Japan's Dying Market Economy

Why Tokyo desperately needs to adopt the South Korean model.

BY MASAAKI KANNO

With concerns about a retreat of economic globalization stemming from the Iraq war, the market economy in Japan increasingly appears to be suffering setbacks. One of the fears is that the growing economic role of the public sector, including the Bank of Japan, being promoted as part of the government's efforts to tackle deflation, may lead to a paralysis of the market mechanism. What is urgently called for now is liberalization of the public services on par with the breakup of the chaebol in South Korea.

The difficulties of applying the lessons of history are keenly apparent in the recent debate on how Japan should tackle deflation. The only time of deflation in the 20th century was the Great Depression of the 1930s. The decline in prices at the time was in the double digits, well beyond acceptable levels, and monetary policy failures in the United States only made the situation worse. It is not so simple, however, to assess the fiscal policies in those years. President Roosevelt's New Deal and Japan Finance Minister Korekiyo Takahashi's aggressive policies helped pull their respective economies out of their bottomless quagmire. From 1930, immediately after the Great Depression began, to 1933, U.S. prices—as measured by the consumer price index (CPI)—fell by 6.6 percent per year and real economic

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growth contracted by 7.4 percent per year. Then from 1934 to 1936, real economic growth registered more than 10 percent per year and the price trend turned inflationary. Prices declined again in 1938–39, and GDP growth turned negative in 1938. It is widely viewed in the United States that the U.S. economy did not fully recover until World War II (that is, around 1941). Thanks to the aggressive fiscal policies of Korekiyo Takahashi (who served as prime minister as well as finance minister), Japan came out of deflation earlier than the United States did. In 1930–31, the CPI registered a total 25 percent decline and national income dropped by 20 percent. Starting around 1932, when Takahashi's policies started to have an impact, consumer prices and national income both quickly started to increase.

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However, military spending as a proportion of general account expenditures ballooned during this time, purportedly as part of the expansionary fiscal policy efforts. Takahashi opposed the increase in military spending, but ended up being assassinated in the so-called 2-26 incident of 1936. Thereafter, Japan moved onward on the path to war. Unfortunately, war ended up being the way out of depression for both Japan and the United States.

One lesson from Takahashi's approach is that policies need to be devised based on a blueprint of what the economy will look like after it comes out of its deflationary state. His anti-deflation policies centered on promotion of heavy and chemical industry, an increase in military spending, and the Bank of Japan's underwriting of government debt, but, after all, he was unable to keep military spending from ballooning.

Today, the Japanese government has a policy aim of tackling deflation, but its policy stance after deflation is tackled remains unclear. To be sure, the government has emphasized deregulation and structural reform, but so far all that has happened is a reduction of the market economy and an expansion of the public sector's economic role. The developments over the past year or two increasingly point to indications of a government-controlled economy.

The Bank of Japan's zero interest rate policy resulted in a contraction in the callmoney market from ¥34 trillion at the end of 1998 to ¥15 trillion today. Banks have kept excess reserves at the Bank of Japan, and on the flip side, have reduced their fund-raising in the interbank market by roughly that amount. The central bank remains the largest buyer of Japanese government bonds, of which the government issues about ¥30 trillion per year. These purchases have spiked from ¥4–6 trillion per year prior to 2000 to ¥20 trillion in 2001 and ¥13 trillion in 2002. In the stock market as well, the BOJ has become the largest buyer since it started to purchase commercial banks' stock holdings in the January–March 2003 quarter. And in the currency market, the central bank has regularly intervened by selling yen. If downward pressures on the dollar strengthen, the BOJ is likely to step up its sales of the yen and purchases of the dollar. In these ways, the BOJ has become an increasingly prominent buyer in the bond, stock, and currency markets. The result is a developing paralysis of the underlying market mechanism. In the Japanese government bond market, some financial institutions tend to lose some of the vigilance in their risk management and lengthen the durations of their JGB portfolios, as a result of their expectation that the BOJ will come in and support JGB prices if they fall. Meanwhile, the government is compelled to support JGB prices to prevent the earnings of financial institutions from deteriorating. These moves lead to a vicious cycle of moral hazard for financial institutions.

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Controls over the stock market have increased since the imposition of restrictions on stock futures in 2002. There is talk that every time stocks take a serious dip, the government tries to verbally intervene with threats of tightening restrictions on short selling. What is for certain is that some politicians are seeking a rollback of the mark-to-market accounting rules. The government is essentially trying to distort the asset markets to make itself look better than it is. One result has been a sharp increase in the number of foreign financial institutions pulling out of the Tokyo market completely, or cutting back their operations. If these financial institutions were in a slump because of a cyclical downturn in Tokyo's financial markets, they would not be shrinking their operations. Clearly, they have instinctively picked up on the qualitative changes in Tokyo's markets. The decline in the number of financial institutions in Tokyo is associated with the considerable external diseconomies. The impact is evident not just in an increase in office vacancy rates. The financial services sector is already heavily dependent on information technology. Hence, the fallout in the financial services sector will be significantly felt in the communications and other peripheral sectors.

With hopes for the internationalization of the Tokyo market quickly disappearing, the government does not appear to be taking it seriously. It is seeking to increase direct investment in Japan, but it first needs to understand that foreign financial institutions that have already set up shop in Japan have been retrenching significantly. Indeed, what has happened to the "free, fair, and global" vision for Japan's markets that was pushed by former Prime Minister Ryutaro Hashimoto, on the occasion of Japan's "Big Bang" in 1998?

The post-deflation era ought to be a decentralized one, with regulations abolished to allow the market mechanism to flourish. However, most of the anti-deflation measures being considered are ones that would paralyze the market mechanism. Strong anti-market tendencies prevail, with some in the BOJ aiming to consistently keep long-term rates low. The corollary, then, is a possible rollback to the 1940s, when bureaucrats governed the economy.

Amid the Iraq war, the world faces the risk of a retreat of economic globalism, something that cannot be allowed to affect the markets. A policy to keep the yen artificially weak would be a replay of the prewar competitive devaluations on a worldwide scale.

Aside from war, then, what policies could help pull the economy out of deflation? The model that Japan should be studying is South Korea, and its economic reforms of the past several years. China and neighboring countries have deflation or inflation rates close to zero, but South Korea achieved real growth of 6.3 percent and had inflation of more than 3 percent in 2002. The keys to South Korea's economic achievements were an overhaul of the economy, starting with a breakup of the chaebol, and the development of new business models. A question for Japan, then, might be what new business models could it develop? First, the need for a transformation of the industrial structure, specifically a transition to a services-oriented economy, should be fully acknowledged.

Although a rise in competitiveness of manufacturing is needed, it alone is not sufficient to support employment. Since 1990, when Japan's asset bubble was burst, labor productivity has managed to improve as the number of people employed in manufacturing declined by 3 million. This trend is likely to continue.

On the other hand, the services sector has generated almost 4 million jobs since 1990. It is quite telling that Japan and Germany, whose economies are heavily dependent on manufacturing, are in the doldrums. From this perspective, the government's top policy priorities should be promoting growth in the services sector through deregulation and decentralization.

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The Japanese equivalent of the breakup of the South Korean chaebol would be complete liberalization of public services. The creation of a public corporation to take over postal services and the privatization of the highway-related public corporations represent the first steps in this direction, but just as in the case of non-performing loan disposals in the banking sector, progress has been too slow.

The key policy issue to be considered is not the extent to which vested interests should be challenged, but rather removal of all kinds of restriction on entry into public services from the perspective of how employment can be increased by developing new businesses. Not much surpasses the wisdom of the private sector, which has created the innovative services, such as door-to-door package delivery, delivery-by-bike services, and convenience chain stores.

Finally, the Industrial Revitalization Corporation is just about to get fully underway, but it should make the fullest use of the risk money and expertise of the private sector. There are a number of cases of other countries that have cleaned up their non-performing loan problems and rehabilitated the corporate sector, but they all involved private-sector investors putting up risk money.

It has been more than 130 years since Japan developed a new business model with the Meiji Restoration. Without a paradigm shift, centered on decentralization and an expanded functioning of the market mechanism, we might see the next fifty years, or even 100 years, go to waste. ◆