LESSONS FROM DECADES LOST

ECONOMIC CHALLENGES AND OPPORTUNITIES FACING JAPAN AND THE UNITED STATES
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The Peterson Institute for International Economics is a private, nonprofit institution for rigorous, intellectually open, and indepth study and discussion of international economic policy. Its purpose is to identify and analyze important issues to making globalization beneficial and sustainable for the people of the United States and the world and then to develop and communicate practical new approaches for dealing with them. The Institute is widely viewed as nonpartisan. Its work is funded by a highly diverse group of philanthropic foundations, private corporations, and interested individuals, as well as income on its capital fund. About 35 percent of the Institute’s resources in its latest fiscal year were provided by contributors from outside the United States. A list of all financial supporters for the preceding four years is posted at [http://piie.com/supporters.cfm](http://piie.com/supporters.cfm).
From the early 1970s through the early 2000s, the Japan-US economic relationship was at the center of the global economy and of international policy making. With the ability of US growth seemingly to shrug off Japan’s persistent underperformance, the rise of the Chinese economy, and the preoccupation with the acute economic failures of the United States starting in 2008, the relationship lost salience on both sides of the Pacific. This was, however, a mistake of misplaced priorities in both Tokyo and Washington. Together Japan and the United States still account for 20 percent of world GDP—more importantly, the two allies are bulwarks of the liberal economic order of rules-based and ever freer trade, respect for property rights, and multilateral lending and surveillance of the international financial system. To continue to shape a peaceful world with maximum economic benefit for all, but consistent with the two countries’ democratic values, the US-Japan alliance must be at least as active in the economic sphere as in national security matters. This is particularly critical for the successful integration of China into a position of responsible multilateral leadership of the world economy and the continued economic success and openness of Emerging Asia.

With these policy goals in mind, the Peterson Institute for International Economics, the Sasakawa Peace Foundation, and Sasakawa Peace Foundation USA came together in early 2014 to found the High-Level Working Group on Japan-US Common Economic Challenges. This group is intended to provide an intellectually grounded and policy-engaged informal dialogue between influential voices in the United States and Japan regarding major economic issues that affect both economies and the international system. The distinguished membership consists primarily of individuals who have combined public service in senior policymaking or advisory roles with economic research during their careers and who previously have been directly engaged in Japan-US relations (the membership list follows).

The group meets semiannually, once each in Tokyo and Washington, for intensive off-the-record discussion of current policy issues, and benefits from the presence of a rotating group of experts on specialized topics as well as commissioned background research (supported by the Sasakawa Peace Foundation). Select current senior officials in the United States, Japan, and international institutions are regularly invited to participate as guests or to address the group. The group does not issue joint statements or seek consensus, but rather pursues active exchange of views. When consensus does emerge, however, and is of substantive relevance for policymakers, the group will issue statements calling for action.

This publication is the result of the first meeting of the Working Group held in Washington, DC, on June 2 and 3, 2014, followed by a public discussion held at the Peterson Institute. Reflecting current events, the meeting focused on Abenomics, monetary tightening in the United States, fiscal sustainability on both sides of the Pacific, and especially the bilateral Japan-US trade agenda needed to advance the Trans-Pacific Partnership negotiations. Subsequent exchange and review of the discussions as well as of the commissioned background
papers led to this finished document. We hope it stimulates further discussion between interested parties in Japan and the United States and provides additional ground for common understanding if not policy action. The next meeting of the Working Group will take place in Tokyo on December 18 and 19, 2014. While trade relations and Abenomics remain topics of concern, the agenda will also focus on innovation in energy supply and on the course of and spillovers from China’s growth slowdown.

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ABOUT THE ORGANIZATIONS

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Sasakawa Peace Foundation USA is an independent American nonprofit and nonpartisan institution devoted to research, analysis, and better understanding of the US-Japan relationship. Sasakawa USA does this through programs that benefit both nations and the broader Asia-Pacific region. Key issues addressed by our research programs include security, diplomacy, economics, trade, and technology. Outreach programs facilitate people-to-people exchange and dialogue on these and other issues with American and Japanese policymakers, influential citizens, and the broader public in both countries. Sasakawa USA has become a major hub for information, news, and commentary on US-Japan affairs, building relationships between current and future leaders of both countries and offering a venue for dialogue and discussion. For more information, please visit www.spfusa.org.
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Japan has been the subject of unrealistic growth expectations for more than two decades. When I was first writing about Japan 17 years ago, for example, the expectations were unrealistically pessimistic. At that time many experts feared that Japan would be doomed to unending stagnation, that it would never grow again. Yet when Prime Minister Junichiro Koizumi and Heizo Takenaka, his economic policy czar, cleaned up the banking system in 2002–03, and then the Bank of Japan (BOJ) stopped promoting deflation, Japan had its longest postwar expansion.

Today, the expectations have flipped. A number of people in markets and in Japanese politics set unrealistically high expectations for Japan in 2014 following Prime Minister Shinzo Abe’s election in December 2012. These overly optimistic promises are distorting the current policy choices and now have dampened a number of forecasts for GDP and inflation for 2015 because everyone is overreacting to the surprisingly bad data of 2014Q3 (the second quarter contraction was no surprise). A more realistic approach is needed, one that is more positive about the successes of Abenomics to date, than the views underlying some recent exaggerated markdowns for 2015 and 2016. Yet, I would emphasize that Prime Minister Abe’s government must still confront some important policy challenges to get growth up sustainably and meaningfully.

ACHIEVEMENTS ON ONE-AND-A-HALF OF THREE ARROWS

In essence, the Japanese recovery is going right even if it is not going well. Prime Minister Abe’s government was trying to combine a long-term fiscal consolidation with monetary expansion and real structural reform. Pursuing these three goals simultaneously is not easy. The most important structural reform for Japan is actually well under way. Many economists around the world have repeatedly emphasized the paramount importance of mobilizing the educated underemployed women of Japan to expand labor supply. The Abe government has made meaningful progress on that front. There is also some progress on other labor market issues. Also, the monetary regime change has been effective. The BOJ has not only driven down the currency for a few months at a time; there has been a fundamental shift in the price-setting regime and we are now seeing that throughout the economy. If Southern Europe were half as successful at pursuing this combination as Japan has been in the last two years, including its adoption of a sound fiscal-monetary policy mix and its implementation of significant labor market reforms, people would be impressed.
But because Abenomics as initially proposed represents genuine change, required actual reform, and harmed certain interest groups, as well as representing implicit recanting of mistaken past policies, its future is not certain. Japan’s form of democracy may not be entirely comprehensible to outsiders, but it is clear enough for me to say that the outcome is up in the air. Reforms are far from guaranteed to continue, even with the Liberal Democratic Party’s renewed mandate.

Two major policy choices are at the center of the situation. In both, the Abe government is failing to carry through of late after initially proposing the right policy measures. First, Japan is not doing enough to avert a potential breakdown of the Trans-Pacific Partnership (TPP) talks. Frankly this failure hinges on whether Japan is willing to reduce its agricultural protectionism in its own self-interest. The other policy failure is fiscal. Prime Minister Abe, responding to political pressures and misplaced fears of lasting damage to the economy, has postponed the previously announced (and needed) consumption tax hike from 2015 to 2017. These two choices will have very significant implications for the outlook for Japan, both short- and long-term, and thus the world.

Let us start with the most important and best news. Japanese female labor force participation has been rising for years, but its growth has accelerated enormously since Abenomics began. Female prime-age participation is now 2.6 percentage points above its long-term trend since January 2013 (figure 1). To give a sense of the magnitude of that achievement, the United States is now actively debating about whether an additional 1 percent of those who left the workforce between 2008 and the present could return to work. For Japan, the rise in female labor force participation constitutes a positive structural shift on the order of 1.5 percent of the total workforce. This matters and gives the lie to claims that there has been no reform so far.

The depth and size of this structural labor reform, bringing women in greater numbers into the workforce in Japan, however, is producing a deflationary effect. Such downward pressure on wages is only to be expected. Serious labor market reform, as Germany undertook in the early 2000s, for example, or as Spain and Italy are attempting right now with varying degrees of success, puts downward pressure on wages during the transitional period of expanding labor supply and deregulating labor markets. But these developments constitute a positive trend for the Japanese economy. (An equally positive development with more room to expand would come from allowing immigration, but leave that aside for the moment.) Of course, in the short run, it is a positive supply shock, which reduces inflation.

A large share of that participation increase has taken the form of part-time work, which produces mixed benefits and costs for the economy as a whole. As we know from the Nordic experience, an important way to bring women into the workforce on a sustained basis is to adopt flexible and part-time work arrangements. Of
course full-time work would bring an even bigger benefit to the economy. But establishing a more flexible labor market system, enabling part-time work for women, brings real benefits. I doubt labor supply will continue to grow at this pace. Straightforward policies to further encourage female participation—family care tax credits, reforming the tax penalty for couples’ second income, adding more child care facilities—all at least considered by the Abe government would continue to increase female participation. Another 2 percent of well-educated or skilled Japanese female workers could be added to the labor force in the next few years. But the progress so far is genuinely large.

Second, it is important to remember that Japan is experiencing a tight labor market. The average unemployment rate has dropped to a multiyear low of about 3 percent, and this situation has persisted even during recent slowdowns. The ratio of job openings to applicants keeps going up. We are seeing a better functioning and heating up labor market in Japan, which must eventually help transmit inflation. This is not just the result of exchange rate depreciation. The economy is actually approaching full employment.

For the last several months of Abenomics, however, inflation has outpaced nominal wage growth. That is not good news. But the transmission of new inflation expectations and growth into the broader macro economy, and into the labor market, is a healthy trend. Inflation should start rising. Again, the headline inflation rate has been temporarily lowered by energy price declines and liberalizing labor supply. The underlying upward trend should reemerge, and inflation expectations remain well above zero, i.e., far higher than what they were before the monetary regime shift.

Underlying these developments is the impact of the monetary regime change at the BOJ, which has resulted in a rise in medium-term inflation expectations. According to the BOJ survey of inflation expectations, these expectations have not changed very much, but frankly, that survey is not entirely reliable. Another survey, by the Cabinet Office, is much more reliable, as are indicators extracted from the prices in the Japanese Treasury Inflation-Protected Securities (TIPS) market. The Japanese TIPS market is thin, and it cannot be read directly. But there has been a significant upward trend in inflation expectations on those two measures since the announcement of the 2 percent inflation target in April 2013.

Some forecasters will object to this line of argument, contending that inflation and inflation expectations are lower, and the BOJ will fail to get Japan to 2 percent inflation by April 2015. I think the promise of delivering 2 percent inflation by April 2015 was the one mistaken part of the new monetary policy. It should have been stated as the medium-term goal, as the aspiration. Governor Haruhiko Kuroda and the BOJ board have now adjusted their goal, saying that if it is not achieved, they will do what is necessary to achieve it shortly thereafter. They should have phrased it that way in the first place. Setting unrealistic goals may have resulted from the politics of Japan at that time, the sense of excitement associated with the regime change at the BOJ, or the more general arrogance of central bankers, which I have criticized, in pretending that they can control the economy closely. The belief that such trends can be fine-tuned arose in the late 1990s and early 2000s. As Milton Friedman said many years ago, fine-tuning is not a realistic expectation for a complex economy.

That the BOJ has more to do to reach sustained inflation and anchor inflation expectations at 2 percent cannot be denied. But, by the standards of Japan’s recent past and the record of comparative central banking over the last ten years, fluctuations of inflation of plus or minus 0.5 percent over a few months are hardly unusual. Achieving an inflation rate that has moved from below zero to more than 1 percent on average, while various other measures of inflation expectations have moved in a positive direction, is more important than whether or not Japan gets to 2 percent inflation by April 2015. The BOJ regime shift, moreover, is actually a success when measured by the right standard. The shift is a necessary condition for Japan to move forward. It is not a sufficient condition by any means, but only by the standard of unreasonable expectations would one label the BOJ’s policy anything other than a success. Price shocks are being transmitted differently because there is a different monetary regime. In the past, when there was growth or exchange rate depreciation, it was
clear that the old BOJ would lean against these trends, limiting transmission to the rest of the economy. We are now seeing actual transmission of the price shocks to the rest of the economy.

One other structural reform effort deserves mention, but because it has gone wrong. In the spring of 2014 a very interesting proposal was introduced for setting up special economic zones in many of the major urban areas including Osaka and Tokyo. It was convincingly explained to me, among others, that the major impact of the special economic zones would be felt through freeing up the labor market. These changes were described as improving small business competitiveness and the start-up culture, potentially breaking ground for changing the tax code for entrepreneurs. Most promisingly, the special economic zones were meant to promote more competition in the healthcare field through changes in hiring rules and zoning laws. Those are quite worthwhile objectives that could have furthered the reform agenda—if the Abe Cabinet had kept to the proposal.

But over the last few months sudden concern is being expressed over what are now being called regional issues. A famous think tank report declared that there are too many rural communities in Japan and that hundreds of “regional cities will disappear by 2040.” As a result, many Japanese politicians—perhaps using the report as an excuse—are now contending that money should be spent on regions where there may still be some employment and residents but no real demographic or economic future. Of course, such redistribution measures not only look like but also actually are the old fashioned fiscal politics of Japan: Diet members putting money into backward places to buy votes to maintain support. This practice is pernicious—a waste of public money and a bad signal that the Abe government cannot maintain its reform priorities.

Good economists should all be criticizing this backsliding in the form of letting the special zones fall prey to regional capture. There is a genuine issue of how to deal with the persistent decline of some regions in large economies—whether to invest in them, empty them out, or ignore them. A universal political calculus governs the resources spent on the Mezzogiorno in Italy, Alabama and West Virginia in the United States, Okinawa and Northern Hokkaido in Japan, and so on. Whether these regions can develop is an open question. But my understanding of the literature is that, for the most part, the best policy is to increase rather than decrease mobility, to invest in making it easy rather than difficult for people to leave. For compassion and equity, benefits should be tied to individual citizens and not to regions. That is obviously a public interest and an economic argument, not an electoral logic, but it should be acknowledged.

**TWO CRITICAL POLICY CHOICES**

The other critical choices facing the Abe government start with fiscal policy, especially given Prime Minister Abe’s postponement of the planned 2015 value-added tax (VAT) hike. No doubt tax increases are contractionary in the short run. The fantasy that fiscal consolidation is expansionary works only under very specific circumstances, which do not apply to Japan. Yes, a downturn in growth and consumption has followed the April 2014 tax hike. But the political establishment has overreacted because people underestimated the impact of the tax hike beforehand. Many officials and colleagues from Japan told me earlier this year that the tax hike was not going to have a big effect averaged over the year or even immediately, as occurred in 1997. Of course, there was a big short-term effect, but that does not mean that impact is meaningful for fiscal decisions about sustainability.

One definition of fiscal sustainability is that as long as the government bond market does not crash, the situation is fiscally sustainable. Forward-looking agents acting in markets could in theory sell Japanese government bonds (JGBs), so if they do not, there still is fiscal space. A more nuanced view is that fiscal sustainability is about foreign debt. Japan can run about another 12 years of current account deficits at reasonable rates before it runs out of net foreign assets. At that point, Japan is going to have to start paying off foreign rather than domestic creditors. Foreign creditors can get a country into trouble, so, on that criterion, Japanese fiscal policy

is sustainable for a decade or more. Another view is to do the simple math and project an extremely alarmist view: “This is what Japan has promised on healthcare, and this is how many 70-year, 80-year, and 90-year olds will be living—Japan must already be bankrupt.”

I would suggest a relatively boring middle ground for assessing Japanese fiscal sustainability. First, we should calculate whether Japan can stabilize its net public debt level at what would be a plausible future interest rate. This can be is algebraically projected. Of course, for Japan, some stronger assumptions are necessary than they would be for other countries, because the Japanese debt level is so high and because the interest rates are unusually low. But without getting into too many details, a case can be made for Japan getting on to a sustainable debt path if real GDP growth rate is in excess of 1.25 percent on average; the inflation rate is well in excess of 1 percent on average, preferably 2 percent; and—here is the key—the VAT rate is raised to something over 20 percent.

The taxation share of the economy in Japan is extremely low by advanced-country standards (see figure 2). Japan has room to raise taxes significantly as a share of GDP without becoming like Portugal or France, where the marginal tax rates are already so high that they distort the economy. In most other advanced economies, or even many middle-income economies, VAT rates of 20 to 25 percent are common and sustainable. Arguably, the existence of this room to raise taxes when needed is a major contributor to markets maintaining the low interest rates in Japan to date.

I do not claim that if Japan gets fiscal policy to live up to these numbers for the coming years, everything works out perfectly. But if Japan were to get to these numbers, the amount that the Japanese government would have to cut from benefits and transfers, in order not to have to renege on huge amounts of debt payments, is manageable small over a reasonable range of interest rates. In other words, the debt level would become sustainable without extreme further austerity. I am thus more optimistic than many people because I am saying there is a possible path.

It is not feasible absent major tax increases, however, which brings us back to the consumption tax decision.

When in October 2014 I endorsed the idea of proceeding with the planned October 2015 tax increase, I was on the opposite side of the argument from many people I admire and whose worldview I usually largely share, like Koichi Hamada or Paul Krugman. To be clear, I am not in favor of a rapid consumption tax hike on the grounds that there will be an imminent crisis of confidence in the JGB market, let alone anything like the crises afflicting Greece or Argentina. I agree with Krugman, Hamada, and others on that point. Given the ability of Japan to print its own currency, and given the overwhelming share of public debt that is domestically held, I do
not see that danger as pressing. Nor do I believe that raising the consumption tax would be costless in terms of
growth and of tax revenues in the short term. It would be contractionary, not expansionary. So I have not recant-
ed my basic economics from 1997, and I think Japan continues to demonstrate the relevance of basic economics.

I would argue instead that Japan, like some (not all) parts of Southern Europe, and like many other coun-
tries in history, does have to undertake a multiyear fiscal consolidation—but not because Japan is in danger of
imminently becoming Greece or Argentina. Rather, as I argued in January 2013, after Abe’s election, exceed-
ingly high public debt imposes costs on even large economies with their own currencies. These costs include
displacement of investment, particularly of public investment, distortions in saving behavior, and other vul-
nerabilities—for example, in the case of national emergencies, when funding may not be as easy to obtain. Financial repression results from having to cram down as many JGBs as possible into the financial system and
into savers’ accounts. And over time, the longer the consolidation is put off, the harder it gets, or rather the less
time there is left in which to make the necessary adjustment.

In short, 2014 is not 1997 in Japan. Japan has twice as much net public debt as a share of GDP today as
then, so the costs and risks are bigger. Japan’s economy has been growing since 2002, with the longest recovery
in decades, except during the worst of the US-led financial crisis. Japan has a sound banking system, which it
did not have in 1993 or 1997 or 2001. Japan has monetary policy that will stay as accommodative as it is ever
going to be. Japan can also take other temporary steps to offset the contractionary effects of such tax increases.
Finally, I note that Japan has a prime minister with a large mandate and as long a time-horizon as any recent
Japanese prime minister has enjoyed. If Prime Minister Abe were pursuing the best possible economic policies
for Japan, he would be adopting a succession of small VAT hikes over several years.

In politics, the bottom line is voters and their beliefs about the future. Prime Minister Abe is, however,
focusing too much on the short term in the classical sense in which we economists criticize politicians. It made
sense to postpone fiscal tightening in 1997, when the world was falling apart inside Japan, and then in 1998,
when the Asian region was falling apart around Japan. During this period, the banking system was fragile, and
the BOJ was causing even more danger. In 1997, the net debt-to-GDP ratio was still well below 100 percent of
GDP. So it was perfectly reasonable then, as I argued at the time, not to raise taxes. The view was at the time:
stabilize the economy, fix the banking system, and get the monetary policy in order first. The fiscal consolida-
tion can wait. Seventeen years later, however, when everything else is much better in the Japanese economy,
except that the total public debt level is much worse, consolidation perhaps can literally still wait—but it is no
longer a good idea to wait. That is why I advocated that the consumption tax should be hiked as part of a series
of ongoing, gradual rises.

Are there alternatives to increasing the VAT substantially? It is far from clear that raising taxes and cut-
ting spending have considerably different economic effects. You have to go to a much more granular level of
analysis to tell. What specific spending is being cut? Which particular taxes are being raised? One could come
up with a reasonable proposal entailing major cuts in certain kinds of social welfare spending, while raising
taxes by a smaller amount. The most persuasive argument for this alternative is that a higher consumption
tax can be regressive—depending on how it is structured—and it punishes at a minimum all ages equally. We
know that, if anything, old people in Japan have been getting a great deal versus young because of defl ation,
government transfers and the way that the politics works. Cutting spending could actually be more fair inter-
generationally than raising taxes depending on what spending is cut. I choose not to advocate that alternative,
however. The plan for raising the consumption taxes is already in place, putting money in the bank with easier
and simpler implementation than other policies.

The second poor policy choice by Prime Minister Abe concerns trade. The TPP bilateral US-Japan talks are
in danger of breaking down because Japan is not offering enough on agriculture. Granted, the United States

is hypocritical on this policy to a large degree. The US government protects sugar and subsidizes corn, among other crops. But Japan stands to gain more on a sustained basis from a comprehensive TPP deal than any other country, including the United States. The reason is that it would constitute structural reform for Japan, as competition trickles down from agriculture through the retail and distribution sector. Japanese GDP would rise 2 percent a year with a full TPP deal, according to forecasts of Peter Petri et al., using a computable general equilibrium (CGE) model.3

Such reform would also cut the cost of food to average Japanese people. If, as a result of such a deal, Japanese households were to spend only 8 percent of their income on food, like their foreign counterparts who have access to food at world prices, they would save roughly $1,500 a year per household. That saving is 1.25 percent of GDP, or more than half of Japan’s projected gains from TPP. If politicians are worried about inflation outpacing Japanese workers’ real income, then they should be in favor of a comprehensive TPP deal, based on domestic agricultural liberalization.

To summarize my bottom line on Abenomics: Womenomics is under way, though sexism is still rife in Japan, and the labor force has already seen substantial gains in flexibility and supply. Other labor market reforms are ongoing. The BOJ’s monetary policy approach was not just a gambit to get the yen down (even if that was part of the motivation for some). The monetary regime shift has been genuine and is affecting how prices are transmitted throughout the economy. Thus, my forecast is that Japan is going to bounce back, not very strongly, but solidly from the 2014 VAT hike. It will grow reasonably solidly by its own standards, around 1.5 percent real year-over-year in 2015 and 2016, and inflation will resume rising. The BOJ’s political commitment to 2 percent by April 2015 was a little too strong, but inflation will be closer to that than to zero percent.

The good news on Abenomics seems to end there, though, at least for now. There are two other major choices for Japanese economic policy and Prime Minister Abe is getting both wrong. The first regards TPP. It really is in Japanese negotiators’ hands whether they are going to reduce pork and beef protection and gain 2 percent annually in Japanese national income for their own people or whether they are going to continue to be cowards in the face of an overprotected but still dying farming sector. If election manifestos and comments are to be believed, Prime Minister Abe will not use his renewed mandate to make TPP happen by closing the deal with the United States. Second, the prime minister’s postponement of the VAT rise was a bad judgment, despite its short-term buoyant economic impact. At some point Japan is going to have to start paying down its accumulated debt. Starting now and continuing down the path of steady tax increases is the best way to do so.

ABENOMICS IN THE GLOBAL CONTEXT

Finally, what does Abenomics mean for us in the United States and the rest of the world? Japan is not on a cliff. If anything, the 20 years of start-and-stop growth in Japan should have convinced the world that even very bad policies do not cause Japan to tumble over a cliff. Japan is afflicted by disappointing policies in some areas; less disappointing policies in some other areas; and positive motion in a few but important select areas. So Japan is going to be alright on growth and inflation for the next few years, barring a major external shock. If anything, Japan will experience positive growth surprises over the next year because of the delay in fiscal contraction while the BOJ has increased its rate of monetary expansion, and the yen falling further. (The extent to which the yen stimulates the Japanese economy is less now than it used to be, especially given energy imports, but the decline will also feed short-term recovery.) In short, Japan may get some additional short-term growth that is unsustainable on top of the lasting benefits of true reform on labor and monetary regime.

Does this kind of partial improvement short of transformational reform in Japan change the game in Asia? No. I have always believed the real motivation of Abenomics was to permit Japan to have a strong, independent role in determining arrangements in Asia and strengthen its attractiveness as alliance partner with the United States and other Japanese neighbors. Both mean greater capability to stand up to China, though ideally not in an overly confrontational way. Yet, given Abe’s failure to deliver on taxes, agriculture, and trade to date—and his lack of promises to do so during the end-2014 election campaign—it is increasingly doubtful that Abenomics is going to deliver that capacity.

It would be worrisome if reform were to end there. Some Japanese are doubtful of the benefits of Abenomics because they did not benefit directly or obviously in the last couple years. That disappointment is unavoidable when a currency depreciates at a time of energy shock and structural labor market reform: real incomes do temporarily decline. I do not deny that reality. It is not easy to sell such adjustment, even in a snap election with weak opposition. But given that some adjustment was in a sense inevitable, this was a good form and a good timing in which to take that adjustment. So, more Abenomics as originally scripted would be better, and stopping here is harmful.

Finally, regarding the rest of the world, the most important lessons of Abenomics are for Europe, not for the United States or China. The main lesson relates to the importance of coordinating fiscal and monetary policies. Another lesson is to recognize that fundamental labor market reform is deflationary and countries have to ride that out and offset it with other macroeconomic policies. Still another lesson relates to deciding realistically which economies need aggressive fiscal tightening and which do not, and how to do so given the existing tax share of GDP. And frankly, Greece and Portugal do need that tightening, whereas Spain does not, just as Japan did not in 1997 but does now. As I said when I first wrote about Japan 17 years ago, textbook macroeconomics actually do apply in Japan. They still apply to Abenomics. They probably do not apply to the election debates. But, we have to hope that the Abe government will get back to textbook economics now that the elections have been won.

Although Japan had largely resolved the problem of banks’ nonperforming loans and firms’ damaged balance sheets by the early 2000s, economic growth hardly accelerated, resulting in what now are “two lost decades.” This summary presentation explores the underlying reasons from a long-term and structural perspective and concludes with important lessons from Japan’s secular stagnation. It was presented at the High-Level Panels on Japan-US Common Economic Challenges held at the Peterson Institute for International Economics, Washington, on June 3, 2014.

STRUCTURAL CAUSES

I examine the chronic lack of domestic demand since the mid-1970s caused by the long-run decline in capital formation through the slowdown in the growth of the working age population as well as the resulting current account surplus and yen appreciation and supply-side issues such as slow total factor productivity (TFP) growth. While large firms’ TFP growth since the mid-1990s has outstripped that in the 1980s as a result of research and development (R&D) and internationalization, TFP of small firms has stagnated. The likely reason why small firms’ TFP growth has lagged behind is their sluggish investment in R&D and information and communication technology as well as a decline of technology spillovers from large firms.

Insufficient Demand

Japan has been suffering from a lack of final demand for the last two decades. Through the Bank of Japan’s (BOJ) massive stimulus measures and active fiscal policies, Japan finally appears to be escaping from deflation (figure 1). (However, we need to take account of the “front-loading” of consumption prior to the consumption tax hike.)

From an investment-saving balance viewpoint, the recovery in aggregate demand heavily relies on huge government deficits, which is not sustainable (figure 2).

The fundamental problem of the Japanese economy is not stagnation of investment but low rates of return on capital. Japan has continued rapid capital accumulation, but its capital-GDP ratio has increased substantially. That must have contributed to the continuous decline in the rate of return on capital in Japan (figure 3a).

In contrast to Japan, the United States has experienced a continuous decline in the capital-output ratio and an increase in the rate of return on capital (figure 3b).
Figure 1  GDP and inflation in Japan, 1980–2014

trillion yen per year

CPI = consumer price index
Sources: Cabinet Office; CPI Statistics.

Figure 2  Japan’s saving-investment balance relative to nominal GDP (four-quarter moving average), 1969–2013

Note: The data were compiled by Ryutaro Kono of BNP Paribas Japan. The original data source is the SNA Statistics published by the Cabinet Office.
Figure 3a  Capital coefficient and gross rate of return on capital in Japan, 1960–2009

Source: EU KLEMS ISIC Rev. 4 Rolling Updates.

Figure 3b  Capital coefficient and gross rate of return on capital in the United States, 1977–2007

Source: EU KLEMS ISIC Rev. 3, March 2011 Update.
Low Potential Growth Rate

Comparing the 1970–90 period and the 1990–2010 period, the annual contribution of capital accumulation, labor input growth, and TFP growth declined by 1.1, 1.2, and 1.3 percentage points, respectively (figure 4).

In the 1990s and the 2000s, man-hour input declined mainly as a result of the reduction of working hours per worker. From the 2010s, the working age population is projected to decline rapidly (figure 5).

The Japanese government now has a target of 2 percent annual GDP growth in the medium term. Even if we are optimistic about labor supply and assume that labor service input does not decline, for sustainable 2 percent growth, Japan needs to accelerate TFP growth.

- A scenario of sustainable 2 percent GDP growth is as follows:
  - (Harrod-neutral) TFP growth: 1.3 percent
  - Contribution of labor service input growth: 0.0 percent
    - Labor quality growth: 0.5 percent
    - Man-hour growth: –0.5 percent (for this, Japan needs to substantially increase the labor force participation rate of women and the elderly.)
  - Contribution of capital service input growth: 0.7 percent
    - Capital service input growth: 2.0 percent

It seems that the Japanese economy is now entering a new situation where economic growth is constrained mostly by supply-side, not by demand-side, factors.
Why Japan’s TFP Growth Has Been So Low Since the 1990s

Both the manufacturing and the nonmanufacturing sector dragged down macro TFP growth after 1991 (figure 6).

Productivity Dynamics in the Manufacturing Sector

From 1990 onward, the within effect steadily declined and the negative exit effect expanded (that is, productive factories were shut down, while less productive factories remained). These two trends reduced TFP growth in the manufacturing sector substantially (figure 7).

Why Did the Within Effect Decline?

In the manufacturing sector, the TFP growth of large firms has actually accelerated. Small and medium firms (SMEs) have been left behind. Possible reasons are (a) SMEs left behind in R&D and internationalization and (b) decrease in technology spillovers from large firms (figure 8).

Why Was the Exit Effect Negative?

There is a statistically significant negative correlation between the industry-level exit effect and industry-level gross output growth by Japanese multinational enterprises (MNEs) in Asia. MNEs have higher productivity than non-MNEs (Fukao 2012) and many of them have relocated, or are relocating, production activities abroad (figure 9).
**Figure 6**  TFP level of the manufacturing and the nonmanufacturing sector, 1970–2010

TFP level of the manufacturing sector assuming that the TFP growth rate after 1991 had been the same as the average annual TFP growth rate in 1970–91.

TFP = total factor productivity

Notes: TFP values are on a value-added basis. The nonmanufacturing sector (market economy) does not include imputed rent for owner-occupied dwellings.

Source: JIP Database 2013.

**Figure 7**  Decomposition of TFP growth in the manufacturing sector, 1981–2005

TFP = total factor productivity

Source: Fukao et al. (2014).
Figure 8  TFP growth by factory size, 1980–2000

Figure 9  Overseas production and the exit effect at home (percent)
The large negative exit effect appears to be mainly concentrated in industrial districts in prefectures such as Kanagawa, Tokyo, and Osaka. The closure of productive factories, most of which are owned by R&D-intensive firms, potentially reduced geographical spillovers to SMEs in these districts (figure 10).

**Productivity Dynamics in the Nonmanufacturing Sector**

In the nonmanufacturing sector, just as in the manufacturing sector, the exit effect is negative throughout the entire period covered by the data. Moreover, the reallocation effect, depending on the period, is either very small or negative (figure 11).

**Information and Communication Technology (ICT) Investment in the Nonmanufacturing Sector**

TFP growth in ICT-using sectors, such as distribution services (retail, wholesale, and transportation), declined substantially after 1995. It appears that the ICT revolution did not happen in Japan simply because Japan has not accumulated sufficient ICT capital (figures 12a and 12b).
Structural Impediments to ICT Investment in Japan

One of the main contributions of the introduction of ICT is that it allows firms to save unskilled labor input. However, because of the high job security in Japan, it may be difficult for firms to actually cut jobs. Young and growing firms tend to be more active in ICT investment. However, because of the low entry and exit rates in Japan, firms that have been around for 45 years or more have a majority of market share in most industries. Japan’s retail sector is characterized by small shops. And these smaller firms in Japan probably have found it more difficult to introduce ICT because of their small scale. In order to avoid changes in corporate structure, employment adjustment, and training of workers, Japanese firms tend to choose custom software rather than packaged software, making ICT investment more expensive and network externality effects smaller, because each firm uses different custom software.

ICT capital and intangible assets are close complements. The contribution of intangible investment to labor productivity growth in Japan is the lowest among the major developed countries. Japan invests a lot in R&D but very little in economic competencies such as brand equity, firm-specific human capital, and organizational structure (figure 13).

It seems that the decline in the accumulation of economic competencies was partly caused by the harsh restructuring resulting from the long term economic stagnation. For example, many firms increased the percentage of part-time workers in total workers and did not provide intensive training in the case of part-time workers. This change reduced training expenditure substantially (figure 14).

![Figure 11: Decomposition of TFP growth in nonmanufacturing firms, 1991–2010](image-url)

*TFP = total factor productivity
Source: Fukao et al. (2014).*
Figure 12a  TFP growth in the distribution sector, 1980–2008

Source: EU KLEMS Database, Rolling Updates.

Figure 12b  ICT investment–gross value-added ratio in major developed economies: Distribution services, 1970–2009

Source: EU KLEMS ISIC Rev. 3, March 2011 Update.
Figure 13  Contribution to growth in output per hour, 1995 to 2007

annual rate, percent

TFP = total factor productivity

Sources: Corrado et al. (2012) and Miyagawa and Hisa (2012).

Figure 14  Share of part-time workers in total workers by sector, 1970–2008

percent

Source: Fukao (2012).
Summary of the Structural Causes

1. Through the BOJ’s massive stimulus measures and active fiscal policies, Japan finally appears to be escaping from deflation.

2. From an investment-saving balance viewpoint, the recover in aggregate demand heavily relies on huge government deficits, which is not sustainable.

3. The government is pursuing policies to overcome deflation and seems to be planning to stimulate private investment through a reduction in real interest rates.

4. However, Japan continued to accumulate capital rapidly after 1990 despite slow GDP growth and the decline in the working age population. That must have contributed to the continuous decline in the rate of return on capital in Japan.

5. For sustainable growth, it is necessary to raise the rate of return on capital through productivity growth.


7. The natural selection mechanism does not work well both in manufacturing and nonmanufacturing.

8. MNEs have higher productivity than non-MNEs and many of them have relocated, or are relocating, production activities abroad. Decrease in technology spillovers from large firms.

9. Large firms enjoyed an acceleration in TFP growth. Increase in productivity gap between large firms and SMEs in 1990s and 2000s.

10. The ICT revolution did not happen in Japan simply because Japan has not accumulated sufficient ICT capital.

11. Low levels of ICT and intangible investment closely related with labor market problems.

GOVERNMENT’S GROWTH STRATEGY

The government is pursuing policies to overcome deflation and seems to be planning to stimulate private investment through a reduction in real interest rates. However, since investment opportunities are limited and the rate of return on capital is very low, extremely low or negative real interest rates are required. Maintaining very low or negative real interest rates, a positive inflation rate, and full employment without causing bubbles is likely to be extremely difficult. Therefore, for sustainable growth, it is necessary to raise the rate of return on capital through productivity growth and to stimulate private consumption through job creation and higher wage incomes.

Japan needs the following policies for productivity growth:

- promotion of ICT and intangible investment;
- more rapid restructuring of firms left behind in innovation and internationalization, through mergers and acquisitions and other measures;
- promotion of entrepreneurs and startups;
- promotion of startup of domestic establishments by Japanese multinationals through improvement of regional logistics, free trade agreements, reduction of corporate taxes, etc.; and
- restructuring of the labor market (improvement of social safety net, enhancement of labor market liquidity, reduction of unfair gaps between regular and part-time workers).

Growth strategies are mainly drafted by ministries. Ministries are quite reluctant to reduce their regulations. No real change from the failed strategies of the last two decades.
THE RISK OF A HARD LANDING IS RISING

According to recent estimates by the International Monetary Fund, the combined negative GDP gap of 36 developed economies in 2014 is expected to be about $1.1 trillion (2.2 percent of their GDP). Japan’s current GDP gap is much closer to zero than that of many other developed economies.

Through unconventional monetary policy, the BOJ has supplied huge amounts of high powered money and kept interest rates on long-term government bonds close to zero. If inflation expectations spread, the BOJ will face a difficult policy decision:

- Keep interest rates low → further expansion of money supply, sharp depreciation of the yen, hyperinflation?
- Raise interest rates → Bondholders will incur huge capital losses, potential damage to financial system, deep recession?

LESSONS FROM JAPAN’S SECULAR STAGNATION

Japan’s experience of the lost decades likely provides important lessons for the rest of the world currently characterized by “secular stagnation” (Summers 2013).

Lesson 1. Although it is important not to fall into the deflation trap, keeping real interest rates very low or negative through a zero nominal interest rate plus moderate inflation will not be sufficient for solving the fundamental problems. It is probably possible for economies to keep on growing by maintain high investment rates through low real interest rates. However, as capital accumulation continues, the rate of return on capital will decline, so that extremely low or even negative real interest rates will be required. Yet, keeping very low or negative real interest rates, a positive inflation rate, and full employment carries the danger of leading to new bubbles. Therefore, for growth to be sustainable, it is necessary to raise the rate of return on capital through productivity growth (figure 3a).

Lesson 2. At least, in the case of Japan, the productivity growth slowdown seems to be caused not by an exogenous drying up of innovation (on this issue, see Gordon 2013), but by structural factors of the economy such as low intangible and ICT investment by SMEs, an inflexible labor market, etc., most of which could have been fixed through sensible policies. We need sensible and courageous policymakers, not fatalists (figure 15).

Figure 15  Gross prefectural product per capita and social capital stock per man-hour labor input

Source: R-JIP Database 2012, RIETI.
Lesson 3. The largest part of excess savings went to the government deficit. But most of the government expenditure was used in inefficient ways. We need to use public investment to enhance productivity growth.

Lesson 4. In the case of Japan, the decline in household saving was cancelled out by an increase in saving by large corporations. Large corporations—despite their high productivity—do not actively invest domestically and use their surplus funds not for capital investment or paying dividends but for debt repayment and the accumulation of liquid assets. Whether this kind of corporate saving behavior is desirable, and whether governance in major corporations functions properly, is an important research topic for the future (figure 16).

Lesson 5. Some countries, such as China and Germany, seem to be enjoying low real exchange rates and huge current account surpluses, and other economies suffer from that. On the other hand, many low-income economies still want capital inflows. We need a fundamental reform of the international monetary system, which will mitigate the scarcity of final demand in developed economies.

Lesson 6. Japan’s negative GDP gap has almost disappeared. The risk that Japan provides another lesson, namely that exiting from unconventional policies is likely to entail a hard landing, is rising.

**Figure 16** Corporate savings/GDP and household savings/GDP ratios, 1980–2012

Note: Corporate savings are the sum of the savings of nonfinancial corporate firms and those of financial institutions. The benchmark year for the data before 1994 is 2000. The benchmark year for the data after 1994 is 2005.

REFERENCES


This paper applies the European Debt Simulation Model (EDSM) developed in Cline (2012, 2014) to the cases of the United States and Japan. The objective of the EDSM (which for present purposes may be generalized to Sovereign rather than European, or SDSM) is to investigate whether public debt is on a path that reflects solvency or insolvency. If debt begins at a moderate level and remains stable or declines relative to GDP in the future, the diagnosis is one of solvency. If instead debt begins already extremely high and spirals ever upward relative to GDP, the diagnosis is one of potential insolvency, even if the government currently has comfortable financial market access.

I begin with a review of how the US debt burden reached its current level and a summary of the Congressional Budget Office’s (CBO) baseline projections through 2024. Next I provide a brief review of long-term trends in Japanese public debt. I then present an initial summary view of whether the United States and Japan meet a well-known criterion for debt sustainability, involving the size of the noninterest (primary) surplus in comparison with the difference between the interest rate and the growth rate. The paper then describes the SDSM, and then applies it first to the United States and next to Japan. The conclusion draws policy implications.

UNITED STATES BACKGROUND

The stylized facts about US public debt run broadly as follows. Federal debt held by the public, the central concept in US fiscal discussions, was only about 25 to 30 percent of GDP in the 1970s. Then in the 1980s and early 1990s, revenue losses from tax cuts, rising Cold War defense spending, and high interest rates pushed the debt up to about 50 percent of GDP. In contrast, in the second half of the 1990s the tech boom spurred tax receipts even as post–Cold War defense cuts delivered a peace dividend. By the early 2000s policymakers had begun to worry that the federal debt would be eliminated by surpluses as far as the eye could see and wondered what would replace it as the risk-free asset. Debt eased to about 30 to 40 percent of GDP. But then the Great Recession inflicted prolonged and massive fiscal deficits that have left the debt held by the public at a new and relatively high plateau of about 70 percent of GDP. The pending fiscal cliff embodied in the prospective expiration of the Bush era tax cuts provoked a standoff in mid-2011 in which there was a brief risk of at least technical default because of disagreement over the debt ceiling (a tactic that had not been risked since early in the Clinton presidency).
A temporary “sequestration” deal (Budget Control Act of 2011) set caps on discretionary spending for 2012–
21, imposing equal dollar-amount cuts on defense and nondefense discretionary spending. The more permanent
budget agreement at the end of 2012 (American Taxpayer Relief Act of 2012) retained most of the tax cuts but
restored the top bracket to its earlier level of about 40 percent. That agreement still left a legacy of spending caps,
set at a total of $1.01 trillion for discretionary spending in 2014, rising 2.4 percent annually thereafter through
2021 (CBO 2014a, 20). Considering that medium-term inflation is typically placed at about 2 percent, the impli-
cation is a near long-term freeze in real discretionary spending and a persistent decline of its share in GDP. That
prospect in turn is driven by the seemingly inexorable rise of mandatory spending, mainly for health.

The general sense of the fiscal problem after the end-2012 legislation seems to have been that it is taken care
of for the next decade or so, but could return in severe form over subsequent decades if rising healthcare expen-
ditures are not somehow curbed. Moreover, the dominant view has been that whatever the remaining long-term
problems, care should be taken to avoid excessive fiscal tightening in the immediate future because the economy
still remains in substantial underemployment. This view in turn requires some view of whether the unemploy-
ment rate (6.3 percent in April 2014) is seriously understating the true level of unemployment considering that
the labor force participation rate (for the population of 16 years and older, including post-65) has fallen from 66
percent in late 2007 to 63 percent in 2013. For its part the CBO (2014a, 38) considers that this trend is mainly
driven by the aging population, and it projects a further decline to 61 percent by 2024. That view implicitly leans
against major additional short-term fiscal stimulus by gauging the output gap as not much larger than re-
lected in reported unemployment.

The simulations presented below suggest that there is some downside risk to the benign view that fiscal matters are un-
der control even for the next decade or so. The basic problem is that plausible alternative scenarios tend to suggest that the
CBO baseline is on the optimistic side.1 Even the CBO baseline shows some increase in the debt burden, by about 5 percentage
points of GDP from a plateau in 2014–20 to the level by 2024 (CBO 2014b, 3).

Figure 1 reports the ratio of government debt held by the public to GDP for the past 40 years and the coming decade (CBO baseline).
The most closely watched metric is gross federal debt held by the public, amounting to 72.1 percent of GDP in

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1. Although not nearly as much so as before the end-2012 legislation when the “current law” CBO projections had to incorporate a
large boost to taxes from expiration of the tax cuts, such that the agency emphasized its “alternative” scenarios.
2013 and reaching 78.1 percent in 2024 in the baseline. Sizable assets (primarily student loans amounting to about $1 trillion) mean that the net debt held by the public is significantly lower, 67 percent of GDP in 2013 rising to 71 percent by 2024. The figure also shows gross and net debt of the general government (including state and local) as estimated by the IMF (2014a). This measure shows an increase in gross debt from 53 percent of GDP in 2001 to 104.5 percent in 2013 and 106.7 percent by 2019. The general government has larger financial assets than the federal government, so the difference between general government and federal net debt is smaller than the corresponding difference in gross debt. In principle the best measure for policy purposes is net federal debt held by the public.

Figures 2, 3, and 4 show the corresponding influences that lie behind the debt path and the stylized facts reviewed above. Figure 2 shows the large downswing in defense spending from 6 percent of GDP in 1986 to 3 percent by 1998 (the peace dividend). It also shows that discretionary nondefense spending had been squeezed when defense spending was high but rose after 2000 (and soared to 4.5 percent of GDP in 2010 with unemployment insurance benefits in the Great Recession). The figure also shows the rigid dietary regime for both defense and nondefense discretionary spending from 2013 to 2024, during which period each one will have fallen by about 1 percent of GDP.

The figure also shows the sharp decline of interest payments from about 3 percent of GDP in the mid-1980s to mid-1990s to about 1½ percent of GDP in the most recent decade. The decline reflected lower interest rates combined with still modest debt in the initial part of this period, but a combination of historically low interest rates with higher debt in the later part. The interest path also reveals a major challenge going forward: paying

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3. Thus, in 2013 general government net debt at 81 percent of GDP was about 13 percentage points of GDP higher than net federal debt held by the public, whereas the corresponding difference in the gross concepts was 32 percentage points of GDP.
4. The plight of Detroit shows that in the United States “discovered debt” for the federal government from provincial debt is not the problem often found abroad. Moreover, the main holders of federal debt other than the public are the Social Security trust fund and the government employees’ retirement fund. Neither is about to declare bankruptcy and shift a major burden to the federal government. Nonetheless, the annual net cash flow of the Social Security trust funds and Postal Service are projected to swing from +0.2 percent of GDP in 2014 to –0.8 percent of GDP by 2014 (CBO 2014b, 3), posing a small source of discovered federal debt over the period.
for about an additional 2 percentage points of GDP (by 2024) in interest as interest rates return to more normal levels in the face of relatively high debt stocks.

Figure 3 reports the corresponding path of mandatory spending. The striking feature it shows is the persistent, steady rise in mandatory health-related spending from only 1 percent of GDP in 1974 to 5 percent in 2013 and 6.6 percent by 2024.5 (The CBO’s long-term projections anticipate a continuation of this straight-line increase to 8 percent of GDP by 2038; CBO 2013, 42). By contrast, other mandatory spending (mainly Social Security, federal retirement, and income security) will still be about 7 percent of GDP in 2024, the same level as the average in the 1970s and 1980s.6

On the revenue side, figure 4 shows the path of income taxes and other revenue as a percent of GDP. The principal components of other revenue are Social Security taxes and corporate taxes. Both income and other tax revenue show cyclical response to the recession in 2001 and again, especially, in the Great Recession.

Perhaps the most intriguing pattern in the figure, however, is the pronounced increase in personal income taxes in the CBO baseline projections, rising from 8 percent of GDP in 2013 to 9.4 percent of GDP in 2024. This expected increase is a relatively well kept secret. The CBO attributes it mainly to the facts that “growth in people’s real (inflation-adjusted) income will push more of their income into higher tax brackets and … withdrawals from tax-deferred retirement accounts will increase faster than GDP as baby boomers retire” (CBO 2014b, 10).

Finally, figure 5 reports the overall fiscal balance as a percent of GDP, as well as the primary balance. The total balance (including net flows from Social Security and Postal Service) reached a peak surplus of about 2 percent of GDP in 2000. The on-budget surplus peaked at about 1 percent of GDP in that year. Both measures

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5. These costs include Medicare, Medicaid, health insurance subsidies in the exchanges, and the (much smaller) Children’s Health Insurance Program.
6. The $500 billion spike to over 9 percent of GDP in 2009 was driven mainly by outlays for the Troubled Assets Relief Program (about $150 billion), Fannie Mae and Freddie Mac (about $90 billion), and mandatory increases from the fiscal stimulus legislation ($80 billion, largely for Medicaid, unemployment benefits, Social Security benefits) (CBO 2010, 3-4).
Figure 4  US revenue as percent of GDP (personal income taxes and other), 1974–2024


Figure 5  US fiscal balance as percent of GDP, 1974–2024

OnBudg = On budget; PrimGG = primary, general government
showed a collapse to a deficit of about 10 percent of GDP in 2009. For its part, the (total) primary balance was systematically about 3 percent of GDP higher than the (total) fiscal balance in the mid-1980s to mid-1990s (the amount of interest payments, figure 2), but the two concepts have been much closer in recent years with low interest payments. By 2024 the primary balance returns to about zero, whereas the total deficit is projected at almost 4 percent of GDP, mainly reflecting interest at over 3 percent of GDP but also an off-budget deficit (Social Security, Postal Service) of 0.8 percent of GDP. For comparison, the figure also reports the International Monetary Fund’s (IMF) estimate of the primary balance for the general government as a percent of GDP for 2001–19.

As shown in figure 5, the total fiscal deficit is at a plateau close to 3 percent of GDP in 2014 through 2018, and then widens to about 4 percent of GDP by 2022. The relative stability of the overall deficit masks major changes in the components. Essentially higher income taxes and lower discretionary spending are being used to cover higher health spending and higher interest costs over the coming decade. The changes from 2014 to 2024 as a percent of GDP are: income tax revenue, +1.4; discretionary spending, −1.7; health spending, +1.2; interest costs, +2.0.

**JAPAN BACKGROUND**

For many years now the central stylized fact about Japanese public debt seems to have been that the seemingly stratospheric debt ratios are meaningless, because of four factors. First, interest rates are low. The economic burden of the debt depends not only on its magnitude but also on its price. If the interest rate is zero, even an extremely high debt ratio poses no economic burden. Second, there is a strong home bias, such that Japanese households will ensure that the interest rate stays low. Third, the Japanese government has large assets as well as debt, and the net debt figure is much less foreboding than the gross figure. Fourth, unlike Greece, Japan has its own currency and its own central bank that if necessary can print currency to service the debt, which is denominated in its own currency. The central question about Japanese public debt is whether a time will come when investors shift the paradigm of their perception away from these considerations toward greater weight on more normal international comparisons (such as the benchmark Maastricht 60 percent of GDP debt target, less than half the level of net debt in Japan) and conclude that Japanese government debt does at least potentially have sovereign default risk.

Figure 6 shows long-term debt trends as reported in the IMF’s *World Economic Outlook* (IMF 2014a). Gross and net general government debt as a percent of GDP are shown on the left axis and net interest payments as a percent of GDP on the right axis.7 The figure shows that the debt levels have not always been high, nor have interest payments always been low. The net interest burden was much higher in the 1980s than so far in the 2000s (although by 2019 the Fund projects the interest burden returning to its 1983–84 peak of 2 percent of GDP). The figure does confirm the vast difference between the gross and net debt levels. Although the figure shows the debt ratios stabilizing rather than continuing to rise, that change lies wholly in the future. In the most recent three years of actual history (2010 to 2013) the average escalation of the gross debt ratio was 9 percentage points of GDP annually.

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7. Net interest is calculated as the difference between the primary fiscal balance and the total fiscal balance.
THE SUMMARY SUSTAINABILITY TEST

Before proceeding to the SDSM analysis, it is useful to consider a classic summary measure of debt sustainability. This measure asks whether the primary surplus being run by the government is sufficient to keep the debt from rising as a percent of GDP. The debt rises both from inheritance of interest on past debt and from borrowing to cover new deficits. GDP rises at the real growth rate plus the inflation rate. So the summary test is:

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\pi \geq \lambda (r - g)
\]

where \(\pi\) is the primary surplus as a percent of GDP, \(r\) is the interest rate (nominal), \(g\) is the growth rate (nominal), and \(\lambda\) is the initial ratio of public debt to GDP. If the left-hand side exceeds the right-hand side, then the ratio of debt to GDP will be falling. If instead the left-hand side is smaller than the right-hand side, the debt to GDP ratio will be rising. A larger initial debt ratio (\(\lambda\)) means that the primary surplus needs to be larger to keep up with the inherited interest burden.

Table 1 reports the performance of the United States and Japan on this test. For the United States, the main test is using the federal debt held by the public. An alternative test is included, however, based on the IMF’s projections for the general government. For Japan, only the IMF projections are applied. In all cases the test is applied to net debt, the proper concept if the interest rate applicable to assets is identical to the interest rate on borrowing.

Both Japan and the United States enjoy an advantage unavailable to most sovereigns: Their average nominal growth rates for the periods in question exceed the average nominal interest rates on their debt, so the sustainability equation will permit some primary deficit rather than requiring a primary surplus. Nonetheless, it turns out that the average primary deficit is somewhat too large to avoid a rising debt ratio, for the United States, and more substantially too large in the case of Japan. The final row of the table shows how much the average primary balance over the period would have to rise to meet the debt sustainability equation test. This increase would amount to a primary balance higher than the baseline by 0.28 percent of GDP for the United States (federal) or, alternatively, 0.5 percent of GDP (based on general government debt). For Japan, be-

cause the prospective average primary balance is in such large deficit (about 4.5 percent of GDP), an increase in the primary balance by 2.5 percent of GDP on average over the period is needed to keep the net debt to GDP ratio from rising, even though the average interest rate is low (less than 1 percent). This summary test tends to confirm what one suspects: The US fiscal path is not quite on track for stability over the next decade, and the Japanese fiscal path is substantially below such an outcome.

**THE SOVEREIGN DEBT SIMULATION MODEL**

The European Debt Simulation Model developed in Cline (2012, 2014) is a probabilistic accounting framework focused on projecting the likely path of the ratio of public debt to GDP. The debt at the end of the year equals the previous year’s debt plus the total fiscal deficit plus borrowing needed to acquire financial assets, plus any newly “discovered debt” (e.g., from socialization of bank losses), minus amounts received from privatization. Gross borrowing needs in a given year further include the amount needed to cover amortization of existing debt, and the model distinguishes between interest rates on the new debt and those on the old debt tranches being amortized.

In the context of the euro area debt crisis, there are five key variables with alternative scenarios: real GDP growth, primary surplus, interest rate (reflecting sovereign risk spread), bank recapitalization, and privatization. For each key variable there is a baseline scenario, an unfavorable scenario, and a favorable scenario, so there are $3^5 = 243$ possible outcomes. As discussed below, application to the United States and Japan involves replacement of the bank recapitalization and privatization variables with alternative variables more germane to each economy respectively.

The model considers the likely correlation between the scenario states (good, bad, central). After taking account of these correlations, the probability of any specific combination of scenarios can be obtained. The resulting projections, arrayed by most favorable to least favorable, can then be reviewed to find the 25th percentile cumulative probability favorable case, baseline case, and 75th percentile unfavorable case (with ascending debt ratios by the end of the period). The probability-weighted path (which is not necessarily the median case) is identified and serves as an important benchmark for inferring the implied relative pessimism or optimism of the baseline.

For application as a generalized SDSM for the United States and Japan, over the 10-year horizon considered in this paper there is little basis for anticipating either banking cleanups costly to the government (or other major sources of discovered debt) or privatization receipts in either economy. The key variables for scenarios thereby freed up are assigned here in the following way. For the United States, instead of a single fiscal

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9. Note further that for the interest rate, the implied rates are from net interest relative to net debt at the end of the prior period.
variable (primary surplus) there are three: income tax revenue, discretionary spending, and mandatory health spending. For Japan, the GDP deflator is considered as a scenario variable.

Table 2 shows the state correlation coefficients assumed for the key scenario variables for the United States; table 3 shows the correlations for Japan. Complete good-good or bad-bad correlation is indicated by a coefficient of +1; complete good-bad correlation is indicated by −1.

For the United States, the good scenario for growth (high) is fully correlated with the bad scenario for interest rates (high) because of the likely response of monetary policy and the absence in this horizon of serious sovereign default credit risk (which, as in the euro area periphery, would make the scenario states positive for growth and the interest rate rather than negative). The good state for income tax revenue is fully correlated with the good state for growth, given the positive response of revenue to higher GDP. Health spending is treated as exogenous to the state of growth (zero correlation). Discretionary spending from past data tends to show a positive state correlation with growth (high growth good case correlated with lower discretionary spending good case) but this relationship derives from cyclical components (e.g., unemployment compensation) and the analysis here omits any business cycles. There might be a case for a mild negative state correlation (high growth good case induces greater spending bad case), but with little past basis for this relationship the correlation is simply set at zero. The state correlations for the interest rate are all zero for tax revenue, health spending, and discretionary spending. The correlation for tax revenue is set at zero for health spending but placed at moderately negative for discretionary spending. The idea is that if tax revenues are high (good state) there may be some tendency to spend more on discretionary uses (bad state for the debt profile, though not necessarily for welfare). Finally, health spending also has a moderate negative state correlation with discretionary spending, because if such factors as slower escalation of pharmaceutical costs facilitate less rapid increases in health spending, there may be a tendency to spend some of the savings on discretionary categories.
For Japan only four key macroeconomic variables are used to specify the scenarios. The interest rate has the same state correlation with growth as in the United States (−1). The primary surplus has a complete positive state correlation with the growth rate (because of higher revenue, as in the United States). The GDP deflator has a positive state correlation with growth, because higher growth will tend to be associated with higher inflation, which will boost the nominal value of GDP (and thus the denominator in the debt/GDP ratio). The interest rate has a negative state correlation with the GDP deflator because the good interest rate state (low rates) will be correlated with the bad GDP deflator state (low inflation). The primary surplus is assumed exogenous to the GDP deflator.

It is important to clarify that the two sets of correlation coefficients are essentially business-as-usual conditions for the two countries. They do not capture the reversals that could be associated if the countries were to reach a zone of serious perceived default risk (as noted above regarding the growth-interest rate correlation). Nor do the essentially fixed alternative scenario paths allow for feedback from the resulting debt path to the variables. In a richer version of the model, it would be desirable to add feedback from higher debt ratios to slower growth because of higher cost of capital formation, and from higher debt ratios to higher interest rates as a consequence of rising default risk.

PROJECTIONS FOR THE UNITED STATES

Table 4 presents the scenario assumptions for the United States. The baseline for real growth is from CBO (2014a). Baseline interest rates are the average of the projections in CBO (2014a) and OMB (2014). Income taxes, health spending, and discretionary spending are from CBO (2014b), as are the fixed paths for other revenue and other (nonhealth) discretionary spending (not shown).

The CBO growth baseline is premised on average labor force growth of 0.7 percent per year. The average total growth of 2.52 percent in the CBO baseline implies average labor productivity growth of 1.82 percent. In the 15 moving 7-year periods from 1991 to 2012, labor productivity growth in the sixth-highest (63rd percentile) was 2.16 percent; productivity growth in the 10th highest (37th percentile) was 1.64 percent. On this basis, the favorable growth scenario adds 0.34 (= 2.16 – 1.82) percentage point to baseline annual growth, and the unfavorable growth scenario subtracts 0.18 percent (= 1.82 – 1.64) from the baseline.

For the long-term (10-year) interest rate, the favorable scenario subtracts 75 basis points from the baseline beginning in 2015; the unfavorable scenario adds 50 basis points. For income taxes, the unfavorable scenario freezes the share in GDP at the 8.0 percent of GDP average actually collected in 1990–2007. The favorable scenario adds 0.5 percent of GDP to the baseline. For health spending, the unfavorable scenario postulates faster growth in health spending by 1 percent per year than in the baseline. In the favorable scenario health spending is capped at 6 percent of GDP, about one-tenth below the baseline by 2024. For discretionary spending, in the unfavorable scenario it is assumed that there is no decline from the 6.8 percent share in GDP at the beginning of the period. (The CBO’s “alternative” projections similarly include a less stringent discretionary spending path than in the current law, with spending allowed to grow at the rate of inflation; CBO 2014a, 23.) Because of the already sharp cutbacks in discretionary spending as a share of GDP in the baseline, the favorable scenario allows only a token further reduction by 0.1 percent of GDP from the baseline.

The combination of baseline assumptions for the tax and spending variables generates a path for the primary balance that begins with a deficit of 1.5 percent of GDP in 2014, narrows to 0.7 percent by 2019, and is still in small deficit at 0.5 percent by 2024. The failure to reach a primary surplus even by the end of the horizon is an indication that the fiscal effort is not particularly ambitious for an economy with debt already relatively high.

The implementation of the model distinguishes between interest due on the legacy debt stock already in place at the end of 2013 and interest on new debt incurred subsequently. For subsequent years there is a long-term interest rate applicable to each year’s vintage of new borrowing that persists through the maturity of that vintage.

Figure 7 shows the results of the projections for the United States for gross debt held by the public as a percent of GDP, in the upper panel, the corresponding projections for net debt held by the public, in the middle panel, and net interest payments as a percent of GDP, in the lower panel. In the baseline, gross debt held by the public rises from 72 percent of GDP in 2013 to 79 percent in 2024.11 Net debt also rises, from 67 percent of GDP to 75 percent. Net interest payments rise from 1.3 percent of GDP in 2014 to 3.3 percent in 2024. (Appendix table A.1 provides additional details on the baseline projections.) The figure also shows the corresponding probabilistic range of projections, from the favorable 25th percentile of cumulative probability to the unfavorable 75th cumulative percentile. For gross debt relative to GDP, the ratio rises from 72 percent in 2014 to 77 percent of GDP in 2024 even in the favorable 25th percentile; it rises to 89 percent in the unfavorable 75th percentile.

The probability-weighted gross debt ratio rises to 83 percent of GDP by 2024, significantly higher than the baseline. The strong implication is that there is more downside risk to the prospect of stabilizing the US debt ratio than upside risk in this period. In other words, the baseline assumptions (largely the CBO current law version) tend to be on the optimistic rather than pessimistic side. The same divergence holds for net debt,

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11. This baseline closely tracks that of the CBO (2014b), which places the debt ratio at 78 percent of GDP in 2024.
Figure 7 Debt projections for the United States (federal debt held by the public), 2013–24

Source: Author's calculations.
which rises from 67 percent in 2013 to 75 percent of GDP in 2024 in the probability-weighted path. Overall, the picture that emerges from these calculations is that the US debt problem is not quite as fully “fixed” for the next decade as many might have thought, despite the important legislation of December 2012.

**PROJECTIONS FOR JAPAN**

Table 5 shows the scenario assumptions for Japan. The baseline assumptions for all four macroeconomic variables are from the “reference” scenario in the January 2014 projections of the Cabinet Office (2014). Growth is at an average of 1.2 percent annually over the decade. Considering that Japan’s labor force is expected to shrink by 0.5 percent per year in this period (Kitahara 2014), this baseline implies labor productivity growth at 1.7 percent per year, almost the same as the 1.82 percent for the United States in the CBO baseline. Measured on a comparable basis, then, Japan would be growing just as fast as the United States. For the interest rate, the baseline 10-year rate rises from 1 percent in 2013 to 3.1 percent by 2024. In the latter part of the decade, the difference between the 10-year rate and inflation as measured by the GDP deflator (set at 0.5 percent in this period) implies a real rate of about 2½ percent, comparable to the corresponding 3 percent real rate in the US baseline (where the GDP deflator runs at 2 percent inflation per year). The baseline primary balance is disappointing, for an economy with such high public debt. Although the primary deficit falls from 5.7 percent of GDP in 2013 to 3 percent by 2015 and after, by international standards a deficit this size would be considered still relatively large.

The “revitalization” variant in the same source provides the basis for several of the alternative scenarios in table 5. In the revitalization case the Cabinet Office projects that growth would average 2.1 percent annu-

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**Table 5  Scenario assumptions for Japan**

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<td>2.3</td>
<td>2.4</td>
<td>2.4</td>
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</tr>
</tbody>
</table>

| Primary surplus (percent of GDP) |      |      |      |      |      |      |      |      |      |      |      |
| 1        | –5.7 | –4.8 | –4.0 | –4.0 | –4.0 | –4.0 | –4.0 | –4.0 | –4.0 | –4.0 | –4.0 |
| 2        | –5.7 | –3.8 | –3.0 | –3.0 | –3.0 | –3.0 | –3.0 | –3.0 | –3.0 | –3.0 | –3.0 |
| 3        | –5.7 | –3.5 | –2.4 | –2.3 | –2.2 | –2.0 | –1.9 | –1.7 | –1.4 | –1.2 | –1.2 |

| Interest rate: MLT new (percent) |      |      |      |      |      |      |      |      |      |      |      |
| 1        | 1.0  | 2.1  | 2.4  | 2.8  | 3.2  | 3.6  | 4.0  | 4.3  | 4.6  | 4.8  | 4.8  |
| 2        | 1.0  | 1.5  | 1.9  | 2.1  | 2.3  | 2.5  | 2.7  | 2.9  | 3.0  | 3.1  | 3.1  |
| 3        | 0.6  | 1.1  | 1.5  | 1.7  | 1.9  | 2.1  | 2.3  | 2.5  | 2.6  | 2.7  | 2.7  |

| GDP deflator (percent) |      |      |      |      |      |      |      |      |      |      |      |
| 1        | 1.9  | 0.9  | 1.0  | 0.4  | 0.4  | 0.4  | 0.4  | 0.4  | 0.4  | 0.4  | 0.4  |
| 2        | 1.9  | 1.1  | 1.5  | 0.5  | 0.5  | 0.5  | 0.5  | 0.5  | 0.5  | 0.5  | 0.5  |
| 3        | 1.9  | 1.7  | 1.9  | 1.4  | 1.4  | 1.3  | 1.3  | 1.3  | 1.3  | 1.3  | 1.3  |

MLT = medium and long term
1: adverse 2: baseline 3: favorable

Source: Cabinet Office (2014) and author’s calculations.
ally over the decade. This variant is applied here as the favorable scenario for growth. It would seem to imply considerable success in staving off the declining labor force through higher female labor force participation and perhaps greater immigration. For the unfavorable growth scenario, in contrast, a reduction of 0.2 percent per year is applied against the baseline. This reduction from baseline is approximately the same as for the US, implying that downside deviation from expected labor productivity growth is comparable for the two simulations.

For the primary fiscal balance, the favorable scenario is also taken from the Cabinet Office revitalization variant. In this scenario the 10-year average for the primary deficit is 2.3 percent of GDP, instead of 3.3 percent in the baseline. Faster growth presumably spurs higher revenue and lower primary deficits. Table 5 places the unfavorable primary balance at a uniform 1 percent of GDP below the baseline primary balance path. For the interest rate, the Cabinet Office revitalization scenario provides the benchmark for high interest rates (thus, ironically, the unfavorable scenario). The rate reaches the range of 4½ percent by 2020–24. The favorable scenario for the interest rate subtracts 40 basis points from the baseline. Finally, the Cabinet Office revitalization scenario is also the basis for the favorable GDP deflator scenario, in which the deflator rises at an annual average of 1.5 percent over the decade instead of 0.7 percent in the baseline. Higher GDP inflation boosts the denominator of nominal GDP and hence tends to reduce the ratio of debt to GDP. In the unfavorable scenario the deflator is set arbitrarily at only 0.1 percent lower than in the baseline, considering that the baseline GDP inflation rate is already very low.

A key feature of Japan’s public debt warrants further discussion. There is a large difference between gross public debt and net public debt. The Organization for Economic Cooperation and Development (OECD 2014) places the 2013 gross public debt at 225 percent of GDP and net debt at 138 percent; the IMF (2014) places the gross figure at 243 percent and the net figure at 134 percent. The Cabinet Office (2014, 8) reports a debt figure that is intermediate, at 195 percent of GDP in 2013. It does not specify whether the figure is gross or net, but its order of magnitude suggests that the concept is gross. The SDSM requires an estimate of financial assets to arrive at net debt, so the procedure adopted here is to use the IMF’s 2013 figure for net government debt (134 percent of GDP) and impute the 2013 general government financial assets as the difference between this figure and the Cabinet Office figure for total debt (with the result of an initial level of financial assets at 61 percent of GDP). In the simulations it is assumed that the interest rate earned on government assets is relatively low.12 As in the case of the United States, the amortization profiles of existing debt and average interest on legacy debt stocks, as well as the vintages of new long-term debt and their relevant future interest rates, are specifically estimated for Japan.13

Figure 8 shows the resulting model projections for Japan. In the baseline, the ratio of gross public debt to GDP rises from 195 percent in 2013 to 221 percent in 2024. For the year 2023, the final year in the Cabinet Office horizon, the baseline here approximately replicates the Cabinet Office estimate (at 217 percent of GDP versus 216 percent, respectively). (Appendix table A.2 provides additional details on the baseline projections.)

For Japan, international policy discussions seem to have focused more on net debt. Thus, in its most recent Article IV consultation for Japan, the IMF (2013, 3) forecast that Japan’s net public debt would rise from 144 percent of GDP in 2013 to 177 percent in 2024 in the “baseline scenario,” and 200 percent of GDP in a “no adjustment scenario,” but that the ratio could be brought down to 137 percent of GDP by 2024 in a “fiscal adjustment scenario.” In the baseline SDSM projections here, Japan’s net public debt rises from 134 percent of GDP in 2013 to 171 percent by 2024. Net interest payments rise from 1 percent of GDP in 2013 to 4.9 percent of GDP in 2024, a dramatic end to the era of low interest burdens despite high debt levels.

12. A rate of only 25 basis points. Higher rates begin to cause the path of debt to be significantly lower than in the Cabinet Office baseline.
13. Based on Bloomberg data for debt stocks, interest rates, and maturities.
Figure 8  Debt projections for Japan, 2013–24

Debt

Net debt

Net interest

Source: Author’s calculations.
Figure 8 shows that the probability-weighted outcome for the debt ratio is considerably more favorable than the baseline outcome. The baseline may thus be on the pessimistic side (versus the opposite for the United States). Unfortunately, even in the probability-weighted case the debt ratio rises quite substantially over the decade, by about 20 percentage points of GDP.

CONCLUSION

The implication of these projections is that even for just a 10-year horizon, somewhat more effort will be required to keep the debt-to-GDP ratio from escalating in the United States, and much more will need to be done in Japan. Using the probability-weighted ratio of net debt to GDP (federal debt held by the public for the United States), holding the ratio flat at its 2013 level would require cutting the 2024 debt ratio by 8 percentage points of GDP for the United States and by 32 percentage points of GDP for Japan. In broad terms achieving this outcome would involve reducing the average primary deficit by about 0.75 percent of GDP from the baseline in the United States and by about 3 percent of GDP in Japan. These orders of magnitude are approximately the same as in the back-of-the-envelope sustainability tests of table 1.

Ideally both countries would do even more, to begin reducing the debt ratio. This conclusion would only be reinforced by an extension of the analysis incorporating adverse feedback from a rising debt ratio to a higher sovereign risk premium in the interest rate and slower capital formation from the crowding out of private investment by government borrowing.

For Japan further adjustment is especially needed because the previous factor offsetting extremely high debt—low interest rates—is scheduled to disappear over the decade, as Japan’s real interest rates rise to nearly the same levels as those in the United States. Both private and official sources have called for aggressive action in Japan. Thus, the Japan Center for Economic Research has recommended that the consumption tax continue to be increased by one percentage point annually from its present 10 percent level to reach 19 percent at the end of the decade. The consequence, it calculates, would be to eliminate the primary deficit by 2023. Indeed, the center asserts that “Without further consumption tax hikes, sovereign default cannot be avoided” (JCER 2014, 4). For its part, the IMF (2013, 3) concluded that an additional 5.5 percent of GDP fiscal consolidation needs to be identified, approximately equal in size to the consolidation represented by the increase of the consumption tax to 10 percent and the expiration of stimulus and reconstruction spending. By implication, the Fund sees a need to boost the primary balance from a deficit of about 3 percent of GDP in the second half of the decade to a surplus of about 2 percent of GDP, a fiscal posture that would be much more in keeping with gradually bringing down debt from high levels.

14. The probability-weighted net debt ratios rise from 67 percent of GDP in 2013 to 75 percent in 2024, for the United States, and from 134 percent of GDP in 2013 to 166 percent in 2024, for Japan.
15. Hoshi and Ito (2013) similarly argue that a debt crisis could occur in the early 2020s, because by then the domestic asset market would be fully absorbed by government bonds. The government would be forced to borrow from abroad, which would cause interest rates on new government debt to surge (see Cline 2013, 307).
# APPENDIX A BASELINE PROJECTIONS THROUGH 2024

## Table A.1 United States

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<tr>
<td>Debt</td>
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<td>73.1</td>
<td>72.8</td>
<td>72.8</td>
<td>73.1</td>
<td>73.7</td>
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<td>75.5</td>
<td>76.8</td>
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<td>0.7</td>
<td>0.7</td>
<td>0.7</td>
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<td>0.8</td>
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<td>2.5</td>
<td>2.7</td>
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<td>14.8</td>
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<tr>
<td>Nominal GDP</td>
<td>16,627</td>
<td>17,332</td>
<td>18,208</td>
<td>19,166</td>
<td>20,116</td>
<td>21,011</td>
<td>21,924</td>
<td>22,855</td>
<td>23,825</td>
<td>24,811</td>
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<td>1,195</td>
<td>1,196</td>
<td>1,211</td>
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<td>1,295</td>
<td>1,330</td>
<td>1,357</td>
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<td>Other spending</td>
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<td>1,300</td>
<td>1,365</td>
<td>1,412</td>
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<td>1,511</td>
<td>1,587</td>
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<td>1,825</td>
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<td>(-) Income tax revenue</td>
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<td>1,552</td>
<td>1,657</td>
<td>1,758</td>
<td>1,855</td>
<td>1,952</td>
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<td>(-) Other tax revenue</td>
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<td>575</td>
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<td>712</td>
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<td>Net borrowing requirement</td>
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<td>477</td>
<td>535</td>
<td>575</td>
<td>622</td>
<td>712</td>
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ST = short term; MLT = medium and long term

Source: Author’s calculations.
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ST = short term; MLT = medium and long term

Source: Author’s calculations.
REFERENCES

1. INTRODUCTION

In this paper, I first summarize developments in US fiscal policy since the 1980s and then discuss Japan’s tax and fiscal policy since 1990, a period known as the “lost decades.” In the second half of the paper, I discuss various aspects of the fiscal problems Japan is facing today—fiscal sustainability, political economy, institutional design, local government finance, tax system, and so on—using the United States as a comparison.

2. UNITED STATES

After the stagflation of the 1970s, US macroeconomic policy under the Reagan administration, Reaganomics, succeeded in stabilizing inflation and restoring economic growth in the United States in the first half of the 1980s. However, as nonnegligible side effects, Reaganomics created large budget deficits and current account deficits—so-called twin deficits. In his 1980 campaign speeches, Ronald Reagan proposed a return to the free market economy that had been in favor before the Great Depression and Franklin D. Roosevelt’s New Deal policies. However, the Reagan administration’s actual macroeconomic policy was a combination of tax reductions and expenditure increases and consequently a Keynesian fiscal policy. As shown in figure 1, the federal deficit as a percentage of GDP rose from 2.6 percent of GDP in 1980 (Carter’s final budget year) to 5.9 percent of GDP in 1983. Even in 1988, Reagan’s final budget year, it remained 3.0 percent of GDP. During Reagan’s tenure, total public debt as a percentage of GDP rose from 32.5 percent in 1980 to 50.5 percent in 1988.

Under such circumstances, the Gramm-Rudman-Hollings (GRH) Balanced Budget Act—a joint resolution increasing the statutory limit on the public debt—was introduced by Congress in 1985. The GRH Act set targets on federal deficits starting from fiscal year 1986 and aiming for a balanced budget by 1991. The GRH Act provided for automatic spending cuts if the total discretionary appropriations in a fiscal year exceeded the budget spending thresholds.

However, the GRH Act did not operate as expected. The main reason was that it forced a simple reduction in fiscal expenditure while ignoring business cycle fluctuations. Even if the economy was in recession, an automatic reduction in government spending would occur. Furthermore, there were some significant loopholes in the system: In particular, Social Security–related expenses were excluded from automatic spending reductions.

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1. The discussions in this section draw heavily from Gruber (2009) and particularly from Tanaka (2011, 2013).
The GRH Act targeted the initial budget plan rather than the final expenditures, and it is possible to be overly optimistic about economic growth. The GRH Act was too rigid for budgetary planning, yet too flexible for accounting maneuvers. As a result, the GRH Act never created true fiscal discipline in US fiscal policy.

The continuing failure to meet the GRH Act deficit targets led to the 1990 adoption of the Budget Enforcement Act (BEA). Instead of the target level of the GRH Act, the BEA aimed to restrain government growth. The BEA set caps on annually appropriated spending. It also created a pay-as-you-go process for revenue and entitlements, which prevented any policy changes from increasing the estimated deficit. The BEA appears to
have been successful in restraining government growth in the 1990s. Strong economic growth in this period was also a major force that contributed to the improvement of the fiscal situation in the United States. At the beginning of the Clinton administration, the budget deficit was 3.8 percent of GDP in 1993. The budget balance turned to surplus toward the end of the 1990s and recorded a surplus of 2.3 percent of GDP in 2000.

However, toward the end of the Clinton administration, discretionary spending started to grow again, this time by avoiding the BEA's caps by using the loophole of uncapped “emergency spending” (such as NATO's intervention in Kosovo). As the US economy slowed following the collapse of the dot-com bubble and the war on terror under the Bush administration in the early 2000s, the fiscal situation quickly deteriorated again. The US budget balance turned to deficit in 2002, at 1.5 percent of GDP, and has remained in deficit since then.

Responding to the recession that started in 2007 and the outbreak of the subprime mortgage crisis in 2008, the Obama administration implemented a large-scale fiscal stimulus. The budget deficit increased to 9.8 percent of GDP in 2009 and 8.8 percent of GDP in 2010. Correspondingly, national debt as a percentage of GDP increased from 55.4 percent in 2000 to 91.5 percent in 2010.

3. JAPAN

3.1 Brief History

From the mid-1970s, Japan’s budget deficits and government debt began to increase, as the high-growth era ended with the significant economic slowdown after the first oil crisis (figure 2). Furthermore, Japan’s aging population problem—the continuing decline of the fertility rate and rising number of elderly people—emerged as a serious social problem for the first time in Japanese society in the late 1970s.

Despite this, at the peak of its prosperity in the late 1980s, Japan’s fiscal situation was sound and improving substantially. The ratio of gross government debt to GDP fell from 70 percent in 1988 to 67 percent in 1989, the first decline in 10 years, thanks to the strong economy and increased tax revenue. As forcefully argued by Ishi (1989) and Asako, Ito, and Sakamoto (1991), the Japanese government utilized some distinctive policy tools to reduce the deficit during the period of fiscal recovery from 1983 to 1990. First, the “zero ceiling” policy for government expenditure was introduced so that no ministries were allowed to ask for an increase in their budget over the previous year. The zero ceiling was imposed in nominal terms. Under mild inflation, a freeze on nominal expenditure implied a reduction in real expenditure. Second, the income brackets have never been indexed to inflation in Japan. In the 1970s, the government had “corrected” the brackets frequently to adjust for inflation. In the 1980s, they were intentionally not adjusted. Under mild inflation and a highly progressive income tax schedule at that time, taxpayers moved up into higher marginal tax brackets as their nominal income increased. As a result, there was a rapid increase in income tax revenue in the 1980s.

However, the economic/fiscal situation began to deteriorate after the real estate and stock market bubbles burst and the performance of the economy deteriorated in the early 1990s. This deterioration was initially thought to be a temporary slowdown, a hangover after the financial euphoria of the late 1980s. The Japanese government implemented only a half-hearted stop-start fiscal stimulus in the mid-1990s, as Posen (1998) has argued. Later, based on the incorrect presumption that the Japanese economy was returning quickly to its previous upward trend, the Japanese government, in April 1997, raised the consumption tax rate from 3 to 5 percent. From this point onward, the Japanese economy performed badly for the rest of the 1990s. The Asian currency crisis started during the summer of 1997. In the fall of the same year, a domestic banking crisis hit the Japanese economy, revealing the seriousness of the nonperforming loan problem. In 1998 and 1999, Japan experienced its worst recession since the first oil crisis in the early 1970s. To combat this sharp economic downturn, the government implemented a series of large fiscal stimulus packages in the late 1990s. All of these
packages, however, were smaller than advertised, were less than fully implemented, and allowed cuts in public investment (Posen 1998, Kuttner and Posen 2002).

Even this fiscal expansion came to an end as the economy started to improve and Junichiro Koizumi became the prime minister in 2001. Though Koizumi successfully ended the nonperforming loan problem in the first half of the 2000s, the debt-to-GDP ratio continued to increase throughout the 2000s. To cope with the global recession subsequent to the Lehman bankruptcy, the 2011 Tōhoku earthquake and its aftermath, the Japanese government increased its spending once again over the period 2009 to 2012, which caused a further deterioration of Japan’s fiscal situation. According to the International Monetary Fund (IMF), Japan’s gross

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Figure 2  Japan’s budget balance and gross/net government debt, 1977–2015

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Source: OECD Economic Outlook, No. 95, May 2014.
government debt to GDP ratio was only 12 percent in 1970. Twenty years later in 1990, it had increased to 67 percent. This ratio more than tripled in the subsequent two decades, reaching 215 percent in 2010.2

Japan’s fiscal deterioration is alarming in international comparison. As shown in figure 3, the debt-to-GDP ratio has risen much more rapidly in Japan than it has elsewhere—even in the troubled countries in the periphery of the euro area. According to OECD projections for 2015, Japan’s debt-to-GDP ratio will be 235 percent. For other developed economies, the corresponding numbers are: Greece, 193 percent; Italy, 146 percent; Portugal, 140 percent; the United Kingdom, 112 percent; and the United States, 107 percent.3

Figure 3     Gross debt-to-GDP ratios for selected industrialized countries, 1990–2019

3.2 Fiscal Sustainability

Japan’s debt-to-GDP ratio is exceptionally high relative to the peacetime experience of other developed countries and has now reached a point that has often been associated with the onset of fiscal crises. However, unlike some European countries, the Japanese economy has yet to feel the threat of a fiscal crisis in the form of high interest rates on government bonds. This reflects some of Japan’s fundamental attributes, including high

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2. We refer to the gross debt-to-GDP ratio rather than net ratios here, because they are readily available for international comparison. As Broda and Weinstein (2004) argued, however, the gross debt ratios significantly overstate the size of Japan’s net debt burden. The true number is probably close to 150 percent of GDP, which is still higher than any other developed economy except Greece.

3. According to Fukao (2012), Japan’s net debt/GDP ratio was 131 percent in 2011, which was lower than that of Greece at 153 percent, but higher than that of any of the other developed economies mentioned above. The net debt/GDP ratio is projected to increase to 200 percent in 2020 and 300 percent in 2038, incorporating the existing government plan to increase the consumption tax rate to 10 percent in the near future and without any further measures/restructuring. Under similar assumptions to those of Fukao (2012) and Braun and Jones (2012), the net debt/GDP ratio, which was 150 percent in 2012, will increase to 350 percent in 2038. See also Hoshi and Ito (2013, 2014).
private-sector savings, a high degree of risk aversion and home bias by Japanese savers, and strong domestic demand for Japanese government bonds (JGBs).

It can be argued that Japan should have increased its consumption tax rate much earlier. Given Japan’s demographics, even if the government and central bank had avoided all the other macroeconomic policy mistakes since 1990, the fiscal situation would not be significantly better than it is today. Tax increases alone, however, will not solve the problem. Simulation results reported by Fukao (2012) and Braun and Jones (2012) suggested that an increase in the consumption tax rate to over 20 percent, which would be comparable to that of the Scandinavian countries, would not halt further increases of its debt-to-GDP ratio. The recently implemented consumption tax rate hike from 5 to 8 percent (with a further increase to 10 percent planned for October 2015) will buy time, but stabilizing and reducing Japan’s debt-to-GDP ratio will eventually require major social security reforms as well, including significant reductions in public pension payments and medical expenditures.4

The rapidly aging population is part of the reason why Japan’s long-term interest rate has remained at its current low level. While European countries currently suffering from overt fiscal crises have been running current account deficits, Japan has run current account surpluses for more than 30 years, and has, as of 2012, accumulated over ¥600 trillion in foreign assets and a net international investment position of nearly ¥300 trillion. In addition, with 90 to 95 percent of JGBs held by domestic investors, pressure from foreign creditors has been minimal.

But as the aging of the population continues, the Japanese household sector will eventually start to dissave, and at some point the current account surplus will turn into a deficit.5 When that happens, the Japanese government will have to start borrowing from foreign lenders, possibly at a higher interest rate. Another possible scenario is that private savers decide that the Japanese government has lost control of the debt problem, so that they start to move savings into foreign assets and to sell domestic government bonds at the same time. This could trigger a selloff of JGBs, exacerbating the fiscal problems and increasing the risk of a financial crisis.

A drop in the value of JGBs would also have positive effects. This would almost certainly cause the yen to depreciate, boosting exports and increasing both GDP and tax revenues. This would ameliorate the fiscal situation, offsetting the increased debt burden caused by a rise in interest rates.

3.3 Discretionary Fiscal Policy during the Lost Decades

Why Have Fiscal Stimulus Packages Become Ineffective?

Despite the multiple fiscal stimulus packages during the 1990s and 2000s, the efficacy of fiscal policy in boosting Japanese economic growth has been hotly debated. While Kuttner and Posen (2002) found strong positive effects of (correctly measured) fiscal stimulus packages, the results of Ihori et al. (2003) and Ito et al. (2010) indicated that Japan’s fiscal multiplier has declined in recent years.

There are two reasons why it has been difficult to discern the effects of Japanese fiscal policy. First, as pointed out by Posen (1998) and to some extent acknowledged by Ihori et al. (2003), the total amount of fiscal expenditure has been exaggerated, with the true amounts being much lower. The Ministry of Finance (MoF) has used various accounting manipulations and rhetoric to inflate the “headline” numbers. Second, some economists have argued that Japanese households became conservative and precautionary, causing them to

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4. Fukao (2012) suggested that the consumption tax rate must be increased to 25 percent to stabilize the debt/GDP ratio in the near future. According to Braun and Jones’ (2012) calculations, the consumption tax rate must increase to 53 percent toward the second half of the 21st century in order to stabilize the net debt/GDP ratio, if it is the only policy tool that can be used.

5. As described in Iwaisako and Okada (2012), since the late 1990s, Japan’s private sector savings measured as a share of GDP have remained relatively constant, while the increased corporate savings have offset the decline in household savings. Corporate savings fell in 2006 and 2007 when Japanese firms started to increase their investment spending. However, after the global financial crisis, Japanese firms decreased their investment spending and reduced borrowing. As a result, corporate savings returned to higher levels from 2010 to 2012.
spend less of the money they received from increases in fiscal spending or tax reduction. Furthermore, because of ongoing globalization, Japanese households spend more money on imports, so some of the stimulus spending leaked abroad. The share of international trade, measured by the sum of exports and imports as a percentage of GDP, has been increasing over the past 20 years.\(^6\)

Another contributing factor to the perceived ineffectiveness of fiscal stimulus is the nature and timing of Japanese fiscal policy. The delay in decision making and policy lag undermine the effectiveness of fiscal expenditure. As argued by Hall (2009) and Auerbach and Gorodnichenko (2012, 2013), fiscal policy in the United States has tended to be more effective during times of crisis. However, compared with monetary policy, the response time of fiscal expenditure tends to be longer, especially at a time of crisis such as the domestic banking crisis in 1997–98, post-Lehman recession in 2008–09, and Tōhoku earthquake in 2011. This was relevant to the fiscal expansion under the Obuchi administration, and especially during the Mori administration at the beginning of the 2000s. Such ill-timed policies therefore led to further increases in the debt-to-GDP ratio, while having little stimulative effect. Another important aspect of the timing issue of fiscal stimulus is the coordination with monetary policy. We will return to this issue in section 4.

**Has the Productivity of Public Investment Declined?**

In addition to the explanations above, many empirical analyses suggested that the beneficial supply-side effects of public investment have weakened in recent years. These studies argued that Japan’s physical infrastructure was close to the saturation level, so that positive productivity spillovers to private sector investment and productivity diminished. While there is some truth to that characterization, if we look into the composition of public investment during the 1990s and 2000s, it also becomes apparent that two other problems have undermined the effectiveness of public investment. First, because of a combination of privatization and fiscal decentralization, local governments in Japan started to invest in and manage local transportation systems (railroads and buses), tourism, and other regional enterprises previously owned or heavily subsidized by the government. Most of such semiprivatized or corporatized public enterprises made substantial losses, and local governments eventually had to pay for those losses.

Second, public investments by the central government increasingly favored road construction over more public infrastructure. Most of the road construction budget was spent on roads in rural areas, with no serious assessment of the economic benefits. Instead, the main purpose of the so-called investment was to redistribute income from urban areas, such as Tokyo, to rural areas experiencing rapid population aging and decline. Without those unnecessary road construction projects, many local Japanese cities and villages could not provide adequate employment opportunities for their working-age populations. The evidence presented by Mitsui (2003) suggested that the marginal productivity of public investments in rural areas is much lower than in urban areas. Hoshi and Kashyap (2013) also argued that, based on the work by Doi and Ihori (2009), the bulk of public investment spending was in the areas with the lowest marginal productivities.

**3.4 Lessons from the 1997 Consumption Tax Hike**

The arguments presented so far seem to suggest Japan should have started fiscal restructuring much earlier. It is, however, not that simple. The debt-to-GDP ratio can increase either through issuing more government debt or through the slowing of GDP growth. In particular, recent experiences in the eurozone crisis strongly suggest that ill-timed and aggressive austerity does not work, as it lowers growth and tax receipts, as well as the long-term growth potential. Misguided austerity can increase net public debt as a result (as argued in Kuttner and Posen 2002) so the needed rise in consumption taxes, discussed above, must be spread over several years, and take into account the fiscal policy lag.

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\(^6\) The share of imports in GDP was 9.2 percent in 1990, 9.7 percent in 2000, and 16.4 percent in 2007. It had declined during the global recession subsequent to the Lehman bankruptcy, but bounced back to 17.1 percent in 2012.
account its short- and long-term impact on growth. In this light, the 1997 consumption tax hike was a mistake, especially given its coincidence with the Asian financial crisis and a worsening of Japan’s banking problems.

However, the consumption tax hike in 1997 was part of a policy package that began to be implemented in the early 1990s. The income tax rate was cut over the 1993–95 period, in a rather complicated process that included both permanent and temporary reductions. Because of the recession after the collapse of the asset bubble in the early 1990s, a scheduled consumption tax hike was delayed.

Still, the Japanese government’s decision to increase the tax rate in April 1997 was questionable. Figure 4 plots the diffusion index (DI) of corporate performance from a short-term corporate survey (Tankan) conducted by the Bank of Japan (the dark bold line denotes the DI for the overall economy). Its movement suggests that by the second half of 1996, the Japanese economy had bounced back to the same level of activity as in 1992. However, domestic economic conditions, denoted by the line with circles, tell a different story. First, immediately after the collapse of the asset bubbles at the beginning of 1990, domestic economic conditions had deteriorated much faster than those for the Japanese economy as a whole. Second, the recovery in 1996 was mainly a result of the improvement of external economic conditions. At its peak in the summer of 1995, the yen had strengthened by 40 percent relative to its 1990 level. It began to reverse in 1996, helping to restore the profitability of Japan’s export sector. However, the DI shown in the graph suggests that the domestic economy was still in deep trouble in 1996, and the government perhaps should have postponed the tax hike for another year.

![Figure 4](image_url)
4. SOME US-JAPAN COMPARISONS

4.1 Origins of Fiscal Problems in Japan and the United States and Future Paths for the Debt/GDP Ratio

As discussed in section 3.2, the most important source of Japan’s fiscal problems, symbolized by its ever-increasing debt/GDP ratio, is its rapidly aging population. Demographic change is one of the few variables for which economists can provide quite accurate forecasts. This means there is little that can be done about population growth.

However, there is another side to this issue. It is difficult to imagine that the population will decline until it reaches zero. As effectively argued by Broda and Weinstein (2005), it is more sensible to assume that this aging process will stop at some point in the second half of the 21st century and that the Japanese population will converge to a new steady state. If so, Japan’s debt/GDP ratio will be humped shape, not an explosive path.

The peak of the hump-shaped curve will be extremely high, most likely well above 300 percent. Thus the real issue for Japan’s fiscal sustainability is whether the Japanese economy and society can cope with such a high debt level, even if it eventually declines in the long run. In this regard, Japan is the frontrunner of the group of rapidly aging East Asian economies, including China and South Korea. If fast-growing African nations can continue their current growth miracle, they will also experience the same problem in the future. Those follower countries will face an even faster aging process than Japan, but (hopefully) will respond much more wisely after learning from Japan’s policy failures.

In contrast, the US debt/GDP ratio is at a much lower level and increasing relatively slowly. However, there is no obvious mechanism that will stabilize and hopefully reverse this trend, because population aging does not explain the deterioration of the US fiscal situation. Hence, strong economic growth and a drastic policy/institutional change will be the only way to solve the US fiscal problem.

4.2 Political Economy and Institutions

Consider these tales of two households. One couple struggles to come to an agreement on how much to spend on various expenses and has to have the same discussion every year, as the husband’s and wife’s priorities are in conflict with each other. As this couple has established a rule that nothing can be spent unless they both agree on it, water and electricity may be stopped, the children may not be fed, and stores in the neighborhood where the couple shops on credit are worried about whether or not they will get paid. This couple causes extreme difficulties to those around them, and around the same time every year, a stalemate occurs over the same issues.

As for the other couple, the husband has the authority to make the final decisions on spending, but it is the wife who really knows how much money they have. The wife always complains of financial hardship. However, if the husband says, “If the economy is bad, we should go out and eat something delicious to cheer ourselves up and get it going,” then she will reluctantly find the cash from somewhere, saying, “Honey, this is the last time, OK?” They also repeat this every year, and it is a wonder that they have not gone broke yet. This couple, however, does not bother those around them, as they always buy things with cash. Nevertheless, there is a rumor that if they ever go broke, they will have to sell their beautiful furniture, state-of-the-art home appliances, etc., and their neighbors secretly plan to bargain these things down to cheap prices.

These stories of the two households might be a little clumsy, but the former is meant to describe the fiscal situation of the United States, while the latter describes that of Japan. Although the possibility of a full-scale fiscal crisis is a domestic and international concern for both countries because of the debt that each government has accumulated, the impact of the fiscal problem on their actual economies is viewed differently. While the “fiscal cliff” problem in the United States is dealt with as a serious concern for the global economy, with
respect to Japan, the continuing low yields of JGBs are a mysterious phenomenon. As discussed in section 3, according to gross debt/GDP ratio, Japan’s fiscal situation is much more serious than that of the United States. Therefore, it is more important for Japanese to project what will happen to their own country if things continue as they are, instead of sitting on the sidelines and viewing the situation in the United States as “someone else’s problem” and as posing no flow-on risk to Japan.

One important institutional advantage of the United States over Japan is the transparency of fiscal information. Although the Democrats and Republicans have a habit of having similar fiscal debates every year, which is certainly a nuisance to others, at least the United States is in a situation where the parties recognize that a problem exists and are prepared to sit down at the bargaining table. In Japan, on the other hand, both the ruling and the opposition parties do not want to implement serious fiscal consolidation because of their goal of winning elections, although both claim to recognize the importance of fiscal reform in their rhetoric.

Second, in the United States, the amount of debt the government has currently accumulated and the amount of spending and tax revenues expected in the future are clear. In Japan, by contrast, it has become difficult to determine quantitatively the amount of necessary spending and the seriousness of the fiscal situation, as Japan’s fiscal investment and loan program (FILP) and pension system have become extremely complex. This has also given the politicians a reason and incentive not to bother looking into the seriousness of the fiscal problem. In other words, as a result of repeatedly fiddling with these systems through various piecemeal measures, even bureaucrats—those who are supposed to be familiar with these systems—now have only a vague understanding of the situation, particularly the state of the pension system.

Of course, the United States is also facing a serious problem. As it has a sort of built-in stabilizer, spending is automatically reduced when the fiscal situation deteriorates, which has far-reaching ramifications on areas that would be unthinkable in Japan, such as the police force, firefighters, and compulsory education. Provided that there are no other differences compared with Japan, this system, which would automatically cut spending in areas directly related to the safety and security of people’s lives, cannot be considered superior as a whole. However, it has its merits in that the public is forced to become aware of the seriousness of the fiscal problem through its own experience.

By contrast, if Japan one day finds itself in a situation that requires a serious reduction of spending on compulsory education, the police force, and firefighters, it will mean that the country has already passed the point of no return and is in a dire situation. A system in which people feel some pain before suddenly discovering that they have run into an irrevocable crisis without any advance notice is beneficial in its own way. Therefore, I would argue that it is no longer enough for Japan to make fiscal reform simply a nonbinding “target.” To prevent the economy from becoming a frog in the slowly boiling water of its deteriorating fiscal situation, it may be time for Japan to institutionalize strictly its reform so that policymakers will be forced to sit down at the discussion table by, first of all, tightly tying their own hands with a legal rope, in the Anglo-Saxon style.

4.3 Local Government Finance

An issue closely related to the topics discussed in section 4.1 but worthy of independent discussion is the institutional difference in local government finance in Japan and the United States. Historically, both political power and economic power have been much more concentrated within the central government in Japan than in the United States. Both the left wing and right wing have promoted more autonomy and independence among local governments for a long time. More recently, some self-claimed neoliberal politicians and social critics demand federalism and fiscal decentralization loudly as a part of their economic proposals. Thus, Japan can learn from the United States about the advantages and disadvantages of fiscal decentralization, particularly on the financial front.
The dismal state of affairs in California and some other US states illustrates that if fiscal sovereignty is delegated to a local government on a grand scale, the local government naturally has to take full responsibility for its own management failures. In Japan, the allocation of national tax revenues to local governments—a system called *chibo-kofuzei-seido* (literally means tax system for local distribution) in Japanese although it is not actually a *zei-seido* (tax system)—has been functioning as a mechanism for redistributing tax revenues from wealthy prefectures to poorer ones. If Japan fully pursues decentralization, it would face a situation in which the gap between rich and poor prefectures becomes unbearably wider unless the country creates a new redistribution system to which all regions agree in lieu of *chibo-kofuzei-seido*.

### 4.4 Tax System

As symbolized by the Reagan tax reform, global trends in the late 1970s and 1980s were favoring a flattening of income tax, while expanding the tax base by increasing revenue from indirect taxation such as sales taxes and consumption taxes. The tax system in Japan in the mid-1980s, on the other hand, relied heavily on revenue from income taxes that were much more progressive than in other developed economies. In this sense, the Japanese tax system at that time was rather outdated.

The major transformation process of the Japanese tax system started with the introduction of a consumption tax in 1989 and continued for nearly 10 years. Both the introduction of a consumption tax in 1989 at 3 percent and the tax hike in 1997 to 5 percent were parts of this process and associated with the permanent income tax cuts for households. In this sense, the tax hike in April 2014 was a very first permanent increase in the consumption tax without any offsetting of the permanent income tax cut.

The consumption tax hike in 1997 was the final step in Japan’s large-scale overhaul of its tax system in the 1990s. After the introduction of the consumption tax in 1989, a series of income tax cuts were implemented during the period 1993 to 1995. This was a rather complicated process including both temporary and permanent tax cuts. In summary, as shown in table 1, taken from Bessho (2010), the maximum income tax rate was reduced from 70 to 50 percent and the number of income brackets was reduced from 15 to 5, during the 10 years from 1985 to 1995. According to the calculation by Atoda et al. (1999), the average income tax rate of Japanese households fell from 9.2 percent in 1990 to 7.9 percent in 1996. Obviously, an offsetting increase in the revenue from the consumption tax had been part of the government’s (Liberal Democratic Party and the Ministry of Finance) plan from the beginning. The planned consumption tax rate hike was postponed and took place much later, in 1997, because of the severe recession following the collapse of the asset bubbles in the early 1990s.

Today, the Japanese tax system is more similar to that of the United States than it had been prior to 1990. One important policy implication of this change is that one of the distinctive policy tools the Ministry of Finance utilized during the period of fiscal recovery in the 1980s as described at the beginning of section 3.1 will not be as effective as it once was. With a much less progressive income tax schedule today, even if the Bank of Japan, led by Governor Kuroda, successfully attained and maintained a 2 percent inflation rate in the coming years, the strategy of leaving the nominal tax brackets unchanged would not increase income tax revenue as much as it did in the 1980s.

#### Table 1  Japan’s income tax system in transition

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<td><strong>Japan</strong></td>
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<td><strong>United States</strong></td>
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</tr>
<tr>
<td>Minimum rate (percent)</td>
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<td>Number of brackets</td>
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<td>14</td>
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*Source: Bessho (2010).*
5. CONCLUSIONS

In this paper, I summarized briefly the recent developments in the US and Japanese fiscal situations. In the second half of the paper, using the US experience as a benchmark, various aspects of Japan’s fiscal problem were discussed.

As a conclusion to this paper, I now discuss yet another fiscal problem faced by Japan today, which has emerged as a major issue recently following the Tōhoku earthquake in 2011. As discussed in section 3.3, a significant fraction of investment spending by the Japanese government was concentrated on road construction rather than more production-enhancing social infrastructure and industrial infrastructure such as railways, highways, or airports. The main purpose of such local road construction projects was the redistribution of income to rural areas suffering from rapid depopulation and aging, from rich urban areas such as Tokyo. Without these unnecessary road constructions, many rural areas could not have maintained adequate employment opportunities, and they may have turned into ghost towns in which only a small number of elderly people remained. Ultimately, however, when a declining birthrate and a rapidly aging population is a problem for the nation as a whole, such government spending aimed at income redistribution may slow, but definitely not stop, the depopulation and aging process in Japan’s rural areas.

Since the Tōhoku earthquake in 2011, this problem has been receiving considerable attention as a major policy problem requiring urgent action. From the viewpoint of economic efficiency, the elderly people living in sparsely populated rural areas that suffered extensive damage from the earthquake and tsunami should relocate to urban areas where they have better access to high-quality social services and healthcare. On the other hand, when considering the well-being of individuals, and the well-being of elderly people in particular, their wishes to stay in the communities they have lived in for the majority of their lives and where they have old friends and long-time acquaintances should be fully respected.

Politically, the problem is even more subtle. Politicians and the heads of local governments experiencing depopulation have incentives to prevent any further emigration of constituencies from their districts. As it is a matter of political survival, the wishes of the elderly people who want to remain in the area may receive preferential treatment. As a consequence, there are reasons to suspect that local governments used the funds they received from the central government for reconstruction inefficiently, investing too much in the reconstruction of damaged social infrastructure. As a practical matter, in the presence of such large differences in economic and social prosperity between regions, some inefficiency in local government expenditure in rural areas suffering from depopulation is unavoidable. However, there must be clear social limits too.

After the Tōhoku earthquake, maintaining aging social infrastructure under such severe fiscal conditions in a rapidly aging economy has become an important policy problem for Japan. The United States started to face the same problem of dealing with deteriorating social infrastructure as early as the 1980s. In this sense, the US experience will provide important lessons for Japanese policymakers, although the problem is more pressing and severe for Japan.
REFERENCES


Over the past two decades, the United States and Japan built an extensive network of free trade agreements (FTAs) with countries in the Asia-Pacific region but did not move forward with bilateral talks. Japan’s participation in the Trans-Pacific Partnership (TPP) marks the first such venture, albeit in the context of broader regional negotiations. Japan makes the TPP a big deal for the United States. Its GDP is the same as the combined total of the non-US participants. So from a US perspective, adding Japan doubles the size of the trading arrangement covered by the prospective TPP accord.

THE BASICS OF US-JAPAN TRADE

In 2012, Japan was the United States’ fifth-largest goods trading partner, with two-way trade (exports plus imports) of $220 billion. But bilateral trade has expanded relatively slowly over the past decade, with US exports to Japan growing on average just 4 percent and US imports from Japan on average 3 percent (see table 1). Moreover, since 2003, US-Japan trade has increasingly comprised a smaller share of total US trade. Indeed, while Japan was once the top US trading partner in the Asia-Pacific region, China has now usurped that role, and Korea has now concluded the most comprehensive FTA to date with the United States.

US and Japanese bilateral exports are concentrated in similar products, including electrical machinery, optic and medical instruments, and nuclear reactors (table 2). In 2012, aircraft and parts was the United States’ top export to Japan, while motor vehicles and parts was Japan’s top export to the United States. Importantly, the United States is the largest source of agricultural imports for Japan, supplying $20 billion or 21 percent of Japan’s total agricultural imports (see table 3). The United States ran an $80 billion deficit in merchandise trade with Japan in 2012 and a modest surplus in services trade of $17 billion.

Japan remains a top destination for the United States foreign direct investment (FDI) in the region, second only to Singapore. The market for FDI centers primarily in the finance and insurance, manufacturing, and wholesale sectors. In 2012, US FDI stock in Japan was $134 billion, which comprises just 3 percent of total US global FDI but 20 percent of total FDI in the Asia-Pacific (see table 4). By far, Japan is the most important source of FDI in the United States from the region. In 2012, the United States reported inward FDI stock from Japan of $308 billion, which accounts for 72 percent of total FDI from the Asia-Pacific. The primary targeted sectors include wholesale trade, manufacturing, transportation equipment, and finance and insurance.

Jeffrey J. Schott, senior fellow, joined the Peterson Institute for International Economics in 1983. This paper was presented at a conference held by the High-Level Working Group on Japan-US Common Economic Challenges, cohosted by the Peterson Institute for International Economics, the Sasakawa Peace Foundation USA, and the Sasakawa Peace Foundation Japan, at the Peterson Institute, Washington, June 2, 2014.
JAPAN’S CAUTIOUS TPP OVERTURES

In 2010, former Prime Minister Naoto Kan sought to accelerate Japan’s decision on whether to join the TPP talks, and began to develop strategies for garnering support and muting opposition from agricultural and other key domestic constituencies. Sadly, the Tohoku earthquake, tsunami, and nuclear disaster of March 2011 necessarily set back the timeline for Japan’s decision so the government could focus its efforts on a rebuilding strategy.

The Japanese government’s *Interim Report on Strategies to Revitalize Japan* (August 2011) recognizes these problems and recommends reforms over the following five years “to enhance the competitiveness and soundness of Japan’s agriculture, forestry, and fisheries” including “introducing more efficient distribution systems.” Some Japanese observers wonder whether it would be better to provide income support to farmers in lieu of trade protection. With the exception of rice, the cost of such transfers could be accommodated in the budget without too much difficulty—especially if recent tax changes succeed in generating additional revenues. Japan has already begun to implement reforms.

In October 2011, the US-Japan Business Council released a white paper supporting Japan’s participation in the TPP, emphasizing the positive benefits it would have on Japan’s economic growth by stimulating economic reforms in key areas that will “make the economy more dynamic and competitive, and a more attractive place to invest and operate.” The paper also emphasizes the importance of a realistic reform plan and timeframe. Two months later, Prime Minister Noda announced at the APEC summit in Honolulu that Japan would enter into consultations with current TPP participants to explore the possibility of joining the negotiations. It was not until March 2013, however, that the new Prime Minister Shinzo Abe actually requested a seat at the TPP table. After approval by all the current TPP countries, Japan became the 12th country to participate in the TPP when it entered the talks in July 2013.

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2. The Hawaii statement only expressed interest and did not formally ask to join the TPP talks (as Canada and Mexico did at the same meeting).

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### Table 1  US-Japan bilateral goods and services trade, 2003–13

<table>
<thead>
<tr>
<th>Year</th>
<th>US exports to Japan</th>
<th>US imports from Japan</th>
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<tr>
<td></td>
<td>Billions of US dollars</td>
<td>Percent share of total US exports</td>
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<tr>
<td>2003</td>
<td>81</td>
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<td>2004</td>
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<tr>
<td>Average over 10 years (2003–13)</td>
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n.a. = not applicable

Note: Figures for 2013 are preliminary estimates.

THE TPP IN A NUTSHELL

From the onset of the talks in March 2010, TPP countries have sought to craft what they call a “21st-century” trade pact. Their goal is to make it comprehensive in scope, covering policies that affect trade and investment in goods and services whether implemented at the border or through domestic regulatory policies. The TPP countries have been like-minded in their pursuit of this overarching goal. But these like-minded countries are not alike in terms of their size or level of development (see table 5), and each has its own specific negotiating priorities and political sensitivities that will need to be addressed in the final TPP deal.

The TPP is the most substantial trade agreement under negotiation in the Asia-Pacific region in terms of its economic footprint, depth of prospective trade liberalization, and scope of rule-making obligations. TPP countries now represent almost 40 percent of global output and 25 percent of world exports of goods and services. TPP’s “high standards” would create important new export opportunities, encourage inflows of foreign direct investment, and spur improvements in the quality of economic institutions and economic governance. Importantly, the TPP would promote more competition and investment in services, which in turn would spur productivity growth across the economy.

At the same time, TPP disciplines would impose binding constraints on specific policies often favored by politicians that provide preferences to domestic firms and restrictions on import competition. The rule-
making obligations would constrain the use of industrial policy measures that discriminate against foreign suppliers and investors, including via government procurement preferences. In that regard, disciplines on subsidies and other preferential policies favoring state-owned enterprises (SOEs) would be required to achieve competitive neutrality among public and private enterprises in the domestic market. In addition, the TPP probably will require effective implementation and enforcement of international obligations in areas such as labor, environment, intellectual property rights, and competition policy, which may also be subject to binding dispute settlement procedures.

Unlike many agreements among Asian countries, the TPP participants have committed to comprehensive coverage of agriculture, including eliminating tariffs and streamlining nontariff measures (NTMs) such as sanitary and phytosanitary standards. The TPP agreement aims to cover “substantially all” goods with the more import-sensitive products subject to a protracted liberalization schedule. For a narrow range of prod-

<table>
<thead>
<tr>
<th>Industry</th>
<th>Stock of US FDI in Japan</th>
<th>Stock of Japan FDI in the United States</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Billions of US dollars</td>
<td>Percent of global US FDI by sector</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>19</td>
<td>3</td>
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<tr>
<td>Food</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Chemicals</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Primary and fabricated metals</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Machinery</td>
<td>2</td>
<td>3</td>
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<tr>
<td>Computers and electronic products</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Electrical equipment, appliances, and components</td>
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<td>4</td>
</tr>
<tr>
<td>Transportation equipment</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Other manufacturing</td>
<td>7</td>
<td>4</td>
</tr>
<tr>
<td>Wholesale trade</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>Retail trade</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Information</td>
<td>6</td>
<td>4</td>
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<tr>
<td>Depository institutions</td>
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<tr>
<td>Finance and insurance</td>
<td>79</td>
<td>10</td>
</tr>
<tr>
<td>Real estate, rental, and leasing</td>
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<td>0</td>
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<tr>
<td>Professional, scientific, and technical services</td>
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<td>3</td>
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<tr>
<td>Other industries</td>
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<td>3</td>
</tr>
<tr>
<td><strong>Total industries</strong></td>
<td><strong>134</strong></td>
<td><strong>3</strong></td>
</tr>
</tbody>
</table>

Addendum

Total stock of US FDI in Japan (percent of total FDI in Asia-Pacific) 20

Total stock of Japanese FDI in US (percent of total FDI in US from Asia-Pacific) 72

n.a. = not applicable

Note: A zero indicates a value less than $500 million.

Like agricultural goods, manufactures are protected by an array of restrictions that benefit domestic industries such as automobiles, electronics, and clothing. The TPP negotiations aim to dismantle tariffs and liberalize NTMs that inhibit trade flows by inter alia introducing less-restrictive rules of origin and creating nondiscriminatory access to government procurement contracts.3

In services, negotiations are seeking to liberalize barriers to trade and investment across all modes of supply and will introduce new disciplines on foreign investment to ensure nondiscriminatory treatment and provide security and protection to foreign investors. Priority attention is being given to key infrastructure services like finance, insurance, telecommunications, air express delivery, and other transport services. The goal is to reduce restrictions on commercial presence and establish new disciplines on foreign investment to ensure nondiscriminatory treatment, security, and greater transparency (for example, by removing or reducing limitations on foreign ownership and giving foreign individuals and firms the right to provide cross-border services without the requirement to establish commercial presence).

3. US negotiators are still insisting on a “yarn-forward” origin rule for clothing. However, the TPP will include a special list of textile products not readily available that could be sourced from non-TPP countries and exempted from the origin rules.
The TPP will thus do more than grant preferential access to member countries. It will also create an extensive new trade rulebook with broad-ranging obligations on investment policy comparable or greater than those embodied in bilateral investment treaties (BITs) along with enforcement provisions such as investor-state dispute procedures. As such, the TPP investment chapter will be a “BITs-plus” accord, which should encourage flows of FDI.

The TPP rulebook also aims to include new disciplines on issues like SOEs, competition policy, environment, and labor, starting from existing WTO commitments and FTA obligations as a baseline for the negotiations. The “additionality” will come from WTO-plus provisions in areas not yet subject to WTO disciplines, FTA-plus provisions that augment existing FTA commitments, and development provisions to assist in enhancing human capital, technology transfer, capacity building, and assistance for small and medium enterprises (SMEs). The “plus” provisions will focus mainly on new issues that affect businesses and consumers. For example, the prevalence of significant SOEs in the economies of several TPP participants has prompted negotiators to focus on crafting new rules to level the playing field between private firms and SOEs, including new disciplines on the provision of public funds. The objective is not to force privatization but rather to ensure competitive neutrality between public and private firms in access to finance, factors of production, and distribution of goods and services in the marketplace.

Assuming a robust result with the usual modest dilution of reforms to secure the requisite political support for the deal, the TPP-12 could yield significant gains to output and exports of the participating countries once the deal is fully implemented. Table 6 summarizes the projected impact of the TPP based on the comprehensive work of Petri, Plummer, and Zhai (2014). Overall, the TPP should boost the GDP of member countries by $285 billion (in 2007 dollars) over baseline projections, or by 0.9 percent. Japan and the United States would account for $181 billion of that total or 63 percent of the combined gains of the 12 participating countries. Japan would be the largest gainer in dollar terms, with income gains of about $105 billion or 2 percent of GDP. Of course, to generate those gains, Japan has to undertake substantial economic reforms pursuant to TPP obligations on trade and investment in goods and services, including agriculture.

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Table 6   TPP: Prospective income gains in 2025

<table>
<thead>
<tr>
<th>Country</th>
<th>TPP-12</th>
<th>TPP-16</th>
<th>TPP-17</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>76.6</td>
<td>0.4</td>
<td>108.2</td>
</tr>
<tr>
<td>Japan</td>
<td>104.6</td>
<td>2.0</td>
<td>128.8</td>
</tr>
<tr>
<td>China</td>
<td>-34.8</td>
<td>-0.2</td>
<td>-82.4</td>
</tr>
<tr>
<td>Europe</td>
<td>-3.7</td>
<td>negl.</td>
<td>-4.9</td>
</tr>
<tr>
<td>Korea</td>
<td>-2.8</td>
<td>-0.1</td>
<td>50.2</td>
</tr>
<tr>
<td>World</td>
<td>223.4</td>
<td>0.2</td>
<td>450.9</td>
</tr>
<tr>
<td>TPP countries</td>
<td>285.0</td>
<td>0.9</td>
<td>572.6</td>
</tr>
</tbody>
</table>

negl. = negligible; TPP = Trans-Pacific Partnership

Note: TPP-16 includes Korea, Indonesia, Thailand, and the Philippines. TPP-17 adds China.

WHY JAPAN JOINED THE TPP NEGOTIATIONS

Japan’s participation in the TPP negotiations follows several years of intense debate among Japanese people and businesses over the benefits and risks for the Japanese economy of the prospective trade pact. Much of the Japanese debate over the TPP has focused on Japan’s traditional resistance to changes in its farm policies and the new competitive challenges facing companies in the services industry. Until recently, the debate gave short shrift to analysis of how Japan would benefit from the TPP.

For Japan, the TPP can advance important economic and foreign policy objectives. In many respects, these considerations are comparable to those that Korean officials weighed when deciding to pursue the KORUS FTA.

First, the TPP should help Japan advance its domestic economic priorities by spurring policy reforms that create a more attractive environment for new investment and enhance the competitiveness of domestic firms and workers. In that regard, TPP provisions should complement and reinforce the structural reforms put forward by Prime Minister Abe to boost productivity and stimulate higher growth in the Japanese economy. To be sure, some firms, workers, and farmers will face more competition, but TPP provisions will likely ensure that, for all TPP participants, the pace of reform will be moderated to facilitate the adjustment of those adversely affected. Overall, the TPP could boost Japanese GDP by more than 2 percent above baseline growth and generate double-digit gains in Japanese exports (see table 7).

Second, the TPP should support Japan’s policy of deepening trade ties with countries in the Asia-Pacific region and securing new arrangements with others where bilateral trade negotiations have not been successful to date. In that regard, the TPP provides a surrogate for long-vetted but never launched bilateral negotiations with the United States; the TPP effectively would deliver a US-Japan FTA. The TPP also finalizes deals that negotiators have to date failed to conclude with Chile, Mexico, Peru, and members of the Association of Southeast Asian Nations (ASEAN) as well as possibly the newly minted pact with Australia.

Third, the TPP is an important complement to other Japanese trade initiatives in the region, including trilateral talks with China and South Korea as well as the broader negotiation of the Regional Comprehensive Economic Partnership linking ASEAN with Japan, China, South Korea, India, Australia, and New Zealand. It also would establish an important pathway toward the longstanding goal of creating a Free Trade Area of the Asia Pacific (FTAAP) linking together the economies of the United States, Japan, China, and the other members of the Asia-Pacific Economic Cooperation forum.

Fourth, the TPP will provide Japanese firms and investors preferential treatment in TPP partner countries. In many cases, these benefits will help offset the discrimination that Japanese firms now face in some foreign markets due to trade pacts to which Japan is not a signatory. In particular, the TPP provides new advantages for Japanese firms that have faced some trade discrimination in the US market since the implementation of the KORUS FTA.

<table>
<thead>
<tr>
<th>Table 7</th>
<th>TPP: Japan’s prospective income and export gains in 2025</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Billions of US dollars</td>
</tr>
<tr>
<td>Income</td>
<td></td>
</tr>
<tr>
<td>TPP-12</td>
<td>104.6</td>
</tr>
<tr>
<td>TPP-16</td>
<td>128.8</td>
</tr>
<tr>
<td>RCEP</td>
<td>95.8</td>
</tr>
<tr>
<td>FTAAP-hybrid</td>
<td>228.1</td>
</tr>
<tr>
<td>Exports</td>
<td></td>
</tr>
<tr>
<td>TPP-12</td>
<td>139.7</td>
</tr>
<tr>
<td>TPP-16</td>
<td>202.5</td>
</tr>
<tr>
<td>RCEP</td>
<td>225.1</td>
</tr>
<tr>
<td>FTAAP-hybrid</td>
<td>423.1</td>
</tr>
</tbody>
</table>

TPP-16 = TPP-12 plus Indonesia, Korea, the Philippines, and Thailand; RCEP = Regional Comprehensive Economic Partnership, i.e., ASEAN countries plus six (Australia, China, India, Japan, Korea, and New Zealand); FTAAP-hybrid = Free Trade Area of the Asia-Pacific, i.e., consolidation of the TPP and Asian tracks to cover all 21 APEC economies

Note: All figures in constant 2007 dollars unless otherwise noted.

Fifth, and perhaps most importantly from a strategic Japanese perspective, the TPP deepens US engagement in the Asia-Pacific region at a time when both countries face continuing political and strategic challenges in Northeast Asia. Working together in the TPP for mutual economic benefit will also improve the already strong US-Japan relationship.

To be sure, Japan’s entry complicates the TPP talks but also makes a big deal more likely. Japan supports strong provisions on investment and intellectual property and should work with the United States and others to push for KORUS-like provisions in these areas. In addition, TPP countries will benefit from Japan’s liberalization of specific farm products and new trade and investment opportunities in the Japanese services market, though—to be sure—Japan is seeking to temper farm reforms for five key products and will ally with NAFTA countries in pushing a go-slow approach to dairy liberalization (discussed in detail below).

Japan maintains relatively high agricultural tariffs across product groups (see table 8). While the average MFN applied tariff for all agricultural products is 16.6 percent, peak tariffs can range from 189 percent in animal products to 692 percent in dairy products. Most of the TPP participants have been unable to wrest such concessions from Japan in bilateral talks; in essence, they are riding the coattails of the United States in gaining new access to the Japanese market. In return, they will likely be more flexible in responding to US requests for new TPP trade rules and market access reforms. And that in turn will allow US negotiators to commit to at least partial reforms in areas previously seen as off-limits.

### FINISHING THE TPP IN 2014

TPP ministers are engaged in intensive talks to craft the final deal. Resolution of the remaining sticking points could result in a political handshake in the coming months. Ongoing US-Japan bilateral talks are a key driver of efforts to conclude the TPP.

Uncertainty about the extent of agricultural market access in Japan has been a major bottleneck in the TPP negotiations. Several TPP participants, including the United States, need substantial new export opportunities in Japan for specific farm products to ensure domestic political support for the overall TPP deal. However, officials of Japan’s Liberal Democratic Party (LDP) have demanded that import restrictions affecting five groups of sensitive farm imports (rice, beef and pork, dairy, wheat and barley, and sugar) covering over 500 tariff lines should not be eliminated.

Contrary to numerous media reports, bilateral talks between US and Japanese officials in April 2014 in Tokyo achieved notable progress in balancing the political requirements of Japan and other TPP countries. While details are still being fleshed out, the basic framework of the US-Japan understanding seems to involve the following:

- Japan will commit to substantial reductions in tariffs on key products but may not fully eliminate all the tariffs.
- The most sensitive products will be subject to unusually long transition periods during which tariffs are phased down or out.
- Some products may be subject to only limited reform, or exempted entirely.

### Table 8  Japan’s agricultural tariffs

<table>
<thead>
<tr>
<th>Product group</th>
<th>Average MFN applied duty</th>
<th>Maximum MFN applied duty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Animal products</td>
<td>18.1</td>
<td>189</td>
</tr>
<tr>
<td>Beverages and tobacco</td>
<td>15.3</td>
<td>54</td>
</tr>
<tr>
<td>Cereals and preparations</td>
<td>27.5</td>
<td>610</td>
</tr>
<tr>
<td>Coffee and tea</td>
<td>16.1</td>
<td>182</td>
</tr>
<tr>
<td>Dairy products</td>
<td>89.6</td>
<td>692</td>
</tr>
<tr>
<td>Fruit, vegetables, and plants</td>
<td>12.5</td>
<td>337</td>
</tr>
<tr>
<td>Oilseeds, fats, and oils</td>
<td>11.0</td>
<td>580</td>
</tr>
<tr>
<td>Sugars and confectionery</td>
<td>27.5</td>
<td>93</td>
</tr>
<tr>
<td>Agricultural products</td>
<td>16.6</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

MFN = most favored nation; n.a. = not applicable

These terms suggest an implicit balance of concessions between US and Japanese farm interests. US officials place priority on opening new access for US exports of pork and beef, but have less political pressure to achieve gains on rice. In contrast, rice is the most sensitive product for Japan, so getting flexibility to manage rice programs should help Japanese officials agree to deeper reforms in other products. On dairy, the new US farm bill supplements already distortive protectionist policies, so US officials will likely tread lightly on efforts to open Japan’s market to limit their own exposure. Other TPP countries will continue to demand greater access to both US and Japanese dairy markets.

To be sure, no agreement was announced following the April meeting in Tokyo or subsequently; the terms above are merely speculative. Press reports assumed that the failure to announce a deal meant that the talks were a failure. But there was no way that US and Japanese officials could have done so, for two simple reasons: First, countries will commit to reform only their most politically sensitive products as a part of a final TPP deal that includes major benefits for other parts of their economy; and second, the deal has to be extended to the other 10 TPP countries, which want assurances that their priority exports such as dairy and sugar are included in the Japanese offer.

US and Japanese officials briefed the other TPP countries on the Tokyo talks during the meetings of the TPP chief negotiators and trade ministers in mid-May in Vietnam and Singapore, respectively. With an understanding about the terms of a “commercially relevant” package of farm reforms, TPP officials can then accelerate ongoing work on crafting landing zones for the remaining sticking points in the negotiations regarding inter alia rules on intellectual property rights, environment and labor, investor-state dispute settlement, and disciplines on state-owned enterprises. The next meeting of chief negotiators is scheduled for July 2014. A deal could be forthcoming later this year.

**IS TRADE PROMOTION AUTHORITY (TPA) NEEDED TO CONCLUDE TPP?**

To this point, the paper has not discussed what the United States would have to do as its part of the TPP bargain. Like Japan, the United States maintains high tariffs or nontariff barriers that protect sensitive farm products (e.g., sugar, dairy, cotton). In addition, while the average US tariff on manufactures is relatively low, there are a few notable peak tariffs on products such as footwear, apparel, and light trucks. The TPP deal will almost certainly require changes in existing US law and practice, and US trading partners are understandably concerned about the willingness of Congress to ratify and implement in a timely manner the prospective trade accord.

Will Congress pass new TPA? It was last voted by Congress in 2002 and expired in 2007. New TPA legislation was tabled January 2014 but was quickly side-tracked by partisan differences regarding (1) the coverage of sensitive issues such as intellectual property, labor, environment, and currency manipulation; and (2) the change in Senate Finance leadership with the departure of Senator Max Baucus. Demands to link TPA renewal to trade adjustment assistance have added fuel to the partisan fires.

TPA passage is certainly desired but not required before the TPP deal closes. With some reservations, US trading partners recognize that it is better to finish the TPP negotiations this year rather than delay talks pending congressional action on TPA. However, the TPP countries are unlikely to begin their domestic ratification procedures until Congress acts on TPA.

Prospects for the TPA vote in Congress will rest heavily on efforts of new Senate Finance Chairman Ron Wyden to craft revisions to the Baucus-Camp draft legislation that attract sufficient Democratic support without losing Republican votes. It won’t be easy, especially with midterm elections on the horizon. Senator Wyden’s priorities—free and open internet, labor rights, environmental protection, and countering currency manipulation—will surely complicate dealing with House Republicans. The timing of congressional action regarding TPA will depend critically on whether there is engagement this summer between the Executive branch and Congress on a revised draft of TPA legislation. If so, a vote could be possible either in a lame-duck session...
of Congress after the November midterm elections or early in the new Congress (i.e., February–March 2015). While some pundits argue that Republican gains in the midterm elections could derail TPA to prevent “giving Obama a legislative victory,” it is much more likely that US business leaders will pressure Republicans to act expeditiously and not delay TPA passage for political purposes. Meanwhile, TPP-TPA votes will likely proceed in parallel or close tandem.
Japan’s macroeconomic performance during the 1980s was nothing short of stellar. As shown in figure 1, the country enjoyed a rapid expansion in economic activity, with real GDP growth averaging 4.4 percent per year over the decade. Inflation was subdued, averaging 2.6 percent per year from 1980 to 1989. Moreover, except for 1986, when oil prices fell sharply, inflation remained in positive territory over the period. Then came the collapse of property price and stock market bubbles in 1990. The economy stagnated as GDP grew at a mere 0.8 percent annual rate from 1992 to 2001. Chronic deflation set in, with consumer prices falling on average by 0.3 percent per year from 1999 to 2012.

There has been a great deal of debate over the years about the extent to which Japan’s economic malaise was caused by insufficient spending, as opposed to long-term structural factors. To be sure, slowing population growth and decelerating productivity account for some of the slowdown. However, the fact that deflation accompanied economic weakness suggests that inadequate aggregate demand deserves a large share of the blame for the prolonged downturn. Monetary policy, normally the first line of defense against recessions, failed to arrest the economy’s slide into stagnation.

Section I of the paper summarizes the history of Bank of Japan (BOJ) policies from the period leading up to Japan’s Great Recession through the recently implemented policy changes under BOJ governor Haruhiko Kuroda. Up until the Kuroda regime change, BOJ policies were consistently characterized by conservatism and inaction. The bank was too slow to tighten policy during the four years leading up to the downturn. Symmetrically, it was slow to cut rates as the economy contracted in the early 1990s. While it took the steps necessary to contain the banking crisis in the mid-1990s, for years the bank resisted calls to implement quantitative easing policies that would have expanded its balance sheet. Even then, it made only token purchases of unconventional assets and limited its purchases of government securities to those on the short end of the yield curve.

Section II offers several explanations for the BOJ’s inertia in responding to deteriorating economic conditions. The four candidates, not mutually exclusive, are an irrational fear of inflation, conflicts with the finance ministry, the failure to recognize the severity of the zero lower bound, and concerns about the possible loss of independence. Section III discusses the lessons learned from the Japanese experience for the future direction of monetary policy.

KENNETH KUTTNER is the Robert F. White Class of 1952 Professor of Economics at Williams College. This paper was presented at the High-Level Panels on Japan-US Common Economic Challenges held at the Peterson Institute for International Economics, Washington, on June 3, 2014.
I. SIX PHASES OF JAPANESE MONETARY POLICY

Before the Bubble

The seeds of Japan’s economic malaise were likely sown years before the collapse of the bubble. Looking back, it is clear that policy was excessively expansionary during the late 1980s. This verdict is confirmed by Jinushi, Kuroki, and Miyao (2000), who showed that the bank’s call rate target remained well below the prescription of a conventional Taylor-style policy rule from 1987 through 1990.

What is puzzling is that the BOJ, as early as 1986, realized that policy was too loose during this period and recognized that it was contributing to unstable financial conditions. Carefully reviewing BOJ’s Monthly Bulletin, Jinushi, Kuroki, and Miyao (2000) documented the BOJ’s concern with financial excesses as manifested in asset prices and the money supply (M2 plus certificates of deposit [CDs]). And yet, in spite of these concerns, the BOJ failed to tighten monetary policy; indeed, it continued to cut rates in early 1987.

Jinushi, Kuroki, and Miyao (2000) cited political considerations as the primary reason of the BOJ’s inaction. International pressure was repeatedly brought to bear on Japan in late 1986 and early 1987 to bring down the value of the yen and promote consumption-led growth. These pressures resulted in a public pledge meeting by then finance minister Kiichi Miyazawa at the September 1986 IMF-World Bank meeting to increase domestic demand. This was followed in February 1987 by the Louvre Accord, which specified a 50 basis point reduction in the discount rate as a means to weaken the yen.

The BOJ began hiking interest rates belatedly in May 1989. The discount rate was raised five times within eight months, reaching 6 percent by August 1990. Inflation, which had increased from under 1 percent in 1988 to 2.5 percent in May 1989, continued to rise and remained in the 3 percent range in late 1989 and early 1990.
Interest Rate Cuts, 1991–95

The BOJ reacted to the economy’s deterioration with a series of cuts in the call rate beginning in July 1991. From a level of 8 percent in early 1991, the rate had fallen to half a percentage point by mid-1995. On the face of it, the policy rate reductions would appear to have been a forceful response to deteriorating economic conditions, comparable only to the decline in the interest rate in the mid-1970s. But the slow pace of the rate cuts, which were spread out over a four-year time span, along with a pronounced decline in the inflation rate, meant that monetary policy was not as expansionary as it would appear at first glance. As discussed in Harrigan and Kuttner (2005) and Posen (2010b), the BOJ’s actions were less decisive than the measures taken by the Fed during the recessions that began in 2000 and 2007.

Figure 2 illustrates this point. The thick line in panel (a) shows the path of the BOJ’s nominal call rate during the eight quarters prior to and the 16 quarters following the commencement of the rate cuts. Allowing for the lower initial level of the nominal interest rate in the United States, the BOJ’s response in 1991–95 appears qualitatively similar, if somewhat more gradual, to the Federal Reserve’s during its two most recent easing cycles.

The real interest rate is a better gauge of monetary policy than the nominal rate, however, and once inflation is taken into account the BOJ’s response looks significantly less decisive. As shown in panel (b), inflation in Japan fell by two percentage points during the same 1991–95 period depicted in panel (a), implying a smaller reduction in the real rate. In contrast, US inflation remained steady in the early 2000s and fell by only one percentage point following the financial crisis.

The paths of the inflation-adjusted policy rates are shown in panel (c). The thick line shows that the monetary easing effectively ended in mid-1992, only four quarters after the peak. The real interest rate remained in the 1.5 to 2 percent range until 1995, a level only modestly below conventional estimates of the equilibrium real rate of interest. Jinushi, Kuroki, and Miyao (2000), Kuttner and Posen (2004), and Harrigan and Kuttner (2005) argued that it is hard to reconcile this level of interest rates with the implications of standard monetary policy rules, which would have called for more aggressive rate cuts in response to falling inflation and the deceleration in real GDP growth.

The BOJ’s response looks especially timid in comparison with the Fed’s reaction to the previous two recessions in the United States. The Fed’s aggressive rate cuts in 2001 led to a near-zero real rate by the end of the year, and the rate remained there for the following three years. The sharp rate cuts are especially striking given the fact that while the US economy experienced a period of slow growth from 2002 through 2003, the 2000–01 recession was itself quite mild, not unlike Japan’s 1991 downturn.

Responses to the Banking Crisis, 1995–99

Interestingly, the Japanese financial system did not experience significant financial stress until several years after the beginning of the macroeconomic downturn. Burdened with trillions of yen in worthless real estate loans, the dire conditions of the jusen became increasingly apparent in 1995, and plans to bail out those institutions began to be formulated later that year. Two prominent events during this initial phase of the crisis were the closure of Kizu Credit Association and the rescue of Cosmo Credit and Hyogo Bank in August 1995. It was only at this point, five years into the downturn, that the BOJ was forced to intervene in the financial markets and exercise its authority as lender of last resort. The BOJ responded to banks’ deteriorating conditions with a series of ad hoc credit extensions, under Article 25 under the old BOJ law, and the provision of temporary fund-

1. The real rate is calculated using the previous four quarters’ inflation rate. The consumer price index (CPI) excluding food and energy is used for Japan, and the personal consumption expenditure (PCE) deflator excluding food and energy is used for the United States. Note that the ex ante real rate in Japan would have been even higher to the extent that the disinflation was anticipated.
Figure 2  Bank of Japan and Federal Reserve responses to the 1991, 2001, and 2008 downturns

a. Nominal policy interest rates

Source: OECD Main Economic Indicators and author's calculations.
ing to the Deposit Insurance Corporation. A selected chronology of the events in Japan is given in table 1.

The November 1997 closure of Yamaichi Securities, and the collapse of Hokkaido Takushoku Bank, marked a new, more perilous phase of the crisis. While not a core part of the Japanese financial system, Hokkaido Takushoku’s failure in particular was regarded as a major shift in Japanese policymakers’ response to financial distress.2 The decision to allow the bank to fail marked an end to the government’s goso-sendan-boshiki (“convoy”) policy in which troubled banks were kept alive through mergers with stronger institutions. The market response was dramatic, with the so-called Japan premium spiking to nearly 70 basis points. At the same time, the share of borrowers in the Tankan survey reporting tighter credit conditions swung 30 percentage points, from -15 to 15 percent.

The next milestone was the passage of bank rescue legislation in October 1998. Half of the bill’s $500 billion appropriation provided funds for recapitalizing distressed banks. The remaining $250 billion financed a blanket guarantee of bank deposits and provided for the possible nationalization of failing institutions. The bill was the largest bailout effort up to that point, although there was some skepticism that it would be enough to solve the long-term problems facing Japan’s largest banks. The bill did, however, make possible the government takeover of failing banks: Just days after the bill’s passage, Long-Term Credit Bank was nationalized, followed by Nippon Credit in December of the same year. In spite of these failures, the Japan premium fell sharply following the introduction of blanket deposit insurance.

The BOJ took a number of incremental steps to regularize its provision of liquidity in the months following the bank rescue bill. In November 1998, the BOJ announced an expansion of its short-term lending against commercial paper collateral, and its intention to establish a lending facility specifically designed to

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2. The second-tier brokerage firm Sanyo Securities also filed for bankruptcy in early November, resulting in the first default in the unsecured call loan market.

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**Table 1  Chronology of key Bank of Japan policy actions, 1996–2013**

<table>
<thead>
<tr>
<th>Action</th>
<th>Announcement (Implementation)</th>
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</thead>
<tbody>
<tr>
<td>Cosmo Credit, Hyogo Bank and Kizu Credit</td>
<td>August 1995</td>
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<tr>
<td>Emergency loan to Tokyo Kyodo Bank</td>
<td>April 1996</td>
</tr>
<tr>
<td>Lending to Deposit Insurance Corporation</td>
<td>September 1996</td>
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<tr>
<td>Emergency loan to Hanwa Bank</td>
<td>November 1996</td>
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<tr>
<td>Introduction of repo operations</td>
<td>October 1997</td>
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<tr>
<td>Emergency loan to Kyoto Kyoei Bank</td>
<td>October 1997</td>
</tr>
<tr>
<td>Failures of Yamaichi &amp; Hokkaido Takushoku, emergency loans</td>
<td>November 1997</td>
</tr>
<tr>
<td>Emergency loan to Tokuyo City Bank</td>
<td>November 1997</td>
</tr>
<tr>
<td>Emergency loan to Fuji/Yamaichi</td>
<td>November 1997</td>
</tr>
<tr>
<td>Lending to Deposit Insurance Corporation</td>
<td>February 1998</td>
</tr>
<tr>
<td>CP operations for repos</td>
<td>November 1998</td>
</tr>
<tr>
<td>Temporary Lending Facility to Support Firms’ Financing Activities</td>
<td>November 1998</td>
</tr>
<tr>
<td>Zero interest rate target</td>
<td>August 1999</td>
</tr>
<tr>
<td>Expansion of eligible collateral</td>
<td>September 1999</td>
</tr>
<tr>
<td>Lombard facility</td>
<td>March 2001</td>
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<tr>
<td>Quantitative easing</td>
<td>March 2001</td>
</tr>
<tr>
<td>Stock purchases</td>
<td>October 2002 (December 2002)</td>
</tr>
<tr>
<td>ABS purchases</td>
<td>June 2003 (August 2003)</td>
</tr>
<tr>
<td>Reaffirmation of LOLR function</td>
<td>March 2005</td>
</tr>
<tr>
<td>End of quantitative easing policy</td>
<td>March 2006</td>
</tr>
<tr>
<td>Introduction of pooled collateral</td>
<td>April 2006</td>
</tr>
<tr>
<td>Suspension of stock purchase program</td>
<td>October 2008</td>
</tr>
<tr>
<td>Resumption of stock purchase program</td>
<td>February 2009</td>
</tr>
<tr>
<td>Comprehensive monetary easing</td>
<td>October 2010</td>
</tr>
<tr>
<td>Quantitative and qualitative monetary easing</td>
<td>April 2013</td>
</tr>
</tbody>
</table>

ABS = asset-backed securities; LOLR = lender of last resort; CP = commercial paper
Source: Based on Kuttner (2010).
“support firms’ financing activities.” It also announced plans to study change in operating procedure, in which funds would be lent against pooled collateral, ultimately backed by corporate bonds and loans on deeds. It announced in September 1999 an expansion in the range of collateral to include assets such as bank debentures and corporate bonds. Those guidelines were subsequently modified, and generally relaxed, in a series of steps over the next several years.

**Unconventional Policies, 2001–05**

Responding to weakening economic conditions, the BOJ resumed its rate cuts in late 1998, first with a reduction in the call rate to ¼ percent, and then to virtually zero.³ This marked the beginning of the zero interest rate policy (ZIRP), which also involved some tentative efforts to influence expectations of the path of future policy. Specifically, the minutes of the policy board meeting of April 9, 1999, released a month later, stated that “it was important to maintain the current decisive easy stance of monetary policy, firmly underpinning economic activity until deflationary concerns were dispelled.” (Fourteen years later, the Fed would take a similar approach in its use of “forward guidance.”)

The BOJ’s highly expansionary setting of short-term interest rates was, however, undercut by the statements of senior officials—especially by those of then–BOJ governor Masuru Hayami. In the most notorious of these, a speech given on March 21, 2000, Hayami contended that Japan’s deflation was beneficial, or at least benign, and argued strenuously against policy measures intended to combat it. In reference to an explicit inflation target, Hayami stated that “such a proposal is tantamount to artificially creating inflation ... at any cost.”

The ZIRP came to an abrupt end on August 11, 2000, when the BOJ increased the call rate target to ¼ percent. The policy board cited the “improvement of the economy” as a factor in its decision, but said nothing about deflationary pressures. Long-term Japanese government bond (JGB) rates fell steadily during the six months following the rate hike, suggesting a further decline in inflation expectations. Kuttner and Posen (2004) identified this as the most distinct of several “deflation scares” occurring over the 1996–2003 period. Orphanides (2004) likened the BOJ’s August 2000 rate increase to the Fed’s disastrous policy tightening of 1937, which is widely blamed for extinguishing the incipient recovery that was taking place at the time.

The BOJ reversed itself in early 2001 with the reduction of the call rate, in two steps, to zero. On March 19, the BOJ announced a change in the main operating target to the outstanding balance of current accounts (CABs), initiating its policy of quantitative easing. The central element of this policy was the introduction of a steadily increasing target for CABs, along with an expansion in the range of assets eligible for purchase by the BOJ. The policy change was accompanied by a stronger form of forward guidance, in the form of an announcement that “the new procedure will be kept in place until the CPI [consumer price index] registers a stable zero percent or increase year-on-year.” The specificity of this statement made it a much more explicit effort to influence expectations than the less-precise “until deflationary concerns were dispelled” statement that accompanied the initial ZIRP.

The additional liquidity was provided through a combination of increased short-term collateralized loans, along with outright purchases of JGBs, which more than tripled to 1.2 trillion yen per month by October 2002. The JGB purchases were largely at the short end of the yield curve, however, and thus not designed to reduce long-term interest rates (unlike the Fed’s third round of quantitative easing [QE3] and Operation Twist policies). McCauley and Ueda (2009) documented that the average maturity of the bank’s portfolio of government bonds actually fell from nearly six years in 2001 to less than four years in 2005.

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³. While not literally a zero call rate target, the ZIRP was implemented by way of a new guideline for money market operations that called for the Bank of Japan to “provide more ample funds and encourage the uncollateralized call rate to move as low as possible.”
The BOJ supplemented its policy of CAB targeting and JGB purchases with two new programs aimed at providing additional stimulus. One was a policy of outright equity purchases, announced in October 2002 and implemented in December of the same year. The stated purpose of the program was to free banks’ balance sheets of the burden of equities, which would presumably make them more willing to extend new credit.

Another unconventional policy, announced in June 2003 and implemented in August of the same year, was the purchase of asset-backed securities (ABS), presumably in an effort to increase credit supply. According to the press release, its purpose was to encourage “…the development of the ABS market by directly taking credit risks through purchases of ABSs as a temporary measure. By encouraging the development of the ABS market through this unprecedented scheme for a central bank, the bank could strengthen the transmission mechanism of monetary easing against the background of banks’ weak financial intermediary function.”

These two programs accounted for very little of the increase in the volume of credit extended by the BOJ, however. The much-publicized stock purchase plan never amounted to more than 2 trillion yen, or 1.4 percent of the bank’s assets. The ABS purchase program had only a trivial impact on the bank’s assets, with a maximum of 291 billion yen, or 0.2 percent of the balance sheet. The largest contributors by far to the expansion of the BOJ’s balance sheet were the liquidity-provision programs put in place in the 1990s and the JGB purchases that commenced in 2001 (figure 3).

In three key respects, the BOJ’s actions during the postbubble years differ starkly from the Fed’s reaction to the 2007–09 crisis. First, the BOJ’s response was much more gradual. Significant quantitative easing policies began a full ten years after the initial downturn, whereas the Fed took action within six months of the business

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**Figure 3**  **Bank of Japan’s balance sheet, 1992–2009**

- **Cosmo etc.**
- **Takushoku**
- **Hokkaido**
- **Rescue package**
- **Quantitative easing**

**Source:** Bank of Japan.
cycle peak. To be fair, the Fed’s alacrity is to some extent the result of the rapid deterioration of financial conditions—Japan’s banking crisis began four years after the bursting of the bubble. Still, the economy endured ten years of stagnation before the BOJ began to enact unconventional policies.

Another important difference is that the BOJ’s policies focused exclusively on the level of CABs, using short-term liquidity provision and purchases of relatively short-term JGBs to achieve its targets. There were no significant private-sector asset purchases, nor were there any policies designed explicitly to reduce spreads or lower long-term bond yields. In contrast, the Fed’s policies emphasized the asset side of the balance sheet rather than the liability side, the quantity of total reserves. This involved very large purchases of privately issued securities, especially commercial paper and mortgage-backed securities (MBS). From the outset, the intention of these “credit” policies was to replace the funding that had previously been provided by private investors, thus reducing the spreads. As discussed in Posen (2010c), this reduction in spreads gives investors an incentive to reallocate their portfolios towards higher-yielding and riskier assets. In addition, unlike the BOJ, the Fed completely sold off its inventory of treasury bills and lengthened the average maturity of its holdings, particularly with the implementation of Operation Twist and QE3 (discussed below).

**Unwinding and Rewinding, 2005–12**

The unwinding of these various credit and monetary measures began in 2005, as deflation receded and the economy began to show signs of a more sustained recovery. In that year, the Deposit Insurance Corporation lifted the blanket guarantee of bank deposits, and the BOJ suspended its ABS purchases. The quantitative easing policy came to an end in the spring of 2006, and CABs fell rapidly from its January 2006 peak of 33.6 trillion yen to 7.5 trillion yen as of November 2007. While inflation continued to hover around zero, the economy managed to maintain a respectable rate of real GDP growth of roughly 2 percent from 2004 through 2007.

The onset of the 2007–09 global financial crisis cut the recovery short, however. The BOJ belatedly (but no more so than many other central banks, including the European Central Bank) cut the policy rate target in early 2009 from 0.5 to 0.1 percent. GDP shrank by 1 percent in 2008 and 5.5 percent in 2009.

Once again confronting a recession and constrained by the zero lower bound, in October 2010, two years after the Lehman failure, the BOJ enacted a set of policies it referred to as comprehensive monetary easing. Besides setting a target of 0 to 0.1 percent for the uncollateralized call rate, the policy entailed the purchase of several classes of assets other than the usual menu of government securities and collateralized lending. These included commercial paper (CP), asset-backed CP (ABCP), corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs). At first glance, this had the appearance of a bold step, similar to the asset purchases implemented by the Fed in 2009. The quantities involved were minuscule, however. As of December 2012, the BOJ had purchased only ¥2 trillion of CP, ¥1.5 trillion of ETFs, and ¥3 trillion of corporate bonds. Each represented less than 2 percent of the bank’s total assets, which then stood at ¥158 trillion. There was no significant increase in the rate of government bond purchases and consequently acceleration in the growth of CABs.

Unsurprisingly given its position at the epicenter of the financial crisis, quantitative easing (QE, which the Fed prefers to call large scale asset purchases or LSAPs) was carried out much more aggressively than in Japan. One difference is that QE began more quickly, with large-scale purchases of privately issued MBS commencing in February 2009 as part of QE1. QE2, which involved large-scale purchases of treasuries, followed in 2010. Both measures greatly expanded the Fed’s balance sheet, as shown in figure 4. Operation Twist, which lengthened the average maturity of the Fed’s portfolio, and QE3, which established a program of purchasing $40 billion a month in MBS and $45 billion per month of long-term treasuries, were both launched in 2012.
The most decisive shift in BOJ policy did not come until January 22, 2013, more than two decades after Japan’s economy slid into recession. Under pressure from the newly elected Abe government, the bank finally announced an explicit inflation target of 2 percent and committed to open-ended monetary easing.4

Three months later, the bank released further details of what it referred to as a policy of Quantitative and Qualitative Monetary Easing. One element of the policy is to set a time horizon of two years for the achievement of the target announced in January. A second is a much more rapid expansion of the monetary base, at a pace of ¥60 trillion to ¥70 trillion per year. Third, rather than limit JGB purchases to the short end of the yield curve, the bank extended the maturity of the bonds purchased, its first explicit effort to bring down long-term interest rates.5 The policy also entails purchases of ETFs and J-REITs, but the quantities involved (1 trillion and 30 billion, respectively) are comparable to those of the comprehensive monetary easing policy under Masaaki Shirakawa and remain quite small relative to the size of the bank’s balance sheet.

The BOJ’s balance sheet has grown spectacularly since the adoption of the policy. As shown in figure 5, the bank’s total assets have grown from ¥163 trillion in February 2013 to ¥225 trillion as of early 2014. (The “other” category consists largely of short-term liquidity measures, such as loans made against pooled collateral.)

4. Prior to the announcement, the BOJ framed its intention in terms of its “understanding of medium- to long-term price stability,” as defined by the individual policy board members. The midpoint of the board members’ “understanding” was a 1 percent annual rate of inflation.

5. The maturity extension required the suspension of the so-called banknote principle, which limited the purchase of long-term securities to the amount of currency in circulation.
Most of this growth has come through increases in the purchases of long-dated JGBs, and the average maturity of the bank’s portfolio of government securities has risen from less than three years to more than seven.

Just as important, the bank’s communication changed dramatically with the appointment of Haruhiko Kuroda as governor. In his public statements BOJ governor Kuroda has reiterated the seriousness of the bank’s commitment by downplaying the risk of inflation getting out of control and by pledging to use any tools necessary to achieve the inflation target. In fact, the April 2013 announcement stated explicitly that one of the goals was to “drastically change the expectations of markets and economic entities.”

Kuroda’s rhetoric differs starkly from that of his three predecessors, who often emphasized the risks associated with expansionary policy and lamented the lack of effective tools for combating deflation, as noted by Posen (2010b). Taken together, these policies are a sharp break from previous BOJ policy. Prime Minister Shinzo Abe was not exaggerating when he hailed the move as a “regime change” in monetary policy.

II EXPLANATIONS FOR BOJ CONSERVATISM

The fundamental lesson from Japan’s experience of the past 20 years and the 2007–09 global financial crisis is that periods of severe economic and financial stress call for extraordinary monetary policy measures. Why, then, did the BOJ act so deliberately even as the economy slid into deflation?
Underestimating the Importance of the ZLB

One hypothesis is that members of the policy board simply were not attuned to the risks posed by the extraordinary shocks the economy experienced in the 1990s. One such shock was the sharp decline in asset prices, and the financial stress caused by the resultant balance sheet effects. Subsequent research has shown (or reminded us) that recessions precipitated by financial crises call for policies that are considerably more interventionist than in normal times.

In extreme cases, it may be appropriate for the central bank to temporarily resuscitate significant parts of the financial system through the direct provision of credit. This is essentially what the Fed did with its support of the CP and MBS markets, where the buy side of the market simply evaporated. Referring to this form of support as “credit easing,” Bernanke (2009) drew a distinction between this set of tools and conventional monetary policy and traditional liquidity provision as part of the central bank’s lender of last resort function.

Another aspect of the first hypothesis is that the BOJ was slow to recognize the possibility of deflation and the constraints on policy imposed by the zero lower bound (ZLB) on nominal interest rates. These issues were relevant to the 1930s, of course, but by the early 1990s these were viewed as curiosities and relegated to the footnotes in macroeconomics textbooks. It took Paul Krugman’s (1998) paper to bring the ZLB issue back into policymakers’ consciousness. In the absence of a sharp contraction (year-over-year real GDP growth never fell below –1 percent during the 1990–93 recession), it is perhaps understandable that BOJ policymakers should not have taken the ZLB possibility into account. The BOJ was not alone in that regard. Research conducted in the 1990s by Federal Reserve economists, such as Fuhrer and Madigan (1997), suggested that the deleterious effects of the ZLB were relatively modest.

The 2007–09 global financial crisis forcefully demonstrated that ZLB was a far more serious problem than either the BOJ or the Fed realized in the 1990s, and was not an idiosyncratic Japan-specific phenomenon. Subsequent research, such Hess et al. (2012), suggests that the relatively sanguine view of the ZLB may have been unduly influenced by the absence of large adverse shocks during the “great moderation” period in the United States. If nothing else, the post-2007 experience shows that policy needs to be more aggressive when there is a risk of hitting the ZLB. Blanchard, Dell’Ariccia, and Mauro (2010) suggest that the ZLB threat may call for an inflation target in excess of the 2 percent adopted by most advanced-economy central banks.

Unfounded Fears of Inflation

A second hypothesis is that the BOJ leadership clung to erroneous beliefs about ideas about the causes and risks of inflation. As discussed in Bernanke (2000), Blanchard (2000), and Posen (2000), there seems to have been a self-induced paralysis at the BOJ, and at times a mistaken belief in the real benefits of tighter credit conditions.

A 2000 speech by then-governor Hayami encapsulated this mindset. Perhaps reflecting a Cagan-style model of unstable inflation dynamics, he hypothesized that any increase in the target inflation rate would destabilize inflation expectations,

The point that “inflation is most likely uncontrollable once triggered...
Some argue that [the Bank of Japan] can raise the inflation rate to 2 or 3 percent and then contain it around that level...However, if we tried to contain inflation after it had gained momentum, we would need very strong monetary tightening.”
This view clearly flies in the face of the experience of other industrialized countries, most of which had successfully targeted and maintained inflation rates of roughly 2 percent.

In addition to exaggerating the risk of inflation instability, BOJ officials apparently failed to recognize the potential benefits of a positive inflation target. In the same 2000 speech, Hayami asserted that because increasing inflation would not have stimulative effects, it was not a solution to Japan’s economic problems. In fact, there seems to have been sympathy for the view that in the case of Japan, falling prices were a manifestation of “good deflation.”

These concerns receded over time, with BOJ officials recognizing that the rapid increase in current account balances posed no risk of inflation. Then-governor Shirakawa conceded in a 2011 interview that the proposition that “inflation is always and everywhere a monetary phenomenon” had been proven wrong by Japan’s experience.6

Fear of Loss of Independence

A third hypothesis is that the BOJ’s aversion to aggressive action had its roots in political considerations. One aspect of this centered on the fiscal implications of purchases of private-sector securities, such as ABS, which were purchased in only very small amounts. As then–deputy governor Yutaka Yamaguchi put it in 2001,

The basic rule in a democratic society is that fiscal policy using taxpayers’ money needs to be approved as part of a budget by a parliament composed of members elected by the people. [A policy of purchasing private-sector assets] should be discussed publicly in the context of governance in a democratic society.

Ueda (2003) raised similar concerns, arguing that capital losses—and in extremis insolvency—would undermine the bank’s independence. More generally, Cargill, Hutchison, and Ito (2001) argued that the BOJ found itself in an “independence gap” that led it to resist external advice, particularly that coming from the finance ministry. This, in turn, inhibited the adoption of more innovative and aggressive policies. The BOJ is likely to have been especially sensitive to the independence issue, having just been granted an enhanced degree of independence with the passage of the New Bank of Japan Law in 1997.

Noncooperative Policy Games

A fourth hypothesis is that suboptimal monetary policy was the outcome of a noncooperative game between the BOJ and the finance ministry. Hoshi (2014) argued that the BOJ’s reluctance to continue ZIRP resulted from concerns that doing so would reduce the pressure for financial restructuring. Underlying this view is the assumption that aggressive monetary policy, in the form of very low interest rates or direct credit extensions, would allow insolvent (“zombie”) firms to survive. Since the survival of firms would reduce the efficacy of monetary policy, the central bank would like the financial supervisor to close or restructure the zombies—but this is costly for the regulator. Hoshi showed how the central bank and the regulatory agency can fall into a trap with insufficient restructuring and an overly contractionary monetary policy. Posen (1998) identified this belief on the part of Japanese macroeconomic policymakers early in the Great Recession and summarized the evidence against monetary tightness causing the right firms to close.

6. Apparently oblivious to the Japanese experience, some prominent economists, including Allan Meltzer and Martin Feldstein, have warned about the threat of inflation in the United States created by the expansion of the Fed’s balance sheet.
A variation on this theme is that aggressively expansionary monetary policy would enable reckless fiscal policy. BOJ policymakers, such as Hayami (2000), raised this objection from time to time.

III LESSONS FOR THE CONDUCT OF MONETARY POLICY

Japan’s monetary policy during the lost decades and the international experience after the 2007–09 financial crisis call into question several tenets of the prevailing central banking framework. The three key elements of the conventional framework are: (1) policy is implemented exclusively via the short-term policy interest rate, (2) the central bank should be fully independent from the elected government and finance ministry, and (3) there should be no attempt to coordinate monetary with other (fiscal, regulatory) policies.

It has become abundantly clear that there is more to monetary policy than the short-term overnight interest rate. Debt management—changes in the maturity distribution of central banks’ portfolio of government securities—is a potentially useful tool, one that was largely neglected by the BOJ during the lost decades.\(^7\) Purchases of securities other than government debt have proven to be effective in reducing private-sector interest rates. And there has been renewed interest in noninterest rate policy instruments, such as reserve requirements, maximum loan-to-value ratios, etc., as tools to dampen the sorts of asset price bubbles that ultimately led to Japan’s economic malaise.

Equally dubious is the assumption that government involvement in the policymaking process is inherently bad. This long-held view of monetary policy, which was formalized in the highly influential work of Barro and Gordon (1983), assumes that governments pressure the central bank to generate surprise inflation in an ultimately futile effort to artificially boost output. Independence insulates the central bank from government pressure, the thinking went, thereby mitigating inflation pressure.

In this context, the removal of Shirakawa and his replacement in April 2013 with Kuroda, a former finance vice-minister with close ties to Prime Minister Abe, could be viewed as a blatant attempt to impose the government’s will on the BOJ, which would presumably have inflationary consequences.

Japan’s experience shows that coordinated fiscal-monetary stimulus in extreme times may be necessary. As argued in Posen (2010a), strong government oversight of central bank goals over a multiyear period, and voluntary policy cooperation by the central bank in pursuit of those goals, does not harm and can enhance monetary credibility. In this context, succession of Shirakawa in April 2013 by Kuroda has rightly been seen as a regime shift but has not caused a collapse in confidence or surge in inflation.

This interpretation is consistent with the key distinction between goal and instrument independence. Following Debelle and Fischer (1994), Bernanke et al. (1999, 38) argued for goal dependence in inflation targeting, on the grounds that it would “maximize central bank accountability while still leaving the ultimate goals of policy to be determined at least in part by democratic processes.... This strategy calls for the inflation targets themselves to be set by a political process in which the central bankers consult with the appropriate legislators or ministers.”

The experience of inflation-targeting central banks suggests that there is nothing to fear from government involvement in the setting of monetary policy goals. Among advanced economies, seven of the eight countries with formal inflation targets have those targets set either unilaterally by the government or in cooperation with the government. (Sweden is the sole exception.) There is no evidence to suggest that these countries either set higher inflation targets or allow inflation to systematically overshoot the targets. To the contrary, Flood and Isard (1989) and Lohmann (1992) argued that government involvement is desirable to the extent that it allows an inherently conservative central bank to be overridden in dire economic circumstances.

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7. To be fair, the prevailing wisdom was that debt management was ineffective, a conclusion that was based largely on the small Operation Twist experiment from the US 1960s. More recent research by Bernanke, Reinhart, and Sack (2004) and Kuttner (2006) indicated that debt management could in fact affect the term structure of interest rates.
IV CONCLUDING REMARKS

Fourteen years ago, Ben Bernanke (2000) described the BOJ’s hesitance to cut interest rates and failure to commit to aggressively expansionary policy as a case of “self-induced paralysis.” The BOJ adopted incrementally more activist measures over the years. To its credit, the bank pioneered some of the policies that would later be adopted by the Fed. These included quantitative tools, such as the large-scale purchase of government securities and efforts to guide expectations through the announcement of policy targets.

These policies were generally “too little, too late,” however. The rate cuts in the early 1990s were gradual. It took ten years for the bank to commit, even halfheartedly, to a zero interest rate policy. Quantitative easing focused on liquidity provision, eschewing the purchase of long-dated government securities and private-sector assets. Expansionary policies were prematurely reversed. Communication emphasized the risks of forceful policy, not the benefits. It was not until Kuroda’s appointment in 2014 that the BOJ’s Hooverian conservatism was replaced with Rooseveltian resolve.

Since we will never observe the counterfactual, it is impossible to know how the Japanese economy would have performed had the BOJ reacted more decisively to the postbubble downturn. But there is little doubt more assertive policies would have helped. Long dismissed as a footnote in intermediate macroeconomics textbooks, recent research has shown that the problems created by the zero lower bound justify aggressive actions. Moreover, the experiences of both Japan and the United States show that the risks of unconventional policy are minimal. Or as Roosevelt put it, “there is nothing to fear but fear itself.”
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Transcript of the public seminar held at the Peterson Institute for International Economics on June 3, 2014, on current policy regarding the Trans-Pacific Partnership (TPP), fiscal sustainability, and slow growth.

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Adam Posen: Good morning ladies and gentlemen. In the interest of courtesy to our global network of podcast and live-stream watchers we will start roughly on time. I’d like to welcome you to the special joint event between the Sasakawa Peace Foundation [Japan], Sasakawa Peace Foundation USA, and the Peterson Institute for International Economics.

My name is Adam Posen; I’m the President of the Peterson Institute. And it’s been our pleasure here to host for the last day-and-a-half a distinguished group of economists and former policymakers and mostly economists who were former policymakers from both sides of the Pacific and our high-level group focusing on common challenges to the United States and Japan. We’ve had a very fruitful couple days of discussion and while we’re not here to inundate you with grand and banal proclamations, we hope to share with you and our audience abroad the spirit of some of our discussions and some of the specific points we raised, both on the real and reform sides of the economy and on some of the monetary and macro fiscal issues.
But first I’d like to call upon retired Admiral Dennis Blair, who is now chairman of the Sasakawa Peace Foundation USA, to say a few remarks about our intent and what we’ve done. Dennis, thank you.

Dennis Blair: Thanks very much Adam for hosting this fine event and thanks to all of you for joining us to launch the public part of this high-level working group on Japan-US economic challenges. And we’re delighted to cosponsor this project with the Sasakawa Peace Foundation in Japan and with the Peterson Institute and to work again with Adam Posen; he’s done just a terrific job as the president of PIIE, such an important organization. And of course he has a distinguished reputation as one of America’s leading experts on Japan’s economy. So wonderful leadership and thank you Adam.

And we’re also delighted that our cochair from the Japan side, Professor Motoshige Itoh, is not only a preeminent economist but also a long-time advisor to many prime ministers and notably Prime Minister Abe, who is now trying to take so many dramatic measures in the economic life of Japan.

At Sasakawa, we decided to launch this new initiative because it’s been really more than 15 years since the last important trek to bilateral economic dialogue and it’s really time to discuss the common economic challenges and common economic aspirations of the United States and Japan.

And I’d like to set these economic discussions in the slightly larger security context, because we are at an important—I’d really go further and say a critical—juncture in the development of East Asia, which is the economic power, and growing power center of the world. For 60 years, it’s been a combination of American military power. It’s huge and ever growing consumer market. Japan’s economic development, its overseas development assistance, these have really been the pillars under which East Asia has developed so dramatically, both economically and politically. And now these pillars are in question. China has been challenging American political influence, American military domination in the region. The US market notably turned down a few years ago and it’s only barely recovering. Japan has been in a period of economic stagnation for 20 years.

So the big pieces of the tectonic plates are moving in the security architecture of East Asia and the United States and Japan, the largest and third largest economies in the world; very powerful military forces. Similar democratic values need to work together in order to move into the next phase because security and economics are and always have been intertwined. And while the United States and Japan neither can nor desire to go back to that old formula that worked for the past 50 years, they have to restore sustainable economic growth in both countries and cooperatively in order to maintain and rebuild a strong political and military policy that will support our shared vision for that part of the world, which includes a peaceful, prosperous democratic free-trading Asia benefiting all of the citizens of the region.

So it’s an important time and it’s important that Japan and the United States talk together at the informal as well as the formal levels and figure out the way forward. If Japan and the United States are working together I firmly believe we can make Asia’s future even better than its past. If we don’t we risk all of that.

And the issue at the center of concern now, working together, is the Trans-Pacific Partnership (TPP). We’ll hear some more about it in one of our panels, but the group spent quite a bit of time discussing the economic and the political factors that are involved. But of course, there’s more than just narrow economic and political factors at play in the TPP. The larger significance of it is to establish together with the other countries that are working in the TPP negotiations, a set of economic relations that really will support that prosperity, freer trade, higher standards on the economic issues of the future, the important issues: intellectual property rights protection, labor standards, the role of state-owned enterprises. It’s really getting this framework right that will be the key to a brighter future. And if the US-Japanese negotiations broke down on an issue like say, pork, when these huge wider issues are at stake, which will really determine the future of the region and potentially of the world, I don’t think that history would forgive us.
There’s a matter of timing; each country has its own politics, each country has its own domestic interests, which it must work through, but I think we have to keep our eyes on the prize here and ensure that we are moving forward and reach that goal. It’s so important to both our countries and to the regions.

So with that, let me turn the podium over to Motoshige Itoh, who has a few words to say and then I think we have our panel starting.

Motoshige Itoh: Thank you very much for giving me a few minutes to talk about this new project. About 25 years ago I was invited to the meeting here in the Institute to have a kind of a forum between the American economists and Japanese economists, to talk about various issues between the two countries. At that time the most heated discussion was trade conflicts on automobiles and integrated circuit. So times have changed, but there are still many things we have to discuss between the two countries and many new issues are coming up. So I’m very glad we can restart this kind of dialogue and I hope we can provide a better output from our discussion. And so thank you very much for coming to the public seminar today.

Dan Bob, Sasakawa Peace Foundation USA: We want to kick off this morning’s event with a first panel, which is going to be focused on trade and competitiveness. And as the other speakers have mentioned, we had a really good set of discussions yesterday and today about a range of issues. A lot of time was spent on trade and competitiveness, particularly on TPP.

And we’re going to begin today’s panel asking Professor Itoh to come back and give a few thoughts. For those of you who are not familiar with Professor Itoh, he is a professor at the Graduate School of Economics at the University of Tokyo, where he formally served as dean. And importantly, he’s on the Council on Economic and Fiscal Policy, which gives direct advice to the prime minister and the cabinet on major economic issues, including on the third arrow in the reforms that will be taking place in Japan.

Our second speaker will be Bob Lawrence from Harvard. He’s the professor of trade and investment at the Kennedy School of Government, and previously served on the Council on Economic Advisors, and is a non-resident fellow here at Peterson Institute.

And then we have with us also Hideichi Okada, who is currently the senior advisor to NTT Data Institute of Management and Consulting, but previously served as vice-minister at METI for International Affairs from 2010 to 2012. And before that was director-general of Trade Policy at METI. And batting cleanup for us will be Jeff Schott, who’s the trade guru here at PIIE; been here since 1983, but among many other things, has taught at Princeton and Georgetown and wrote a book in 2012 on understanding TPP.

So my understanding is each of the panelists will come here to speak, because we’ve got a presentation up there. But when all the panelists are finished we’ll take Q&A from up there. So if I could turn it back to Professor Itoh.

Motoshige Itoh: Thank you very much. We just discussed so many issues and I’ll try to highlight some of the aspects I am familiar with. Because we have an expert on TPP and competitiveness in this session, I’d rather just focus on “Abenomics,” which may be a very good starting point.

As you know, after Prime Minister Abe took office, he introduced various drastic measures, which surely has surprised the market. And now everybody is talking about what the next stage of Abenomics is. And obviously the so-called third arrow is very important.

Before talking about the second stage of Abenomics, I have to say the performance of the Japanese economy after Mr. Abe took office was more than I expected in the beginning. Let me point out a few economic indicators like inflation rate. As you probably know, we have been suffering from deflation. It’s now constantly
increasing and reaching a level of the 2.0 percent, I hope. And the unemployment rate was about 5.5 percent. It’s now 3.6 percent, which is almost close to what we call full employment. And the growth rate for the fiscal year of 2013 was more than expected; it was something like 2.5 percent, which is very high. And profitability, you probably know is very good, so everybody now in Japan is expecting an increase in wages and bonus, which will also be very important to stimulate the economy, as well as many other areas. So far so good (see figures 1 and 2).

But the question is: What is coming next? And I think it is very important to think very carefully; what’s the sequence of the process of the policy influence on the economy? The sequence is very important. And there are two missing words when people talk about economics. One missing word is time-lag and the other missing word is demand-supply distinctions.

Now let me first talk about time-lag, because Mr. Kuroda, the governor of the Bank of Japan, was so successful to surprise the market. So everybody is now talking about what is coming next from Bank of Japan. And of course that is very important, but you have to go back to university to remember what you are taught, there is a time-lag between the timing of the introduction of the policy and the timing of the effect on the economy. Especially in the case of Japan, just stopping deflation is a very important element to discuss the process of the [impact on] real economy.

We often talk about the concept of the real interest rate. During the period of deflation, remember what happened is inflation rate is minus 1.0 percent. A nominal growth rate is something like minus 1.5 percent.
And the interest rate was very low, but the real interest is very high and so no investment, no expenditures. Under deflation, the best thing is to invest on cash.

Now what happened is the consumer price index is moving towards 2.0 percent, nominal growth rate is moving towards 3.0 percent, and nominal interest rate is still very low. So obviously, it has a very strong influence on the investment and household consumption behavior. And the interesting thing is just how market expectations responded to this kind of change of atmosphere very quickly after Mr. Kuroda started the [monetary easing] process. So you probably know, for example, expected inflation rate just revealed in the market indicator in the price index form, just moved very quickly. But when it comes to the behavior of ordinary business people, manufacturers, exporters or ordinary people, it takes some time for them to realize now Japan has a very different process of inflation. Wages are increasing, which pushed up prices and so forth.

So we will see a visible influence on real economic activity from now on. For example, the investment by corporate sector has jumped up rapidly.

The second important thing is the distinction between demand and supply sides. Everybody is talking about the supply side because the growth rate is surprising. But the important thing is it takes some time for supply side policy to have an influence on the real economy. We need labor market reform, but it will have an effect on employment and economic performance maybe in 2 or 3 years. We need reform of our agricultural sector; it is very effective to enhance our competitiveness. But again, that kind of policy [needs] some time to just be realized in actual competitiveness.
So there’s some kind of missing link between the immediate effect of monetary policy and the very long-term effect of supply side policy. So what happens is demand side.

The third arrow of Abenomics is not growth strategies—it is the growth strategies that promote private investment, and they’re different. When you say just growth strategies, it implies supply side policy. But when you say the growth strategy that promotes private investment, have that a lot of implications for the demand side.

Japan suffered a lot from 20 years of economic stagnation and very weak demand. That was not very good for us, but there is at least one good thing. That is, we actually corrected the balance sheet problems. So household sectors, corporate sectors, banking sector corrected the balance sheet problem, overdebt or overborrowing, and now they have a huge amount of cash. The problem is they are not using this cash.

I once had a very interesting discussion with a famous businessperson in Japan, Mr. Son. He’s the president of SoftBank. Japanese people know him very well because he decided to buy Sprint-Nextel of the United States, and it is one of the biggest purchases by a Japanese company of an American company. And surprisingly he borrowed about 75 percent of the money for investment from banking sectors. So it’s a very risky investment. And I was on this TV program and he came to my program and I asked him, “Are you okay with this kind of very risky project?” And his answer was very interesting; he said, “I am a boy.” I don’t know whether this [makes sense in] English or not; that means the problem for Japan is not lack of money, lack of financial resources; the problem for Japan is the lack of the business people who take risks to make investment.

So in that respect we have a lot of opportunity if we can agitate the business community to move forward. And that is the important part of stopping the deflationary mindset.

So I think the government’s growth strategies have a very interesting combination of the very important supply side reform, which will provide sustainable growth in the future, but at the same time change the mindset of the business community to make them invest more. So this is very important timing.

And the government I think now increasingly recognizes the importance of this combination: demand side—supply side. You probably know what kind of a supply side policy or growth strategy policies are discussed in Japan. And to name a few, I have several very important examples: corporate tax reform, reduction of corporate tax rate, or TPP, which will be discussed by other presenters after me; also very important timing. Not only is the trade negotiation important but also it will be very important timing for us to change our mindset for agriculture policies and other policies.

And also, the government is now working very hard to attract more foreign direct investment to Japan, which will also provide a lot of opportunities for our economy, including increasing the participation of female workers, which has a very strong support by the Japanese people because we have to do a lot of things to have more participation of workers and so on and so forth. But the important thing is there is no magic to the supply side. So what is important is you have to do as much as you can do so that you can have a collective result of the supply side policy and more important thing is change the mindset of the Japanese business community, Japanese people, and also oversee investment in Japan.

So I want you to have more focus on the demand side of the Japanese economy; it’s changing from now on. I’ll stop here and ask the other people to talk about more of the contents of the present policy. Thank you very much.

Dan Bob: Thanks Itoh Sensei, that was terrific. And now we’re going to turn to Bob Lawrence, who’s going to give a more direct talk about TPP in three scenarios.
Bob Lawrence: Well thank you very much. Yes, TPP is still a work in progress; it’s under negotiation. And as I listen to the debates about it I hear three contrasting views. And I believe there’s an element of truth in each of these views. Ultimately, the negotiations and their implementation will tell us what mix of these three views actually turns out to be correct.

The first is the view which was given to us, actually most prominently by the policymakers themselves who are implementing the program. They’re offering this Trans-Pacific Partnership as a solution, both to the needs of Japan internally, when it comes to structural change—indeed it has been pointed to as a key component of the third arrow of structural change within Japan—as well as a response to the needs of both Japan and the United States, for a global economy that is better suited to the needs of the emerging supply chains and multinational firms that operate in that economy.

The multilateral trading system essentially has been at an impasse. It has failed to produce the kinds of agreements which relate to deeper international integration that the multinational corporations have called for and has been unable to do so basically because there’s a split among its members and unanimity is required for an agreement.

One group of members, you can call them “The Willing,” are really eager to see agreements on foreign investment, to integrate with respect to common standards, or reconciling differences in national standards. And I think it’s because what they seek is a governance structure which allows firms to be truly global. On the other hand there are a group of countries, some major emerging economies, who believe that it’s in their interest to have more interventionist domestic policies and indeed to protect their domestic economies. And so it’s been impossible to get an agreement at Doha. Nonetheless, those who are more interested in deeper integration have moved regionally. And the TPP and indeed the TTIP [Transatlantic Trade and Investment Partnership] are manifestations of this drive to negotiate agreements that can deal, not only with tariffs, but with the behind-the-border barriers, which are essential to the operation of these arrangements.

I would also point to a second major trend which relates to the desire of those concerned about the environment, to those concerned about labor standards, to have these issues included in a trade agreement. And the TPP also is likely to respond to their demands. So from one vantage point, this is an agreement which has deep consequences for the global trading system, which is likely to also have geopolitical consequences. It raises the issue of if these countries can join, if Korea and others join too, what kind of pressures will be placed on China? So from all of these vantage points this is an agreement with great potential, provided it can be negotiated in sufficient depth it could really transform the global trading system.

So that’s the positive spin, that’s the positive scenario. But there’s a second view, again with some elements of truth, which says that actually there are considerable political problems facing the negotiation of this agreement and people who raise questions about whether the agreement is going to go far enough. Particularly when it comes to Japan, major issues relate to the question of agriculture. The structural needs of the Japanese economy, I think everyone agrees, require a major opening and restructuring of the agricultural sector. But the normal political responses have been to resist that opening and the talks that have been embroiled in discussions over the details of tariff structures and so on, which are quite understandable but nonetheless, not really compatible with the view that what is needed is deeper structural change.

On the American side there are a fair number of people who oppose these agreements in principle. And there’s a serious issue about whether even if an agreement is negotiated, it’s actually going to get passed by the US Congress. Trade Promotion Authority, which the President proposed in his State of the Union Address, was immediately rejected as an issue for this year’s legislative agenda. And so it’s quite natural that there’s a skeptical view about these agreements.

And then there’s a third question and I would characterize this as the stumbling blocks view of these agreements, as opposed to the positive spin which is being given about building blocks. This is an agreement
that after all will reflect the political driving forces in the group of countries who are in the room. And the question is whether they negotiate an agreement that can in fact be used as a model or as a building block for others to join. If we do include issues like labor standards and environment in the agreement, if we do have particular deals which we cut within the context of that negotiation, will it then be possible for the large emerging economies like India, or like China in particular, simply to sign up and join on the same terms? Or in fact, will we see the evolution of a world economy in which there are the standards makers and the standards takers; those who are able to agree with each other and others who’ve been excluded with major negative consequences, not only for their own interaction, but also for the multilateral trading system?

So I just wanted to present those three pictures. As I say, I think we need to be mindful of all three. What we need to have is an agreement that’s negotiated, that can genuinely deliver on the potential for structural transformation, on the market opening potential, and on the provision of governance that are required for global integration. At the same time, I think we need also to be mindful of the need to construct an agreement that can genuinely serve as an integrative and building block arrangement, rather than one that actually fragments the global economy.

So with those three reflections I look forward to my colleagues’ interactions to hear which of those they feel is most likely. Thank you.

**Dan Bob:** Thanks Bob, that was great. And now we’re turning to Hideichi Okada, who will talk a bit about regional integration and supply chains.

**Hideichi Okada:** Thank you for your kind introduction Bob Dan and good morning everyone. I’m Hideichi Okada, and it’s a great pleasure to be here at the First Annual US-Japan Economic Dialogue, jointly hosted by Sasakawa Peace Foundation and the Peterson Institute for International Economics.

First of all, I would like to express my deep appreciation to the Sasakawa Peace Foundation for its effort to try to revitalize various policy dialogues between Japan and the United States in a wide variety of areas. I’m also thankful to its dedication to keep encouraging a policy dialogue between the two countries made [possible] by the Peterson Institute for International Economics.

Let me start with this slide (figure 3). This shows the trade flows among Japan, China, ASEAN countries, United States, Canada, Mexico, and European countries. The size of arrows represents the volume of trade and the color of arrows indicates the weight of intermediate goods, such as parts and components in those trade flows. Dark blue represents 70 percent or more, purple 60 percent, blue 50 percent, green 40 percent, orange 30 percent, and yellow less than 30 percent. This chart tells you that Japanese exports are mainly parts and components to China and ASEAN countries. And then these countries export finished goods to the United States and Europe.

So as you see in Asia, horizontal division of labor beyond the border has been highly developed. And it seems to me that the United States is becoming an important part of this supply chain. And these internationally intertwined supply chains in the Asia-Pacific have been and will be supported by the efforts to develop regional economic integrations as shown in this slide.

Let me [turn to] the lower left-hand side corner of this slide (figure 4). ASEAN-10 countries have been playing a very active role to establish ASEAN-plus FTAs with China, Japan, Korea, India, and Australia and New Zealand. And it is quite natural to think about setting up 10 plus 6 FTAs instead of 5 ASEAN plus 1. So China proposed 10 plus 3 arrangement in 2003, and Japan proposed 10 plus 6 arrangement in 2006. And then it finally ended up with the idea of a regional comprehensive economic partnership or RCEP, and in 2012 16 heads of states announced their decision to start negotiation.
The launch of the negotiation of China, Japan, and Korea (CJK) FTA on the upper left-hand side corner of figure 4 was announced in 2012, November 2. Xi Jinping has been refusing to meet with Prime Minister Abe since Abe took office. And recently there have been no bilateral meetings between government officials from Japan and China, but the negotiation on CJK trilateral FTA is an exception. Officials from the three countries have had four rounds of negotiations as of now.

The upper right-hand side of the slide indicates TPP, when Japan finally joined the negotiation in July of last year. Japan and the United States are major trading countries and share the goal to further enhance economic growth and expand regional trade and investment through strengthening the rules-based trading system. It is important for Japan to have a high-standard regional FTA arrangement with Asia-Pacific countries, including the United States, when business has been developing highly integrated supply chains, as [shown on] the previous slide (figure 3).

Some of my friends in China told me that it looked to them that TPP was a part of the US strategy to exclude China from the free trade structure in the Asia-Pacific, but I do not agree with that idea. As you know, in 2011 at the APEC Summit in Yokohama, all the leaders of APEC economies, including Chinese leaders, agreed that their future final goal is to build a free trade area in Asia-Pacific or FTAAP, which was originally proposed here in this building; both RCEP and TPP were two possible pathways to their ultimate goal of FTAAP. I’m very pleased to learn that recently China has shown its strong interest in TPP.

Now let us take a look at the comparison of the tariff rates of certain products among major countries. It is well known that the tariff rate on rice in Japan is extremely high, but however, when you look at the other tariff rates on vegetables and fruits, such as spinach, carrots, and lemons, Japanese tariff on those agricultural goods is not so high compared to the other countries (table 1). And as you know, Japanese tariff on industrial goods is almost zero. There is the famous [US] demand [for] 25 percent tariff on pickup trucks.
**Figure 4  Regional economic integrations in East Asia**

**China-Japan-Korea**

**RCEP**

**5 ASEAN+1s**

**TPP**

**FTAAP (APEC)**

ASEAN = Association of Southeast Asian Nations; RCEP = Regional Comprehensive Economic Partnership; TPP = Trans-Pacific Partnership; EAFTA = East Asia Free Trade Area; CEPEA = Comprehensive Economic Partnership for East Asia; FTAAP = Free Trade Area of the Asia Pacific

### Table 1  Tariffs by products of major countries, 2011 (percent)

<table>
<thead>
<tr>
<th>Product</th>
<th>Japan</th>
<th>United States</th>
<th>European Union</th>
<th>South Korea</th>
<th>China</th>
<th>Australia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rice</td>
<td>*778.0</td>
<td>11.2</td>
<td>0.0</td>
<td>5.0</td>
<td>65.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Spinach</td>
<td>3.0</td>
<td>20.0</td>
<td>10.4</td>
<td>27.0</td>
<td>13.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Carrots</td>
<td>3.0</td>
<td>13.9</td>
<td>13.6</td>
<td>0.0</td>
<td>13.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Lemons</td>
<td>0.0</td>
<td>0.8</td>
<td>12.8</td>
<td>30.1</td>
<td>11.0</td>
<td>0.0</td>
</tr>
<tr>
<td>TVs</td>
<td>0.0</td>
<td>4.7</td>
<td>14.0</td>
<td>8.0</td>
<td>30.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Automobiles (medium size)</td>
<td>0.0</td>
<td>2.5</td>
<td>10.0</td>
<td>8.0</td>
<td>25.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Trucks</td>
<td>0.0</td>
<td>25.0</td>
<td>10.6</td>
<td>10.0</td>
<td>25.0</td>
<td>5.0</td>
</tr>
</tbody>
</table>

* = 3.4 US dollars per kilogram.
During President Obama’s visit to Japan in April, the two leaders also talked about TPP and they committed to taking bold steps necessary to complete a high-standard ambitious comprehensive TPP agreement. They announced that “they had identified a path forward on important bilateral TPP issues,” and also said “that it marked a key milestone in the TPP negotiations, and would inject fresh momentum into the broad topic.”

The GDPs of Japan and the United States account for 80 percent of total GDP of the TPP-12 countries. Every country in the negotiation is watching very carefully what’s going on between Japan and the United States. I strongly believe that speed of the negotiation and the content of the agreement between Japan and the United States are very important because they create a momentum for the whole negotiation and also set the standard of the ambitiousness of the whole agreement. Between Japan and the United States the two countries share most of the points on rural issues. The major areas for negotiation right now are market access on autos and certain agricultural products. I think it’s hard negotiation, but I’m very respectful of negotiators from both countries for their hard work to try to forge out a win-win solution to this very important 21st century agreement.

And two weeks ago, when trade ministers from the 12 countries gathered in Singapore, it seems to me that the recent bilateral negotiation between the United States and Japan in late April created a new momentum among other negotiating member countries for promoting and advancing the negotiations.

I will not touch on Abenomics and its third arrow, but as Professor Motoshige Itoh pointed out that now Prime Minister Abe is focusing on promoting the third arrow, the growth strategy, to encourage private investment (figure 5). Key elements of these initiatives are deregulation in the area of energy, welfare, medicine, labor, agriculture, creation of a national strategy special zone, reduction of corporate tax, increasing women’s [participation] in the workforce, and so on. Though critics say the speed and level of accomplishment are not adequate, I believe that things are heading in the right direction.

**Figure 5  Abenomics and economic recovery**

<table>
<thead>
<tr>
<th>Three Arrows</th>
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<tbody>
<tr>
<td>1. Aggressive Monetary Policy</td>
</tr>
<tr>
<td>2. Flexible Financial Policy</td>
</tr>
</tbody>
</table>

**Economic growth** (percent)

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>III</td>
<td>IV</td>
<td>I</td>
</tr>
<tr>
<td></td>
<td>3.2</td>
<td>0.1</td>
<td>4.5</td>
</tr>
</tbody>
</table>

Dan Bob: Okay, and batting cleanup we have Jeff Schott.

Jeff Schott: Thank you very much. One of the things that we pride ourselves here at the Institute is trying to encourage an informed public debate on important international economic issues. And so I’m very pleased to
have been able to participate with the Sasakawa Peace Foundation in this project to have a better understanding of the Trans-Pacific Partnership in particular. We've done a lot of work on this here at the Institute. And to try to encourage a similar intensive public debate in Japan we published and translated our major study on the TTP in Japanese. So hopefully our viewers in Japan will be able to get a hold of this copy and have greater access to a basic understanding of what the TPP is.

Now Japan became the 12th participant in the TPP negotiations a little less than a year ago and has made incredible strides in coming up to speed and participating very actively in the negotiations. It has very important economic and foreign policy objectives. And I think in order to clarify some of the three scenarios that Bob Lawrence presented earlier; it would be useful just to take off very quickly some key objectives for Japan and the United States in their joint participation.

For Japan the TPP should help advance its domestic economic priorities by spurring policy reforms that create a more attractive environment for investment; that’s what Professor Itoh mentioned before. Peter Petri here and his work at the Institute, has estimated that the TPP could boost Japanese GDP by more than 2.0 percent above baseline growth when the deal is fully implemented and generate double-digit gains in Japanese exports. That’s big gains for an economy and would be a function of the reforms that would be required by the agreement.

Second, the TPP should also support Japan’s policy of deepening trade ties with countries in the Asia-Pacific region. Japan already has a number of trade agreements, but they’re not of the same quality as the TPP and so the TPP would help upgrade a lot of Japan’s economic relations with partner countries in the region, just as TPP will help the United States upgrade NAFTA.

So that’s very important, but Japan and the United States don’t have an existing pact. And so one of the important benefits of the TPP would be to provide a surrogate for the long-vetted but never launched bilateral FTA negotiations with the United States.

Third, the TPP is also an important component, complement, to trilateral talks that Japan has with China and South Korea, as well as broader negotiations of the Regional Comprehensive Economic Partnership. The 10 plus 6, or ASEAN plus 6 negotiations that really were an inspiration of Japanese policy of 5 or 6 or 7 years ago. The RCEP and the TPP are not alternatives. They can and should be pursued simultaneously and indeed, many countries are already doing that. Seven of the 16 participants in the RCEP are also in the TPP, and 4 other countries in the RCEP are considering very carefully future participation in the TPP. South Korea, Indonesia, Philippines, and Thailand. And even China is seriously studying for the first time TPP participation before the end of this decade.

And so what we see is a convergence towards the TPP among the countries in the Asia-Pacific region, and I think that’s very important. It tends to indicate that TPP is a building block to regional integration and will not be the stumbling block that Bob Lawrence posed in his three scenarios.

Fourth, the TPP helps offset discrimination that Japanese firms now face in some foreign markets due to trade pacts in which Japan is not a signatory, most importantly the Korea-US Free Trade Agreement, which has affected some competition between the three countries.

And fifth and perhaps most importantly, and with a bow to Admiral Blair, from a strategic perspective, the TPP deepens US engagement in the Asia-Pacific region at a time when both countries face continuing political and strategic challenges in North East Asia. Working together in the TPP for mutual economic benefit will also improve the already strong US-Japan relationship.

So there’s good reason for both countries to work together and they’re doing so. Japan’s entry into the TPP talks made the negotiations more difficult, more complicated, but it also made a big deal more likely
because there’s a lot more on the table. Benefit for the United States, benefit for the other TPP countries who are now negotiating with Japan.

Certainly there has been a bottleneck on the agricultural negotiations. That bottleneck seems to be breaking down as a result of the progress that was made in April in talks in Tokyo between US and Japanese officials. While the details of that progress that it’s being called are not well-defined, I think the indications that we get are that it seems to be evolving along the following lines: First, that Japan will commit to substantial reductions in tariffs on key products, but may not fully eliminate all the products, all the tariffs on all the products. What’s important as Mike Froman said in Singapore a couple of weeks ago, is that the deal open up substantial new market opportunities and that makes a big difference in accessing the Japanese market and selling more goods to Japan. And that I think is an interest in both countries.

And I think that type of progress opens the door to broader work among the 12 countries to develop the final compromises needed in the areas of the negotiations that are still open, with regard to intellectual property rights, with regard to some investment issues, particularly investor state dispute settlement, with regard to the labor and environmental chapters, and with regard to disciplines on state-owned enterprises. In many of these areas US and Japanese positions are quite complementary. And indeed, US and Japanese officials have been working very closely together to try to build a broad consensus needed to finish the TPP negotiations. I think for both the United States and for Japan the benefits in those areas grossly outweigh the economic benefits from the hard but limited frictions that we have on agriculture. Those problems need to be resolved to ensure that there is political support for the overall deal. But I think when we do the balance of the TPP for both the United States and Japan we’ll find that it’s strongly in our economic interest; it’s strongly in our political interest to finish the deal before the end of this year. Thank you very much.

Dan Bob: Thanks Jeff, that was great. If I can ask the panelists to come up on stage, we have just a little bit of time left over for Q&A.

Again, thanks all for terrific presentations. If I could take the prerogative of the chair just to ask one question; there’s been a lot of discussion about the upside for TPP agreement, and I tend to think that failure on TPP is unthinkable. But if the unthinkable were to happen, what would be the consequences, not only economically, but politically, strategically?

Motoshige Itoh: It’s very difficult to think about failure at this moment. It may take some more time in the negotiation, even if it’s not going very well immediately, I think there’s some kind of momentum for having the agreement. And also, the one thing that hasn’t been discussed yet, is the interaction among various types of FTAs. TPP is not the only negotiation we are doing in Japan. [There is] RCEP, we are also negotiating an FTA or EPA with Canada, we finished an agreement with Australia, and we have a negotiation with the EU. And the United States also is negotiating, not only in the TPP but also EU. So this has a very interesting dynamism of negotiation.

We started the negotiation with Australia some years ago, but it was stalled for a while. But the activation of the TPP negotiation actually gave a very interesting stimulation to speed up the process of negotiation. So I hope this kind of interaction will continue for a while so we can finish not only the TPP negotiation but also other negotiations. Thank you.

Bob Lawrence: Well I think failure would be a really serious setback, especially for American trade policy. This is the centerpiece of our initiative in Asia and the consequences of failure would mean that we could try to go back to the drawing board and I mean, much depends on the reason for the failure, but I think it would be
a severe setback. And meanwhile, other countries, the Europeans and others, would continue to pursue their initiatives. So I think relatively speaking, it would be severely damaging to the United States.

I think the great upside of the TPP and of the TTIP is that it presents a challenge to the multilateral system to come up with its responses, which help other countries participate in these deeper integration agreements. The failure of the TPP negotiations would therefore undermine that impulse as well. So I think in fact, we could also see that the WTO, ironically, would be weakened as well. So I think there are risks underlying this initiative that face both countries.

Then the final point has to do with the role of TPP and Japan’s structural reforms. There is the issue of agriculture, but I think far more important, as Professor Itoh has spoken about, is trying to stimulate investment. And I see liberalization and opening of markets, particularly in non-traded areas for foreign investors, as giving a major impulse for mergers, acquisitions and investments. And so I think that opportunity would be lost as well and it would be a severe setback for the structural arrow in the Abenomics.

Hideichi Okada: When we see an impasse in Geneva as Bob Lawrence pointed out, high-standard regional economic integration arrangement suggests TPP would play an important role for a freer trade system right now.

I participated in lots of trade negotiations, and as you may think that I won’t say I always try to solve the easier one. And at the end of the day we will have a most difficult agenda on the table. I believe that both the United States and Japan are at a critical juncture, so I think that both sides have to work even harder to seek an arrangement agreeable by both sides. And I can’t imagine TPP without Japan because TPP without Japan will be less meaningful. And also, if Japan pursues only the RCEP I don’t think that we can move toward higher standards with just the RCEP arrangement. So we have to push every regional economic integration arrangement, and especially TPP is one of the key elements right now.

Dan Bob: Jeff, did you have any comments?

Jeff Schott: I think Robert Lawrence put it very well and I just reinforced his comment on the risks of the multilateral system if it’s shown that we can’t put together a deal among like-minded countries. Thank you.

Dan Bob: Okay, we have time for—I’m afraid for only one question, and there’s a mic I see back there. So if you could identify yourself.

Claude Barfield, American Enterprise Institute: Jeff gave a very optimistic view about the agricultural negotiations, but as he and maybe Robert know, there’s been a growing course here in the United States put in by the business community to say, “Well, if the Japanese can’t compromise we should just leave them behind.” How seriously do you take that, in other words kick them out? How seriously do you take that and what are your own views about this possibility if we can’t reach agreement in agriculture?

Jeff Schott: Well, you have domestic negotiations and international negotiations. And I think the business community is rightfully trying to steal the resolve of negotiators to get the best deal possible. I don’t think the business community views failure as an option, but I don’t regard the lack of total elimination of every tariff as a failure. And indeed, in many products you can have a very substantial liberalization that is very meaningful and causes a substantial change in the policy of the Japanese government and opens up new export opportunities. So I think the negotiators are moving in that direction, of course making the final commitments to sensitive policy reforms needs to be done in the context of the broader package where you know you’re going to get
benefits across the board, affecting benefiting agriculture, manufacturing and services. And so that has to be put together, so I think I’m still optimistic and I think the negotiators are doing a good job.

**Bob Lawrence**: I guess I’m somewhat more negative. I think a key element in American free trade agreements has been to seek virtually universal coverage. I think it was unfortunate that sugar was exempted from the US-Australia agreement and I think if we were to agree to exclude large numbers of tariff lines and even if we were to allow for small tariffs to remain in place, that would set bad precedence for future potential agreements with others. The WTO requirement is for liberalization in substantially all trade. The word substantially has a variety of interpretations, but I think there’s merit in that rule and I think it would require a serious examination were we to be confronted with the prospect of having an agreement that had significant exclusions.

**Jeff Schott**: If I could just clarify, I agree with Robert, but the problem is solved if we don’t have different exclusions or exceptions than we had in the KORUS FTA, where you had a number of tariff lines where there was partial liberalization as well.

**Motoshige Itoh**: Just a brief comment about negotiations. Although information is not given to outsiders like us, we are watching very carefully from outside...and there are a lots of ups and downs in expectations. Three months before President Obama went to Japan, I was not expecting the agreement to be made immediately; I expect more time is required.

There was very intensive negotiation, maybe one or two weeks before President Obama’s visit to Japan, and increasing expectation that there’s going to be some kind of agreement. And in that process of adjustment issues are becoming more focused to some limited areas, pork and maybe automobiles and some other areas. So as Mr. Okada said, negotiations are starting from the easier one and try to just finish the more difficult one in the end. But the important thing is we do have some kind of progress, so we have to make more effort to finish the final point of this difficult part of negotiations.

**Dan Bob**: Well, thank you all very much. I only wish we had a little more time for questions, but lunch awaits and as does the second panel. So please join me in thanking our panelists.

**Adam Posen**: Good afternoon everyone. Notice the change from good morning to good afternoon. We’ve had one great panel and you’ve been fed and I hope our web-streaming fans are out there as well. Welcome back. I’m Adam Posen, President of the Peterson Institute for International Economics and it’s my pleasure to be calling to order the second half of this event we’re doing with the Sasakawa Peace Foundation, the Sasakawa Peace Foundation USA on US-Japan common economic issues and challenges.

We’ve already spoken about the trade aspects and TPP in particular, we’re now going to be talking about some of the common macro-challenges, fiscal and monetary and in particular, balancing the short-run needs with the long-run sustainability issues, which is of course critical for both Japan and the United States.

I’d like to call upon my colleague Dr. Marcus Noland, the Institute’s executive vice president and director of studies to chair the panel.

**Marcus Noland**: Thank you. We’re going to go slightly out of order of the agenda as it’s been presented to you because a slightly different order was presented to us originally this morning and it’s the order in which the names have actually been presented to me to read the bios.
So our first speaker will be Takatoshi Ito. He is professor at the National Graduate Institute for Policy Studies and project professor at the Graduate School of Public Policy, University of Tokyo. He has recently concluded his tenure as the dean of the Graduate School of Public Policy at the University of Tokyo. In the public sector his previous positions include senior adviser in the International Monetary Fund’s Research Department, deputy vice minister for international affairs at the Ministry of Finance and serving as a member of the Prime Minister’s Council of Economic and Fiscal Policy. He is the author of many books and articles, most importantly the 2001 volume *No More Bashing: Building a New Japan-US Economic Relationship*, published here at the Peterson Institute, coauthored with me and Bergsten.

Our second speaker will be our president Adam Posen, who in addition to being president of the Peterson Institute was a member of the Monetary Policy Committee at the Bank of England. He is a member of the Council of Foreign Relations, the Trilateral Commission, the Bellagio Group, but as far as I know, not the Illuminati.

Our third speaker will be Masahiro Kawai of the University of Tokyo Graduate School of Public Policy. Until recently, Hiro was the dean of the Asian Development Bank Institute. He was previously special adviser to the ADB President in charge of Regional Economic Cooperation and Integration. He also has served as chief economist to the World Bank’s East Asia and Pacific region, where he was my wife’s boss, and as deputy vice minister for international affairs in the Ministry of Finance.

Our final speaker, batting cleanup to continue the baseball metaphors that work equally well for Americans and Japanese, is Peter Fisher, who is currently senior lecturer, senior fellow, Center for Global Business and Government at Dartmouth University. Before that he was a senior director at The Blackrock Investment Institute, chairman of Blackrock Asia, undersecretary for domestic finance of the Treasury, executive vice president of the Federal Reserve Bank of New York.

To save time in terms of getting up and sitting down, I would ask the four speakers to just play tag team. When the previous speaker finishes just come on up here. And then after Peter speaks we will all converge on the stage. So Taka Ito, please.

Takatoshi Ito: Thank you very much for the kind introduction and I’m very happy to come back to this building and give you some thoughts on the Japanese macro situation. I’ll talk about mainly monetary policy and fiscal policy.

So you’ve already seen in the first panel about Abenomics. It has three arrows: The first one is aggressive monetary policy in inflation targeting, the second arrow is flexible fiscal policy, and the third arrow is growth strategy, mainly structural reform.

As you might have read in the newspaper in the last 15 months, the first arrow has been a big success; to get out of the deflation was the objective and we have reached halfway towards the 2.0 percent inflation targeting. Japan was under 20 years of stagnation and 15 years of deflation and we are getting out of this long stagnation and deflation. This is a remarkable achievement and was the cooperation between our central bank and Prime Minister Abe’s initiative of a big change in central bank policy. So it completely changed from a defeatist, weak central bank to an aggressive central bank to expand the balance sheet, which is known as QQE in Japan, quantitative and qualitative easing. So it’s almost consensus that the first arrow has been a big success.

The second arrow, flexible fiscal policy, needs a little bit of explanation. The first part of this flexible fiscal policy is a timely, short-run, countercyclical fiscal stimulus. So when needed, like cooperating with the monetary policy to boost demand, fiscal policy was in stimulus mode. So right after Abe took office, he ordered the big supplementary budget to work on the weak demand part and this really helped to change the mood from
deflation to something new and the growth rate immediately went to 4.0 percent range in the first half of last year.

But that was misunderstood by some people, that this government is just putting fiscal stimulus all the time. It was not, because the Japanese fiscal situation is actually really bad. The debt to GDP ratio is more than 200 percent. Now Greece got into trouble when their debt to GDP ratio was 130 percent, and Italy and Spain, they are in the range of 100 percent to 80 percent and still got into fiscal crisis. So Japan had 200 percent debt to GDP ratio; some people thought Japan is on the verge of fiscal crisis. Others thought, “If 200 percent and no crisis, then we could go to 250 percent.” Both are wrong. So a fiscal crisis didn’t happen, has not happened, there are good reasons that the 200 percent debt is held by Japanese residents who are extremely home-biased and risk-averse.

Through the Japanese banking system, domestic residents hold 95 percent of the Japanese debt. So that’s fortunate for the fiscal authority, but there is a limit. So when these private savings are exhausted or saturated by the government debt, fiscal crisis will come. My simulation shows that fiscal crisis will happen in 10 years if nothing happens and that will be a very, very bad situation.

Now, how to avoid the crisis? The deficit can be closed; deficit is expenditure more than a tax revenue situation. Deficit is large still in Japan. How to close the gap? Well, expenditure cuts or tax increase—one of the two. Expenditure, actually Japanese expenditure, has been really restrained in the last 20 years, except Social Security spending. Social Security spending has been steadily rising and all other expenditures including self-defense and university professor salary and bureaucrat salary are all declining and our public works has been declining. So if you think that Japanese fiscal deficit has been caused by runaway public works, infrastructure, bridges going nowhere, tunnels going nowhere, that’s wrong; it has been controlled in the last 20 years, declining to the minimum.

In OECD ranking the size of the government of Japan is the last or second last among the OECD countries. So there is very little you can cut in the expenditure, except you control the pension and other social security expenditures, which is politically very difficult, but still that would help. So the best bet is tax increase. Now which tax—income tax, corporate income tax, or value-added tax (VAT)? Those are the three major tax items and those are the candidates.

On income tax, we are on the verge of a dramatic demographic change. All the baby-boomers are now aged between 60 and 65. In 5 years they’ll all retire and that tips the balance to the retirees. And if you increase income tax, that is just putting more burden on the younger generation, where population is shrinking. And the pension system is already biased in favor of the older generations and the younger generation knows that they cannot get as good social security pension plan as their parents. So increasing income tax is aggravating this intergenerational inequality.

Corporate tax rate is 40 percent and we’re talking about decreasing corporate tax rate to keep the Japanese companies in Japan. Japanese companies offshoring are holding out, whatever you call that, they’re building all their operations abroad, partly because of the high corporate income tax. So the best bet is consumption tax.

So that is why Prime Minister Abe initiated this consumption tax increase, which happened on April 1. So consumption tax has been on the low end, 5.0 percent until March this year and was raised to 8.0 percent. And next year, October, it’s going to increase to 10 percent. Ten percent VAT is still low among the OECD countries. The United States is an exception, with no federal VAT. But most European countries have a VAT rate of 20 percent, plus or minus 5. So when Greece got into trouble, the VAT was already 19 percent. The International Monetary Fund came in and asked for a tax increase, and they raised it to 23 percent, but didn’t have much.
While Japan has from 10 percent to 25 percent, there is additional 15 percent tax increase space. And this has to be exploited, unfortunately, to balance the budget and produce some surplus, to bring down this huge debt to a more long-run sustainable level. But the good news is that there is a way to do it, which is consumption tax increase. And the bad news is, if you don’t do it there will be a fiscal crisis in 10 years. And Mr. Abe knows this and the Abe cabinet is working on the growth policy to make the economic growth rate higher, which makes the ground for the tax increase. And if everything goes well, by the 2020 Tokyo Olympic Games, we will have 20 percent consumption tax rates and strong growth despite the tax rate hike. Thank you very much.

**Adam Posen**: Thank you. It’s been my privilege to participate in the discussions as a member and as a cochair with Motoshige Itoh. And so now, let me try to offer a few thoughts on some of what we learned about Japan’s implications for the United States and our attempts to bring together, sort of the two sides of the Pacific on these challenges. And I think the place we have to start is the nuanced view of fiscal sustainability that was sort of apparent in Takatoshi Ito’s presentation, and I think has successfully become the norm since the correction of some of the Reinhart-Rogoff claims.

As our colleague Joseph Gagnon has documented and many others have observed, it is difficult to find any point in history where a country that had its own currency is issuing debt in that currency and has an independent central bank has had a crisis of fiscal policy. That doesn’t mean it can’t happen and we can think of circumstances where it might. But it does mean that we’re not all sitting here teetering on the edge at every moment. Instead, as Japan has demonstrated and the United States has been increasingly demonstrating, as numerous members of our group would agree, when you have too high a fiscal deficit recurrently you run into another number of other problems; you tend to displace public investment, you tend to bias things towards the present and against future generations, you tend to have less room in case of true emergencies, Japan surviving the Fukushima tsunami and the accident certainly knows where the true emergency is, but the United States surviving 9/11 is also a true emergency.

There are issues of credibility and how people view the world. It is not costless to run ongoing large deficits, even if it is not crisis to run ongoing large deficits. And so part of what I think we’ve usefully been talking about, is this question of how does one make progress on resolving these issues without phony claim of a crisis? And I think this is a place where the current Japanese government, the technocrats of the Ministry of Finance and the Bank of Japan and the Japanese people frankly, deserve a certain measure of credit, that they have reached an intellectual consensus that I think most of us find justified, that Japan, like the United States has a share of GDP going to taxes that is much lower than what we know can be sustained. It doesn’t mean that you have to become the Netherlands circa 1984 and put everything into the public system, but it does mean that there is a good 10 to 20 percent of GDP in Japan and the United States and notably really only in Japan and the United States, where the tax rate has stayed much lower and you could raise taxes without causing hugely undue distortions.

Now that is not the only way you can resolve these issues. As we discussed, there are better and worse ways to spend money and there are certainly pieces of money being spent by both governments that can be cut back. But I think the common point and the big lesson from Japan for the United States is the idea that a steady, long-term tax increase plan on a national basis can be managed.

Now our colleagues who work on Europe in this Institute will also talk about the sort of enforced crisis plans of austerity in Western Europe and that’s a different matter. And I think we should be very conscious of the fact that in Japan, even if we are seeing a path towards a 20 or 22 percent value-added tax rate over say 10 years, that’s a fiscal drag of less than 2.0 percent, probably 1.0 percent a year. And that is not trivial, but nor is
it tragic. And it is very much a challenge to the United States to think about having a radical restructuring of tax code, let alone an upward, well-established, credibly committed path.

Now let me not get carried away here. The Abe government and Prime Minister Abe himself have said it’s not guaranteed that they’re going to raise the taxes again this fall or commit this fall to raising them next year, let alone the additional percentages to come. Speaking solely for myself, not for the group, I would just issue a warning to people in the Abe government who would like to postpone this, that they do so at their peril; that there are a large share of Japanese equities and of trade in Japanese yen that are totally subject to market forces, even if the Bank of Japan is buying up Japanese government bonds (JGBs) and you could see a very stiff correction, in fact I would strongly expect a very stiff correction if we get to late October, early November and the Abe government does not affirm the next step of the tax increases.

Again, is this a crisis in the sense that those people who’ve been betting on the collapse of the JGB market will make money? Probably not. Is this really bad in the sense that it would be a huge asset loss in Japan and a setback to momentum and probably build-in a permanently higher interest rate? Yes.

So now, turning to the United States. We had a number of experienced ex-Treasury officials, some of whom you’ll hear from shortly, and ex-White House officials in our group and we all are, I must admit and I shouldn’t say we; I’m not one of them, members of the group who do that I think are suitably chastened, even more than our battle-hardened friends on the trade front, about what is feasible and possible, remembering that we all just came out of the tantrums over the government shutdown and the debt ceiling and all the rest of it.

I think we did however, thrash out two important things that are worth remembering. The first is, there seems to be real improvement on the rate of price increase in health care. And remember that what makes the US debt scary is the rate of inflation in Medicare. It’s not our demographics because we are fortunate to have much nicer demographics than Japan; it is not the level of current spending, it’s the rate of inflation outpacing everything else. Our Bill Cline has done some interesting work on this and has a paper on the website looking at some of these issues.

But the bottom line is there is a strong case to be made that we’ve seen the rate of inflation of health care decline over the last several years; that it may continue to decline. In fact, we may even see some health care cost reduction. Now I’m going to leave aside whether that is thanks to despite Obamacare ACA [Affordable Care Act]. I think there’s reason to think that is contributing, but we don’t need to get into that. The fact remains we are seeing this in the data. And while we cannot yet count on it as a sustained thing, it helps to emphasize how tractable this problem in reality really is, instead of people throwing up their hands and saying, “Oh my God, we’re doomed because we’ve committed too much to Medicare or Medicaid or health care or the VA system,” it is instead, “Oh, you mean we have been walking around the world, telling the Japanese, let alone the Greeks, let alone the Argentineans, ‘Time for you to do structural reform.’ Maybe we can do some structural reform at home.” And in the United States there is structural reform to be done.

A final point about monetary policy. I and I think the other people on our panel, our group, who have been active in monetary policy, are pretty unstinting in our praise for what the Bank of Japan has been doing for the last year plus, Professor Itoh already mentioned that, I will not recap it. I will simply say that as we extend that to the Fed, I think we are looking at a world where the Federal Reserve is facing a limit to how high they can reasonably go on interest rates in the near to medium term. I think even people with very differing views of the short-term forecast or the amount of slack in the labor market, would agree that given financial regulations and given slow down in productivity, that probably the Federal Reserve cannot shoot for a neutral rate as high as we used to. This has a number of implications, but the most important one is to say that the room for play we have with the interest rate may be much less than people are accustomed to, even when we
get off the zero lower bound. And so for that, as well as financial stability reasons, we may need to think about a broader set of tools for the Fed, which of course the Bank of Japan has already begun to implement. Thank you very much.

**Masahiro Kawai:** I am going to talk about the subject of integrating long-term and short-run macroeconomic policies. From a short-term perspective, when there is some shock hitting an economy we have macroeconomic policy, monetary policy, fiscal policy. But in the long run we want to make sure that sustained, noninflationary and nondeflationary economic growth is going to take place with financial stability and fiscal sustainability. So that’s really the issue I want to talk about. Professor Itoh and Adam talked about this issue from their perspectives.

Now monetary policy, the Bank of Japan has been using QQE, quantitative and qualitative easing, since April 2013, to achieve sustained 2.0 percent inflation rate. And Mr. Kuroda, Taka Ito talked about fiscal policy to support aggregate demand. Now aggregate demand is being supported in order to make sure that economic growth would continue, so that the next year the consumption tax rate could be further increased. In the second quarter of this year we expect a downturn of GDP because of the consumption tax hike, but in the third quarter we expect positive economic growth to come back. So the government wants to make sure that aggregate demand would be sustained in order to convince the general public that another consumption tax increase could be implemented.

From a long-term perspective, it’s a really amazing situation for Japan for 20 some years. After the bursting of the bubble, nominal GDP, blue line stayed stagnant for 20 years. The red line is real GDP (figure 1). Yes, we observed real GDP growth in Japan when nominal GDP was virtually constant. That was achieved by a declining GDP deflator. This has been a significant problem and over time in the 1990s and the 2000s, Japan persistently ran a fiscal deficit and then debt was accumulated.

In 1990 net government debt was only about 10 percent and in 2013 it was 140 percent of GDP; 10 percent of GDP to 140 percent of GDP, in terms of net government debt as a ratio of GDP. Government revenue was 30 percent or so in 1990 and in 2013 it was also around 30 percent. But the government expenditure rose from 30 percent in 1990 to 40 percent in 2013. So revenue was stagnant and then expenditure persistently rose and then we have this government debt problem. From a medium-term and long-term perspectives, this fiscal sustainability issue is at least one of the most important challenges for Japan.

I am not that much worried about financial stability in the case of Japan; it’s manageable. One of the biggest concerns is that if 2.0 percent inflation is achieved then the bond rate can increase, meaning that the bond price would go down and that would have a significant impact on bond holders, including the commercial banks.

According to the Bank of Japan analysis and the usual circumstance of reasonable increase of the bond interest rate, the banking sector is basically sound. The overall banking sector is sound. However, there could be several small regional banks that may be affected, but systemic problem can be contained. So from a medium-term and long-term perspectives, financial stability issue would be managed.

Fiscal sustainability is quite important. I agree that further consumption tax increase would be needed, but also containing spending would be quite important; pension spending, health spending have been rising persistently and somehow we need to contain this increase. And also we need to achieve healthy nominal GDP growth, 2.0 percent inflation, plus real GDP growth of 1.5 percent or 2.0 percent and then make sure that the interest rate would not jump up. I think if we can do this combination of containment of spending and consumption tax increase and nominal GDP growth, supported by Bank of Japan monetary policy and growth strategy, in the medium and long terms the fiscal problem could be contained.
The bond rate remains very low, the market believes that there is more fiscal room and also foreign holding is limited; more foreigners could be induced to hold JGBs. Japan has huge external assets, which must be giving some comfort to bondholders and the Bank of Japan continues to purchase JGBs. And Mr. Kuroda has been saying that if 2.0 percent inflation is threatened he will do everything possible to make sure that 2.0 percent inflation is achieved. I think this would keep the interest rate low and growth rate exceeding the interest rate, fiscal consolidation is quite possible. Thank you very much.

Peter Fisher, Tuck School of Business at Dartmouth: I’m happy to bat cleanup here. Also a board member of the Institute here. Let me just echo really, maybe in a different context, some of the things my colleagues have been saying about fiscal sustainability. I have a unique perspective among the group as I was once the Debt Manager of the United States government and would wring my hands at the thought of managing a debt of $4 trillion outstanding, when now we’ve almost quadrupled that. So the speeches I gave on the subject were perhaps premature.

What I’d like to emphasize really about the group that we had together talking that had been brought together by our sponsors, is the opportunity we have to think about things that we haven’t figured out yet, the things we don’t know, the things we’re trying to learn. And I particularly feel that way, notwithstanding having spent my life in bond markets and debt management, by how much we don’t know and how much we still have to figure out about debt sustainability, both in the long run and the short run.

In the long run, I have always taken to heart that a small island nation with a debt to GDP ratio of 200 percent did manage to work its way out of that crisis after the Napoleonic Wars, when the United Kingdom managed to bring down its debt to GDP ratio over the next 100 years. An awful lot had to go right for that to happen and it did go right. And so I completely share the view expressed by Adam and others on our group in this panel, that things can go right for Japan, but I think there’s a lesson that we in the United States have to take from the position Japan has gotten itself to.

I would emphasize back to maybe the importance of TPP and other things; the importance of productivity growth for both of us. That’s really how we work our way out of a debt problem, a debt sustainability problem. How are we going to get our economy to grow a little faster? We found that in the 1990s in the United States when we even managed to run surpluses for a brief period. And Japan and we now face that problem, how do we get productivity going at a higher rate? And there are many things we have to learn from one another.

I think the United States needs to think hard about the lessons Japan has faced over the last decade in demographics. Our demographics are different, but the Federal Reserve certainly is paying attention to our labor participation right here in the United States and we should think hard and long about the path Japan has been down and what we can learn from that.

In the micro, in the near-term, as the former debt manager let me tell you I know when the crisis comes. It comes when you can’t roll over your debt; when you’re nervous that at tomorrow’s auction sufficient buyers will not show up. And while we all can imagine that that’s a problem of excess supply, you’ve got to borrow too much, I’ve always thought of that as the mere counter-factual. The real problem that will happen to you at tomorrow morning’s auction is a failure of demand. That is a failure of bidders who were there a week ago or a month ago, not to show up. Something happened to their expectations that changed, that’s leading them to not want to play and not come to the auction. And I think, as Adam emphasized, if you have your own currency, you have your independent monetary policy, interest rates and exchange rates have been adjusting, you’re much less likely to come to that rather than donnybrook moment, if you will, than if you have other constraints.
So I think there are things now that we can learn from each other in thinking hard about the positions we’ve gotten in to and what it will take to dig our way out of holes that come back to reform, whether on the trade front or the domestic economy front that we all have to take very, very seriously or then the idea that we don’t have to worry about a fiscal crisis in our future, I’m afraid will be in the null set.

I’ll just briefly mention one other issue that I found fascinating, even though we’re in very different positions, Japan and the United States, on the rate of public investment and public infrastructure, I think there are things we still need to learn from one another about the dilemma of a constrained budget and what happens to that small amount that is left over for investment in public infrastructure and the perverse consequences of less and less productive investments being made. And I think that’s a conversation we have that I’m very intrigued with. We see here less and less fiscal multiplier coming from out expenditures. Japan had that experience, even as they’ve managed to bring down the rate of bridges to nowhere. I think we both have to worry about that and that’s a matter of political economy at the micro level; that’s another area where I think we could learn from one another. So let me stop there and bring the panel together up here on the podium.

Marcus Noland: Okay, well I think we’ve had four very interesting presentations, and we actually do have some time for questions. There is a roving microphone at the front, and there is a standing microphone in the back, so I would invite you, if you’re in the front, to raise your hands and if not to line up at the back. And since nobody has immediately raised their hand, I will ask the first question.

So one of the things that kind of struck me in these four presentations and the discussion of these macroeconomic adjustments, was the lack of the discussion of the exchange rate, which is an obsession of some people in this building and more generally, an issue of political concern in Washington and an issue on which historically the United States and Japan have had conflicts. So I would wonder if anyone on the panel would like to address the role of exchange rate adjustments in achieving these macroeconomic adjustments in the two countries.

Takatoshi Ito: Exchange rates, not too undervalued or not too overvalued, roughly an equilibrium exchange rate is a good thing to have for macroeconomic stability. When the economy is weak the weaker currency will help to boost exports if it’s overheated, probably it’s the overvaluation that will help to contain the inflation. That’s the general theory.

Now Japanese yen appreciated from about 110 to the US dollar, to 80 yen in the matter of half a year in the wake of the Lehman Brothers collapse. And that was, I would say, mostly because of the failure of the Bank of Japan to expand balance sheets when the Federal Reserve, Bank of England, and the European Central Bank expanded their balance sheets, tripled, doubled and 50 percent increase. So it was partly due to a portfolio shift and partly due to Bank of Japan’s fault, but that overvaluation period, 80 yen, from 2009 to 2012 was corrected by aggressive monetary easing, thanks to Mr. Abe’s strong decisions to correct the Bank of Japan’s mistake. And in the last 12 months it has been 100 yen, around 100 to 105 [range]. This is a good range; Japanese corporations are now gaining strength and the fundamentals are getting better. So we are now back into the comfortable range and we hope that this will continue.

Peter Fisher: Could I offer a for a different perspective maybe? Which is exchange rates are an adjustment mechanism. One of my duties at the Fed was managing currency interventions for the US monetary authority and Alan Greenspan would like to remind me that no one has a good model of exchange rate determination, notwithstanding my monthly reports on what was driving exchange rates one way or the other. And I think that we in the United States especially will do well to recognize the importance of floating exchange rates and learn to live with their consequences. And to see that they play an important role as an adjustment mechanism.
And clearly the Japanese yen, given the difficulties the Japanese economy's been in, was much too tight for the last several years, much too strong an exchange rate, given the weakness in their economy and the risk of deflation that the second and then third largest economy in the world was facing.

So I think that the most important thing about exchange rates is for us in the United States to have the confidence of our conviction that we believe in them as an adjustment mechanism. Sometimes they’ll go up and sometimes they’ll go down and to not paint ourselves or our trading partners into any corners.

Masahiro Kawai: Japanese yen depreciation is clearly a result of easy monetary policy or expectation of easy monetary policy before the actual implementation of easy monetary policy. It’s a natural result and monetary policy has been targeting the domestic objective of divorcing deflation and supporting a growth environment.

Now the yen depreciated on the real effective exchange rate basis by about 30 percent and initially there was a concern expressed by several Asian countries, China, Korea and a few others, said that yen depreciation could be a beggar thy neighbor policy. But actually what’s been happening is that Japanese real exports haven’t quite grown, although the nominal value of exports has gone up in terms of yen and that’s what’s been helping the corporate sector, the exporters. They have obtained windfall gains and that’s been making the Japanese economy brighter. So the exchange rate usually should have an adjustment mechanism, but so far Japan’s trade account has not improved. But now Japan runs a trade deficit because of the increased fuel imports and exports have not been stimulated yet, although over time, this effect may come in, but not at this point.

Adam Posen: I guess one last comment. As you’re all, I hope, well aware, Fred Bergsten and Joe Gagnon from this Institute have done a lot of work, not all of which I agree with, but that’s fine, on the idea that currency manipulation can be a very substantial problem and there are clearly people in the US Congress who believe that very strongly. And what I think underlies everything, Peter, Taka, Hiro and I are saying and in particular Hiro’s last remark, is that there is a G7 norm that was established a year and a half ago that you don’t directly unilaterally talk down or intervene in another member’s currency without permission and that even though some over-eager members of the perspective Abe administration had to be called and warned on this in December of 2012, they then responded. And this is very different than say, the behavior of say from the People’s Bank of China recurrently through the years.

And so even as we go forward with TPP, I think we should recognize that Japan and the United States and frankly the EU, are allies in terms of saying countries should pursue their domestic monetary policy goals and not manipulate exchange rates, rather than as some people would cast that there’s some division between Japan and the United States on this point. And remember that with the exception of some intervention in 2011, part of which was justified, Japan has not directly intervened in the exchange market since 2004. Now were they to change behavior on that, that would be a different matter, but they did not.

Marcus Noland: John Macon.

John Macon, American Enterprise Institute: It seems to me you’re treading a little lightly on the exchange rate issue. I had thought that in 2012 and in early 2013, the notion that was advanced, partly by the Abe government, but also I think understood by the US government, was that it was probably better to have a Japan that’s growing in nominal terms at 3.0 percent than a Japan that is not growing in nominal terms and still has deflation and yet has a stronger currency. A weaker currency is partly an endogenous variable, it should be part and parcel of an effort by a country that has experienced deflation to reflate. And I think if the outcome is a faster growing total pie, everybody else can perhaps just stand back and let it happen. I’m always amazed at the
American government’s view, whereby we overlook over a trillion dollars of dollar purchases by the Chinese and never cite them for currency manipulation and get very sensitive about very small moves by other Central Banks.

Adam Posen: I think you phrased it as though there was a difference between where you were and most of us in the panel, but I don’t think there is. And to go back and Minister Doi from the Japanese Embassy read this quote here helpfully about a year ago. Then Chairman Ben Bernanke at the Federal Reserve had a very clear quote and testimony to, I think it was Senate Banking Committee, that you get refl ation when you pursue monetary policies that support refl ation, and that the Bank of Japan was doing something not meaningfully different on this score over the last year than what the Fed was doing. And the People’s Bank in China is doing something quite different and at times the Bank of Korea has done something quite different. And so in line with what Taka was saying a few minutes ago, a big part of the reason why the exchange rate was bad and over-valued for Japan was because, unlike other reasonable Central Banks, the previous regime at the Bank of Japan chose to be defl ationary during the crisis, which was insane, but it was credible. So the markets refl ected that.

Marcus Noland: So we have time for one more question. Anyone wants to ask a question? Yes, Lee.

Lee Price, FDIC: I have a question about 17 years ago, when consumption taxes were raised, some people think that contributed to the slowdown of the economy or weakening of the economy that seemed to be emerging; why should this time be different, that a sizable increase in the consumption tax won’t? I think it’s too early to tell what’s going to happen in the third quarter and the fourth quarter; why should we be so confident now in the third and fourth quarter this year? Obviously this quarter is going to be negative, but after that, why should it be better than in 1997?

Takatoshi Ito: The experience of 1997 is completely misunderstood by many, and the misunderstood notion is that consumption tax hike in April 1997 produced huge negative growth in 1998. But this is mistaken because the negative growth in 1998 was mostly, if not totally, due to the banking crisis, which happened in November 1997 and the Asian crisis, which started in July. So without those two crises it would have been okay. So this time there is no Japanese banking crisis as Mr. Kawai mentioned, the financial system is robust and barring an external crisis, I think the economy will bounce back.

Peter Fisher: If I could just echo that description of history. I think when we look back in hindsight at 1999/2000, we thought, “Well, gee we wish we hadn’t had a consumption tax increase in Japan.” But the sequence that year in 1997 was it was actually the rather surprising rate of growth the Japanese economy had that got interest rates to be shocked, that led to the collapse of the Thai Baht. And so that was actually a movement of expectation the Japanese economy doing surprisingly well that create—there were many other contributing factors, a shock to the East Asian economies. And so I think when we look back in hindsight, we had a consumption tax increase, we had an Asian financial crisis, we had a banking crisis in Japan and when we got to 99 we look back and said, “Gee, it would have been nice if we hadn’t had a consumption tax increase in Japan.” But that’s quite something else from saying it was the proximate cause of the rapid slowdown that Japan had at the end of ’97 and into ’98.

Adam Posen: I respectfully disagree with my colleagues on that; I do think it was the proximate cause. Nonetheless, I come out where they do on things will be different this time Lee, for much the same reasons. The financial system is much sounder and much better capitalized and much less leveraged as are household and
corporate balance sheets in Japan now versus 97. So whatever shock you give will not be multiplied to the same extent.

And I think my colleagues alluded to this, the monetary policy in 1997 was wrong. They were busy tightening, basically, at the first sign of growth, which compounded the impact of the consumption tax hike. But the other point I would make is, even I, who usually am held up as the Keynesian dove, wanting to always do stimulus, it matters now, as I’ve been saying for a while, that the debt-to-GDP ratio is 200 plus percent, whereas 17 years ago in 1997, it was a fraction of that. And so you had a choice in 1997 about spreading it out or offsetting it, which I frankly don’t think you have quite the same amount of choice about it now. So to me those are the differences.

Masahiro Kawai: The economic fundamentals are much better now than then. The labor market in Japan is very tight; the rate of unemployment has come down persistently since the peak or immediately after the global financial crisis. Now our unemployment rate is 3.6 percent, just below the best performance precrisis. And upward wage pressure is there and the BOJ’s Mr. Kuroda says he would do anything possible if there is a threat to the goal of achieving 2.0 percent inflation rate. That’s providing a lot of confidence on the part of the business sector.

Marcus Noland: Okay, well please join me in thanking our four panelists and we’ll move on to the concluding session of our event. Thank you.

Adam Posen: I promise you this wasn’t setup so I would keep coming back to the podium in some keystone cops way. I would like to call upon my colleague and cochair of our group, Motoshige Itoh of the University of Tokyo.

Motoshige Itoh: Thank you very much. I’m going to be very brief. As everybody is very busy in many different types of issues, in Japan I’m very busy talking about many issues about Japanese economic policies. So it is very important to get together to discuss the common issue, especially the important issue just across the Pacific. So I think the discussion yesterday and today was very, very useful for us to identify one of the most important areas where we have to discuss more carefully. TPP is a very important issue for the integration of this vision and it is also very important timing at this point.

TPP is a very important project for both Japan and the United States to move forward to a new regime of economic integration in these regions. And also, it will set kind of a momentum for the new rules for the global economic system. And just like other trade negotiations, negotiations are not very easy. Both countries have very complicated politics. But the observations [heard here today] just show us we are now just focusing to start very limited area of the very difficult issues.

So whether we can go through the difficult issues, such as pork, automobiles, it’s very important that we can have a very good result of the new regime or just to go back to the old regime. So I think to highlight the importance of the issue and the timing is one of the important tasks for us to discuss. So I hope we can share some of the very important issues and continue the discussion on this issue. Thank you very much.

Adam Posen: To close this, let me play my usual role of being a little more blunt than some of my distinguished colleagues, Japanese or not.

I think we’ve all agreed and cheerleaded for TPP for good reason. Motoshige Itoh has led that effort within Japan, my colleague Jeff Schott and co-authors have done some great studies here about its importance. Robert
Lawrence has articulated, including today, how this sets a precedent going forward and I think Dennis Blair opening put us in context of how important this is to the overall relationship. And we should not lose sight that TPP is only one part of the US-Japan economic relationship, which includes cross-border investment, joint ventures, training of people in each other’s schools, migration and coproduction, extensive world of ties in intellectual property and development and on, and we can hope for extensive ties in natural gas and other energy trade.

We should also not lose sight of the fact that economics alone, even TPP within economics, is not the majority of the US-Japan relationship, which is multifaceted and strong. But this is an important moment as several of us have said repeatedly. And it’s a difficult moment because, as Motoshige just reminded us, there’s politics on both sides. And so realistically, whether we like it or not, we are unlikely to get a vote on TPP, a strong proposal on TPP in the US Congress, until year end or early 2015, after the election, the midterm election. And realistically unfortunately, that creates a vacuum wherein Japan and some other countries participating in TPP can try to, in a sense, backslide from the aspirations that we could have for the kind of high-quality agreement.

It is the responsibility of the US government and the government of Japan to make sure this vacuum does not become self-fulfilling; to make sure that we do make progress towards an actual high-quality agreement, which will be something that will open up jointly for us the markets that we need in East Asia as well as in Latin America by renewing NAFTA, that will jointly put pressure on China and Korea to play by rules that we can all recognize, including but not limited to exchange rates. These will be open deals, but deals depending on how good Japan and the United States shoulder-to-shoulder can create a high-standard agreement that the rest of the countries in the negotiations can agree to.

And it is a finite window, not because of threats, possibly because of political patience, impatience, but realistically because Japan is facing a race where many other countries, including the United States, are involved in many other regional negotiations. And if Japan and the United States miss this window it will be to the detriment of both of us and the world trading system, but it has to be said as often as the case in economics, even though both would be worse off without the deal, one would be truly worse off.

And so I think it is important that we convey to our friends in Japan as well as in the United States that, as Prime Minister Abe initially said when he bravely took Japan into TPP, reform and growth in Japan is needed so that Japan can play its role in Asia and have some control over its own destiny. And that does mean sacrificing backwards ideas on agriculture that are harmful to the Japanese people themselves. And it will be right if the United States and Japanese negotiators get past those ridiculous things in order to achieve the greater goal.

Thank you all very much for your participation today. Thanks to the Sasakawa Peace Foundation for working with us. Thanks to my colleagues.