

**Japans Economic Policy in the 1990s  
- An Insider Analysis -**

Discussion with Kazuhide UEKUSA,  
Senior Economist, Nomura Research Institute

and

Hanns Günther Hilpert and Jörg Raupach  
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## Portrait of Kazuhide UEKUSA



Born in 1960 the Senior Economist at Nomura Research Institute, Japans largest economic think tank, is presently one of the most influential economists in Japan. As a regular commentator in Japans media and frequent participant in economic debates Mr. Uekusa is known for his critical and insightful economic analysis and has actively shaped the discussion on Japans economic policy in the 1990s. The graduate of the Faculty of Economics of the University of Tôkyô is also working in the academic field. As a Research Fellow at the Hoover Research Institute of Stanford University and Assistant Professor at Kyoto University Mr. Uekusa has contributed to research and teaching in the fields of economic policy, macro-econometrics and capital market theory. Next to various papers and essays Uekusa published his first book in 1992 titled "Political-economic Theory of Interest, Exchange Rates and Stock Prices". In 1998 Japans leading economic newspaper, The Nikkei Shimbun, named him "No. 1 Economist of the Year". His book "Japans Settlement Account" ("Nihon-no Sokessan") has become a bestseller since it was published in May 1999.

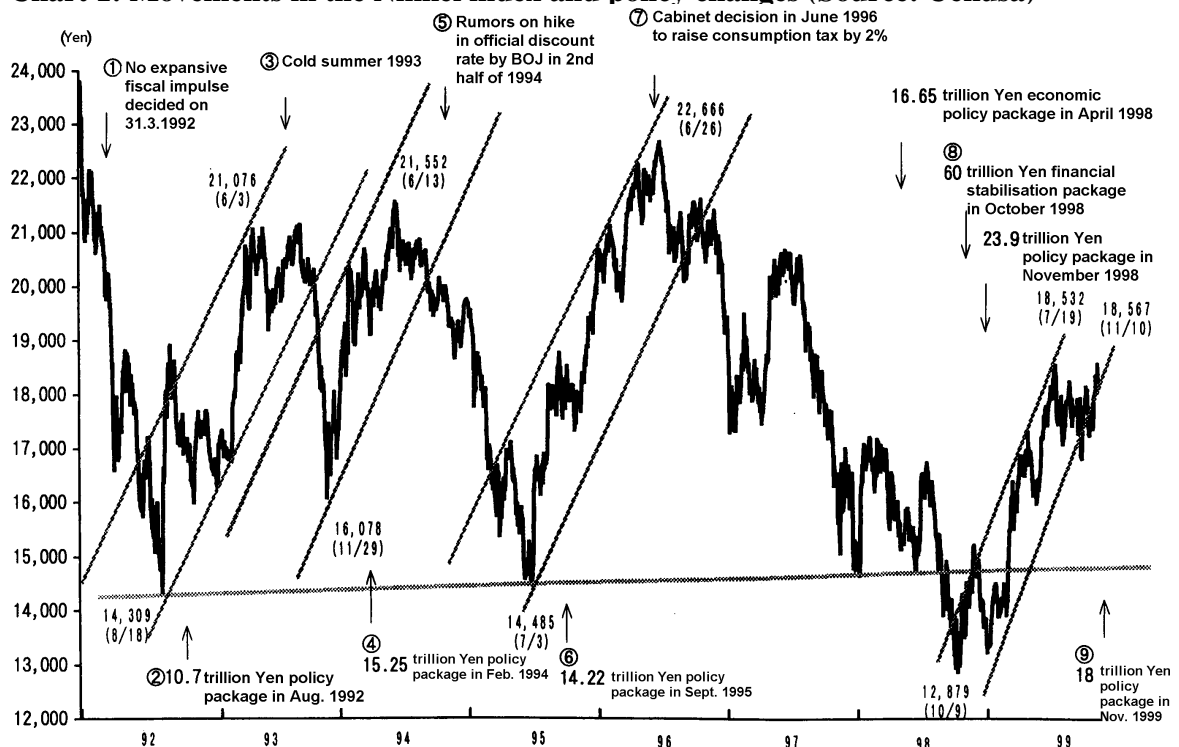
**Raupach:**

First of all, I'd like to ask you about the past economic policies, particularly of the Hashimoto Administration. Since 1992 there have been eight major economic packages, totaling more than 110 trillion yen. We have just learned that another economic package has been decided by the LDP and will probably be passed by the Diet amounting to 18 trillion yen, which is nearly the same size as the last package. However, the badly needed self-sustained economic recovery has still not been achieved, and we would like to get your comments on why fiscal policy obviously seems to have failed.

**Uekusa:**

When discussing Japan's economic policies, I often use the attached chart (see chart 1).

**Chart 1: Movements in the Nikkei index and policy changes (Source: Uekusa)**



This chart shows the movement of the Nikkei index in the last eight years. Ten years have already passed from the peak of the Nikkei index at the end of 1989. At that time the Nikkei index stood roughly at 38,900. We then experienced a sharp drop in early

1990 and, in early October 1990, the index fell sharply to a level of 20,000, that is almost 50% below its former peak level. However, in the period between 1992 to 1999 the Nikkei index moved in a rather narrow range between 13,000 to 23,000. In this sense, the Nikkei index very well reflects the very weak conditions of the Japanese economy in this period. If we look at the chart of the Nikkei index more precisely, however, we can observe four phases of a sharp up-swing in stock prices during these eight years. At the moment we are experiencing the fourth up-swing situation. In the chart, I have numbered the turning points in the Nikkei index movement from 1 to 9. At each of the turning points of the Nikkei index in these four upswing cases, namely at number 2, number 4, number 6 and number 8, the government had decided a major fiscal program to stimulate the economy. In 1992 the government decided a 10.72 trillion yen economic package, in 1994 the government decided a 15.25 trillion yen package including a 5.5 trillion yen income tax cut, and in 1995 the government decided a 14.22 trillion yen package. In the latter case the Bank of Japan also cut the short-term interest rate twice, in July and September. And last year the government decided another economic package totaling 16.65 trillion yen. The government also developed a scheme to resolve the problems of the financial industry by using 60 trillion yen, and in November last year the government decided yet another 24 trillion yen policy package. What we can observe is that every time after a major action was taken by the government, we have a sharp upswing of the stock prices, and every time after that we have a fairly clear improvement of the economy. In the case of 1993, Mr. Funada, the former minister of the Economic Planning Agency, announced that the Japanese economy had entered the stage of economic recovery in June 1993. In the case of 1994, we had a very strong economic recovery, and, in addition, the very hot summer of that year supported the Japanese economy substantially, and many people expected a very good course of the Japanese economy in the middle of 1994. In the case of 1996, we had a very strong increase of the Nikkei index, to more than 22,000, and the Japanese economy marked 5.1% of real economic growth. This was the highest growth rate among the industrialized countries, and I can say that the Japanese economy stood on the threshold of a firm, self-sustained recovery. Domestic demand started to grow by 2% or 3%, and we observed a basic change in capital investment from 1995 to 1996. At that time the Economic Planning Agency also

announced that the adjustment process for excess capital stock had already been resolved. This time the Nikkei index rose by 44% since October 1998, and we are having very clear economic recovery from the beginning of 1999. In this sense I can say that fiscal policy worked efficiently at every point in time in the case of 1992, 1994 and 1995 and also this time. Many people insist that the effect of fiscal policy is now decreasing, and that despite the Japanese government spending of more than 100 trillion yen in eight years, the Japanese economy is still very weak. If we connect these measures directly, indeed, it appears that fiscal policy has not produced a sustained recovery. But this view is misleading. If we look precisely at the reaction of the Japanese economy after each course of government action, we can recognize a very effective reaction of the Japanese economy. In this sense I think we have to find other reasons for the prolonged deterioration of the Japanese economy. These reasons can be found at Numbers 1, 3, 5 and 7 in the chart which each mark a downturn in the economy. Number 1 is the first policy package after the collapse of the stock prices. The Japanese economy entered a recessive situation from February 1991, but the government announced that the Japanese economy entered a recession only in February 1992, one year later. At that time the Prime Minister was Mr. Miyazawa. He had the reputation of being very strong and very clever, especially regarding the economy, but it took him a year to determine that the economy was in a recession. The government announced that the Japanese economy entered a recession situation for the first time in February of 1992, and in March 1992 the government decided the first policy package. This was March 31st. We usually talk about the "real water" (i.e. additional fiscal spending) when we discuss an economic policy package. However, this time I cannot find any "real water" in this policy package. The government did not add any fiscal spending in this policy and just after the policy announcement, stock prices started to drop sharply to 14,000 in 1992. In the case of 1993 it was a chain of unfortunate accidents in which two important occasions stand out. One is that we had some trouble in the Parliament and Mr. Miyazawa resigned in June 1992. The government discussed the reform of the election system. And we had general elections on 18 July 1992. Afterwards the Hosokawa Administration began. We had a very long period that passed from the former government to the new government where we could not get any new policy action until the middle of 1992. On the other hand we

had a cold summer. In addition we faced a sharp appreciation of the Japanese yen under the influence of the new Clinton administration in the United States. Finally we had several scandals involving general construction firms in 1993. In autumn we had a sharp drop of stock prices, and the direction of the economy changed. In the case of 1994, at mid-year, the Japanese economy was showing very promising signs and indicators revealed a very good economic recovery. But at this point in time very important news spread that the Bank of Japan would raise short-term interest rates by the end of the year. I insisted that the Bank of Japan should reduce short-term interest rates instead of raising them, but the number of persons who insisted on this opinion were very few. I only know Mr. Iwata, professor of the Sophia University, who also voiced such an opinion. He and I were the only two persons who insisted that short-term interest rates should be cut instead of being raised. Well, I recognized that the Bank of Japan had begun to prepare the hike in interest rates by the end of the year. The specific reason for this policy was Mr. Mieno, who was scheduled to resign at the end of that year. Basically central banks prefer monetary tightening rather than monetary easing. But as Mr. Mieno had cut short-term interest several times, especially in the second half of his tenure, people who surrounded Mr. Mieno wanted to give Mr. Mieno some kind of farewell present before his resignation. In this sense the Bank of Japan entered a preparation process by the end of that year. As a reaction to these rumors, the short-term interest rates rose by 1.5% in the second half of the year. The Nikkei index started to drop gradually in the second half of the year and fell below 20,000. Just at the beginning of 1995 we had a big earthquake in Kobe on the 17 January. Next we had the nerve gas attack in the Tōkyō sub-way on 20 March and we saw a sharp appreciation of Japanese yen to more than 80 yen against the dollar. As a result stock prices dropped substantially to around 14,000. All this caused a severe crisis in mid-1995, in the process of which government policy changed substantially. The Bank of Japan reduced short-term interest rates twice, instead of raising interest rates, on 7 July and 8 September. Then the government approved a 14 trillion yen package on 20 September of that year. The government made great efforts by using fiscal and monetary policy in mid-1995, after which we saw a sharp hike of stock prices from 14,000 to 25,000. We had 8,000 points in one year, and we had 5.1% economic growth in 1996. In the case of 1996 the government formerly decided to raise

the consumption tax by 2% as of 1 April in 1997. From the beginning of 1996 I had started a campaign in order to reduce the size of the tax increase in fiscal 1997. The Ministry of Finance, however, had started a very big project called TPR: Tax PR. Accordingly the Ministry of Finance made a great effort from the beginning of 1996 to succeed in raising the consumption tax in the middle of 1997. The government broadly used the media to gain support for a tax increase, including television. NHK featured a two-day special program at the end of November of 1996 which stressed the point that Japan's public finances were in a state of near bankruptcy. The people who watched the TV program gained the impression that the conditions of Japanese public finance were so bad that the government needed to take action to restore fiscal health. But I insisted that the Japanese economy had just entered an economic recovery in 1996, but that the fundamentals were not so firm. I warned that in case the government would choose strong austerity, economic policy this direction might change. And the second point is that in such a case a sharp drop in stock and real estate prices could be expected. Considering that the basic conditions of the Japanese financial industry were still so fragile, I feared that in such a case the Japanese economy might face a crisis situation again. Therefore, I recommended that the government should limit the scale of the tax increase. However, after the LDP won the general election of 20 October 1996, the government decided on measures which increased the burden on the national economy by a total of 9 trillion yen. Just before the general election in October 1996 the government had announced a 5 trillion yen tax increase in the form of a 2% hike in the consumption tax. But it also promised to provide a 5 trillion yen supplementary budget by the end of the year, thereby neutralizing the tax increase. But after the LDP won the general election this story changed drastically. The LDP cancelled the 5 trillion yen supplementary budget and instead of the supplementary budget the LDP cut 3 trillion yen worth of income tax reductions and raised the people's cost burden for medical services by a total of 3 trillion yen. After the announcement of this 9 trillion yen increase of the national burden at the end of 1996, stock prices dropped sharply to a level of 17,000. In this sense I think the mistake of the tax increase was really serious for the Japanese economy, especially in 1996 as the Japanese economy had entered a very steady path towards economic recovery. I believe the government should have taken a long-term approach to restore

healthy fiscal conditions. I had insisted that the government should raise the consumption tax only by 1% in April of 1997 and follow with a second hike by 1% in April 1998. Such a 1% increase of the consumption tax would have implied an increase by only 2.5 trillion yen. I recommended that the government should take two years to raise the consumption tax step-by-step to 5%. By doing so, I judged that the economic recovery could be maintained. Again, I did not insist on expansive fiscal spending in 1997 and 1998, but I recommended a 2.5 trillion yen tax increase. However, I insisted that the government should reduce the size of the tax increase from 9 trillion yen to 2.5 trillion yen. If the government had chosen such a policy, the Japanese economy would now be in the fourth year of recovery and the Nikkei stock index would probably be above 30,000. But instead we witnessed very important mistakes. The major reason for these kind of policy mistakes is that the Japanese economy policy is decided by ministries. It is, however, very difficult to find any person in the ministries, also in the Ministry of Finance, who knows economic policy well. The bureaucrats in the ministries are experts on legislation or administration, but there are very few economists in the Ministry of Finance. If we compare Japanese economy policy decisionmaking with that of the United States, we find big differences. The Clinton administration asked investment banker Mr. Rubin to be the Secretary of the Treasury. He is an expert on financial markets, the economy and economic policy. Those kind of experienced people decide economic policy in the United States. In Japan economic policy is usually decided by senior people in the Ministry of Finance.

Raupach:

In your book you criticize the Hashimoto Administration. On the other hand, when Hashimoto took office he initiated some major structural reforms, the so-called six big reforms like administration reform, structural reform, the "Big Bang" deregulation of the financial system, reform of the educational system, reform of the social welfare system and fiscal consolidation. For this he was given a lot of praise at the time. So why do you think Mr. Hashimoto failed?



Uekusa:

The Hashimoto administration started at the beginning of 1996. Just before the election, Mr. Takemura, who was then the Minister of Finance, announced that Japan's public finances were in a very bad state. After that the Ministry of Finance started to successfully promote the need for tax increases in 1997. Just after Mr. Hashimoto had become Prime Minister, he heard many presentations from senior people of the Ministry of Finance. And the Ministry of Finance told him that it was his task to decide and implement tax increases. Mr. Hashimoto accepted this request by the Ministry of Finance at the beginning of his tenure, and he started to prepare policy actions in this direction. People said that Mr. Hashimoto had a kind of complex against the people of the Ministry of Finance, and he was pleased to become Prime Minister and the head of the government with the Ministry of Finance under his control. I think Mr. Hashimoto is a very aggressive, keen and ambitious person and he tried to push through several kinds of reforms, such as structural reforms in administration, education and deregulation and the social welfare system. But such structural reforms are very difficult because many people oppose them. In addition at that time many financial institutions had taken a position against the LDP, and many people of the financial institutions supported the opposition party, the Shinshinto. On the other hand, the US government wanted structural reforms in the Japanese financial market. In this sense, I think Mr. Hashimoto selected especially the structural reform in the financial market. But it was my judgement from the very beginning that such kind of change would benefit foreign countries more than the Japanese domestic industry. I suspected that there was a kind of transaction between Japanese senior people and the US government to push through structural reform of the Japanese financial system. In return a specific person was rewarded for achieving success in structural reform, by promoting him to a higher position in the government. I think Mr. Sakakibara was the one who was considered to be an important person in this deal, and he became vice minister of the Ministry of Finance. I cannot confirm the exact argument between the US and Japanese governments, but there was strong pressure especially from the US government to make progress with structural reform. The Hashimoto



administration chose to make big changes in the Japanese financial market. On the other hand, Mr. Hashimoto wanted to be a good Prime Minister and to put his name into the history books. I believe, he selected fiscal consolidation and the restoration of public fiscal health as his main policy and, therefore, pursued an austere fiscal policy. I think the purpose of this action was not so wrong. Fiscal reconstruction is a very important task for the middle and long term, but Mr. Hashimoto made a very big mistake in the way he intended to achieve the restoration of Japan's fiscal health. After the decision on the tax increases at the end of 1996, the subsequent decline in the economic climate, the sharp drop of the Nikkei index and the rapid depreciation of the Japanese yen, the Hashimoto Administration was faced with very serious political challenges in January, February and March of 1997. But at the time, the Hashimoto administration received strong support from the US government. Mr. Greenspan announced that the Japanese were too pessimistic and this announcement supported Japanese stock prices and stopped the price drop at around 17,000. I was on a business trip to the United States in October of 1996. Many people in the US government told me that the Japanese policy was not correct. They warned that if the government took such kind of austere fiscal action, the Japanese economy would probably face a very difficult situation. Nevertheless, between January and March 1997 the US government kept quiet. I understood that the US government supported the Hashimoto administration in order to maintain the very important gains in the progress of structural reform of the financial system. The US government was afraid of losing the benefits from financial structural reform if the Hashimoto administration was replaced. Therefore, the US government supported the Hashimoto administration. Just before the hike of the consumption tax in the spring of 1997 we had a rise in stock prices to more than 20,000, because we had some rapid increase of consumption just before April. Mr. Hashimoto was at the peak of his power. But after that, the situation changed drastically. First of all, stock prices started to drop substantially. And then the economic situation gradually changed and in the

autumn stock prices dropped substantially and we had the insolvencies of large financial institutions such as Yamaichi, Sanyo and Hokkaido Takushoku Bank. Under these conditions, the government approved new legislation to conduct an austere fiscal policy for the next five years as of 28 November. I think making efforts for healthy fiscal conditions is very important, but the approach of the Japanese government in taking an austere stance was too direct and immediate with the effect that it killed the economic recovery, and the Japanese economy entered a very serious recession. The result is that tax income decreased substantially and the budget deficit increased significantly. In such a situation massive policy action was required. The government introduced a 16 trillion yen policy package in April 1998 and in October 1998 the government provided 60 trillion yen to resolve the financial crisis in the Japanese financing industry. >Finally, the government approved another 24 trillion yen package. Last year the government used 100 trillion yen in order to achieve a net increase of 9 trillion yen. If the government uses 100 trillion yen per year to get 9 trillion yen, it is easy to understand that the budget deficit will increase substantially. Well, the Hashimoto administration had to resign after it lost in the upper house election. The election results were a strong verdict on the policies of the Hashimoto administration. After his resignation, Mr. Obuchi became Prime Minister and he changed Japan's economic policy 180 degrees

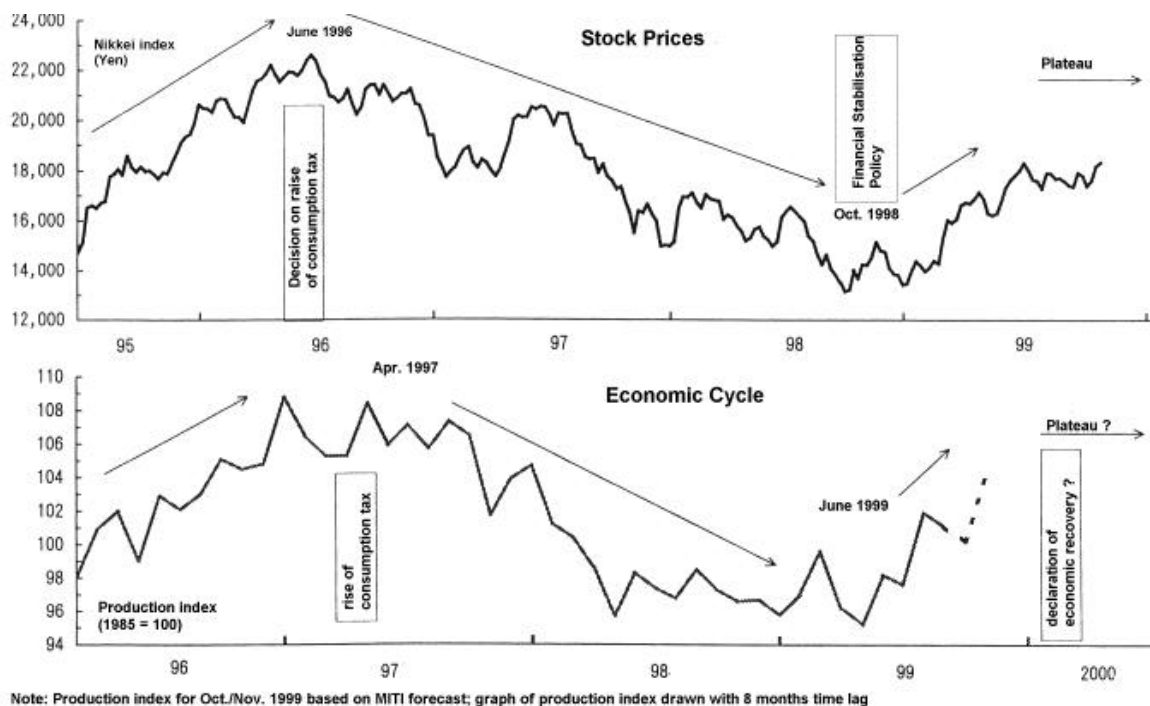
Hilpert:

In your policy recommendations, you stress the importance of fiscal policy and government-led demand creation in order to achieve the economic turnaround, to jump-start the economy and to rebuild confidence. The Obuchi administration seems to have followed your policy recommendations and is giving priority to demand creation. How do you assess the fiscal policy of the Obuchi administration? What are the prospects for a sustained economic recovery this time?

Uekusa:

Please let me try to explain this issue in more detail by using the following chart (see chart 2). There are two graphs, the top graph shows the movement of the Nikkei index and the lower chart shows the development of the index for industrial production.

Chart 2: Movements of Nikkei index and production index with 8 months time lag

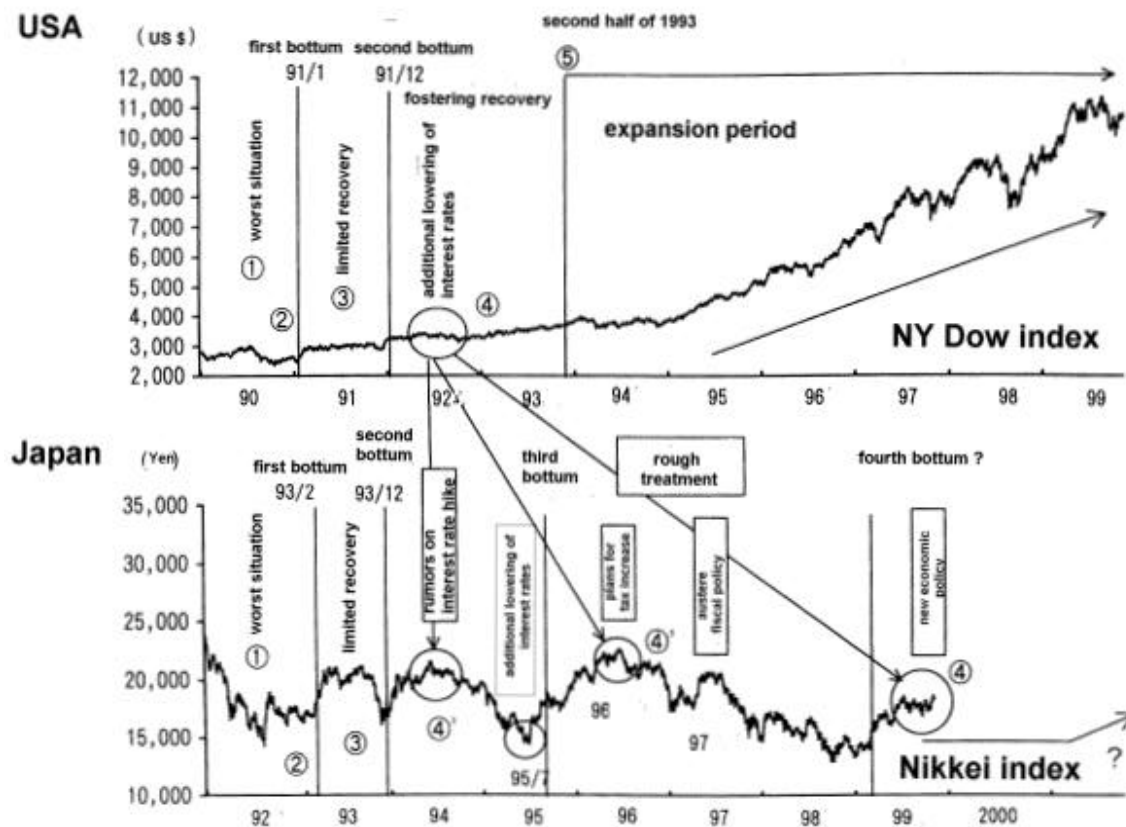


(Source: Uekusa)

If you look at the time scale, you notice that I draw this chart with an eight month time lag. By doing so, it becomes obvious that both indexes move almost in parallel. For instance, in June of 1996 the stock prices started to drop. At the same time the government decided to raise the consumption tax by 2% from April 1997 on. The decision was made on June 25, and stock prices started to drop from June 26 on. On the other hand, industrial production started to drop from spring 1997 just after the hike of the consumption tax. Such a time lag of eight months between the Nikkei index and the industrial production can be explained as follows. Stock prices usually react to the

announcement of some policy change, but production usually changes after some specific action has occurred. The implementation of policy decisions into concrete action usually take six or eight months. Last year in October the government approved a 60 trillion yen policy package to rescue some financial institutions, in November a 24 trillion yen policy package and in February of 1999 the Bank of Japan adopted a zero interest rate policy. Due to these kind of policies, the direction of stock prices changed from the end of last year. By taking into account the time lag between stock price movement and production movement, I expected that the Japanese economy would enter some kind of economic recovery phase from the second half of this year. And in fact, we saw some upswing in production from the middle of this year. Especially towards the end of this year, I expect some further upswing in production because of the Y2K problem. Many producers will increase production by the end of this year because of the Y2K problem. In this sense we will most probably have some very good economic indicators for the first quarter of next year. In this situation, I expect the government - anticipating such positive economic indicators - will probably formally announce the state of economic recovery in January 2000. And maybe the government will also call for a general election in February after this announcement, because we can expect very good economic indicators in the first quarter. However, after the first quarter of next year I expect that production will need some adjustments in order to reduce inventories. Therefore, I believe that production will show some downswing in the first half of next year. The key question is the direction of the economy after this adjustment process. If the Japanese economy shows some good recovery in the second half of next year, stock prices will go further up again. But if we can expect some deterioration of the Japanese economy from next spring on, stock prices will go down again. In that sense we have to pay special attention to the next policy steps. Let me go a little bit more into detail, in order to explain the scenario for recovery of Japanese policy. Please look at chart 3 (see chart 3), which shows two graphs.

Chart 3: Economic development, economic policy and stock price movements - USA vs. Japan



(Source: Uekusa)

The upper graph shows the movement of stock prices in the US stock market, and the lower one shows the movement of the Japanese stock market. I think there is a two-year time lag between the economic development of the US and Japan. If you look at the movement between 1990 to 1992 in the United States and compare this situation with the Japanese stock prices between 1992 to 1994, you will notice that the movement of both countries is almost the same. The Japanese economy moves almost on the same track as that of the United States' movement between 1992 and 1994. We have a two-year time lag. Number 1 in the graphs indicates the worst state of the economy, and number 3 refers to a temporary recovery. As you can see, the stock prices in both countries move in a

very similar way. As you will remember, we also had a very severe bad loan crisis and a sharp drop of real estate prices in the United States in 1990 to 1992 similar to that in Japan in 1992-1994. But the course of both economies developed in a totally different manner from 1992 in the US and from 1994 onwards in Japan. The US market showed a strong, long-term increase after 1992, but the Japanese market has shown a long-term deterioration after 1994. I think there are three basic reasons which explain the marked difference between the economic development of both countries. First of all, there has been a major difference in economic policy. In the case of United States the middle of 1992 was a very critical time. At the end of 1991, there was a serious discussion about a triple recession. Although after that the US economy showed symptoms of an economic recovery, there was much fear of a triple dip recession. In these circumstances the Federal Reserve Board cut short-term interest rates twice in July and September of 1992. As a result the US real short-term interest rates dropped to zero. The most important lesson was that the US government showed authority, and the confidence of consumers and managers in the corporate sector rose. This confidence was reflected in an upswing of stock prices which, in turn, created belief in an actual economic recovery. This shows that good policy is reflected in the high credibility of government. I believe that there are two crucial keywords: confidence and credibility. In the case of Japan, the government did not succeed in creating confidence and gaining credibility. In 1994 the Bank of Japan tried to tighten instead of easing monetary policy. I wrote several articles in the Nikkei Newspaper in the second half of 1994 urging the Bank of Japan to cut interest rates instead of raising short-term interest rates. I wrote several proposals to the US and Japan at that time, but the Japanese monetary authorities insisted on their course of tightening monetary policy. In the case of 1996, the Japanese economy showed a very encouraging economic recovery, but the government opted for a very strong, austere fiscal policy. The Japanese economy was like a person that was just released from hospital and was recommended to swim in cold water. As a result, the person had to go to the hospital again half dead. At the moment, the person is again at the front gate of the hospital, but this time he is being given a small dish of salad and some soup. So we are now expecting good recovery for this person. These examples show the most important differences between the US and Japan. In the case of the US, the government achieved economic

recovery. This economic recovery led to a substantial increase in US tax revenue, and the US budget deficit is disappearing in the long term. The major factor which contributed to the reconstruction of the US budget situation was the increase in tax revenue from the economic recovery. This process is needed to improve budget conditions in Japan. The second reason is the difference in policies for solving the problems of the financial industry in both countries. The US also had severe problems in their financial industry. The Bush Administration successfully implemented important legislation to resolve the financial problems in August 1989, as one of its first tasks. You know the custom in the US which calls the first 100 days of a new presidency the "honeymoon period" between the President and the Congress. The Bush Administration used this period to push through very important legislation which resolved the financial problems. The US government allocated 22 trillion yen to resolve the US financial problems. In the end only 10 trillion yen had to be used, but such legislation was very important to resolve the US financial problems. In the case of Japan such legislation was finally decided in October last year, which is a delay of nine years. However, as the Japanese economy moves with a two years time lag behind the US, the delay measured in real time was seven years. During these seven years, the size of non-performing assets increased substantially. The Japanese government has now allocated 60 trillion yen, but nobody knows whether this 60 trillion yen are enough or not. But on the other hand, I can say that we have achieved some good improvements in the policy situation. It is true that we are now experiencing big changes in the areas of economic policy and policies to resolve our financial problems. Japanese policy has changed gradually and the legislation process is now moving in a direction to resolve Japanese financial problems. I believe that we are seeing similar conditions as in the US in 1992. The third difference, and this is the most important, lies in the corporate sector. In the first half of the 1990s, the US corporate sector made big changes called BPR - Business Process Reengineering. I understand that through BPR significant cuts in labor costs were achieved by the introduction of information technology, such as personal computer networks. The corporate sector employed ten people for a certain task prior to using such information technology, but by introducing information technologies companies reduced white-collar labor from ten to three or from ten to five. In this sense, drastic changes occurred. This has not yet taken



place in Japanese corporations. It is true that many Japanese corporations have initiated programs called BPR, but Japanese BPR is quite different from the BPR process in the United States. Usually Japanese BPR just means purchasing personal computers. Many companies buy many personal computers, and usually every employee in a company gets his own personal computer. But we still cannot observe a substantial reduction in labor costs.

Raupach:

We believe that the last point you raised is very important. However, there is still very little discussion about how to reduce labor costs and how to restructure in the corporate sector effectively. We believe that the reform of the Japanese labor market and the employment system is a crucial element to succeed in corporate restructuring. What are your recommendations to create a more efficient and flexible labor market ?

Uekusa:

The most important structural reform required is that we prepare an environment which enables Japanese corporations to go ahead with BPR. In my opinion we need a combination of two kind of policies in order to support this process: we need supporting measures in the macroeconomic area and measures for structural change in the micro-economic area. The government should take strong action to create an environment which promotes the BRP process in Japanese corporations. On the other hand, during the BPR process we must expect some downward pressure on the economy due to a rise in unemployment. Such an adjustment process will mean an increase in the number of unemployed. In this sense I think the government should take action to support the macro-economy. I think that this combination is very important. Usually people ask which is better: structural change or fiscal signals? But I feel it is wrong to try to select between these policies. I think the combination of both is important. I think that the

required structural change in the corporate sector is most difficult for the Japanese society because we have a very strong custom of long-term employment. Usually nobody thinks about leaving a company before the age of 55 or 60 years. However, we are now faced with a rapidly changing world which places Japan in a very different economic situation. Especially now we are facing more and more the effects from so-called mega-competition. Other Asian countries are now catching up rapidly and their labor costs are much lower than Japan's. The US corporate sector successfully overcame this problem in the early 1990s. Mega-competition put very strong pressure on the US corporate sector, which had to reduce labor costs. In Japan we had very strong barriers against mega-competition. For example, a particular product can be bought for 80 dollars, but is sold in Japan at 20,000 yen in a department store because our distribution system is very complicated and we have many regulations to block foreign goods from coming into our market. In this sense, I think we have been lagging behind for several years, but gradually the barriers against foreign competition will become smaller and smaller. The Japanese corporate sectors will have difficulties to survive in this mega-competition. Therefore, I think the Japanese corporate sector will have to reduce labor costs. This is why I recommend that we create some kind of system to support the adjustment process in the corporate sector. Japanese people, especially middle-aged people, who unfortunately have to leave a company, confront serious problems. One problem is housing. If an employee lives in a house which is provided by the company, unemployment means that he and his family have to leave the company house and find a new house. In such a case I think the government should introduce a housing program which provides public housing for such people. Many people also have received housing loans from their companies which they have to pay back in case they are forced to leave the company. It is usually very difficult for such a family, and they might be forced to sell the house. Often the family bought their house at the peak of the bubble period. Even if they succeed in selling the house, the amount is much lower and it is very difficult for them to repay the loan. So they have no house but a large loan. In this sense, I think the government should introduce public financial institutions to take over the loan of these people from the corporation. A second big problem is the pension system. In many Japanese corporations at least 20 or 25 years of employment is required to become

eligible for a corporate pension. It is very difficult for people to leave a company before this period. They should have the right to receive a pension based on the actual period of the employment. For instance, if an employee has worked for 18 years at a company, he should be able to receive a pension for these 18 years of employment. Employees would probably be satisfied with this kind of compensation. The third, and most important problem is the Japanese seniority-based wage system. In this system, employees are not paid enough money for their work in their early years of employment. After they have been with the company for some time, salaries increase much more compared to the actual increase in work or productivity. Therefore, if a middleaged employee has to leave a company, he faces a huge loss in salary. In this sense I think the government should develop guidelines or rules to support these kind of people who have to leave a company. For example, the government should establish some rules which favor an employed person who is forced to leave the company. The company should have to pay some wage compensation to offset the loss of salary in later ages and for the salary which he did not receive in his younger years because of the seniority-based wage system. In the case of small businesses, the companies probably cannot afford to provide such kind of wage compensation. In this case the government should use public money to support such employees. If we want 2% economic growth, I think an additional 10 trillion yen has to come from the Japanese government. I think 10 trillion yen should be spent in this way rather than spending public money for building bridges or harbors, in order to support these employees. And if this kind of system is created in Japan, I recommend that the government allows the corporate sector to make adjustments in employment. The major reasons for the difficulties in the Japanese BPR process are regulations by the Japanese administration. Although there is no clear argument against cutting labor, court decision have created rules which make it almost impossible for companies to reduce people or to cut salaries. Such court rulings are causing serious delays in the corporate restructuring process. If we create a safety system for unemployment, the government can allow the corporate sectors to make the necessary adjustments in employment. I think this would mark a very important and significant change of the Japanese system. So we probably can expect many arguments and it will take some time. But I think this kind of combined policy approach which, on the one hand, promotes structural reform in the Japanese

corporate sector, and which, on the other hand, supports macro-economic demand through government spending is urgently required.

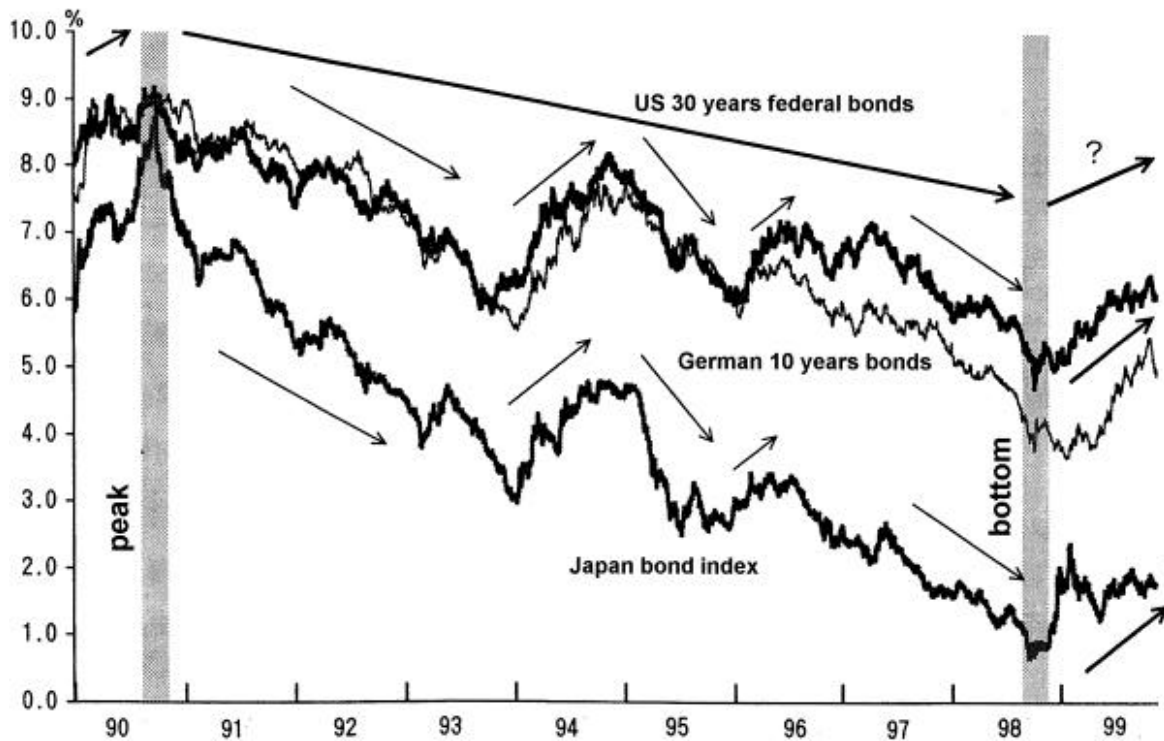
Hilpert:

A prominent critic of the Japanese government economic policy is Mr. Paul Krugman. He sees Japan in a liquidity trap and recommends as the only way out, a policy of deliberate moderate inflation targeting. In your book you have picked up this argument and you argue strongly against quantitative measures such as the direct purchase of government bonds to further ease monetary supply and to stimulate spending by creating inflationary expectations. Can you explain your arguments? And how do you view the recent decisions by the Bank of Japan prior to and after the G7 meeting in Washington?

Uekusa:

Let me explain my way of thinking by using the following chart (see chart 4).

**Chart 4: Comparative development of long-term interest rates - Japan, USA, Germany**



(Source: Uekusa)

This chart shows the long term interest rates in Japan, the US and Germany. The fluctuations in each country are very similar. And I can say that the long-term interest rates are moved by arbitrage between the countries. I do think, that the US long term interest rates are the basic key interest rates. This is my understanding, but it is very difficult to verify it. Furthermore, I would like to emphasize, that there is a peak of the long-term interest rates in the early 1990s. I think, that the long-term interest rates marked their bottom in later 1998. At that time we had a serious situation, with financial panic in Japan. The government allocated 60 trillion yen and it was very difficult to know if this 60 trillion yen was enough to resolve the Japanese financial problem. On the other hand, the Bank of Japan started its zero interest rate policy from February that year, and there is much argument about additional monetary easing by the Bank of Japan. Dr.

Krugman suggested that the Bank of Japan should start purchasing government bonds directly from the Ministry of Finance. I think the Bank of Japan should not take such an action, but I think we have to pay attention to this kind of argument at this very moment, because presently we do face an expansionary monetary policy both from a low interest policy and from the suggested purchasing of government bonds directly from the Ministry of Finance. The Bank of Japan seems to be refusing this purchase of government bonds, and we will not see the kind of inflation policy suggested by Dr. Krugman. But if we look at the low interest rate policy itself, we see a very strong monetary easing. Only one or two years ago many politicians insisted that elderly people were suffering from low interest rates and, eager to make a good performance in the next election, they asked for an interest rate hike. But this year many politicians insist on a further easing of monetary policy. Therefore, I see the possibility that the current strong monetary easing will continue in the long term. I also see that at this moment the basic economic conditions are changing. For the last eight years, from 1990 to 1998, we had a very strong direction towards deflation, but if the Bank of Japan continues this policy in the long term, the trend will probably change from deflation to inflation. We are now standing at a very important turning point. This kind of inflationary policy is required by many people, especially by the corporate sector, which is highly indebted and will be very happy if we get inflation. Also the Japanese government and the United States will be very happy if we have inflation. The United States will have a presidential election in November next year and US policy authorities will want to avoid fluctuations in the stock market. Having raised short-term interest rates this autumn, the Federal Reserve Board may reduce interest rates again next year to counter possible fluctuations in the stock market. In the case of 1998 the Federal Reserve Board reduced short-term interest three times and thus the stock prices were supported, but at that time the dollar dropped substantially from 147 to 111 yen. We had a sharp 36-yen-appreciation of the Japanese currency and a corresponding sharp depreciation of the dollar. If in the next year the US stock market meets with some change, the Federal Reserve Board will probably have to reduce short-term interest again. If the dollar is at 105 and if the Federal Reserve Board reduces the short-term interest rates again three times, the dollar would drop to 69 yen. If we experience such a situation, the US financial market will face a very serious condition

because foreign investors will withdraw money from dollar-denominated assets and shift them to other currencies. Then US interest rates will drop sharply and US stock prices will drop substantially. In this sense, the US monetary authorities want some monetary easing so that the Japanese yen moves around 130. If the US stock market needs monetary support next year, the Federal Reserve Board can easily reduce the short-term interest rates twice. If the short-term interest rate is cut twice, the dollar will be at around 106, after having depreciated by 24 yen. In this sense the US government would also like to have a monetary easing in Japan, and if the Japanese monetary authorities carry out such a policy, this is expected to trigger some yen depreciation. In the end this kind of expansionary monetary policy by the Bank of Japan will be very favorable for the Japanese corporate sector, the Japanese Ministry of Finance and the US government. Only the Japanese people will have some risk and some loss. In this sense we can expect an inflationary process. However, the independence of the Bank of Japan, which I value highly, could be at stake. Japanese monetary policy is officially decided in the board meetings of the Bank of Japan. The number of persons who have the right to vote is only nine. Voting rights are held by the governor, two vice chairmen and six members, who are mainly appointed by the Ministry of Finance. When recently Mr. Goto resigned, the government appointed Mr. Fukaya, who used to work at the IMF. He is known as the person who administrated the easing of monetary policy. With such appointments it is very easy for the Ministry of Finance to exert influence on the monetary policy of the Bank of Japan. As the six members of the decisionmaking meetings of the Bank of Japan is concerned about their eventual reappointment after the first five-year period, these members will side with the government. I think that new members should be chosen by the Bank of Japan and not by the government, and I have recommended this to very senior people. To conclude, a kind of inflation policy is already going on and I think it is not so important whether the Bank of Japan is purchasing government bonds directly from the Ministry of Finance or not.

Raupach:

In your book you make very precise, very unique and creative recommendations on policy matters. For instance, you say that the consumption tax rate should be cut to zero and be raised by one percentage point again six times according to a fixed timetable. You also favor a radical reform of the tax system, especially the reduction and simplification of corporate tax and income tax. You also recommend the creation of a liquid real estate market by promoting land deregulation in order to stimulate housing investment. However, we have the impression that although Mr. Obuchi is in general following your advice in quantitative terms, in the content of his politics none of your creative suggestions has been taken up. Why is the government so hesitant to promote structural change?

Uekusa:

Already in the last months of the Hashimoto administration I recommended a change of policy. I always insisted that budgetary consolidation is very important but the method applied is not correct, and then I insisted that the government should make economic recovery its first priority. The suggestion that the income tax should be cut was once even stated by Mr. Hashimoto himself, but just before the election he rejected the idea on TV. Later on I submitted a report to Mr. Nukada, who was already part of the Hashimoto Administration, and to Mr. Sakaiya, the Minister of the Economic Planning Agency. I met Mr. Sakaiya many times. His understanding of the economic situation of Japan is almost the same as mine. He is now probably the most effective person in government. With his policies the Obuchi administration is now seeking economic recovery as a first priority, and only afterwards will the government seek structural change. I think the basic policy course has changed. But as you have mentioned, the content of policy has not changed substantially, and the major part of the economic package is composed of traditional public works issues. This weekend Mr. Sakaiya and myself were on a TV



program at the NHK and discussed economic policy. Mr. Sakaiya emphasized that the government has made great efforts to change the policy package, but many people think the change is rather small. I think it is very very difficult to make changes on the content of such policy, because if the government allocates some money to carry out a fiscal stimulating policy many people want the money. And the function of the LDP is the distribution of such funds to various kinds of business, various kinds of people and various kinds of corporations, but the money is limited and the LDP will make some adjustments. The people of the opposition party insist that if we want to have a big change we need a change of cabinet, because the major function of the LDP is distribution and adjustment. For the LDP it is difficult to introduce a new system. When speaking on the needed drastic structural reforms, I emphasize first of all structural change in the labor market and next the change of the tax system, including the introduction of an invoice for sales tax. We also need the reform of the social security system and we need deregulation in the real estate market. Such major reform is needed, but it is very difficult for the LDP to make such big changes because many people are closely involved in the present system. It is very difficult to bring about a new system with the present government. I think it will take a long time and, we need a basic change in the political area. First the political parties should present their opinion to the public and explain what will they do if they form a new government. Before the election we must know the difference in details. So Party A and Party B should disclose their policies and let the people compare. Then we have elections. This provides the opportunity to make changes. But only this political process can effect major changes.

Hilpert:

I think your point on the importance of fiscal policy and governmentled demand creation to achieve the economic turnaround, to jump-start the economy and to rebuild confidence has been well understood. So far fiscal policy has boosted the economic growth rate, but a state of selfsufficient recovery has not yet been reached. The economy is still growing below its potential growth rate, which is generally estimated at around 2% for the late

1990s. If the government continues its current fiscal course, do you expect that a self-sustaining recovery can be reached? If, however, you reckon that the policy measures implemented so far are not sufficient, what more has to be done?

Uekusa:

We have to know some details about the effect of fiscal policy on the economy. In fiscal 1999 the government added around 10 trillion yen to have some increase in GDP from fiscal policy. In November of last year the government approved a 24 trillion yen package by which it financed the increase of GDP by around 10 trillion yen. And now the government is preparing the budget for fiscal 2000. The original budget for fiscal 2000 was at almost the same level as the original budget of fiscal 1999. Thus, if we do not add to this supplementary budget we can expect the reduction of GDP by around 10 trillion yen. In this sense, if the government had not taken action this autumn, we would have had a very strong downward trend because of an increasingly austere fiscal policy. The stock prices would have gone down substantially, anticipating the deterioration of the economy next year. In the former case, however, we got some big improvement: a sharp hike of stock prices and a secured economic recovery. But if the government had failed to take this additional action - because the Japanese economy seemed to look good, stock prices were up and a more healthy budget condition was needed - stock prices would have started to drop. Such was the usual course of fiscal policy in the 1990s, but this time the government decided the 18 trillion package in November. With this addition the budget for fiscal 2000 has almost the same size as the fiscal budget of 1999. However, at the beginning of this year Mr. Miyazawa did not intend to submit a supplementary package at all. But policy changed. However, we have to take into consideration that this kind of policy will be neutral for economic growth next year because the size of public expenditure remains about the same. Therefore, the growth of the Japanese economy is now moving at around zero percent. In this fiscal year the figure will be 0.9% or 0.6%, but since the level of GDP growth in the first quarter is already very high, the real meaning of the 0.9% of economic growth of fiscal 1999 is zero percent growth. I think it

is very difficult to know exactly the potential growth rate of the Japanese economy - the consensus is between 2% and 2.5%. In any case, what we need is 2% economic growth. I recommend the government to seek 2% economic growth as a kind of benchmark. With 2% growth we can expect the start of a virtuous process, including a consumption increase by 2%, a production increase by 2% and an income increase by 2% and finally some increase in income tax. Then we can expect some improvement of the budget condition, and then after two or three years we should take action on structural reforms. This was the course of regulations in the United States in the 1990s. I think at the moment the Japanese economy is almost on that kind of path, but we have to face some risks. One is nobody knows how long Mr. Sakaiya will be the minister of the Economic Planning Agency and nobody knows how long the current administration will remain in office. The other risk is the possibility of a big fluctuation in the US stock market. This would have a strong effect by such an adjustment process. It is difficult to know how the Japanese market would react. And the final major risk is the kind of structural reform. We do not know whether structural reforms can be carried out by the Obuchi Administration. It is very easy to change politics in terms of size but content is much more difficult. This time I am not so pessimistic, but I cannot be fully optimistic either. If the Japanese economy is on the right path, we are now standing where United States stood in 1992. And if we continue this way over the next seven years, then in 2006 the Nikkei index will be at 55,000.

Raupach:

You mentioned that the business restructuring process in the United States has had a great effect on lowering labor cost. I think another aspect is the establishment of many new companies and the stimulation from technological innovation. Many US venture capital companies have been established and grown big over time. There is also a lot of discussion on this topic now in Japan. One key to create new business is to get capital investment on track, which will finance innovations which can penetrate the market. If you look back to the Japanese industrial development in the 1970s and the 1980s, it was

innovation, that created new markets, new companies. And in this respect I am rather disappointed when I look at the budget right now. There is still a lot of protection for small companies but not enough stimulus to generate innovation. As the current restructuring process in Japanese companies is still very backward and both R&D expenditure and R&D efficiency has still to be increased a lot, I am not sure if this economic recovery is sustainable.

## **Uekusa**

I think the important point is the addition of sequence and content. First the government should support the macro-economic side and then we need the restructuring process in the corporate sector. That is why I recommend basic reform in the labor market administration. And the third important thing is support for new businesses. We need venture capital and we need incentives for new companies. In this sense we need incentives in the tax system for the provision of capital for venture business. On the other hand, I think the potential risk for entrepreneurs is very high in Japan. If the person who starts a new company faces some set-back, he will lose everything. This is a very big risk for people who think of starting a new business. In this sense I think we need some limitation of the risks of entrepreneurial failure, such as a change of bankruptcy rules. On the other hand we need structural change in the educational system. The Japanese educational system is very good at producing uniform people, but we need variety. Therefore I think the educational system should be changed drastically. But this will take time. In the case of the United States manufacturing labor decreased substantially and then IT industries, retail business, the restaurant business and health care absorbed a huge amount of labor. These industries should be promoted in Japan, for example, by a change of the zoning laws. We still use a lot of land for agriculture close to the cities. As you mentioned, we need such promotional policies, but the level of achievement in these areas is low.

**Raupach:**

We would like to focus once more on the topic of political risk. If we take a look at the new coalition, the Komeito party and some cabinet appointments are raising doubts. Furthermore, there is the discussion on raising the consumption tax again in order to finance the national pension system or the newly established elderly care system. In a way, one is reminded of the situation of 1995. How do you judge the risk that similar policy mistakes will be made in the near future? How do you perceive the risk that "old conservative powers" regain their control over "reform powers"?

**Uekusa:**

When we think politically about the present administration, we have to pay attention to the role of Mr. Sakaiya. Mr. Obuchi has a long-term relationship with Mr. Sakaiya. I think Mr. Obuchi attaches great significance to the words of Mr. Sakaiya and fortunately Mr. Sakaiya has very good ideas on how to make progress. Under this assumption policies will not be so bad, but if the prime minister changes, nobody knows who will become the Minister of Finance or the Minister of the Economic Planning Agency. There is a possibility that drastic policy change can happen again as in 1990, 1995, and 1996, and in this sense the timing of the next election will be important. There are two scenarios. One is the election will be held after the Okinawa summit, which means sometime from July to September. But it is very difficult to know the economic situation in the summer of the next year. Therefore, we now have a greater possibility of elections in February rather than after the summit. At the first case the LDP will probably lose seats but retain the majority. Now the three coalition parties have 357 seats out of 500. If they keep 250, they can choose the prime minister. But then Mr. Obuchi will have to assume some responsibility for the defeat. I think if we have the general election next February, we have to consider a possible change of prime minister.

**Hilpert:**

After these political reflections let us return to fiscal policy. Our last question is on the topic of fiscal risk, long-term fiscal risk. This year the Japanese public deficit will amount to about 10% of GDP. Public debt already exceeds 100% of GDP. There are even some analysts who state that the overall fiscal debt of Japan would be even double this size if pension and other public obligations were included. On the other hand, you have the argument that public debts matter less in Japan than in other countries, because the average Japanese household is so wealthy. But in any case, the public deficit and the public debt are escalating. Apparently, the Japan of today is living on the expenses of its future generation. And one gets the impression that the Japanese government is behaving like a drug addict. Each time a bigger dose is needed and the addiction gets increasingly worse. Trimming the budget deficit down to a healthy size, however, will be more and more difficult from year to year. Where is the way out here for the Japanese government? What needs to be done in the mid-term to restore solid public finance in Japan?

**Uekusa:**

I think the real topic is the question of the capability of the government. The most important factor is the need of a medium-term vision for achieving both an economic recovery and more healthy budget conditions. It is true that the Japanese budget deficit is now very large and the budget deficit has enlarged in recent years, but this result comes from a bad policy combination. If the confusion of policy management continues, the credibility of the Japanese government bonds will go down further. Now, a good medium-term course is required. The government has to get the economic recovery on a concrete and reliable track and the government has to explain the future budget condition to the people. It must be disclosed, that the Japanese economy is now in a very difficult condition, but that the government can achieve some improvement. At first, the priority should be on economic recovery and for some time the budget deficit may increase further. But if we achieve economic recovery, we can expect a tax increase to improve

the budget situation. Then we will have a choice between three alternatives, especially in the social welfare system: a low burden and low spending, a medium burden and medium spending, and a high burden and high spending. The government has the responsibility to present the different scenarios for these three cases. It must state what the national burden will be like, as well as the future tax rate. Then we will have to select one of the various kinds of system of social welfare. If people want a high level of social welfare, future tax rates should be presented. This kind of long-term story and managing ability is required. If the government succeeds in presenting such a story and people accept it, the huge amount of budget deficit is not so serious. At the moment we do not have a long term plan, but we do have a rapid deterioration of the social welfare system. I think this is the worst combination.

Thank you very much for this discussion.