the bursting of the information technology bubble, the Fed created a follow-on mortgage refinancing bubble. In Japan, the follow-on bubble that the BOJ created in the Japanese government bond (JGB) market has allowed the government to lose all semblance of budgetary discipline and has encouraged politicians to push through wasteful spending programs.

Granted that we should not expect central bankers to be reformers, what should we expect from them? A central bank's essential function should be to promote a healthy market and limit moral hazard, but in a democracy even this function can be politically difficult to fulfill.

In other words, in the context of our discussion of necessary supply-side reform, it is not only unrealistic to expect the BOJ to provide the solution; it might also be unrealistic to expect the BOJ to stop being part of the problem.

Reform of the Japanese economy can be realized only through overwhelming market pressure. In this regard, emerging developments in Japan's balance of payments give grounds for optimism: Japanese exports have begun to fall due to the global effects of the U.S. recession. Equally important, Japan's massive investment income has begun to suffer from the decline in overseas interest rates. These factors have nudged the current account surplus into a decline which will accelerate from now on. Meanwhile, private capital outflow is continuing to accelerate as more individual investors recognize the attractiveness—relative to zero-interest deposits—of overseas securities, especially foreign bonds. It will not be long before the outflow of private capital eclipses the current account surplus. At this point, the yen will weaken and the JGB bubble will burst, causing a full-blown financial crisis.

Lower interest rates have made it possible for inefficient corporations to survive on meagre rates of return on capital.

Thus will begin a new era of genuine supply-side structural reform. Regardless of BOJ intentions and BOJ reactions, it will be an era of rising interest rates. ◆