Policy Issues and Prospects:
Toward Overcoming Deflation and Revitalizing the Japanese Economy

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The Japanese economy experienced a prolonged growth slump in the 1990s and early 2000s; the average growth rate of real GDP during the period was a mere 1.3%, which poorly compares to the rate of around 4% enjoyed in the 1970s and 1980s. At the same time, the average rate of inflation measured by the GDP deflator from 1991 to 2003 was minus 0.2%, while that from 1971 to 1980 and from 1981 to 1990 was around 8% and 2%, respectively.

Today, thanks to strong growth in exports and resumed business investment, the economy appears to be recovering; the past four quarters recorded positive growth in real GDP compared with a year earlier, i.e., 1.7% (IIIQ, 2002), 2.3% (IVQ), 2.9% (IQ, 2003), and 3.0% (IIQ). But, the fundamental problem of persistent deflation coupled with non-performing loans in the banking sector is yet to be resolved, and the current recovery is not likely to be sustained long unless deflation is eliminated.

Persistent Deflation

Deflation in Japan basically started after the bursting of the bubble in 1991-1992, and worsened during the 1990s and 2000s, accompanied by severe asset deflation. By the mid-1990s, the corporate goods price index (CGPI) had declined by more than 5%, and the GDP deflator had started to decline, while the Nikkei Average had almost halved and land prices in Tokyo had fallen sharply. The Bank of Japan had maintained relatively tight monetary policy throughout the first half of the 1990s.

Monetary policy was relaxed from the middle of the 1990s, but it was “too little, too late.” A strong yen (reaching a staggering 80 yen per dollar in the spring of 1995) caused by a combination of expansionary fiscal policy and tight monetary policy exacerbated price deflation, and the deteriorated banking sector further added to the deflationary
pressure. In April 1998, the Bank of Japan was made independent from the government, but this probably made it even less sensitive to deflation.

The GDP price deflator has been on the decline since 1995 by an annual average of 1.0%, except in 1997 when the consumption tax was raised. The consumer price index (CPI) has been declining by about 0.7% per annum since 1999. The CGPI declined around 13% between 1992 and 2003. The Bank of Japan successively relaxed monetary policy by adopting such measures as the “zero interest rate policy” and “quantitative easing,” without succeeding in combating deflation.

Implications of Persistent Deflation for the Corporate Sector

The implications of persistent deflation for the corporate sector are quite clear. First, since debt is fixed in nominal terms, deflation means an increase in the real value of debt, thereby damaging the balance sheet of the corporate sector. Second, asset price deflation directly reduces the value of assets held by corporate borrowers. Third, nominal wages tend to have downward rigidity while prices continue to fall, thus reducing profit margins and rates of return on corporate assets. Fourth, deflationary expectations encourage postponement of consumption and investment, further exacerbating deflation and corporate balance sheets. All of these occurred in Japan in the 1990s and 2000s.

Given the seriously deteriorating balance sheet of the corporate sector, it is only natural that non-performing loans (NPLs) in the banking sector soared in the 1990s and declined only a little in the 2000s despite strenuous efforts by Japanese banks to reduce them. The banks have already disposed of NPLs equivalent to around 17% of GDP, and yet they still hold NPLs worth around 9% of GDP. The government has been requesting the major banks to halve their NPLs by the end of FY2004, but this cannot be achieved unless deflation is stopped soon.

Implications of Persistent Deflation for the Public Sector

Persistent deflation tends to offer similar implications for the public sector. First, like the corporate sector, the public sector is deeply indebted, so that its real debt tends to increase under deflation. Second, asset price deflation impairs the assets of the public sector too. Third, public expenditures, including pension benefit payments, can hardly
be reduced in line with price deflation. Fourth, deflation and slow growth will significantly reduce tax revenues, thus seriously weakening the fiscal position of the public sector. Finally, and most importantly, a combination of deflation and slow growth tends to reduce nominal GDP growth below the long-term nominal interest rate, thus seriously threatening debt sustainability.

The Japanese public sector is now running huge deficits totaling around 8% of GDP, and its accumulated debt is nearly 150% of GDP. It may be recalled that in the early 1990s, Japan had a fiscal surplus with debt around 60% of GDP. More than ten years of active fiscal policy and dwindling tax revenue have resulted in an almost unsustainable fiscal position.

**Anti-Deflationary Measures**

Since the core of the problem is persistent deflation, the key to restoring sustainable growth in the Japanese economy is the adoption of an effective anti-deflationary policy to quickly curb deflation. Here, monetary policy must play a decisive role. Although under the zero (short-term) interest rate constraint, traditional monetary policy may have largely lost its effectiveness, non-conventional measures, such as inflation targeting and/or large-scale open market purchase of wide-ranging domestic assets, would still have significant impact on the inflation rate. In this context, the yen might weaken reflecting economic fundamentals, but this should be accepted by the international community as the Japanese economy's path out of deflation and slow growth.

The use of fiscal policy to fight persistent deflation would be ineffective and even counterproductive at this juncture, because fiscal expansion induces a further debt buildup creating greater uncertainty for the future, and tends to lead to yen appreciation, which would only aggravate the deflationary situation. In any case, the serious fiscal condition leaves almost no headroom for active fiscal policy in Japan. Instead, fiscal consolidation is badly needed. What the government can do is to increase the “effectiveness” of fiscal policy by reallocating the expenditures to areas with a greater and more productive impact on the real economy.

Another important measure complementary to proactive monetary policy would be the revitalization of the banking sector through aggressive NPL disposal coupled, if
necessary, with recapitalization. This would reactivate the monetary transmission mechanism and stimulate bank lending and economic activity. Aggressive disposal of NPLs by the banking sector must be accompanied by an equally aggressive restructuring of the corporate sector.

Medium-Term Scenario for Sustainable Growth

The Japanese economy is at a crossroads. We need to draw a clear roadmap, a medium-term scenario for sustainable growth. The first step would be to stop price deflation and strengthen the current economic recovery through active use of non-conventional monetary measures and more efficient allocation of fiscal expenditures, including increased emphasis on R&D and environment.

Within two years, the fundamental problem of persistent deflation coupled with NPLs in the banking sector must be resolved. The Bank of Japan should pursue a rate of inflation of around 2% per year, considering the well-known tendency of the measured CPI to overstate the true CPI inflation more than 1% and the need to have a buffer against contingency. The government should also resolve the NPL problem by the end of FY2004. In order to do so, it must fully utilize existing tools including the newly established Industrial Revitalization Corporation.

At the same time, the government must continue its effort to deregulate industry and privatize government corporations as quickly as possible. The government is introducing “special deregulated sites” for various services hitherto heavily regulated, such as medical care, to promote private initiatives. It has also been decided that lending by the Housing Loan Corporation will be discontinued and the four Highway Corporations will be privatized. The smooth implementation of these decisions is urgently needed. Privatization of the Post Office is another issue to be decided in the coming year.

After a few years of intensive structural adjustment, the Japanese economy will be on a sustainable growth path. Serious fiscal consolidation can be started at that time, with the aim of creating a primary surplus by the early 2010s.