

Comment on Japan and the Asian Financial Crisis

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Professor Ito's paper covers three topics. First, he discusses, briefly, the economic situation in Japan and the macro policies they have followed. He presents his own view of desirable policy changes.

Second is a summary of banking problems, including non-performing loans, bank failures and insolvencies. This, the longest section of the paper, comments on the policies and actions to deal with financial problems.

Third is a brief discussion of Asian problems that notes several parallels between Asian and Japanese problems. This is the shortest section.

An appendix presents a report of the Shadow Financial Regulatory Committee (Japan). The report correctly distinguishes between "too big to close" and "too big to fail", recognizing that it is often prudent to keep banks open while removing management and owners of equity.

I commend especially section two and the appendix. They summarize effectively and comment usefully on mistaken banking policies. Section 2 is informative about the jusen and the political issues involved in closing these mortgage lenders.

The main story is familiar. A main conclusion that I draw is that, once again, the problem was forbearance, not lack of information or the absence of regulation and supervision. There may have been gaps in regulation and supervision, but more timely and more accurate information would not have made much difference. The political powers failed to take decisive action, just as they failed in the United States. Faced with mounting losses at thrift institutions, U.S. regulators allowed those losses to increase. Their Japanese counterparts did the same.

The lesson I draw, consistent with Professor Ito's discussion, is that there will be no reform without a change in rules, elimination of discretionary forbearance, and improved incentives (1) for bank owners or holders of subordinated debt or equity and (2) for bank regulators and their political overseers.

I was stimulated by Ito's discussion of the government's failure to hold to its promise to make large banks "too big to fail." It brought to mind the first of a series of questions about this section: Should a "bad" policy be kept credible? Or, what are the consequences of sustaining "bad" policies ("too big to fail") instead of ending the policies? Does ending a bad policy reduce or enhance credibility? In Cukierman and Meltzer (1986) credibility is a stock that policymakers can use to accomplish their (other) objectives. If the policy is "bad," when should it be ended? How socially costly is the change during a time of bank failure?

Second, I would like to see more discussion of the relation of micro banking problems to macro policy problems. Did loss of credibility following the Hokkaido bank failure cause a run to currency in November 1997? Did it cause an outflow of yen to safer markets? With a quasi fixed exchange rate, a capital outflow would lead to a fall in money growth that exacerbated macroeconomic problems.

Third, what was the effect of using postal savings and Treasury trust funds to shore up the stock market? What did the administration expect to achieve by a series of one-time purchases of shares? What effects did the purchases have?

I turn now to section one on the Japanese economy and government policy. Professor Ito favors a permanent tax cut, a reduction or elimination of the sales tax on houses, and more supply-side stimulus. He claims that monetary policy cannot be used because monetary policy is in a liquidity trap.

We agree on some points, disagree on others. Two points of agreement are: First, banking reform is a necessary first step for recovery. Some banks lend mainly to keep their customer's debt service on schedule. This postpones, but does not solve, the credit problem. As the present value of outstanding loans

approaches the value of the borrowing firm, more bankruptcies will occur. It seems obvious that something should be done soon.¹ Second, I accept Professor Ito's proposal to reduce the sales tax on housing. Although I recognize that, with the population aging, the government is right to shift taxes from income or earnings to sales or spending as a means of paying for old age and medical expenditures. Reducing sales taxes, even if the reduction were temporary, would be a useful way to encourage consumers to spend. (I will argue presently that Japan cannot reduce taxes permanently, although it can change the mix.)

No Permanent Tax Cut

Unlike Ito and many others, I do not believe permanent tax reduction is possible at present. The government cannot declare that reduction is permanent. Tax reduction can be permanent only if the public believes that taxes will remain lower. There is little basis for that expectation in Japan.

Japanese taxpayers have been told about the need for long-term tax increases and fiscal austerity repeatedly and for more than a decade. The recent, mistaken increase in the sales tax was part of a program to achieve budget balance by 2003. It was preceded by many public warnings about Japan's long-term budget problem--to pay for pensions and health care for an aging population.

The long-term fiscal problem has deteriorated markedly since those warnings began. First, growth has slowed or stopped, so budget deficits have been larger than anticipated. Second, spending has increased, and tax rates have been reduced. Third, entirely apart from the budget, consumers have become more dependent on government pensions because their wealth has been greatly reduced. Stock prices are now about 1/3 of their peak a decade ago. Housing prices, on average, have fallen as much as stock prices during the past ten years. The principal assets which households expected to consume in retirement are now worth 30 to 40% of their values a decade ago.

¹ Within a few weeks of the conference, the Diet reached a political compromise intended to clear up many of the banking problems.

In the past seven years, the ratio of government debt to GDP doubled from 42% to 84%. Government debt rose at a 10.6% compound rate, GDP at a 1% rate. However, reported debt excludes commitments for pensions, healthcare, deficits of the Japanese railways, and at least 60 trillion yen of banking losses. Adding these losses to current and prospective debt outstanding and pension liabilities brings the obligations to GDP ratio well above 100%.

Facing these prospects, people must believe either that (1) their pensions will be reduced or (2) taxes will increase. A permanent tax cut is not credible.

I believe this analysis explains why tax cuts are saved to a very large extent. With lower wealth, higher future tax rates, or smaller pensions, it is rational for an aging population to try to increase its saving. This is true for the individuals who make these decisions even if the result is lower income.

A Liquidity Trap?

I am not only skeptical about a liquidity trap in Japan, I believe there is none. With prices and interest rates falling, Japan appears to suffer from a persistent excess demand for money. The Bank of Japan can expand money by buying foreign exchange, equities, commercial paper, even land. Transaction costs aside, I do not think it matters much.

The generic argument for a liquidity trap is developed within an IS-LM framework. There is only one relative price, the interest rate on bonds. One way to view the model is that bonds and capital are perfect substitutes. By assuming a liquidity trap, and ignoring transaction costs, bonds and money become perfect substitutes.

This simple model does not hold up when there are many assets, all gross substitutes.² Let's assume for this discussion, that two of those assets, bonds and money, have become perfect substitutes. That should not change the response to a central bank purchase of foreign exchange or commercial paper.

In general, transaction costs aside, it does not matter what the central bank buys or sells against base money. Since all assets are gross substitutes, there is

² A general equilibrium model that shows this result is Brunner and Meltzer (1968).

typically little difference whether open market operations use Treasury bills, commercial paper, acceptances, foreign exchange, or some other asset. Assuming there is a liquidity trap eliminates one of those assets--now, by assumption, a perfect substitute for money. It does not make monetary policy useless.

To this point, I have assumed that bonds and money are perfect substitutes, so interest rates and other variables are unchanged by a shift in the composition of the sum base money plus bonds. In fact, I do not believe this has been true in Japan (or elsewhere).

In an earlier paper, I estimated base velocity functions for Japan, Germany and the United States. Meltzer (1998). Data for Japan are challenging. Chart 1 shows the plot of base velocity (annual average) and the long-term government bond rate for 1972 to 1996. The two loops show that there were large departures, in 1972-76 and 1988-92, from the linear relation. Both times, velocity returned to the linear relation. The points for recent years lie along the negatively sloped line. These data show no evidence of a liquidity trap in the middle 1990s.

(Insert Chart 1)

Table 1 shows the regression relating velocity to the long-term interest rate, lagged velocity, and the rate of inflation. The coefficient on the interest rate is approximately 0.11, very close to the estimates for Germany and the United States reported in Meltzer (1998).

I used the estimates in Table 1 to predict velocity for 1997. The forecast is 8.10, the actual value 8.17. The error for the out of sample forecast is approximately 1%, well below the standard error of estimate for within sample predictions (3.8%). Reestimating the equation to include 1997 changes very little. Chart 2 shows predicted and actual values.

(Insert Chart 2)

Again, there is no evidence of a liquidity trap. Chart 2 suggests that the regression fits better in the late 1990s than earlier in the decade. As interest rates and inflation fell, base velocity declined as predicted by the velocity function.

Table 1
Regression for Velocity, 1972-1996
 $\ln V_t = a + b_1 \ln i_t + b_2 \ln V_{t-1} + b_3 \ln p_t + \varepsilon_t$

a	b ₁	b ₂	b ₃	R ²	DW
0.86	0.11	0.55	-0.41	0.67	1.04
(2.86)	(3.62)	(4.02)	(1.69)		

V = base velocity
i = long-term interest rate
p = rate of inflation
t-statistics in parentheses

To strengthen his argument, Professor Ito claims that the monetary base has been growing rapidly. The implication is that the economy has continued to contract because there is a liquidity trap.

I believe that the premise is incorrect. Base growth rose to offset a currency drain following the failure of Hokkaido Takushoku Bank and Yamaichi Securities Company in autumn 1997. The Bank of Japan, properly, allowed the base to increase rapidly to offset the currency drain. This response slowed the currency drain.

Professor Ito used year-over-year growth rates. This measurement keeps the large one-time increase in the fall of 1997 as part of the current growth rate of the base for a year. Chart 3 shows that, by January 1988, annualized monthly growth rates had returned to the approximate range in which they had been before the currency drain.

(Insert Chart 3 here)

I believe that Japan's economic problem requires both: (1) banking reform to remove weak and failed banks and (2) monetary expansion and lower sales taxes. Some banks now lend in part to keep lenders from defaulting. Unless recovery starts, these loans must fail as the present value of the borrowing firm approaches zero.

I am skeptical that banks are as reluctant to lend as is widely believed. Given past losses, weak equity positions, and a declining economy, bankers are more concerned about risk and less willing to accept risky loans that they would have taken in the 1980s. The more important change, I believe, is that fewer firms and households want to borrow, given the common anticipation that recession will continue and deepen.

Monetary expansion would encourage recovery and make more lending possible. It would also increase the stock of bank reserves, inducing expansion of money and bank credit. Together, economic expansion and higher growth of bank reserves would increase borrowing and lending.

Japan has a quasi-fixed exchange rate. Ministry of Finance officials insist frequently that they will not permit the yen to devalue. If the yen does not devalue Japanese prices must fall to equate the nominal prices of tradable goods in world markets. That is consistent with what has happened in Japan. Producer and consumer prices (net of sales tax) have fallen; nominal wages declined 2.4% in the most recent twelve months.

Monetary expansion would increase the base and devalue the yen. Devaluation and money growth would end deflation. I believe that the proper policy for the Bank of Japan is to continue monetary expansion and yen devaluation until asset prices began a sustained increase and output prices stop falling.

References

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