

A Policy for Japanese Recovery

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The United States Treasury has been giving Japan bad advice for several years. Repeatedly, the message has been to reduce tax rates permanently and maintain the exchange rate for the yen in its recent range, about 125 to 135 yen per dollar. A permanent tax cut was supposed to do what previous fiscal efforts had failed to do -- generate sustained expansion of the Japanese economy.

No one should doubt that Japanese expansion is desirable for Japan, its neighbors, and the rest of the world. The Treasury is right about that. The Japanese government has watched the economy stagnate much too long. A policy change is long overdue.

The problem with the U.S. Treasury's advice is that few would, and none should, believe that Japan can reduce tax rates permanently. Japan has run big budget deficits for the past five years and accumulated a large debt that must be serviced at considerably higher interest rates in the future. Debts of the national railways and others add to the burden. And Japan must soon start to finance large prospective deficits for old age pensions and health care. There is no way to finance these current and future liabilities that will not involve higher future tax rates. They may not understand that in the U.S. Treasury, but the ordinary Japanese citizen has been told the truth about this problem for years. That truth is embedded in the Fiscal Reform Act, requiring

scheduled deficit reduction. He or she has every reason to believe that any tax reduction must be temporary.

The U.S. Treasury is wrong, also, when it tells the Japanese to maintain the value of the yen. It is true that the yen has depreciated from its peak, 80 yen to the dollar in the past two years. It is just as true that the yen has appreciated against the dollar in most of the years since 1971. When the U.S. grew more slowly than Japan, or had more inflation, the dollar depreciated, and the yen rose.

The fluctuating rate system should work both ways. Strong economies appreciate; weak economies depreciate. A 20% or 25% appreciation of the yen against the dollar would bring the yen/dollar exchange rate back to the upper end of the band that it has been in since 1988. The yen would strengthen again in an expanding Japanese economy.

What is the alternative? Deregulation is desirable, but it will do its work slowly. If temporary tax cuts are saved, not spent, and permanent tax cuts are impossible, Japan's choice is between devaluation and renewed deflation. The deflationary solution runs grave risks. Asset prices would continue to fall. Investors anticipating further asset price declines would have every reason to hold cash and wait for better prices. The fragile banking system would face larger losses as asset prices fell.

Monetary expansion and devaluation is a much better solution. An announcement by the Bank of Japan and the government that the aim of policy is to prevent deflation and restore growth by providing enough money to raise asset prices would change beliefs and anticipations. Rising asset prices, including land and property prices, would revive markets for these assets once the public became convinced that the policy would be sustained.

The volume of "bad loans" at Japanese banks is not a fixed sum. Rising asset prices would change some loans from bad to good, thereby improving the position of the banking system. Faster money growth would add to the banks' ability to make new loans, encouraging business expansion.

This program can work only if the exchange rate is allowed to depreciate. Five years of lowering interest rates has shown that there is no way to maintain the exchange rate and generate monetary expansion. Recent legislation has freed the Bank of Japan formally. But formal freedom means nothing economically if the Ministry of Finance dictates exchange rate policy and chooses to keep the exchange rate within a narrow band.

Some will see devaluation as an attempt by Japan to expand through exporting. This is a half-truth. Devaluation will initially increase Japanese exports and reduce imports. As the economy recovers, incomes will rise. Rising incomes are the surest way of generating imports of raw materials and sub-assemblies from Japan's Asian neighbors, and computers, software, machinery and other exports from the United States and the European Union.

The U.S. Treasury and the Japanese Ministry of Finance have offered one fiscal nostrum after another. None has worked to restore growth and end deflation. The Bank of Japan has just gained its independence from the Ministry. It should use it in the interest of Japan and its hard-pressed neighbors. Let money growth increase until asset prices start to rise.