

# Back Business with Innovative Reforms

Deficit spending by the government offers no long-term solution to the problems confronting the Japanese economy, argues University of Tokyo Professor **Takatoshi Ito**. Instead, Japan must stimulate those industries that offer scope for growth.

**A**s has been documented in many places, the origin of today's global economic crisis is the subprime mortgage crisis in the United States. Simply put, mortgage providers lent to borrowers who could not afford the housing, on the assumption that housing prices would go up indefinitely and that borrowers would be able to pay back from the capital gains in the future. Moreover, the lenders had counted on selling on those housing loan securities so that they would not be responsible should borrowers be unable to pay them back. The securities were purchased by investment banks and commercial banks, which mixed them up and made a gigantic pool, which they then sliced according to order of payments. This [collateralized debt obligation] they divided into a [top-rated] senior tranche, a

mezzanine tranche beneath that, and a [highest risk] equity tranche at the bottom. With the risk so diversified, the banks reasoned they would be able to count on at least the senior 25% paying back. However, they overlooked or underappreciated the risk that everywhere the market would go down simultaneously. Eventually the banks discovered that the default risk was so great that even the top-rated securities were not paying back, and so the whole structure of the business broke down.

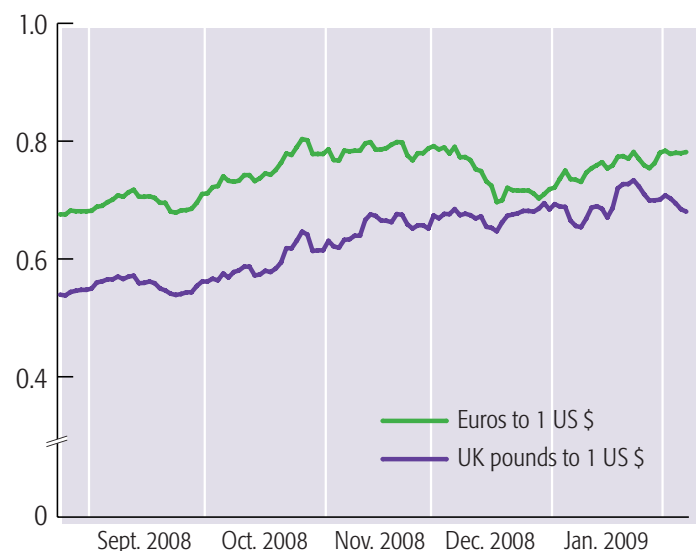
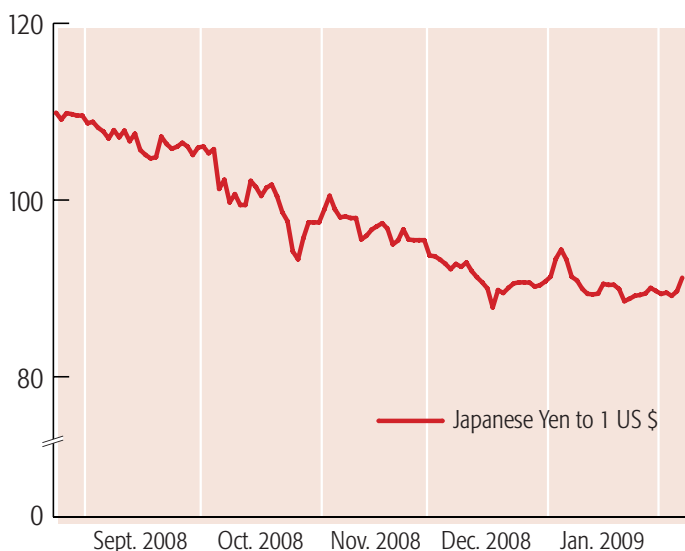
Once the housing bubble burst, people became extremely sensitive to any risk. The spread in any market in which risk was apparent became very wide. The banks could not trust each other, customers could not trust each other for their survival even in the next few months. The markets of corporate bonds, commercial paper, emerging

market bonds and so on, all collapsed.

The problem of subprime mortgage loan defaults first became apparent in the spring of 2007. It translated into an emerging market problem and global stock price problem in the summer of 2008, almost a year and half later. The latter was the case because U.S. institutions short of capital sold all their assets abroad and repatriated the money into the United States so that they could pay back what they had borrowed. That's how the problem in the United States spread internationally. Around the world commercial transactions and financial transactions were denominated in U.S. dollars, so everybody started scrambling for the dollar. Therefore, despite the fact that the United States was the origin of the crisis, the dollar appreciated, while around the world stock prices and currencies declined. With one exception: the Japanese yen.

The yen has appreciated from the summer of 2008 to the end of 2008 because many funds who had borrowed the currency to fund their U.S. dollar business or to invest in emerg-

Exchange rate to US dollar (120 days to Feb. 6)



ing market business (the so-called carry trade) decided to close the positions and pay it back, as these respective businesses collapsed. In addition, the so-called kimono traders—Japanese housewives fed up with the low interest rate in Japanese banks who had been chasing high coupon returns abroad—decided to cut their losses and convert their money back to the Japanese yen.

These are two gigantic opposing forces, and so far the kimono traders and hedge funds unwinding the carry trade position are winning over the repatriation force—the U.S. funds selling Japanese stocks to send money back to the United States. In addition, Japanese financial institutions are in good health compared certainly with the U.S. and European banks, bringing some confidence to the Japanese financial system, which some people have called a safe haven. In summary, the Japanese yen has been strong in the second half of 2008, the U.S. dollar follows, and other currencies—the euro, sterling, and the currencies of emerging markets—are sinking, relative to the U.S. dollar.

## Japanese Yen Policies

Nevertheless, since Japanese stock prices are going down, as they are in the rest of the world, and while the yen is appreciating because of the forces described above, the Japanese economy is in a very difficult position. The financial value of assets held is going down. In addition, in the fall of 2008 it became apparent that the real side of the economy, which is production, consumption and investment, is slowing down considerably, so in 2009 it is likely that all the major economies—the United States, Europe and Japan—will experience negative growth. In view both of financial developments and real economy developments therefore, Japanese corporations are in a very difficult position. In response, they are suspending assembly lines, have stopped exporting to the United States, and are firing workers. This in turn reduces consumption, so all the economies are shrinking. The real side developments in Japan are probably less serious than they are

in the United States and Europe. That's the good news. The bad news is the negative growth and a lot of unemployment to come.

So, what should the government do?

The textbook answer is to stimulate demand by lowering interest rates and increasing fiscal expenditure. However, that is difficult because the interest rate is already low. It has been lowered from 0.5 to 0.3 and then to 0.1, meaning there is only room for another 0.1 until the Bank of Japan returns to the zero rate policy it had from 1999 to 2006. Fiscal expenditure is again difficult, because the Japanese government has already accumulated huge government debt. The debt to GDP ratio is something like 160%, whereas in all other G7 economies it is less than 100% and in the United States it is 65% to 70%. So the United States can do a lot to help the economy by issuing bonds. Germany, France and Britain can also do a lot by stimulating the economy with government expenditure. Deficit spending by Japan, on the other hand, risks the future position of the government budget. Eventually the government would have to raise taxes to pay back the huge debt incurred. The government had promised to balance the primary balance in 2011, but the promise was abandoned. Japanese people continue to have confidence in the Japanese government that fiscal reform eventually can be done, that those bonds will be repaid some time in the future, but it will become more and more difficult in the future to keep this promise as credible as before. In this knowledge, the government is obviously reluctant to take a bold step in terms of fiscal expenditure.

One possible approach, which is politically very difficult, is to pursue structural reform to stimulate the supply side. Such a policy was pursued under the Koizumi government. From 2001 to 2002, then Prime Minister Koizumi did not do much in the way of fiscal stimulus, because the government deficit and debt were already at a level that would normally be considered difficult to maintain. What Koizumi did was to cap the deficit, cap the new issue of govern-

ment bonds and make sure the private sector did its utmost to expand sales and employment. Koizumi implemented structural reforms, privatizing for example the Japan Highway Public Corporation and Japan Post. Such reform, without fiscal stimulus, worked in the years from 2003 to 2006, with the growth rate accelerating and the economy emerging from deflation. I think that's the way Japan has to approach this crisis. The administration has to find policies that work both on the supply side and demand side.

There is a lot of demand and need for supply in the medical area, especially long-term care for the elderly, and in the areas of education, agriculture and the environment. Among these, agriculture is the most backward, least innovative industry, and that is also a drag for promoting free trade, the WTO process and also free trade agreements. We need to transform the agriculture sector, making it more competitive and more productive so that it can be exposed to more external competition. That's the pressure that this sector needs to become more innovative. In the transition period the government could provide help within limits, by offering subsidies for increasing scale and income support for a limited number of years to those farmers who carry out reforms, in exchange for lowering tariffs.


In the case of the environment, clean renewable energy is a major future industry and one in which the government could do a lot, providing seed money for research and temporary subsidies, for example, until businesses are able to lower costs by large-scale production.

These I think would be wise ways of using fiscal money. We clearly have to stop the old-fashioned way of stimulating the economy, of constructing bridges and roads going nowhere, projects which only become a liability in terms of maintenance costs in the future. Japan has to determine where support is most needed and spend money with a view to stimulating both demand and supply and promoting future growth.

This is very difficult time, but a difficult time is also an opportunity.

## Japan's Contribution to the International Financial System

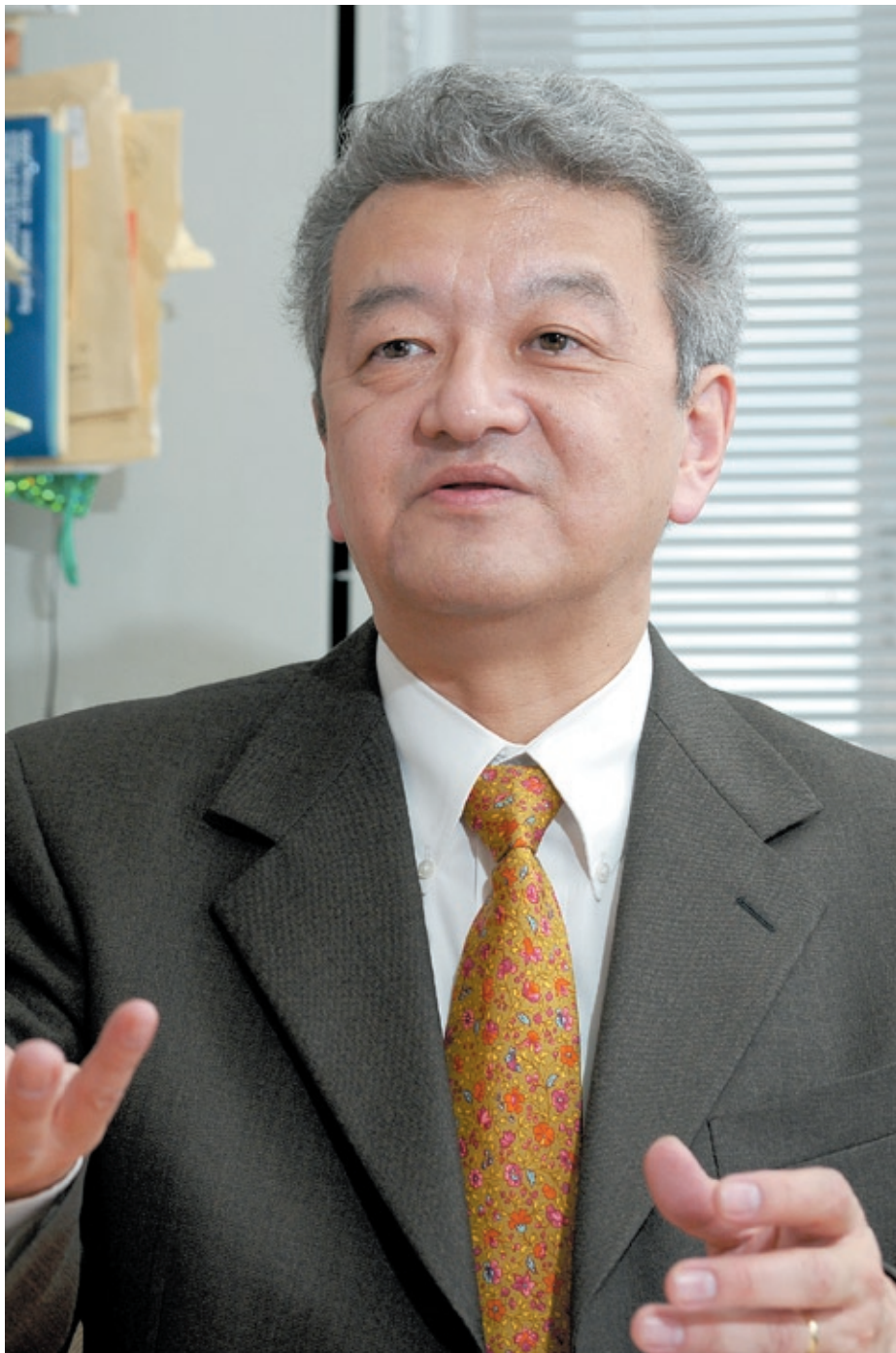
Many small and emerging market economies are in trouble now as an indirect result of the subprime mortgage crisis, with U.S. institutions selling their global assets and sending money back to the United States. Indeed, economies that have experienced such a sudden outflow of investment are in danger of financial meltdown and currency collapse. Iceland is the infamous example, and to a lesser extent Hungary and the Ukraine. Each of these countries has asked the IMF to provide them the foreign reserves supplement, and the IMF has arranged a program to help those countries. However, there may be many more countries that need IMF help. We have to think of the most efficient way to help those emerging economies, and that's what Japan and other core members of the IMF should be thinking deeply about. The IMF made a mistake in advising Asian countries during the financial crisis of ten years ago, and probably made the situation worse. With lessons from ten years ago, it is crucial that the IMF and member countries make sure they get it right this time. Again the IMF should help those countries and help in terms of providing liquidity but without making conditions too stringent.

Japan is providing direct financing to the IMF so that the Fund has plenty of liquidity to help the emerging market economies and smaller economies. Therefore Japan should have a say in the course of action taken, advising the IMF on the terms and conditions under which it lends money to those emerging markets and smaller economies. 

**Note:** This article is a transcription of an interview Professor Ito gave in English to *The Japan Journal* on December 8, 2008.

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