JAPAN—STILL UNWILLING TO TAKE THE CURE

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The Japanese economy has been in recession or near-recession for eight years. For the better part of those eight years the prescription for recovery has been relatively clear. Yet, the Japanese have failed to cease the opportunity to put their economy back on track and on a couple of occasions taken steps to make it worse. (For example, the 5 percent increase in the consumption tax in April 1997 successfully killed a nascent recovery.) As the second largest economy in the world, it is important that the Japanese economy return to health. Japan is a major export market for many of the troubled countries of the Pacific Rim and Southeast Asia and a weak Japan makes it that much more difficult for those struggling countries to revive.

The Japanese economy began to slow from very rapid growth in 1988 along with the U.S. (See Figure 1). The U.S. experienced a mild recession in 1991. Unfortunately, Japan experienced the compounding shock, beginning in mid 1990, of a very rapid deceleration in the rate of growth of money. By early 1992, the annualized growth rate of the monetary base had declined from about 12 percent to –4 percent and M2 growth had fallen from 13 percent to about –1 percent. (See Figures 2 and 3.) During this same period, the annualized growth in industrial production fell from about 5 percent to –8 percent. It was also during this period that markets became aware of the crisis in Japanese banking and the large volume of bad loans that these banks held on their books. Domestic lending by Japanese commercial banks began to slow. Between 1994 and 1997 there was essentially no new lending on net by the banks. In 1998, commercial lending shrank by almost 8 percent.

Japan has repeatedly failed to come to grips with the crisis in their banking system and the deflationary nature of their restrictive monetary policy. Without addressing these issues, the prospects for the Japanese economy remain grim. Structural reform of the financial industry is necessary, but will not solve the problems the weakness in nominal demand caused by very slow monetary growth. By like token, more rapid monetary growth will help but its ability to stimulate increased nominal demand through the banking sector will be limited as long as the banking crisis is not addressed.

The latest efforts towards addressing the banking crisis are not likely to be successful. The government continues to provide resources to existing insolvent or near-insolvent institutions to shore up their capital base. But this does not solve the inherent problem. It doesn't address the regulatory reforms that would be necessary to prevent the problem from happening again and it doesn't open the industry to the competition (both foreign and domestic) that might impose the discipline on market behavior. The Japanese have a reasonable model to follow for restructuring the banks and that is the process followed by the U.S. when it faced the S&L crisis. They must get on with it.

As for monetary policy, the Bank of Japan still seems reluctant to engage in aggressive open-market operations. As interest rates have fallen and banks have withdrawn from lending the money multiplier has fallen. (See Figure 4.) Thus, M2 growth remains below 4 percent even as base growth has sporadically increased. Getting M2 growth increased will be aided by solving the banking crisis.

Lastly, the U.S. should continue to urge Japan to take these steps. It should not, however, use U.S. monetary policy to weaken the dollar relative to the yen making it more difficult for Japan to export. Devaluation is part of the solution to Japan's problems. Over the long term the yen-dollar exchange has been very consistent with the relative performance of the U.S. and Japanese economy. Between 1976 and 1998 the yen has appreciated from about 300 yen to the dollar to about 110 yen to the dollar, or about 3.7 percent per year. This is consistent with the fact that over that period U.S. inflation has exceeded that in Japan by about 2.5 percent per annum and Japanese real growth has exceeded U.S. real growth by almost 1 percent per annum over the period.

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