Restoring the Setting Sun

Takatoshi Ito, Hugh Patrick, David E. Weinstein (eds), *Reviving Japan's Economy: Problems and Prescriptions*, MIT Press, 2005

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With the bursting of its asset and real-estate market bubble in 1990 and 1991, Japan's economy entered into a long period of poor performance. This book develops and recommends policy solutions to return Japan to long-run sustainable economic growth, based on the two-year research project led by professors Takatoshi Ito, Hugh Patrick and David Weinstein. Comprising 11 chapters written by 16 distinguished Japanese and American scholars, it covers a range of important issues including fiscal policy, monetary policy, the financial system, corporate restructuring and financing, the labour market, and international economic relations. Based on thorough analyses of data, institutional details, history, and past research findings, each chapter offers a useful set of policy recommendations in ways that are understandable for non-economists. This book is highly recommended for scholars as well as practitioners who are interested in the revival of the Japanese economy and in learning lessons from its experiences.

Part I of the book analyses macroeconomic policy. A crucial cause of Japan's poor macroeconomic performance has been inadequate aggregate demand necessary to maintain full utilisation of its resources. A key dilemma here, with regard to fiscal policy, is how to increase aggregate demand while curbing government budget deficits. Despite the commonly held view that Japan is on the verge of a government fiscal crisis, Chapter 2 presents a careful empirical analysis that argues that Japan does not face a future fiscal crisis, concluding that Japanese tax rates need not rise above those found in many other high-income countries. Chapter 3 compares the macroeconomic situations and monetary policy responses to the ending of asset price bubbles in Japan in 1991 and in the United States in 2000. It argues convincingly that the eventual deflation might have been prevented if in 1991–94 the Bank of Japan had taken more aggressive action in interest rate cuts, as the Federal Reserve did in 2001–04 in the United States. An important question here is why the Bank of Japan responded erratically, and several possible explanations, including the one based on the conflict between the Bank and the Ministry of Finance, are presented. Chapter 4 provides a comprehensive set of policies for ending Japan's sustained

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deflation, recommending a price-level target and, once that has been achieved, an inflation target.

Part II discusses Japan's financial system. What once was considered to be an extraordinarily large, strong and effective financial system has become one of the weakest among advanced industrial nations. Chapter 5 identifies four basic problems plaguing Japan's banking system: the low level of capitalization; continued support for customers with poor repayment prospects; the excessive size of the banking sector; and the outdated business model. It makes clear that even ending deflation and restoring good economic growth will not be sufficient to create a competitive banking system, and recommends an aggressive policy approach, one that forces the banks to clear up their balance sheets and restructure their loans to distressed borrowers. Chapter 6 provides a careful analysis of government financial institutions and special public corporations. It stresses that, as Japan's economy has matured and the financial system has been deregulated, many government financial institutions have become weak and redundant, and their economic rationales have evaporated. It recommends that some institutions be closed and that the others be transformed into state-owned companies with limited liability and strict budget constraints. Chapter 7 analyses the life-insurance industry, which is in even worse condition than the banking sector and substantially distorted by the presence of the government's postal life-insurance system. It proposes a range of policies to restore the industry's strength.

Part III investigates corporate restructuring and financing, and Part IV discusses Japan's new trade policy. Several studies have found that aggregate productivity growth in Japan slowed substantially in the 1990s, and Chapter 8 identifies this as a main cause of Japan's lost decade. It finds a tendency for industries with lower productivity growth to invest more, and concludes that the Japanese economy has been suffering from a misallocation of resources rather than insufficient investment. Given the problems in the banking sector, Japanese banks are no longer able to play their traditional role of reallocating capital to more productive investment opportunities. It is suggested, however, that government intervention should be limited in order not to crowd out private market restructuring efforts. Chapter 9 analyses Japan's corporate bond market since the late 1990s, when the government's Big Bang policies accelerated its development. It concludes that corporate bond market pricing is working reasonably well because prices and their credit-default swaps are consistent, according to monthly data.

Corporate restructuring has substantial impacts on Japan's labour market, which faces a number of problems, as discussed in Chapter 10. Among other things, it points out that Japanese firms reduced training expenditures during the 1990s in order to save on labour costs, and offers policy recommendations for Japanese firms to pay increased attention to job training and job satisfaction. Job retraining and mobility support, which will help the economy keep up with a changing industrial structure, are also discussed. Finally, Chapter 11 explains Japan's trade policy motivations and strategy, and strongly recommends that Japan pursue free-trade agreements in a manner complementary to the World Trade Organization. It then identifies obstacles to the formation of free-trade agreements and proposes ways to overcome these issues.

Although the book offers quite a comprehensive coverage of the topic, several important issues for thinking about 'reviving Japan's economy' are still missing, including investment in technological advances and information technology. For example, Jorgenson and Motohashi (2005) found that, although Japanese firms have made substantial investments in information technology since 1995, total factor productivity growth has declined during this period. This finding suggests that Japanese firms have not utilised information technology effectively. Another important issue is the changing nature of Japanese industrial policy. For example, a guiding principle of Japanese industrial policy had been the regulation of so-called excessive competition, and the Japanese government often placed heavy restrictions on entry into industries. In the recent trend of deregulation, how has its entry regulation changed and how has the change affected the competitiveness of Japanese industries?

As pointed out in Chapter 1, Japan's extraordinarily successful post-war economic growth was based significantly on its ability to close the huge gap between the Japanese level of productivity and technology and the world's productivity frontier. Given that Japan had caught up with the West by the mid-1970s, there is now a widespread sense in Japan that it has failed to make the transition from a super-effective manufacturing economy to a high-tech service-oriented economy. How can Japan make this transition successfully? I believe that there are several important issues along this line that remain to be explored in future research. In particular, the nature of technological development differs across 'catching-up' economies and 'caught-up' economies, which suggests that research and development is a key issue to be explored. The changing nature of technological development in turn affects, among other things, the nature of labour markets, the structure of industries, and the education system. What should Japanese governments do, and stop doing, to facilitate such a transition?

Reference

Jorgenson, D. and K. Motohashi 2005, 'Information technology and the Japanese economy', *Journal of the Japanese and International Economies* 19, pp.460–81.