

2011

# lakkyara

Kyara, which means "precious" in ancient Japanese, is an aromatic resin regarded as the highest quality of all agarwood. "lakkyara [la-k&eacute;la]" aims to deliver the same quality as Kyara together with NRI's endeavour for continuous excellence and innovation to provide the most advanced and up-to-date information to our readers worldwide.

**vol.123** (10.November.2011)

**Special Edition**

The key to economic revitalization  
is eliminating uncertainty

Three years after Lehman Brothers' collapse, the global economic outlook is still murky and Europe is confronting a sovereign debt crisis that, if mishandled, could lead to renewed financial crisis. Against such a backdrop, NRI's Sadakazu Osaki spoke with Keio University Professor Kazuhito Ikeo about how Japan should approach the seemingly mutually exclusive challenges of economic recovery and fiscal rehabilitation.



### Kazuhito Ikeo

Professor of Economics, Keio University

Graduated from Kyoto University's Faculty of Economics in 1975. Faculty Assistant at Okayama University 1980–86. Assistant Professor at Kyoto University's Faculty of Economics 1986–94. Assistant Professor at Keio University's Department of Economics 1994–95. Professor at Keio University's Department of Economics 1995–present. Appointed Chair of Keio University's graduate economic research program in 2003. Served on the Financial Services Agency's Financial System Council for 10 years from 2001. Author of numerous books, including *Introduction to Modern Finance (New Edition)* (Chikumashinsho).

### Sadakazu Osaki

Head of Research, Center for Knowledge Exchange & Creation  
Nomura Research Institute

Joined Nomura Research Institute in 1986. Earned an LL.M degree from University College, London, in 1990. Appointed Director of Nomura Institute of Capital Markets Research in 1999. Head of Research at NRI's Center for Strategic Management and Innovation (currently the Center for Knowledge Exchange & Creation) since April 2008. Currently teaches as an affiliate professor at Waseda University and the University of Tokyo. Also serves on several public bodies, including the Financial Services Agency's Financial System Council and the Ministry of Economy, Trade and Industry's Industrial Structure Council.



## Current economic conditions

### Sadakazu Osaki

There has recently been a lot of talk in favor of mobilizing fiscal and monetary policy to vanquish the prevailing economic stagnation. I would concur if there were some assurance that such policy measures would be effective, but I am skeptical that they would be.

### Kazuhito Ikeo

The question is whether current economic conditions should be seen as the recessionary phase of a normal business cycle or a deeper economic downturn ensuing from a major financial crisis.

Many Japanese seem to regard recent economic weakness as an ordinary recession, albeit a big one. If this were the recessionary phase of a normal business cycle, the economy should respond to monetary easing and fiscal stimulus. Those who believe that what we are experiencing is simply a major recession therefore think that we should undertake large-scale monetary easing and fiscal stimulus, but I do not agree with such linear thinking.

The idea that large-scale stimulus is the correct policy prescription is not confined to Japan. It is prevalent in the US also. After Lehman Brothers collapsed, the US injected public funds into its banks and eased monetary policy swiftly and massively based on the view that Japan's economic slump of the 1990s occurred because of a "too little, too late" policy response to its financial crisis.

The US was determined not to follow in Japan's footsteps. However, the US policy response proved to be largely ineffective. The US economy remains mired in a slump even now.

### Osaki

Yes, the Fed's QE (quantitative easing) and QE2 did not have much lasting effect. Nor did President Obama's fiscal stimulus package.

### Ikeo

That's right. We therefore need to rethink

the idea that increasing the scale of policy response is the correct approach.

### Osaki

What is the proper policy response to an asset bubble's collapse?

### Ikeo

The direct aftermath of an asset bubble is balance sheet distress.

Financial crises are preceded by sustained buildups in leverage. Once a financial crisis erupts, asset prices fall, resulting in severe insolvency among certain leveraged asset holders. In Japan, such insolvency was concentrated in the nonfinancial corporate sector. In the US, it occurred exclusively in the household sector. Today 15 million US households reportedly have negative equity in their homes. Faced with a negative net worth, people typically endeavor to accumulate savings by cutting back on spending as much as possible to rebuild their net worth.

Consequently, what is needed to spur economic recovery are measures that help the insolvent to regain solvency as early as possible. Next, restoring economic actors' confidence is crucial to reviving economic growth.

Even an ordinary recession dampens entrepreneurs' "animal spirits." A major financial crisis causes an even greater loss of confidence. The economy will not recover until lost confidence is somehow regained.

From such a perspective, the short-term and longer-term are inseparable from each other. For example, some in Japan argue that the government should wait before raising taxes because higher taxes could adversely affect the economy. They believe that fiscal rehabilitation should be postponed until the economy has recovered. In other words, they split their policy prescription into two timeframes, with economic recovery being the short-term priority and fiscal rehabilitation being a longer-term issue. However, if debate on tax increases is postponed out of concern about the near-term economic outlook, anxiety about the future will paradoxically increase.



**Osaki**

People will worry that they will eventually be hit with a large tax increase or the country will face a fiscal calamity.

**Ikeo**

Exactly.

The government is piling up debt to the full extent of its remaining borrowing capacity. If, despite the bleak fiscal outlook, the government's only message is that tax increases are off the table because the economy is weak, private-sector economic actors will respond with defensive behavior, which is detrimental to the short-term priority of economic recovery. Putting the longer-term issue on hold until the short-term priority is attained is not a viable approach.

Policy uncertainty vis-à-vis the future must be eliminated as much as possible, but the Japanese government's approach seems to be exacerbating uncertainty. Its approach is counterproductive in terms of restoring private-sector confidence.

## Worries about the social insurance safety net

**Osaki**

I agree that the government is exacerbating uncertainty.

First, government policy has changed drastically within a relatively short timeframe as a result of the Democratic Party of Japan gaining power, but it is unclear how long such policies will continue.

Additionally, the DPJ has promised various spending programs but many people are worried about their sustainability in light of the fiscal situation.

**Ikeo**

Japan has a demographic problem. I believe that the biggest source of anxiety is uncertainty about what will happen to the social insurance safety net as the population continues to age.

Economically speaking, the typical household's biggest

asset is its entitlement to public pension benefits.

**Osaki**

Indeed.

**Ikeo**

If public pension programs are able to pay currently promised benefits, claims on these benefits would generally be households' most valuable asset, but there is no assurance that public pensions will be able to pay currently promised benefits.

Bank deposits account for a majority of Japanese households' financial assets. Japanese households are often said to be averse to investing in risk assets and this certainly is true from the standpoint of the assets on their balance sheets. However, you could also argue that Japanese households are forced to assume risk through their participation in unstable public pension programs. If households' public pension entitlements were to become a safe asset, households would have more latitude to assume risk elsewhere.

Making public pension programs actuarially sound may not necessarily restore households' confidence in the future, but the government must create an environment conducive to restoration of confidence. The same applies to consumer spending. Encouraging consumers to spend liberally will not work when they are plagued by major uncertainties.

**Osaki**

The government wants to assure the public that they will be adequately provided for after retirement by public pension benefits, but the public is not buying the government's story. The public believes that pension programs may be changed, most likely for the worse, and acts accordingly.

**Ikeo**

That's right.

**Osaki**

But if the government declares that pension benefits will



be reduced as of a future date, the reduction is likely to elicit further anxiety.

#### Ikeo

For example, if public support is limited, awareness that people must cover the rest of their living expenses with their own funds will increase. Such a change would certainly cause apprehension among the already elderly, but it should reduce the need to accumulate precautionary savings.

#### Osaki

To the extent that risk is ascertainable, people can accurately calculate how much money they need to personally save to supplement public pension benefits.

#### Ikeo

Younger generations still have time to prepare for when they are told that they will have to fund a larger share of their retirements themselves. Even among the elderly, many people have large financial asset holdings by virtue of having diligently saved out of anxiety about the future. In short, people are amassing precautionary savings to hedge against both their personal longevity risk and the risk of changes in the public safety net.



I consequently believe that in conducting policy, the government should clarify the future outlook. Establishing a sustainable social insurance safety net through radical reform is a key issue in my opinion.

The energy supply outlook is a similar situation. Will we have to repeat this summer's power conservation efforts again this winter or next summer? I believe that just issuing a credible power-supply outlook as soon as possible would make a big difference.

This is extremely important when companies formulate capital investment plans. Corporate activities, particularly investment activities, entail dealing with future uncertainties, but if companies face undue policy uncertainty in addition to regular business and economic

uncertainties, they are much less likely to take risks. From an economic policy perspective, I believe that it is important to dispel uncertainties about the future, even if only to a small extent.

## Exiting deflation demands caution

#### Osaki

Listening to you now, I have become even more convinced that monetary policy and the Bank of Japan cannot do much to revive the economy. In response to uncertainty, companies refrain from actively investing. As a result, their cash holdings increase. Banks are consequently unable to grow their loan books. No matter how much money the Bank of Japan supplies, it merely leads to growth in bank reserves at the Bank of Japan.

Some say that deflation is a monetary phenomenon and therefore can be rectified with monetary policy. What is your opinion on this point?

#### Ikeo

Deflation does not mean that prices of all goods and services are declining in unison. Even in Japan, prices of staple goods are rising. Meanwhile, prices of consumer electronics and IT hardware such as LCD TVs and PCs are declining. These divergent price trends negate each other almost perfectly, resulting in a virtually flat trend in the headline CPI.

Prices of consumer electronics and IT hardware are falling in Europe and the US also. But prices of services are rising. This difference in service price inflation rates accounts for the inflation rate differential between Japan and Western countries.

Services are in a sense labor-intensive. The reason that nominal wages in Europe and the US are not deflating is that they are downwardly rigid. In Japan, nominal wages' downside rigidity largely broke down during the 1997–98 financial crisis. With nominal wages now stagnating or falling, reflecting labor market conditions, Japanese service prices also are roughly flat. In this sense, Japan's deflation stems from labor market slack. Labor demand growth is therefore needed. How effective is monetary policy at

spurring growth in labor demand? This is the key issue in my view.

Contrary to the simple quantity theory of money, prices do not rise in proportion to money supply growth. If they did, prices should rise and fall uniformly with no change in relative prices. In reality, however, CPI movements are accompanied by major changes in relative prices.

I have long believed that deflation is a symptom, not a cause. The Japanese economy remains mired in a long-term malaise. The cause of this malaise is a deficiency of demand. This demand deficiency is due to companies' unwillingness to actively invest or households' curtailment of consumption out of concern about future. Of course, companies make investment decisions based on the expected rate of return and their cost of capital. If the expected rate of return is constant, investment logically should increase if companies are able to lower their cost of capital. However, the cost of capital has fallen to rock-bottom levels, or at least the risk-free rate has. But companies' cost of capital includes a risk premium on top of the risk-free rate. If the cost of capital is not declining, it is because the risk premium is not declining, not because the risk-free base rate has not been lowered by monetary policy. This risk premium is a function of people's confidence.

From such a perspective, I believe that the key issue is how much policymakers can stimulate spending by restoring households and companies' confidence. There is not much that monetary policy can do in this situation.

#### Osaki

Instead of just trying to boost confidence with optimistic talk, what the government should do is enhance forward visibility, including with respect to harsh realities, to allow households and companies to behave rationally. This is what you mean by restoring confidence, correct?

#### Ikeo

Yes.

If everyone believes in a certain story with sufficient conviction, sentiment could conceivably grow increasingly bullish. This is how asset bubbles form. It may be possible

to recover from a post-bubble downturn by inflating another bubble, but this approach is unsound.

## The role now demanded of politics is allocation of cost burdens

#### Osaki

Listening to you just now, it occurred to me that policymakers are afraid to directly face matters. Even in countries with a two-party system, such as the US and UK, for example, there seems to be a prearranged choice between building a high-welfare state with a high tax burden and limiting the scope of welfare programs while minimizing the tax burden.

In Japan, every political party is basically in favor of maintaining the high-welfare state without raising taxes or preferably while cutting taxes. I feel that policymakers are running away from presenting a realistic policy package.



#### Ikeo

I feel that Japanese politics have been proceeding along an extremely unfortunate course since the Hosokawa premiership of 18 years ago.

Previously, when the economy was still in its growth era, politics' role was allocation of surpluses. Since the 1990s, however, with Japan's economy becoming increasingly mature and its population aging, politics' job should have changed to allocation of cost burdens. Even allocating surpluses is a difficult task in the face of various conflicting interests, but allocating costs burdens is much tougher.

#### Osaki

It is truly an onerous job.

#### Ikeo

Perhaps some people were willing to take on such an thankless job. I believe that Japan's electorate of course bears some responsibility for not actively supporting

such people. At the very least, I do not think that simply criticizing politicians as "bad" is a responsible attitude in a country that grants the right to select political leaders through a parliamentary democracy.

As a matter of fact, however, Japan is amassing fiscal deficits as a result of politics' continued avoidance of the role of allocating costs burdens. When politicians attempted to allocate cost burdens among the population, they encountered opposition from various quarters and were unable to reach a compromise. So they have been passing the burden on to future generations that have yet to be born and therefore cannot complain.

#### Osaki

Their attitude is that everything is fine as long as they can continue issuing debt. However, once the public debt gets as high as it is now, a debt crisis cannot be ruled out even if all of the debt issuance is funded domestically.

#### Ikeo

The issue is the size of the domestic private sector's savings surpluses relative to the size of new fiscal deficits. Until now, private savings surpluses have been large enough to absorb fiscal deficits. Going forward, the private savings surplus will shrink, mainly due to societal aging.

Excluding the precautionary share of savings that I mentioned earlier, private savings are already in decline. It would not be surprising if Japan consequently ends up running a current account deficit. Domestic savings have been sufficient to absorb JGB issuance by virtue of precautionary savings. If you calculate the balance of private savings versus JGB issuance, you will see that savings surpluses cannot be maintained much longer because the population is progressively aging. Some people predict that this savings surplus will turn into a deficit within 3–5 years. Once this tipping point is reached, the market will no longer be able to digest JGB issuance without foreign investors purchasing a larger share of JGB issuance.

Household savings has already nearly ceased growing. The private sector's savings surplus is attributable to corporate sector savings, meaning that companies are repaying debt to the banks. From banks' standpoint,

money that had been lent out is flowing back into their coffers. However, they do not have enough new borrowers to lend to, so they purchase JGBs. In this way, corporate savings is being recycled into JGBs.

Funds that flow into the corporate sector or flow overseas give rise to value-added. Currently, however, private savings are mostly flowing into JGBs, which create little if any value-added. This will not continue forever.

#### Osaki

JGBs are at risk of a severe revaluation unless measures are undertaken to enhance their investment appeal before the JGB market becomes seriously dependent on foreign investors.

#### Ikeo

Aside the issue of whether an immediate tax increase is needed, the government must issue a fiscal rehabilitation plan.

The government previously published fiscal rehabilitation simulations up until the Koizumi premiership, I believe. Recently, it no longer does so. While it may issue medium-term fiscal forecasts, it does not issue hard data. I believe that this omission is a source of anxiety.

#### Osaki

It is a difficult problem. The government must issue a somewhat credible fiscal forecast before it is exposed to market discipline. Meanwhile, with corporate savings being recycled into JGBs, if companies begin to actively invest in their businesses, the flow of funds into JGBs would diminish. No one would object to a pickup in business activity, but it would hasten the onset of a fiscal crisis.

#### Ikeo

Yes, it would. Although the Japanese economy must extricate itself from deflation, the process by which it does so requires much careful thought.

The conventional wisdom is that inflation is advantageous to debtors and disadvantageous to creditors, but this holds true only when the debt is a relatively small multiple of income, as in the case of homeowners with home mortgages that are most two or three times their income.

In Japan's case, gross government debt is around ¥1,000 trillion versus general account tax receipts of some ¥40 trillion. The government's debt to income ratio is thus 25:1. With such a debt structure, even if tax receipts increase by virtue of improvement in the economy, interest expense will increase even more. Consequently, when the economy improves is when the most caution is needed.

If the government pursues extrication from deflation, it must lay the groundwork so that emergence from deflation does not cause new problems. One step it should take is to make the income tax rate structure a little more progressive. Another is to prepare in advance to institute some type of tax hike as soon as the economy starts to recover. Such is the severity of Japan's fiscal problems.

In sum, Japan's fiscal situation will never improve as long as politics remain dysfunctional. The situation is such that responsibility cannot be delegated solely to the Ministry of Finance or Bank of Japan.

#### Osaki

Based on what you just said, improvement in corporate performance could become a risk factor. Corporate performance alone consequently cannot improve without rectification of political dysfunction.

#### Ikeo

Everyone has adapted to economic stagnation, resulting in a strange equilibrium. Whichever direction the economy heads next, utmost care will be required when it exits its current state of equilibrium.

#### Osaki

Thank you for an extremely interesting discussion. Your message is of grave importance.



The entire content of this report is subject to copyright with all rights reserved. The report is provided solely for informational purposes for our UK and USA readers and is not to be construed as providing advice, recommendations, endorsements, representations or warranties of any kind whatsoever. Whilst every effort has been taken to ensure the accuracy of the information, NRI shall have no liability for any loss or damage arising directly or indirectly from the use of the information contained in this report. Reproduction in whole or in part use for any public purpose is permitted only with the prior written approval of Nomura Research Institute, Ltd.

Inquiries to : Financial Technology and Market Research Department  
Nomura Research Institute, Ltd.  
Marunouchi Kitaguchi Bldg.  
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan  
E-mail : kyara@nri.co.jp

<http://www.nri.co.jp/english/opinion/lakyara>