

Summary

“Japan's Structural Demand and Debt Problem”

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The two key problems for Japan are the structural savings surplus (from Japan's demographics) and debt. The solution for both is inflation and a lower yen. Japan suffers from a demand problem, not one of supply.

Japan has very few people under the age of 20. Its ability to grow and absorb investment is therefore limited. Its age structure causes Japan's national savings rate to be 4% of GDP above steady state equilibrium and it causes the equilibrium investment rate to be 3.5% below the steady state equilibrium. Thus, for a sustained recovery, Japan needs a current account surplus of about 7.5% of GDP or a shift in population, i.e. immigration. The problem is that the US is uncomfortable with a large Japanese current account surplus, while Japan is uncomfortable with immigration.

Japan's is not a banking problem. The problem is that the companies to which the banks have lent money are bankrupt.

The rise in Japan's real exchange rate has been the natural consequence of 40 years of a catch-up economy (Balassa-Samuelson Effect). The rise in the exchange rate has produced a low return on capital.

Japan is now a mature economy, so the yen will not keep appreciating, and thus the rate of return must rise to US levels. To raise the return on capital, therefore, either the capital income share or the output/capital ratio must improve. Since the capital income share cannot change, the output/capital ratio must rise.

The rise in Japan's productivity is unlikely to be faster than America's. So output will grow in line with the relative growth of the working population. Japan will thus grow at around 2% per annum slower than the US will. Capital investment must therefore be much lower than the US.

Lower investment should improve returns on new capital. Write-downs are needed to improve the returns on existing capital. We estimate a minima write-down would

produce 120 trillion yen in bad loans. You could either let the banks go bankrupt (like the US did in the 1930s), have the taxpayers bailout the banks (assumes the existence of a courageous government), or let the debts be adjusted by inflation (the most realistic). A lower yen would allow Japan's net exports to rise and allow debts to be eliminated by inflation. Inflation deals with the demand problem by raising prices at home and allowing the weakened yen to boost exports.

Question & Answer

Q: Japan has had a savings surplus for decades. This is not a recent phenomenon.

Yes, Japan's savings rate has been high historically, but it was not a surplus. In the past, the number of retirees was lower. Now we speak of the problem that "junior can't borrow."

Q: Can you elaborate on your policy prescription of inflation and a lower yen?

If you have rational expectations, the yen would already be much lower. Instead you have backward-looking expectations. People are expecting the yen to keep appreciating. We want 185 yen to the dollar and a change in funding policy. If the current account surplus is too small, you need a policy weapon: fiscal, monetary, or funding policy. The Bank of Japan can only increase the monetary base; but increasing the monetary base does not necessarily increase the money supply. So the Japanese government should borrow from the banking system directly instead of from the bond market. This would increase the money supply. We cannot be sure if this would work, but it is worth a try and at least it is easily reversible.

Q: Is inflation and a lower yen a politically acceptable solution? Is funding part of monetary policy? What about fiscal policy?

First of all, funding is handled by the Ministry of Finance, not the BOJ. Regarding the political difficulties of a falling yen, Japan's savings surplus has suffered from a lack of debate because Japan is frightened of the conclusion. Let's debate it openly. The US does not want Japan to be in a permanent recession. If a Japanese current account surplus is the only way out, there should not be international objection. But there is, so Japan should ignore it.

Japan will have a current account surplus; there is no choice. It will come either from a

drop in imports (from lower growth) or a rise in exports (from a lower yen and higher growth). The problem with fiscal spending is that it would tend to make the yen stronger, thus lowering exports.

Q: *Are structural problems related to oversavings?*

Not really. The demand problem must be fixed as a demand problem, not a supply problem. There are no economic models that prove that reform will increase demand. Reform, which will bring a 30% decline in wages, cannot contribute to the real economy.

Q: *Is it realistic to ask the GOJ to create inflation?*

It is hard for me to judge the acceptance of my advice. It is also difficult to imagine an effective and determined central bank creating inflation. But I think it is better for the frog to jump out of water that quickly gets hot rather than getting used to water that is slowly coming to a boil.

Q: *What is the difference between monetary policy and funding policy?*

The goal is to increase the money supply. Currently, the government finances the gap between tax revenues and government spending by borrowing from the public (by issuing bonds). I am advocating that the government finance the gap by borrowing from the banks to increase the money supply. This way, bankruptcies are less likely and Koizumi can keep his 30 trillion yen cap on bonds.

-The RIETI editorial department is responsible for this article.