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Attacking Japan's Saving-Investment Imbalance: Structural Adjustment Versus Fiscal Stimulus [redacted] 25X1

Summary

A United States request that Japan alter its macroeconomic structure to reduce its propensity to run ever larger trade surpluses will probably bring a claim from Japanese officials that the country has already embarked on a process of structural change. Most Japanese policymakers, however, apparently view structural adjustment differently from their counterparts in the United States. Despite the nod this week's Maekawa Commission report gives to structural adjustment, Tokyo largely sees this concept as a version of industrial policy designed to encourage economic shifts--such as the phasing out of depressed industries and development of technologically advanced ones--that will enhance long-run competitiveness. Because most Japanese are satisfied with the economy's performance, Tokyo would probably resist major adjustments in savings, consumption, and investment incentives that did not also serve its industrial policy goals. Only the prospect of closed foreign markets or deep recession at home, neither of which Tokyo believes likely in the near term, would change this view. Even the current economic slowdown in

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Information available as of 9 April 1986 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Japan Branch, Northeast Asia, OEA, [redacted] 25X1

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Japan has produced few signs that the government will reverse its commitment to budget austerity and engage in a major fiscal expansion. Moreover, an acceleration of economic growth in the United States relative to Japan--which now seems likely--would again boost Japanese exports, offsetting part of the impact of the stronger yen on the bilateral trade imbalance. 25X1

Too Much Saving or Too Little Spending?

Recent OECD, IMF, and private economic analyses have concluded that Japan's massive current account surpluses stem principally from an imbalance between domestic saving and domestic investment. A substantial portion of Japan's large pool of savings, unused by either the government or the private sector, has flowed out of the country in search of investment opportunities. This capital outflow depresses the yen and makes Japanese products more competitive abroad. Although some of the sevenfold increase in the surplus between 1982 and 1985 resulted from temporary factors--especially the rapid economic growth and relatively high interest rates in the United States--Japan's underlying tendency to save more than it can productively use at home will continue to generate large trade surpluses even after the temporary factors disappear. 25X1

The gap between saving and investment, moreover, has widened in recent years, but not because the tendency to save has increased:

- Household savings rates, although high relative to those of other industrial countries, have held steady or fallen slightly.

- Business borrowing as a share of GNP has fallen from 8 percent in the high growth era of the 1960s to about 3 percent in the mid-1980s. Even the investment boom of 1984-85 was funded largely by corporate profits, leaving most household savings untapped.

- The government sector's demand for funds has also fallen sharply as a result of the fiscal austerity program Tokyo adopted in 1979. The general government budget deficit as a percent of GNP dropped from 4.4 to 1.5 percent last year. 25X1

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The Long Run Solution: Adjusting Incentives

The OECD and other groups have come to similar conclusions about the reforms that would--if implemented--slowly correct Japan's savings-investment imbalance (see table 1).

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- Revise the tax system to change the relative incentives to save, consume, and invest. Because of Tokyo's continuing commitment to budget austerity, cuts in personal and corporate income taxes probably would be accompanied by the introduction of new taxes.

- Simplify regulations that stifle investment--such as zoning codes that restrict land available for housing construction.

- Increase investment in infrastructure, encouraging private-sector participation where possible.

- Wider application of the five-day workweek. [redacted] 25X1

We believe there are other changes Tokyo could encourage that would also ease the macroeconomic imbalance. Chief among them would be a revision of the wage structure of the major corporations. Japanese statistics show that real after-tax income rose only 10 percent over the past decade, far less than the increase in GNP. Passing more of industry's productivity gains to the work force would over time boost consumer spending at the expense of saving. Consumer spending probably would also increase if the present semiannual bonuses, which are largely saved, were instead used to increase regular salary payments. [redacted] 25X1

Structural Change--Japanese Style

Although there are some in Tokyo who argue for reforms along these lines, the consensus appears to interpret structural change in a different manner. Recent statements by top officials [redacted] 25X1 come close to 25X1 equating structural adjustment with industrial policy. This version of structural adjustment focuses on changes in incentives to encourage developments already under way in the economy such as phasing out uncompetitive industries such as aluminum, petrochemicals, and textiles and encouraging companies to cooperate in the development of new technology. Perhaps as important for these shifts as direct government incentives is the traditional practice of issuing industrial or economic "visions" representing a unified view about what the economic structure should look like in 10 to 20 years and thus serve as guides to private business planning.[1] [redacted] 25X1

The Maekawa Commission's report, released this week, does not change our view. Its general language and long-term focus resemble the recommendations of other recent Japanese study groups. The report does not, in our judgment, represent a sincere effort to address the imbalance between domestic saving and investment. To support its industrial policy goals to cope with the rapid aging of its population, Tokyo will probably implement some measures recommended by the Commission (see the table). Other steps such as tax reform, intended to bolster the government's finances

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[1] The latest vision is MITI's <u>Vision of the Industrial Structure in the 21st Century</u>. [redacted] 25X1

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and increase the incentive to invest, may also boost consumer spending, if Japan's highly progressive tax rates are sliced. The government may also have modest success encouraging more housing construction in the next year or two. Nonetheless, we believe any such steps will fall far short of a major revamping of macroeconomic incentives. There appears little internal pressure for Tokyo to alter the underpinnings of a system that has worked well for years. Nakasone said on Monday that he expects strong opposition from his own party--the ruling Liberal Democratic Party--to the Maekawa Commission recommendations that would have the greatest impact on the saving-investment imbalance. 25X1

A Role for Fiscal Stimulus?

The obvious alternative to changing incentives is modifying the fiscal policy stance. Since 1979, Tokyo has pursued a tight fiscal policy as part of an effort to control inflation and contain the national debt. A philosophical conviction that the public sector must be pared down in order not to drain "the vitality" of the private economy reinforces these motives. These views frequently find expression in the conventional Japanese wisdom that there is little Tokyo can do this year or next to alter the savings-investment equation because fiscal stimulus cannot permanently boost growth. Economic theory, however, suggests to us that the conventional wisdom needs to be modified.[2] A substantial increase in Japanese Government spending (or a decrease in taxes) in today's non-inflationary environment would permanently raise growth, strengthen the yen, and reduce Japan's current account surplus. 25X1

Now appears to be a propitious time for Tokyo to reflate its domestic economy. Available evidence suggests Tokyo's budget austerity was holding growth well below its potential even before the recent appreciation of the yen began to slow the economy.[3] A fiscal stimulus would combine with recently lowered interest rates to generate some domestic demand to replace lost export sales. With sharply lower oil prices, Tokyo has little to fear from inflation in the next year or two. If growth in Japan does not pick up soon, moreover, a US economic recovery would rapidly boost Japanese exports, offsetting much of the impact of the stronger yen on Japan's trade surplus with the United States. 25X1

Nonetheless, we see little likelihood that Tokyo will soon abandon its fiscal conservatism. The economic slowdown, while troublesome for Nakasone as the country approaches elections this summer, is not yet serious enough to call forth major fiscal

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[2] The Japanese view that fiscal stimulus cannot permanently raise the growth rate under a system of flexible exchange rates is based on economic theories widely accepted in the early 1970s. More recent work suggests that tax cuts or increases in spending--in an economy operating below its potential--will permanently increase income. 25X1

[3] Japan is now running a substantial budget surplus, once the figures are adjusted to eliminate the impact of inflation and temporary income changes on revenues and expenditures. 25X1

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stimulus. The pump priming measures Nakasone announced this week will do little to reverse the deleterious impact tight fiscal policy is having on growth prospects. It would probably take a recession far more severe than we now expect to loosen the government's purse strings. Even if growth falls below 2 percent--which we believe unlikely-and reflation were pursued, budget austerity would probably return once the economy improved. [redacted] 25X1

Outlook

In our view, Tokyo would seriously undertake a reassessment of its macroeconomic incentives and fiscal policy only if it believed Japan faced a major and permanent protectionist threat that would make its dependence on export-led growth extremely risky. (Protectionist bills introduced in Congress last year did not approach this threshhold, in our view.) Even then, Japanese policymakers would probably want to maintain as high a level of savings as possible as a cushion for the future. We thus expect a large savings-investment imbalance to persist well beyond the end of the decade, continuing to generate large current account surpluses. Recent Japanese efforts to figure out how to recycle these surpluses via foreign aid and foreign investment suggest that Japanese policymakers also believe large surpluses will persist. [redacted] 25X1

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Table 1. Japan: The Maekawa Commission Report and the Saving-Investment Imbalance

Reforms Needed to Ease the Imbalance	Recommended by Maekawa Commission	Specific Implementing Measures in Commission's Report	Comment
I. Short-term measures			
Increase public works spending	Yes	Promote infrastructure spending by local governments.	Commission recommends that Tokyo maintain its basic fiscal policy stance of eliminating deficits in its budget for operating expenditures by 1991. This strongly held position probably precludes major fiscal stimulus. Local government ability to issue bonds constrained by Finance Ministry regulations.
Across the board tax cut to spur consumption	Yes	None	Diet may pose small tax cut before this summer's elections. Larger cuts may be introduced in next year's tax reform package, and will probably be accompanied by new indirect taxes to make up for lost revenue.
II. Longer-Term Measures			
Tax reform to change incentives to save, consume, and invest	Yes	Review tax treatment of savings. Abolish tax-free small savers accounts; expand tax deductions in connection with housing purchases.	Both government and party tax councils are drawing up reform packages to be presented to the Diet this year. Some cuts in personal and corporate tax rates likely but not until 1988 at the earliest. Government has failed in several past attempts to end tax-free status for small savers accounts.
Encourage housing construction	Yes	Expand tax deductions for housing. Ease zoning and other restrictions that drive up building costs.	Powerful Finance Ministry likely to oppose making mortgage interest payments tax deductible. Changing zoning and other laws that protect agriculture will be politically difficult. Maekawa Commission recommends relying largely on private sector initiative.
Promote Five-Day-Work-Week	Yes	The Japanese government should take the first step by implementing a 5-day-week for its employees.	Any moves in this direction will be slow and require change in work habits. Some large corporations already have 5-day-weeks, but many employees work full Saturdays anyway.

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Reforms Needed to Ease the Imbalance	Recommended by Maekawa Commission	Specific Implementing Measures in Commission's Report	Comment
Deregulation	Yes	Ease restrictions that stifle private investment and retard competition among firms.	Some progress made under the government's administrative reform campaign. Further progress will be slow.
Consumer credit measures	No		Despite strong emphasis on increasing consumption, the report made no specific reference to consumer credit.
Financial liberalization	Yes	Further liberalize capital and financial markets. Accelerate development of short-term financial markets. Examine impact of tax laws on financial markets.	Substantial progress made in past few years. There is a possibility that freeing interest rates will increase average return to small savers, possibly encouraging more saving.

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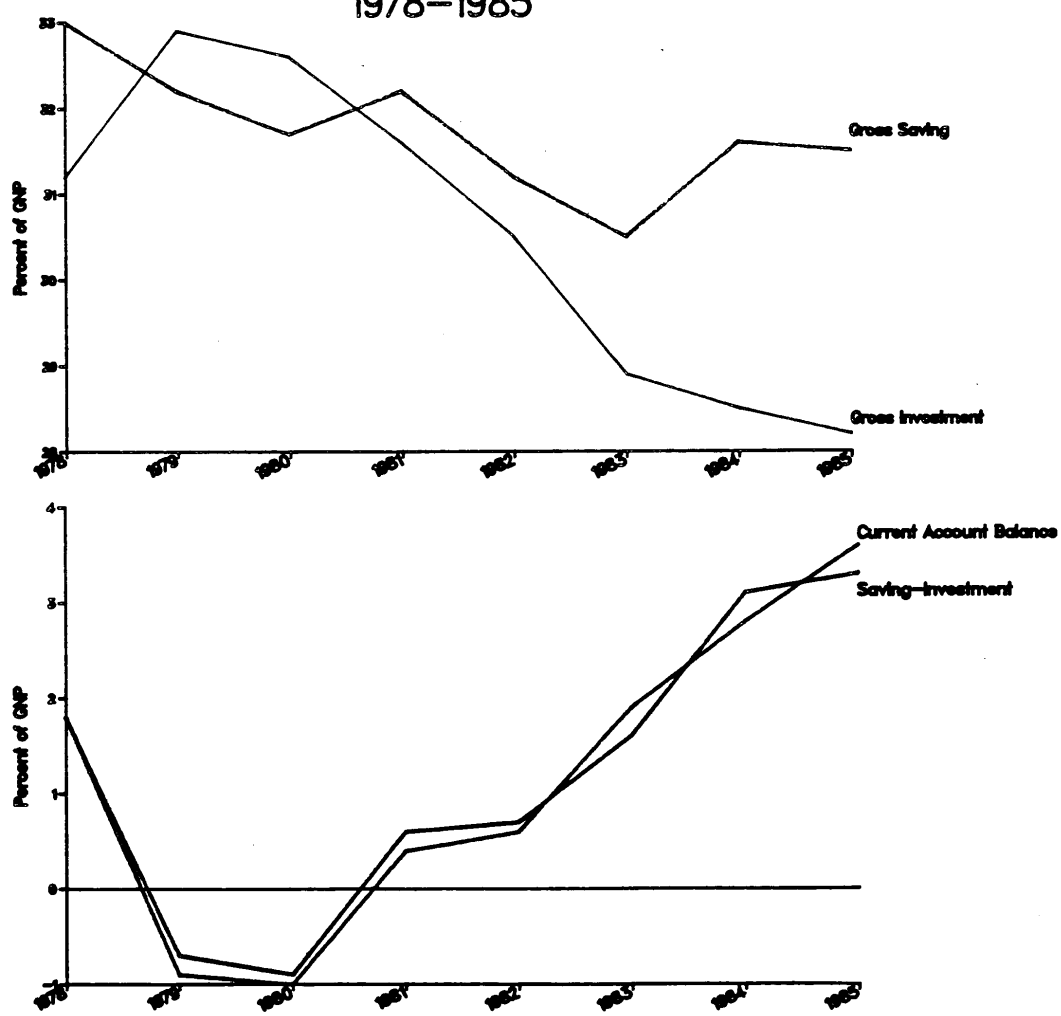
Japan: Excess Saving and the Current Account Imbalance 1978–1985



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