Now is the Last Chance to Escape from the Heisei Era Economic Depression

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1. Basic View

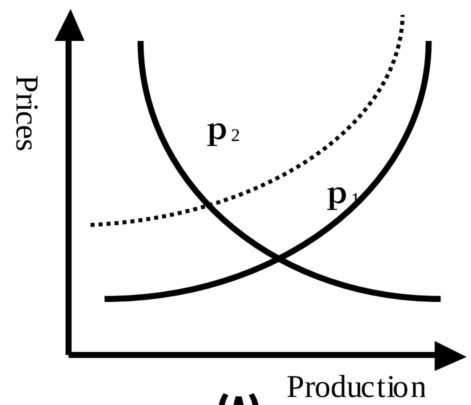
The Japanese economy is already completely in a deflationary spiral. Prices continue to fall, nominal GDP is shrinking, deflation causes new non-performing loans to emerge faster than old ones can be written off, and unemployment is soaring. Despite this crisis, Prime Minister Koizumi continues to chant his slogan "economic recovery can not occur without structural (fiscal) reform." He ruined a perfect opportunity to make a policy change at the time of appointing a new Bank of Japan Governor, by choosing the candidate that most closely represents the status quo, Toshihiko Fukui. As a result, the stock market continues to plummet and we are on the verge of repeating the mistakes of the Hamaguchi Cabinet, which brought on the Showa Era Economic Depression. On top of that, the double punch of the after effects of the Iraq war and the slow-down of the U.S. economy are quickly becoming a reality. If we stand by and do nothing now, a Heisei Era Economic Depression will be unavoidable.[1]

What is needed now is a bold anti-deflation policy to escape from this economic emergency, like the non-traditional monetary and fiscal policies undertaken by the combination of former Minister of Finance Karekiyo Takahashi and Bank of Japan Governor Eigo Fukai.

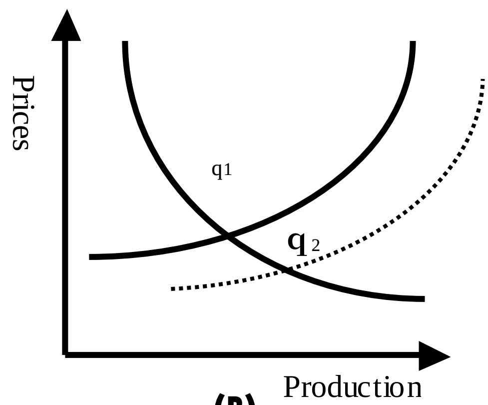
2. Analysis of the Current Situation

(1) Ever since former Bank of Japan Governor Masaru Hayami was appointed in 1998, full-fledged deflation has continued to progress and this deflation is the main factor eating away at the economy. (See table of Hayami's record while in office).

(2) This deflation was the result of insufficient aggregate demand, not due to structural problems. If the deflation was the result of insufficient structural reform, then prices would have had to rise (see graph A), and if the deflation resulted from progress in structural reform, then the economy would have had to grow (see graph B).



(A)



(B)

(3) The estimate of the size of the gap in aggregate demand changes depending on things like base year and assumed potential growth rate, but if we compare the fourth quarter of 2002 with the first quarter of 1998, when former Bank of Japan Governor Hayami entered office, we see the following:

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1 Heisei Era refers to the period that began in 1989 when the current Emperor took the throne in Japan. The previous era, which lasted from 1926 to 1989, is called the Showa Era.

a. Nominal GDP was 522 trillion yen in 1998, compared to 501 trillion yen in 2002.
b. Assuming a real potential growth rate of 1% and a 2% rate of price increases, GDP should have grown to 587 trillion yen by 2002. This suggests a deflationary gap of approximately 86 trillion yen (587 minus 501 trillion yen).
c. If you exclude prices and only look at the real GDP, then the deflationary gap comes to 26 trillion yen.

(4) Under flexible prices, the greatest policy tool for expanding demand is monetary policy. If expectations for deflation can be eliminated through monetary policy, it is because investment and consumption also increase. Currently, particularly with (short term) interest rates effectively at zero, the most effective policy would be to use a combination of quantitative monetary easing and inflation targets to impact expectations.

(5) It is also a problem that under current fiscal policy public investment (public capital formation) is decreasing by 5% annually. Even if total government spending is increasing, this is mainly because of public medical care expenses, which are unlikely to directly contribute to economic recovery.

(6) It is also a problem that supposed anti-deflation policies being pursued by regional governments actually contribute to deflation (such as the increase in fixed asset taxes).

3. Real Nature of the Problem

The root of the problem is the prevailing expectations of deflation in the economy. As long as deflation is expected to continue, industry will curb investment and consumers will tighten their purse strings. The burden is even greater for those who have liabilities such as real estate loans. Stock prices and land prices will continue to fall and non-performing loans will just expand, leaving no other option but for the economy to head toward collapse. If things continue without remedy, then it will become impossible even to issue government bonds and in the end the only remaining solution would be for the Bank of Japan to underwrite government bond issues and escape from deflation by triggering classic hyper inflation. Before that happens, action must be taken as soon as possible to eliminate expectations for deflation and create mild inflation (about 1-3% CPI).

Deflation is a monetary phenomena and only a central bank can counter it. It is criminal that the Bank of Japan has only taken too-little, too-late stop-gap measures and still does not try to tackle the issue of deflation. What is needed is to recognize the crisis at hand and implement bold anti-deflation monetary policies, even if they are not traditional. It goes without saying that it would be even more effective to implement such monetary policies as a package along with complementary fiscal outlays, tax measures, and regulatory reform.

4. Recommended Policies

Monetary Policy

(1) In order to eliminate expectations for deflation, the Bank of Japan needs to implement quantitative monetary easing and adopt inflation targets. In particular:

a. Target a CPI growth rate of 1-3% two years in the future.
b. Until the above target is achieved, implement net purchases of long-term government bonds of five trillion yen per month (equal to the amount of annual government issues, new issues and roll-overs combined).
c. Depending on the situation, expand the scope of assets purchased to include foreign bonds, Exchange Trade Funds, and others.

(If necessary to implement the above, revision of the Bank of Japan Law may be considered.)

There are some who criticize these types of policy proposals by saying "there is a danger of government bond prices collapsing as a result," but as long as the Bank of Japan is prepared to buy an unlimited amount of government bonds there is no reason to expect bond prices to fall. When expectations for deflation become expectations for inflation, nominal interest rates will rise, but under less than full employment, rather than the expected inflation resulting, the real interests will surely fall. Further, there is a limit to the degree to which prices can fluctuate for fixed interest rate products like government bonds, and therefore there is no way that a bubble or sharp collapse can occur. Looking back through history, no such thing occurred during the Showa Era Economic Depression or the U.S. Great Depression.

(2) For those who are still concerned about potential volatility of government bond prices, we recommend the government allow a conversion at book value of government bonds to bonds for which interest rates are linked to prices fluctuations.

(3) Relax the conditions for the government's public body for purchasing excess stockholdings from banks to the following:

a. Eliminate the requirement for an 8% contribution
b. Expand the scope to allow the purchase of shares owned by life insurance companies and other financial institutions.

Fiscal Policy

As for roles of monetary and fiscal policy in filling deflationary gaps, there is also the view that the amount of the real GDP gap should be filled with fiscal stimulus and the rest of the nominal GDP gap should be filled by monetary easing. In order to fill the deflationary gap in real GDP of 26 trillion yen, 10 trillion yen in new central government fiscal outlays would be necessary (20 trillion yen on a project base multiplied by the fiscal multiplier of 1.3 equals 26 trillion). (Project base figures include regional government spending and spending backed by central government guarantees, in addition to actual central government outlays).

(1) Seven trillion yen in projects related to structural reform (14 trillion yen on a project base).
(2) Three trillion yen in public works projects that would eventually have had to be implemented any (six trillion yen on a project base).
(3) In addition, the following additional fiscal outlays of five trillion yen should be considered:
  a. Special temporary regional tax increases of three trillion yen in order to help fund regional public spending.
  b. Small- and medium-sized business support of one trillion yen (such as to fund reductions in interest rates on Fiscal Investment and Loans Program (FILP) loans.
  c. One trillion yen to fund employment boosting measures.

The increase in fiscal outlays will eventually have to be paid for through a future increase in consumption taxes. However, when you consider that doing nothing about deflations allows a decline of 4-5 trillion yen in nominal GDP per year, it becomes clear that it is better to spend more now to stop deflation before the wounds of deflation become deeper.

Tax and Other Policies

(1) Reduce the fixed asset tax rate in order to prevent land price deflation:

a. Reduce the Target Appraisal rate used for calculations from 70% to 55%
b. Reduce the base tax rate from 1.4% to 1.2%.

Currently, due to an increase in the target appraisal rate, land prices are falling, and as a result, fixed asset tax revenues are decreasing, in a vicious circle.

(2) In order to accelerate the rate at which non-performing loans are written off, banks

should be allowed to write off the losses over a 15-year period, and be allowed to deduct deferred losses for 5 years.

5. Conclusion

The Kochikai is a policy group (of Liberal Democratic Party members) that has supported the prosperity of post-war Japan and our basic philosophy rests on the “economicism” of giving highest priority to preserving the stable daily life of our nation’s people. We feel it ominous that today our conservative “economicism” is being pushed to the sidelines and a “politicalism” focused on security affairs and establishing an autonomous Japanese foreign policy is gaining ground in mainstream thinking. The members of the Kochikai are determined to come up with a set of economic policies for improving the daily life of our nation’s people and restore political conservatism to the mainstream.