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## **What Japan Must Do**

Japan has experienced disappointing economic performance since the early 1990s, and there is little sign of an end to this “lost decade.” Economic growth remains very slow, unemployment is historically high, prices are falling, and the financial sector remains in a precarious state. Indeed, Japan now risks a decline in the very high living standard established during the previous decades of spectacular economic growth.

In the face of the country’s continuing problems, the government of Japan has taken several policy steps. To date, though, its actions have not succeeded in resolving the nation’s economic problems. Moreover, these actions appear to have left the government less scope for further policy initiatives.

Government spending programs, combined with the very weak economy, have resulted in enormous annual budget deficits and a rise in the ratio of measured government debt to GDP to a level well above that of most developed countries. Additional spending or tax cuts are, frankly, unaffordable. Practicing loose fiscal policy today means experiencing much tighter fiscal policy tomorrow, for a government that fails to pay its bills now will have to do so in the future. Given Japan’s precarious fiscal status, such payments cannot be deferred for very long. Because the public realizes that they aren’t free, short-term tax cuts will have little macroeconomic impact. The same logic applies to government spending projects. In light of recent history, one must also address the question of whether such projects are socially valuable.

Moreover, any further loosening of Japanese fiscal policy must be considered in light of the country’s demographic transition. Japan is aging much more rapidly than all other developed countries and faces enormous future costs to pay the very high pension benefits and health costs of those who will retire over the next few decades. When measured relative to its GDP, Japan’s long-term fiscal liabilities are substantially greater than those facing any other developed country. Given this fact, the government’s rapid accumulation of debt over the past decade is an enormously dangerous move in the wrong direction.

If expanding fiscal policy further is infeasible, what about using monetary policy to improve the country’s economic position? As everyone knows, past expansions of the money supply have dramatically lowered interest rates on government bonds. Indeed, since short-term interest rates have essentially reached their minimum value, namely zero, the monetary authorities have lost their ability to use short-term rate cuts to spur investment and other interest-sensitive private

sector economic activities. Japan appears to be in a “liquidity trap,” in which expansions of the money supply are simply held by households, firms, and the banking sector.

With its fiscal options limited and monetary policy seemingly impotent, what is Japan to do to alter its economic course? Clearly, one element of a reform package must involve a resolution of instability and insolvency in the banking sector. Without viable financial intermediaries, Japan will no longer be able to channel its traditionally high national saving rate into productive investments at home and abroad. The U.S. experience, in both the Great Depression of the 1930s and the Savings and Loan Crisis of the 1980s, indicates that recognition and resolution of insolvencies is an important precursor to reestablishment of a vigorous system of financial intermediation. While the precise details of a financial reform program need to be resolved, the recent attempts by Minister Takanaka in this direction are to be applauded. They are far preferable to the current policy of ignoring and, thereby, exacerbating the very real problems in the banking sector.

But there is much more that Japan can do, and here we tread cautiously to suggest that, contrary to a standard axiom of economics, there may be a free lunch or at least a cheap lunch. To be precise, we believe that the current situation is one that can be greatly improved by a massive open market operation in which the Bank of Japan would purchase large amounts of government debt with injections of new monetary reserves. Even if such a policy has no immediate macroeconomic effects—and we are optimistic that it would—it would still have major economic benefits, for it would replace government debt with currency and bank reserves that require no debt service, now or in the future. At present, debt service is low compared to the level of outstanding debt, because interest rates are so low. But, at some point in the future, this will no longer be true. Indeed, the fact that long-term government bond rates are well above zero (although still historically low) indicates that short-term rates are anticipated to rise at some point. Thus, getting rid of short-term interest-bearing debt now will save the government resources in the future, and purchasing long-term debt now will save the government resources immediately. These cost savings will allow the government to maintain Japan’s relatively low tax rates by immediately eliminating the government’s enormous debt overhang.

What are the dangers of such a major policy shift, under which a large fraction—perhaps all—of the government’s marketable debt would be repurchased? At worst, the government would enhance its fiscal position markedly, providing confidence for investors that Japan’s future is sound and stable and confidence for households that their tax rates won’t be raised. But we think more good will result, for a large, permanent monetary injection must, at some point and possibly right away, stimulate aggregate demand in the currently weak economy. Might prices rise as a result? Yes, but the first impact on prices would be to offset the deflation that poses major risks to the financial system and the overall economy. This potential impact on prices thus makes the program even more attractive.

Improving fiscal balance, stimulating the economy, and lessening the pressure on the financial system are three good reasons to undertake a major open market operation. No one knows for sure how much such an operation would help. But it’s clear that it can’t hurt. It’s also clear that the alternative methods of resolving the Japanese debt problem—raising taxes, cutting spending or defaulting on the debt—hold great risks to the Japanese economy and its people.

How might the Bank of Japan react to this advice? With skepticism, if past experience is any guide. No doubt the decision-makers at the BOJ feels that Japan's fiscal problems are not of their making and that purchasing a large share of the government's outstanding debt will just encourage the fiscal authorities to be even more profligate in the future. This view is not unreasonable. Printing money to pay its bills is the last thing a responsible government should do under normal circumstances. Unfortunately, the situation now is far from normal. Indeed, the BOJ may have no other option, in that if it fails to print money now, it will have to print even more in the future. The reason is that, fiscally speaking, the country is on the verge of bankruptcy. Without cutting its future liabilities through current money creation, Japan faces the prospect of needing to print money in the future as the only means fully to pay its bills. By printing money immediately rather than waiting and printing a huge quantity, the Central Bank can hope to limit the impact of that policy on inflation, while contributing immediately to the country's economic recovery.

In exchange for bailing out the fiscal authorities, the Bank of Japan should extract a guarantee from those authorities that they will, in the future, live within their means. Specifically, they should require the fiscal authorities to generate an annual long-term forecast of taxes and spending that indicates that their current and future planned spending can, indeed, be covered by their current and future tax receipts. Such intertemporal budgeting would go a long way toward restoring external and internal confidence in Japan's fiscal authorities and the nation's overall economic health.