The familiar remedies for Japan's ills are not working. Last year, the inaptly-named “Big Bang” liberalization program resulted in a limited deregulation of financial services in Japan. In recent weeks, Japan’s Central Bank has lowered its overnight funds rate from 1/2 to 1/4 of one percent (the comparable Federal Reserve rate is 5 1/4 percent). Still more recently, numerous gaiatsu-generating advisors have urged Japan to print money in abundance so as to prod Japanese consumers to divest their futons and postal savings accounts of yen in favor of a buying spree that will galvanize the depressed Japanese economy.

In fact, these therapies aggravate rather than relieve the economy's ailments.

Partial deregulation of financial services has contributed to the yen's depreciation, hardly helping Japan while harming economic recovery elsewhere in Asia. Reducing the funds rate from its already absurdly low level will have little if any positive effect in stimulating the domestic economy, because demand for both business and consumer credit is inelastic at rates as low as those prevailing before the recent further reduction. If the rate reduction has any effect at all, it is likely to be perverse by further retarding recovery prospects of the

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other beleaguered Asian economies. The lower Japanese rate, like the partial deregulation of financial services, increases incentives for holders of yen assets, including such giant holders as Japanese insurance companies, to flee to higher yielding foreign assets, thereby contributing to a weakened yen, hindering the competitive position of other Asian economies, and diverting Japanese capital from Asia to safer markets in the United States and Europe.

The something-for-nothing, repave-the-ginza-with-yen proposal is both hazardous and silly. Because the Japanese public is already disenchanted with and distrustful of politicians and bureaucrats and fearful of an uncertain future, printing money would be simplistic and ineffectual. It is as likely to make Japanese citizens “take to the streets” as they see their life-savings debased, as to make them flock to the shops in a flurry of consumer spending.

Instead of these familiar ideas, we suggest three novel ones for consideration by Mr. Obuchi and his advisors.

First, priority attention should be given to boosting the ratio of banks’ capital to assets by raising the *numerator*, rather than, or in addition to, lowering the denominator. The capital-to-asset (C/A) ratio’s importance arises from the minimum 8-percent standard laid down by the Bank for International Settlements as a necessary qualification for international banking activities. Some of Japan’s largest city banks (for example, Sanwa and Tokyo-Mitsubishi) appear to be in reasonable compliance with this standard. It is more doubtful whether they would remain so if rigorous criteria were applied to evaluate their assets, possibly resulting in an increased requirement for loss reserves. In any event, the C/A ratios of most other Japanese banks—including, of course, the already insolvent Long Term Credit Bank—are far below the 8-percent threshold.

Most recent attention in Japan as well as that accorded by officialdom in the United States and elsewhere has focused entirely on the denominator of this C/A ratio. So, using “public” money (i.e., ultimately provided by Japanese taxpayers) has been repeatedly urged to reduce the banks’ holdings of weak assets by subrogating them to the government (along the lines of the Resolution Trust Corporation in the U.S. savings and loan debacle of the late 1980s).
Instead, the capital of Japanese banks should be enlarged by floating substantial additional equities for purchase by the Japanese public, as well as by foreign investors. To be sure, this would dilute existing equity holdings. But, by widening the relatively thin market for bank equities, which largely represent cross-holdings among other banks and large companies, this measure would inject new capital into bank balance sheets by attracting private capital from both domestic and foreign sources.

Second, the Bank of Japan should raise its short-term rate (reversing the 25-basis point reduction referred to earlier) by a few percentage points. One reason for this unconventional proposal is to attract private savings into banks by raising the deposit rates received by depositors. A second reason is to reduce incentives for yen flight created by the gap between low interest rates in Japan, and higher ones in the United States and Europe. Yen flight is the underlying explanation for the persistent anomaly of a weak Japanese yen co-existing with a surging Japanese current account surplus—two phenomena that do not normally co-habit. The large rate differential drives capital outflows from Japan to foreign equity and bond markets, results in a weakened yen which, while strengthening Japanese exports, aggravates protectionism in the U.S. and elsewhere, makes life more difficult for other Asian economies (especially Korea and Southeast Asia), and might move China closer toward devaluation while blaming Japan if it does so. Removing, or at least reducing, this interest rate differential can help reverse this perverse cycle.

Our proposed interest rate boost can be accomplished by sales of some of the government’s 300 trillion yen (about $2.2 trillion) of government debt to domestic and foreign buyers, thus depressing bond values and increasing interest rates.

Paradoxically, this measure will not have deflationary consequences in Japan. Credit in Japan is, for the most part, extended on a relationship-driven basis, in which interest rates don’t play a significant role, except to the extent that they favor export industries, thereby further aggravating the cycle referred to above. If and as the yen strengthens, import prices in Japan should decline somewhat and consumer demand will respond accordingly.
These measures should be part of a serious effort to replace Japan’s perennial export-led growth strategy with what one of the authors has termed an “import-accommodating” strategy through market-opening policies that are neutral with respect to exports and imports.

This “import accommodating” strategy (see Wall Street Journal, May 20, 1998) is the third of our suggested therapies. Intended to make Japan’s markets more open, accessible, and competitive, it would include several elements:

- rapid reduction and eventual removal of preferential policies for export firms and industries, and of non-tariff barriers that impede import competition;
- permanent reduction of individual and corporate income taxes to levels at or below those in the United States and other healthy economies, as well as elimination of the domestic consumption tax that was introduced several years ago.

Such measures can help revive a Japanese economy whose predicament is the result of four decades of unremitting mercantilism designed and coordinated by its elite Finance and International Trade bureaucracy, implemented by its favored export industries, endorsed by its political class, and accepted by a passive Japanese public. Ultimately, rejuvenating the sclerotic economy depends on raising the productivity and profitability of capital in Japan by opening and expanding its domestic market. In turn, this depends on removing the pervasive barriers inhibiting market access by new firms and producers, whether Japanese or foreign.

Lately, and in part as a result of a profusion of rhetoric from an odd assortment of pundits, including Mohamad Mahathir, George Soros, Yevgeny Primakov, and Paul Krugman, it has become fashionable to harangue against the miscarriages of free markets. Japan is a compelling counter example: revival of Japan’s economy depends on sustained efforts to move its economy away from restricted markets and toward a freer, more open, and competitive market-governed system.
Postaudit

Sometimes advice that seems even more sensible ex post than it did ex ante seems ex post to have been heeded even less than might have been expected ex ante! What is suggested in this article illustrates this point. The following chapter perhaps explains why this has occurred.