Center for Strategic & International Studies
Washington, DC

Richard Koo
March 13, 2001

While many have argued that Japan's major problem is its need of major structural reform, Mr. Koo contends that Japanese companies are all implementing the correct reforms. He said that although he does agree that some structural reforms are necessary, this is not the crux of Japan's economic woes. He believes that the consistent decline in asset prices have forced companies to pay off their debt as opposed to maximize profit. This is because the asset values on the balance sheets are so depressed that they are not enough to cover the amount of debt that they own.

Traditionally this would be proper practice, but Mr. Koo pointed out that because all companies in Japan are reducing their debt instead of increasing consumption and investment, the demand in the economy has waned severely, and as a consequence, prices are taking a fall. He identified this phenomenon as the fallacy of composition, or in other words, even though every company in the Japanese economy is acting prudently, it does not mean that the Japanese economy will benefit from the wise judgments of those individual companies.

Japanese households are still saving a good portion of their income, but Japanese corporations are not borrowing, nor are banks investing these funds. The result is what he calls a "balance sheet recession." He has found that monetary policy will not be useful in this sort of recession since there are so many companies minimizing debt in the economy. Typically, individuals would be more compelled to borrow and consume in the present at lower interest rates, but the Bank of Japan was not able to persuade investors to borrow and consume even at a zero interest rate. The only way banks will be able to get rid of some of this capital will be for them to lower their lending standards.

The one thing that has mitigated this crisis is government spending. By propping up weak demand through spending, the government has allowed the Japanese economy to stay solvent. In 1997-1998, when then-Prime Minister Hashimoto cut government spending in an attempt to reduce the deficit, the consequences were catastrophic as the economy went into five quarters of negative decline.

Mr. Koo sees the move towards structural changes as unnecessary because the economy is still in full employment. He feels that once all resources are employed, and it is determined that equilibrium has been reached in the labor market, then structural changes will be more meaningful. Nevertheless, he said that at this point, it is more prudent to fix the balance sheet recession, even if it requires a degree of deficit spending. Once the balance sheet recession has been mitigated, then the Japanese government will have to begin deregulation and other structural reforms to entice businesses to borrow again. This should help businesses overcome the psychological hurdle against borrowing, and it will give financial institutions outlets to keep savings.

In the end, he offered a caveat to the United States, as he believes it may also be heading into a "balance sheet recession" since the NASDAQ has taken a tremendous decline recently. He sees the Bush tax cut as a step in the right direction, but he still worries that this may not be enough. He advocates government spending as the best way to ensure that capital is going directly into

the economy instead of hoping that businesses will divert some of the tax savings away from paying down debt and towards consumption and investment.

Questions and Answers

Q. Mr. Koo's initial assertion was that Japanese consumer behavior (i.e., savings rate) never changes, but consumers will desire to purchase more goods, especially since goods are becoming cheaper. The Japanese government encourages people to save so that the government can spend. Japanese consumers feel obligated to save because they have to save with regulatory structures. Perhaps the removal of these regulatory structures will encourage consumption.

Mr. Koo said that even in 1990, when Japan was experiencing its highest level of prosperity, Japanese citizens were still saving 7-8 percent of GDP. He argued that it would make sense if the Japanese had curbed their consumption and increased their savings once the recession hit. Nevertheless, the Japanese had high savings rates even in good times. Consequently, it is probably more a part of the culture of the Japanese people to save than it is economic factors.

Q. Government debt in Japan is 130 percent, and with prefectures, postal savings, and hidden liabilities, it could be even higher at 200 percent. Won't increasing the budget deficit through fiscal stimulus create an even greater fiscal shock?

Mr. Koo argued that, though Japanese officials ought to worry about the possibility of a fiscal shock, the real concern is the dropping interest rate. Cutting the budget deficit is a popular message, especially for the Japanese people who are fiscally responsible. Regardless, fiscal restraint is what caused the economic debacle during the Hashimoto administration. Currently, businesses are too afraid to borrow because they were hit so hard in the 1990s. With so many households saving and so few firms borrowing those funds, there is an enormous gap. The only way to repair the economy is by having the government repair the gap through fiscal stimulus. Investment may not come for years; therefore, it is necessary that the government pick up the slack. In addition to fiscal panacea, deregulation would also be helpful to create incentives for businesses to borrow.

Q. The United States has a low savings rate, but savers there put their money in other places. Shouldn't the government try to create incentives for the Japanese to put more of their savings into investments, which would reduce their savings rates?

Mr. Koo agreed, and said the Japanese should purchase more equities. The problem is that many investors were burned by Japanese investments in the recent past. The first thing that needs to be done is for the Japanese to fix their economy. After that, programs that encourage equity investments will be more fruitful and more useful.

Q. What types of risks does the U.S. and global economy face over the next 2-3 years? What benefit could a tax cut offer Japan?

Mr. Koo said there are a number of risks to the U.S. and the global economy. With regard to the United States, Japan holds an enormous trade surplus with the United States that links these two economies inextricably. Many U.S. economists have said that the Japanese should just lower the yen. But devaluing the yen would increase Japanese exports, which would widen the U.S. trade gap even more. Also, it has been found that a strong yen is what fueled much of the Asian economic boom, and when Japan devalued its yen, it led to the downfall of the Asian economies. In this sense, Japan's moves have significant consequences for the U.S. and global economy.

As for the tax cut, Mr. Koo argued that while a tax cut would be beneficial because it is fiscal stimulus, the government would need to make an enormous tax cut to compensate for the recessionary gap. The reason is that the additional money received from a tax cut would be used to pay off debt before it was used for investment or consumption. Also, taxes are paid mainly by the elite of Japan; therefore, they would have little effect on the lower percentage of the population.

Q. It is believed that the public has so little confidence in the Japanese economy that they would tend to save more to offset increased spending. The reason is that citizens would be fearful of their future and would be compelled to save more of their income and consume less.

Mr. Koo returned to his previous argument that the Japanese have saved in good times and in bad times. Also, they saved by relatively the same amount in different time periods. He also argued that Japanese citizens are buying Japanese government bonds (JGBs) even at a time when they cost the most and yield the least, which implies that the Japanese have not lost that much faith in their government.

Q. Government spending would be justifiable if the cost of government debt was low enough, but it is not. In addition, government spending has not been used to increase productivity, and it provides not short-term returns but long-term returns. In this case, why should the government be allowed to spend even more when it is creating less?

Mr. Koo stressed that it was more important to fill the deflationary gap than it was to create a return on projects. Ideally, the public works projects that are necessary to fill the deflationary gaps would also provide long-term returns with regards to their usefulness. Nevertheless, Mr. Koo said that if these projects are not useful in the long term, it is still important to do them to prevent an economic debacle.