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Article

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CESifo Forum

Provided in Cooperation with:

Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

Suggested Citation: Okumura, Hirohiko (2003) : Economic Crisis and Economic Policies in Japan since the 1990s, CESifo Forum, ISSN 2190-717X, ifo Institut für Wirtschaftsforschung an der Universität München, München, Vol. 04, Iss. 4, pp. 3-11

This Version is available at:

<https://hdl.handle.net/10419/166163>

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JAPAN IN CRISIS

ECONOMIC CRISIS AND ECONOMIC POLICIES IN JAPAN SINCE THE 1990s

HIROHIKO OKUMURA*

In the 1990s, the Japanese economy experienced a deep decline, following 40 years of growth. The deterioration of performance became so serious not only because the rate of economic growth was low but also because the soundness of the economic systems supporting the lives of the Japanese citizens deteriorated with no endogenous mechanism for reform. The latter include the pension system, the financial system, and the budgetary system whose increasing uncertainty created great concern among the Japanese citizens about their future lives.

In this paper, we will examine the relationships between the deterioration of performance and economic policies. The period under consideration coincided with the collapse of the bubble economy, which occurred in the latter half of the 1980s. It was an exceptional period in which policy makers found it difficult to predict the conduct of economic agents. Therefore, for an analysis of the relationships between the deterioration of performance and economic policies it is important to look at the relationship between (1) the changes in conduct of economic agents and the reform of the economic structure, and (2) the economic performance and the effectiveness of economic policies, particularly the conduct of each economic entity under the influence of enhanced uncertainty.

“Dynamic inconsistency” in economic policies

Inconsistent policy development

The largest problem since the 1990s in developing economic policies after the collapse of the bubble

economy has been the lack of consistency in policies. The economy therefore fell into a state of “dynamic inconsistency,” in which economic agents could not believe that the government and policy makers would adopt consistent policy-making attitudes in the future. It is said that asset prices (as of 2003) may not yet have hit bottom 14 years after the beginning of their steep fall. One reason for this state, which was not even experienced during the Great Depression in the 1930s (where, for example, US stock prices represented by the Dow Jones 30 industrial index dropped from a peak of 381 on Sept. 3, 1929, to a bottom of 41 on July 8, 1932, after roughly three years), is that the margin of fall from the initial peak was not so large as that in the United States during the Great Depression. Another reason may be that the uncertainty of future revenue and discount rates that should be reflected in asset prices has increased very much under the inconsistent implementation of policies. Similarly, when economic systems as represented by pension, financial, and budgetary systems become highly unsound and their future cannot be predicted, economic activities of consumers and enterprises are less responsive to economic stimulation policies than before.

This dynamic inconsistency of economic policies was observed in both fiscal and monetary policies, as well as in financial management policies. In fiscal policy, for example, while the government enforced tax increases and public expenditure cuts by promoting policies of rehabilitating the economy through budgetary reconstruction in 1996 and 1997, they adopted policies of suspending budgetary reconstruction and economic expansion through tax reduction and increasing public expenditures in 1998, a complete change. Thereafter, in 2001, the government again suspended the fiscal policies to stimulate the economy while the market was still dull and stock prices continued to fall.

In financial investment and loan programs, the government loudly proclaimed that public financial institutions were unnecessary and should be reduced in number and subsequently initiated



Inconsistency of monetary and fiscal policies over time

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their transfer to private hands (1996 to 1997). In 1998, however, it reversed policy and largely expanded the credit limit and guaranty limit of public financial institutions as countermeasures against “reluctant credits” of private financial institutions. Toward the Japan Development Bank, in particular, the government suddenly changed its attitude and began extending credit to small and medium-sized enterprises by exceeding the conventional range of credits for plant and equipment of large enterprises and further requesting to make loans for long-term working funds including measures for fund management, such as smoothing the refunding of bonds. This new policy is equivalent to assigning the role of last resort for long-term finance to the Japan Development Bank, just like the Bank of Japan is playing the role of the last resort for short-term finance. This was quite contrary to the assertion of reducing the role of the Japan Development Bank, which had been made immediately before this change in policy.

No consistent policies for growth

Also in line with the Koizumi Cabinet policy of emphasizing structural reform, this policy is repeated. As a result, while the government asserted its desire to reduce the role of public financial institutions, it actually further expanded the functions of the Development Bank of Japan (the new name of the Japan Development Bank after merging with other government financial institutions) so that it can play a role in revitalising the Japanese economy.

Inconsistent policies for achieving financial system soundness

In financial administration, measures for injecting public funds to protect against bad assets of financial institutions and to achieve soundness of financial systems were changed frequently. The “Comprehensive Economic Countermeasures” issued by the ministerial conference on August 28, 1992 called for implementing measures to secure the stability of the financial systems. Four measures were to cope with the issue of bad assets of financial institutions: (1) measures to give liquidity to pledged real estate, (2) tax procedures based on the practical situation, (3) establishment of a system to publish the amount of bad assets held by financial institutions, and (4) early establishment of methods to deal with issues like the housing loan corporations and non-banks. At that time, however, there was no intention to fully make public the problems of the banks in order to achieve an

early resolution of the problems. In later developments, asset prices dropped continuously because economic policies to promote economic growth consistent with a recovery of asset prices were not implemented, and in 1996, it became necessary to inject public funds in the amount of 685 billion yen to the housing loan corporations. Upon massive criticism, the government and the monetary authority were later content to stand by while large security companies and large city banks collapsed. However, their policy reversed again from 1998 through 2003, when they again found it necessary to inject huge amounts of public funds (about 35 trillion yen) to relieve the financial systems.

From the collapse of the bubble economy to the spring of 1995, monetary policy was characterized by a high real rate of interest accompanied by low growth of the money supply. Thus, in the autumn of 1994, the government raised the money market rate (call rate). From the autumn of 1995, however, the government switched to an ultra-low interest rate policy which was maintained while the economy indicated recovery at annual real rates of growth of 3 percent and 4.4 percent for two consecutive years (fiscal 1995 and 96). During that period, monetary policy and fiscal policy became inconsistent because fiscal policy changed direction to slow the expansion as described above. With business conditions again falling into the doldrums, the Bank of Japan was driven into the zero interest policy from 1999.

These policy developments clearly suggest that, immediately after the collapse of the bubble economy, policy makers had no intent to raise the growth rate as much as possible but were rather governed by the idea that a low growth rate was either allowable or inevitable. Under these circumstances the attitude toward economic growth swayed significantly, and policies to emphasize economic growth became dominant during 1997 and 1998, when the economy suffered a negative growth.

Relationship between economic growth and economic systems

Economic growth as the prerequisite for conventional economic systems

The most important point concerning the “dynamic inconsistency” of economic policies discussed in the previous section is the relationship between

economic growth and the soundness of economic systems. Any economic system, including pension, budgetary, and financial systems, is closely related to economic growth. The reason is that, while the yield on investment assets and the growth of the standard wage of employees in the pension system will vary according to the growth of the economy, so too will the growth of tax revenue in the budgetary system, and the price of equities and real estate held by financial institutions in the financial system. The soundness of loans of financial institutions depends on the soundness of debtors, which is deeply related to the growth of the economy.

In Japan, the economic growth rate used as the prerequisite in designing these economic systems is not made explicit, but a real economic growth rate of 3 percent or more seems to have been tacitly assumed in recent years. It was considered to be almost equal to the potential growth rate of the Japanese economy at that time. It was also considered the medium-term growth rate that was expected by private enterprises until the beginning of 1993. Furthermore, it was also the target growth rate for the government's medium-term economic plan.¹

In contrast, the real rate of economic growth averaged only 1.6 percent from fiscal 1991 to 1997. In particular, the growth rate during the fiscal period of 1992 to 1995 was not only less than the potential growth rate but quite a bit less than the target growth established by the government each year. During that period, the government continued operation of various economic systems without changing their conventional designs. Eventually, business conditions became poor and the economic systems became unsound (i.e., underfunding in the pension system, increase in the public debt (including latent debt), increase in non-performing loans of financial institutions, etc.). But the policy-makers continued to operate these systems in a conventional manner on the supposition that the economy would expand steadily according to its potential. However, without policies to stimulate the economy, the actual growth rate continuously

dropped below the target. Thus, problems expanded while the economic systems were left alone until they fell into unsoundness.

In other words, the government and officials in charge of policy making were buying time until the problems would be resolved by giving the illusion that the economic systems were sound.

Economic systems becoming unsound with confusion over policies

At the beginning of the 1990s, prompt policies to expand demand should have been implemented without creating an illusion in economic systems. Efforts to reform the economic systems should have been made at an earlier stage even in the absence of an expanding economy. In that case people would have realized that a welfare society for the aged cannot be built with a low growth rate and thus would have changed their life styles. In reality, however, with no such policies, the Japanese economy gradually evolved into a state of economic decline, depressed by an unsound economic system, particularly in the latter half of the 1990s. For example, as the pension system collapsed and an extreme increase in government debt was revealed, people became increasingly uneasy about life in the future. Their desire to spend became weaker. This was confirmed by the results of the Opinion Survey on Lifestyle and Financial Behavior of the Bank of Japan in March 2000 which showed that 41.7 percent of all households decreased their expenditures compared to the previous year. (Only 6.3 percent of the households increased their living expenditures.) Three reasons cited by these households were: (1) anxiety about the future job or income (60.4 percent), (2) anxiety about the decrease of payments from a pension or social insurance (52.5 percent), and (3) anxiety about increases in taxes and social security contributions (36.7 percent).

Under these circumstances, a prolonged period of unresolved financial system issues prevented the financial institutions from developing positive investment and financing strategies. The recovery of investment activities of enterprises, particularly medium and small-sized enterprises, was made difficult, and brought about lack-luster stock prices. Given such developments, it is difficult to stimulate business conditions only by implementing policies to increase demand. Therefore, policies that stress

Unrealistic growth assumptions underlying systems operation

¹ The medium-term economic growth rate predicted by private enterprises was surveyed by the Economic Planning Agency. ("Survey of the conduct of enterprises"). As a practical example of medium-term economic planning established by the government, the 5-year plan of 1987 predicted an average real economic growth rate of about 3.75 percent for the period from fiscal 1988 to 1992; the 5-year plan of 1992 predicted an average real economic growth rate of about 3.5 percent for the five-year period from fiscal 1992 to 1996; and the "economic and social plan for structural reform" of 1995 predicted an average real economic growth rate of about 3 percent for the five-year period from fiscal 1996 to 2000.

the aspect of supply, structural reform, and deregulation gradually came to be emphasized.

During the collapse of Japan's bubble economy, economic conduct of each economic entity differed from ordinary conduct. Generally speaking, the policy planning authority was unable to develop appropriate policies under such conditions due to four factors: (1) time lag for recognition, (2) errors in judgment, (3) time lag for changing and implementing policies, and (4) inconsistency of the policies.

With the help of official documents of the Economic Planning Agency and the Bank of Japan we can show how Japanese policy makers assessed the economic situation during the period after the collapse of the bubble economy from 1990 to 1997 and how their assessments were based on erroneous diagnoses.

- (1) From 1990 to mid 1992, when asset prices began to fall, they considered the state of affairs as an ordinary phase of the business cycle. They stressed the fact that steady increases in corporate profits and economic expansion without inflation were continuing in the real economy. They had already noticed that something was unusual in the financial sector during the bubble economy in the later half of the 1980s and did not stress the rise in asset prices due to the bubble economy or its influence on the real economy.² In early 1993, they judged that there would be a recovery during the second half of 1993, though they began to stress the adverse effects of the drop of asset prices. By deeming it a business cycle, they assumed the collapse of the bubble economy itself would end in 1993.³
- (2) When business conditions did not recover in the first half of 1995, the Bank of Japan was driven to lower the official discount rate to 0.5 percent. Factors cited for the unexpected economic lull were the yen overvaluation, the Hanshin-Awaji Earthquake, and the rise of the East Asian economies. At the same time, the problems with balance sheets were cited as an after-effect of the bubble economy.⁴ The gov-

ernment then reduced the income tax for the first time after the collapse of bubble economy.

- (3) Though business conditions improved in the fiscal years 1995 and 1996, they deteriorated again in and after the fiscal year 1997. Some causes mentioned for this dip were the failure of major financial institutions, economic crises in Asia, and increased prudence in lending attitudes of financial institutions due to restrictions by the BIS regulation. Policy makers also began to emphasize, for the first time, how factors such as the increase in uncertainty about the future bring about risk-avoiding actions, which will hinder the recovery of business conditions.⁵

It is important to note here that seven years had passed since the collapse of the bubble economy before Japan came to recognize strongly that (1) there are large influences of financial factors on the real economy and (2) uncertainty and psychological factors of economic agents are necessary for understanding human activities in the market economy.

The implementation of a tax reduction was delayed until fiscal 1994 and a continuous interest rate reduction was delayed until the beginning of 1995. Inconsistency of monetary and fiscal policies occurred but inconsistency was also conspicuous between policies concerning business conditions and policies concerning economic systems.

Thus, being faced with the collapse of conventional economic systems, the arguments for structural reform came to the fore while the arguments for economic growth receded. As a result, at least as a short-term target, the movement to pursue reconstruction of economic systems through a contractionary policy instead of an expansionary policy was enhanced. However, the policy to release the strain of financial institutions as well as business, government, and the United States as debtors by maintaining an ultra-low interest rate for an extended period of time seems to be contradictory. In the 1990s, Japan was the richest economy in the world from a macroeconomic viewpoint, as it had surplus labor and abundant funds to make it the largest creditor nation in the world. Furthermore, it was clear that the working population would begin to decline in 2000 and the total population would

² "Economic White Paper of Japan" compiled by the Economic Planning Agency, 1992 issue. "Monthly Report of the Bank of Japan" published by the Bank of Japan, June 1992 issue.

³ "Economic White Paper of Japan" compiled by the Economic Planning Agency, 1994 issue. "Economic White Paper of Japan" compiled by the Economic Planning Agency, 1998 issue.

⁴ "Monthly Report of the Bank of Japan" published by the Bank of Japan, June 1998 issue.

⁵ "Economic White Paper of Japan" compiled by the Economic Planning Agency, 1995 issue. "Monthly Report of the Bank of Japan" published by the Bank of Japan, June 1995 issue.

⁵ "Economic White Paper of Japan" compiled by the Economic Planning Agency, 1998 issue. "Monthly Report of the Bank of Japan" published by the Bank of Japan, June 1998 issue.

Three factors
prevented appropriate policies

peak in 2007. The population is expected to decrease by about 7 million by the year 2025 and by about 30 million by 2050. Also, a new aged society, including 32 million people over the age of 65, will become a reality in the near future. Thus, when the Japanese economy is positioned in a historical setting, it can be concluded that an expansionary policy rather than a contractionary policy should have been adopted in the second half of the 1990s. It was necessary to redesign the economic systems while converting potential growth into actual growth.

Domestic economic policies and their influence on foreign countries

Extraordinary development of policies in Japan and influences on foreign countries

Adoption of the above mentioned economic policies and a continuously unstable economy in Japan (the largest creditor country in the world) gave rise to a vicious circle, first influencing the economies of foreign countries, particularly the United States (the largest debtor country) which in turn affected Japan.

For example, the ultra-low interest rate policy of Japan affects not only the exchange rate leading to a strong dollar and a weak yen but also the interest rate of the United States. It also affects the stock prices in the United States directly and indirectly. In other words, we should consider that the model of the small open economy is not applicable to the actual relationship between Japan and the United States at this point in time. This may also be supported by the fact that even the US Federal Reserve cannot judge which interest rate is appropriate when there are extraordinary movements in the financial markets or the real economy. Nevertheless, we can suppose that the attitude of the financial authority of Japan during the collapse of the bubble economy complied with the model of the small open economy in the short run.

From fiscal year 1997 to the first half of fiscal year 1998, Japanese fiscal policy shifted toward contraction, while monetary policy was maintaining an ultra-low interest rate. During the same approximate time, neutral monetary and fiscal policies were pursued in the United States. As a result, capital moved from Japan to the United States, the yen depreciated against the US dollar, and net exports

increased in Japan while decreasing in the United States. When the yen tends to depreciate continuously against the US dollar, investors inside and outside Japan move their capital from Japan to the United States, against a background of a gap in interest rates between the two countries. In other words, when capital moves out of Japan due to the ultra-low interest rates there, US bond prices rise due to the purchase by foreign investors or expected purchases (lowering of long-term interest rates). Stock prices will also rise more easily. In this case, economic activity accelerates in the United States due to the lowered long-term interest rates and higher stock prices and the demand for money increases. If policies to maintain a constant money supply are adopted, the trend of US dollar appreciation against the yen will continue. Japanese investors can obtain a high return on investments in dollar-denominated financial assets due to both US dollar appreciation against the yen and increase in prices of financial assets. They are therefore further induced to invest in dollar-denominated financial assets. At the same time, similar effects can also be obtained from transactions where foreign investors obtain yen-denominated funds in Japan at a lower interest rate and then employ such funds in dollar-denominated financial assets either inside or outside the United States.⁶

Instability of exchange rate and policy-induced international expansion of finance

We have already experienced cases in which the exchange rate changes (on a short-term basis) as a result of capital movements. In the first half of the 1990s, for example, when US fiscal policy aimed at expanding the economy, monetary policy left the rising interest rate alone. During the same period, both the fiscal and monetary policies of Japan were operated to maintain neutral business conditions. Capital was transferred from Japan to the United States, resulting in a large US dollar appreciation against the yen. (During that time, changes in the system, such as deregulation on portfolio investments in foreign countries by Japanese institutional investors, was also a factor resulting in fluctuations in the exchange rate.)

Thus, differences in policy mix of monetary and fiscal policies between Japan and the United States is often closely related to the fluctuation of the

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repercussions

⁶ "Borrowing Asia's Troubles," New York Times, December 28, 1977.

exchange rate. In other words, unusual fluctuations of exchange rates are often caused by the unusual economic policies of either Japan or the United States. In the case of monetary policy, for example, when the real interest rate is compared with the actual state of economy, it can be seen that the interest rate in the United States in the first half of the 1980s was abnormally high. The interest rates in the United States from 1991 to 1993 and the interest rates in Japan in the latter half of the 1990s were abnormally low.

This shows that, if countries adopt their unique policies by asserting the independence of policies under the floating exchange rate system, the exchange rate will exhibit unstable fluctuations. Cooperation in policies among leading countries is essential for the stability of the exchange market. "In setting national policies, the international implications and interactions of those policies should receive an appropriately high priority."⁷

In view of this, economic policies implemented by Japan and the United States in the 1990s are seen to have disturbed the short-term movement of the exchange market. The yen rate against the US dollar fluctuated violently from approximately 160 yen per dollar in 1990 to approximately 80 yen in 1995 and to 147 yen in 1998, making the management of Japanese enterprises quite difficult. Japanese foreign reserves reached 204 billion dollars by the end of 1995 as a result of large interventions of purchasing dollars and selling yen in the process of yen overvaluation in the fiscal years of 1994 and 95 (foreign reserves increased by approximately 100 billion dollars in two years). To cope with the yen depreciation in the latter half of the 1990s, there should have been interventions in the first stage in spite of side effects. However, the Government of Japan did not dare to implement such intervention, possibly because they wanted to give some consideration to the United States.

With the increase in the exchange rate of the US dollar and the rise in returns on dollar-denominated financial assets, to which Japanese economic policy related closely, the United States performed the role of international intermediation or funds. They took in huge amounts of funds from foreign countries and put them to use again in foreign countries.

⁷ Group of Ten, "The Functioning of the International Monetary System", 1985.

This movement became evident from mid-1990. From 1996 and through 1997, for example, the annual inflow reached approximately 600 billion dollars, and the outflow reached approximately \$350 billion. In 2000, the inflow was \$932 billion, and the outflow was \$521 billion.

(1) The economic policies of Japan as a creditor country and the international intermediation of the United States as a debtor country, together with a huge amount of fund shifts from personal deposits to mutual funds (approximately \$600 billion in 1992 to 1997) were among the main causes of the extraordinarily steep rise of US stock prices (the aggregate market value of stock increased 2.7 times, or about \$8 trillion from 1993 to 1998 and increased another \$6.2 trillion from 1998 to 1999) and also eventually gave rise to a boom of the real economy inside and outside the United States. However, this boom had the intrinsic potential to cause the Asian economic crisis in the autumn of 1997, and a subsequent world economic disturbance.

In other words, the three abnormalities, i.e. (1) shift of funds from deposits to mutual funds by the household sector in the United States, (2) the large scale international fund mediation by the United States, and (3) the ultra-low interest rate of Japan as a creditor country) are interrelated, and none of them was sustainable. The subsequent phenomena of a simultaneous drop in world stock prices and the disturbance of exchange markets can be said to be a consequence of these abnormal economic policies. The confusion that occurred in the Asian region after 1997 must be understood in the framework of overall world finance and economics. Japanese economic policies provided a very large influence in that context.⁸

Break-out of the "finance trap" and public-sector finance reform

To resuscitate the Japanese economy, the systematic relevance between the real economy, private-sector-related financial intermediation, and public-sector-related financial intermediation must be analyzed methodically since private and public-sector finance coexist in Japan. Japan must thus adopt a properly unified policy.

⁸ The central bank of Germany also performed a similar analysis of the relations between international fund mediation/excess liquidity and the economic crisis in Asia (Deutsche Bundesbank (1998), "Die Verschuldungskrise ostasiatischer Schwellenländer," Deutsche Bundesbank Geschäftsbericht 1997.) pp. 116 to 123.

The market economy and public-sector finance

In a market economy, why is the government involved in financial intermediation? Uncertainty and financial instability are inherent in the market economy. The future is always uncertain for financial entities. When uncertainty grows, financial intermediation by private economic entities tends to increase the costs, as it overestimates the risks of borrower and lender. For this reason, financial intermediation by public-sector finance that satisfies specific conditions may ease the burden on the people. Government participation in the market economy therefore has a desirable aspect as business cycles and financial crises are unavoidable. Uncertainty in the market economy should be considered a different criterion from risk, and public-sector finance should only be employed in areas containing greater uncertainty. In this case, uncertainty defines a situation in which there is either a drastic change of economic structure or instability resulting from loss of balance in the economic conditions. Examples of the former include an abrupt change of industrial structure, innovations in techniques, changes in regulations, and geographical changes in natural resource distributions. An exceptional deterioration of the economy can be an example of the latter.

In public-sector finance, funds are collected from postal savings, postal life insurance and public pensions. These funds are spent on (1) financing by governmental financial institutions, (2) financing governmental institutions for public projects, and (3) purchasing national and local bonds. The presence of public-sector finance in terms of size and business scope is much larger than optimum. Analyzing the background of this dissociation reveals four problems in the government.

- (1) The entities that collect funds and the entities that use those funds do not communicate, and thus they do not act together.
- (2) There is no clearly responsible authority.
- (3) There is no information available about cost and return, and performance on financial intermediation is unclear.
- (4) There are no controllers to recognize and direct public-sector finance.

Harmful influence of excessive public-sector finance on the market economy

The actual scale and function of public-sector finance are far from ideal and are getting out of

control. This adversely influences the healthy growth of a market economy.

First, on both the financial and real-economy sides, putting more weight on the government sector and reducing the role of the private sector lowers the efficiency of resource utilization. Obviously, there would not be any problem if people chose this state responsibly. As noted above, however, public-sector finance is becoming more unmanageable due to a lack of consistent, clear information on costs and benefits, and the question of who bears responsibility for them.

Second, the inflow of huge sums of money into public-sector finance channels exceeds the level of the original purpose, which is (1) being funded by governmental financial institutions and (2) for public-sector projects. In its current state, the funding inflow is diverted from its true purpose and is directed toward funding portfolio investments in national and local bonds. The purchase of national and local bonds by public-sector finance is not a responsible action carried out based on risk-return considerations. A large influx of funds causes prices of national and local bonds to rise sharply and a long-term interest rates to fall. Consequently, long-term interest rates become very low, the interest curve is flattened, and the price mechanism is artificially distorted.

Third, the supply of risk money from the households, the ultimate lenders, becomes inadequate. The major routes open to a flow of funds from the ultimate lender to the ultimate borrower, are deposits and loans through the private sector, postal savings, postal insurance, and public pensions. Capital market routes have been markedly few in Japan. Present conditions and the high presence of public-sector finance are closely related. From the viewpoint of a household, the market is not adequately prepared to diversify risk. Until 1998, regulation of comparison information was applied to financial assets, and information related to portfolio selection itself was not fully available. Funding high-risk, high-return projects thus becomes extremely difficult. How can such a situation continue for over 15 years after the start of deregulation of interest rates on deposits? How do the development of a capital market and the supply of risk money transform into an empty slogan? One cause could be that policy-making authorities do not recognize the financial structure as a means of reducing the information and transaction costs in economic affairs and of promoting the accumulation of capital and techni-

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cal innovations. The authorities also fail to recognize that the growth of the economy depends on the structure of finance. Americans and Europeans understand that the prosperity of the 1990's was attained using the capital market as a catalyst, but that thought has not reached the authorities in Japan. For example, in some reports such as the White Paper on the economy, one central government agency pointed out that the problem of the Japanese economy is that the household single-mindedly prefers deposits-and-savings over providing risk money. Another central agency has declared that several hundred trillions of yen collected from the households are only applied to clearly low-risk financial assets. It is unreasonable to expect any consistent policies under these conditions.

Fourth, excessive public-sector finance introduces a lax attitude of politics and policy-making authorities toward the budget deficit. Given the unconditional purchasing of national government debt by the public sector without any consideration of risk versus return, that sector cannot consider the prices (interest rates) of national government debt instruments as the standard for resource allocation. Politicians and bureaucrats concerned with policy decisions, however, view the low interest rate of national government debt as an indication that people are supporting a policy of deficit finance.

Harmful influence of excessive public-sector finance on policy management

Hypertrophic public-sector finance also negatively affects policy management because it impairs the policy implementation mechanism. For example, the existence of such public-sector finance decreases the effectiveness of expansionary monetary policy after the collapse of the bubble economy or in a financial crisis. In such circumstances, the household sector shifts funds from private-sector finance to public-sector finance. In fiscal years 1991 to 1999, a little more than 50 percent of the rise in financial-assets was turned over to public-sector finance. Public-sector finance applies half of these funds to portfolio investment and circulates funds to national and local government bonds that they believe are safe and certain. In this way, even if a central bank adopts a super-low interest-rate policy and implements quantitative easing, the credit channel through which a loan from private-sector financial institutions passes is not expanded. Furthermore, these activities do not favorably influence risk-asset prices, such as stock prices, and therefore the credit expansion effect that is triggered by a boost of asset prices does not work.

Generally, the state of finance influences economic development by promoting technological change. As finance affects the real economy, the result depends on information and transaction costs, the unbundling and transaction of risks, distribution of resources, supervision of borrowers, and utilization of savings. The capital market that supports economic development must carry out responsible investment based on risk and return. The flow of funds in Japan, which inclines heavily toward public-sector finance, is just the opposite.

Furthermore, public-sector finance significantly influences the behavior of private financial institutions. Public-sector finance not only intrudes in the realm of private-sector finance in terms of deposits, insurance policies, housing loans, etc. but the activities of public-sector finance also flatten the yield curves, making it difficult for private financial institutions to make long-term loans. In other words, because public-sector finance continues to purchase large volumes of government and municipal bonds regardless of the price, thereby helping to lower long-term rates of interest, such yield curves will prevent private financial institutions from obtaining a sufficient profit margin between short-term procurement of funds and long-term lending, and makes it difficult for them to assume the risk of long-term loans. As a result, a vicious circle repeats itself, in which business conditions flag while new bad assets are produced, financial conditions of private financial institutions do not improve, and household funds again flow into public financial institutions.

In addition, if structural reform is attempted, the presence of hypertrophic public-sector finance prevents internal conversion of the economic systems and thus reduces the effect of policies. This is because, in one channel, fund operation of households constitutes a main cause of the bias to indirect finance instead of direct finance and, in the other channel, large investment in public bonds results in a huge budget deficit, while an increasing government debt prevents the decline of the standard of living of households.

A practical solution to the public-sector finance problem

In summary, Japan failed to create the channel for funding via the capital market, but it allowed an unusual flow of funds that infringes on the market-

economy principle by expanding public-sector finance. Japan became increasingly entangled in its own net and eventually fell into the “trap of finance.” The top priority of the Japanese economy should now be to break out of this trap. There is no time to wait for the system reform called public-corporatization or privatization of postal savings and postal insurance. All that is required is the replacement of the portfolio management system by public-sector finance (that, as mentioned above, reaches several hundred trillion yen) by a responsible management system based on public disclosure of performance, personnel evaluation, and a risk-return analysis.

Fortunately, stock prices have fallen a little less than 30 percent from the year-end peak in 1989. Since stocks are held for a long time, this is even less than the historical trend covering 200 years in the U.S. and 40 years in Japan. Annual real returns of 7 to 8 percent are to be expected if stocks are held for a long time. Equity investment by public-sector finance may cause difficulties for the corporate governance of a private enterprise, when an individual stock is chosen. However, Exchange Traded Funds (ETF), which enable dealing in all Japanese stocks at any time and for a low commission, has been available since the summer of 2001, and it also eliminates the need of choosing an individual stock. If portfolio management by public-sector finance is developed into a responsible system, there will be a strong shift of public funds from governmental bonds to stocks, with a comparatively high price of bonds under a record-low interest rate. Ignited by this, an individual fund may be both directly and indirectly shifted from the deposits and savings of zero interest into stocks. A healthy stock price may thus return to a level at which the vicious circle of the Japanese economy may be broken.

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