

**Topic** Open Forum, Session 2 — Post-Quake Issues and Policy Response from the Perspective of Prices and the Economy

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**Participants**

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**Issues for discussion**

1. Outlook for aggregate demand and aggregate supply
2. Currency policy and implications of yen fluctuations

3. Outlook for Japan's potential growth rate and prices

**Summary of comments**

**1. Outlook for aggregate demand and aggregate supply**

**Mr. Takata:**

- Japan's national debt amounted to 75% of GDP at the time of the Hanshin-Awaji earthquake but now stands at 180% of output. Japan's relative position in the world has also diminished over the intervening years. However, that decline increases the potential for the country to benefit from external demand. Then, as now, a new administration had just come to power and the political situation was unstable. Corporate and bank balance sheets are healthier now as a result of the adjustments made since then, but the government's balance sheet has grown as the public sector took over for the private sector. In theory there is room for companies and financial institutions to expand their balance sheets. In practice, however, they are unable to break free from the deflationary mindset that has set in over the last two decades. Current problems include supply constraints imposed by electrical power shortages and supply chain disruptions—the latter in particular have prompted firms to shift production overseas. When thinking about supply, we should keep in mind that both the Great Kanto earthquake of 1923 and the Hanshin-Awaji earthquake of 1995 were followed by deflation triggered by yen appreciation and a financial crisis, and it is important to prevent this from happening again.
- The “lost 20 years” was brought about by adjustments of balance sheets. We now have the problem of capital accompanied by such adjustments again. Capital has been physically impaired, while the debts incurred to acquire that capital remain. Experiences of the past crisis including ours suggest that the first means of dealing with such crises was to take on the problem debt. The second was to provide support for profits from both flow and stock perspective. Once those

measures are taken, it is necessary to improve expectations for the economic outlook. In Japan, expectations for the future were dashed before capital could be sufficiently bolstered, leading to renewed capital problems. How to address this situation is a fundamental question for economic policymakers.

- At present, I think Japan suffers from complications of aggregate supply and aggregate demand. The government needs urgently to do something about supply constraints, and a modern version of the “priority production system” (a postwar policy designed to boost economic output by rationing goods, controlling prices, and providing public financing) is also necessary. However, Japan experienced moderate deflation due to weak aggregate demand following major earthquakes in the past, and a persistent output gap led to the entrenchment of deflationary sentiment starting in the 1990s. The problem is exacerbated by the fact that aggregate demand is being held back by electrical power constraints at a time when there should be robust reconstruction-related demand. There are also the ongoing balance sheet adjustments and fiscal contraction in the West along with persistent upward pressure on the yen. Given the significant downside risk, I think the policy response needs to focus on the lack of demand. Policy discipline is essential, as discussed in the first session.

**Mr. Fukuda :**

- I did not expect Japan's economy to contract this sharply following the earthquake. The decline in industrial production has been greater than that which followed the collapse of Lehman Brothers, and from a short-term perspective, at least, economic conditions in Japan are very bad. Both aggregate demand and aggregate supply are contracting. However, I

think the economic weakness observed up to this point is attributable more to supply-side factors such as power shortages and the collapse of supply chains. An easy way to determine whether supply or demand is responsible is to look at exports. If we take external demand as a given, exports are affected only by domestic supply factors, not by domestic demand. There was little change in exports in March as companies drew down their inventories, but exports plunged more than 10% in early and mid-April. It would be difficult to argue that external demand fell that much in such a short period of time. The drop also corresponded with a slump in industrial production, so I think it is safe to conclude that the decline was attributable to aggregate supply constraints. Moreover, one characteristic that was not observed after the Hanshin-Awaji earthquake was that economic activity contracted not only in areas affected by the quake but elsewhere as well. This also suggests that supply chain problems played a major role.

- Supply constraints should ease as supply chains are restored. In terms of aggregate demand, reconstruction demand should gradually pick up, spurring a modest recovery in the broader economy. Of course there are still many unknowns, including the uncertainty shrouding overseas economies, while supply chain problems are prompting manufacturers to shift production overseas. There are simply too many uncertainties surrounding the supply of electrical power to make any predictions.
- The crisis measures implemented by the Bank of Japan (BOJ) have had a meaningful impact. Notably, the BOJ responded more quickly than it did in the wake of the Hanshin-Awaji earthquake. This time the wider range of tools in its arsenal enabled it to supply large amounts of funds. It also increased its purchases of risk assets, something that was not done in the aftermath of the Hanshin-Awaji earthquake. Moreover, it is providing credit on special terms for financial institutions in the affected areas. Although this was also done after the Hanshin-Awaji earthquake, the large spread between short- and long-term interest rates at the time meant that it was effectively a subsidy of sorts. This time that is not the case. Another difference is that large financial institutions were operating in the areas affected by the Hanshin-Awaji earthquake, whereas most of the banks in the Tohoku area are small institutions, and many do not have current accounts with the BOJ. A further difference is that this time it would have been difficult to supply funds using standard operations.
- Given conditions in the affected areas, I fully understand the desire to provide a wide range of support in the form of financial reconstruction measures. But inasmuch as Japan's is a market economy, we should probably avoid some of the more extreme proposals like the so-called "Heisei debt

cancellation order." Personally I think we should utilize the loan underwriting functions of local financial institutions. We should take advantage of the fact that these institutions know better than anyone which companies have the potential to rebuild. As many of these institutions were heavily damaged themselves, the first policy priority should be to help them rebuild and to create an environment in which the financial system can function properly.

- Tackling deep-seated deflationary tendencies is a key issue for Japan. Recently there have been signs of gradual changes in the environment. First, global commodity prices are rising although they seem to have settled down in recent weeks. Second, short-term supply constraints—including power shortages due to the problems at Japan's nuclear facilities—are significant. Third, consumer sentiment is gradually shifting towards inflation. The latest results of the Cabinet Office's Consumer Confidence Survey show that three fourths of respondents are predicting higher prices, with more than half anticipating inflation of at least 2%. This suggests that deflationary sentiment is no longer as strong as it once was. While many look forward to rising prices, an acceleration of inflation would make it difficult for the BOJ to continue the kind of bold easing policies we have today. I believe the possibility of such an outcome is non-negligible.

**Mr. Fukao :**

- To be sure, there is some tightness in demand for goods due to supply chain disruptions. But inasmuch as production activity requires both capital and labor, a drop in production entails a drop in labor demand, which in turn leads to a sharp deterioration in labor market sentiment. We are already seeing this, even outside the three Tohoku prefectures. Supply shortages may prompt a temporary rise in consumer prices, but a decline in wage inflation and a relaxation of labor market supply and demand—which determine the underlying tone for inflation—could easily keep Japan mired in deflation. I agree with Mr. Takata's view that the drop in aggregate demand will have a greater impact. Realistically, I think the earthquake is likely to result in deflation that is as bad as or worse than it was prior to the quake.

**Mr. Uchida :**

- On the subject of supply constraints, electrical power poses some major problems, and if they continue for an extended period of time businesses will have to review their production systems. That could adversely affect Japan's long-term growth potential. In terms of aggregate demand, Q1 GDP figures indicate a drop of about 5% over the fiscal half. Based on expectations of a V-shaped recovery after the crisis, similar to what was observed after the Lehman-inspired financial shock, the standard view is that aggregate demand will continue to rebound from Q3 2011 through mid-2012 before

settling down in Q1 2013. However, constraints due to supply chain disruptions and power shortages will have an impact as the economy starts to recover in H2 2011. Additional complicating factors include the fact that the earthquake and tsunami affected a much larger area than the Hanshin-Awaji earthquake, an economy that feels substantially weaker, and the market's reduced ability to absorb JGB issues.

- An end to structural deflation will require a recovery in aggregate demand. That, in turn, will require economic measures for reconstruction. After the Hanshin-Awaji earthquake, bold economic policies—including measures to address the rapid appreciation of the yen—were adopted within about six months, fueling a rapid economic recovery led by public demand. This time it remains to be seen whether we will see a surge in public demand starting in Q3. Moreover, more government consumption and public works investment—including urban planning efforts and the construction of temporary housing—are needed to help boost aggregate demand. Next, an increase in external demand could drive a rapid increase in aggregate demand. The fact that foreign investors were net buyers of Japanese stocks for 28 consecutive weeks, providing support for share prices since the earthquake, probably reflects expectations that the Japanese economy will regain its competitiveness and achieve a V-shaped recovery driven by external demand or reconstruction measures. Growing uncertainty over external demand means that a domestic economic package will become increasingly important.

**Mr. Takata :**

- It is difficult to determine the relative importance of aggregate demand and aggregate supply. That said, the debt overhang of the past 20 years has been a very heavy burden. In comparison, designing the postwar reconstruction effort was easy. The government pushed ahead with balance sheet adjustments including a freeze on deposits and, in order to address the shortage of capital in the corporate sector, allowed the banks to earn excess profits while making them supply corporate loans that were capital-like in nature. The government also improved the outlook for external demand by introducing a fixed exchange rate of 360 yen to the dollar. The policy response will be much more difficult under today's circumstances. It will be impossible to quickly relieve the capital shortage, and solving debt overhang will be politically difficult given the problems of discipline and moral hazard discussed in the first session. As such, I think we need to be ready in the event that aggregate demand does not pick up, or even falls.

**Mr. Fukuda :**

- When discussing a revival of the Japanese economy, I think it is better to give separate consideration to the affected areas

and the Japanese economy as a whole. To be sure, economic conditions in the affected areas are severe. At a nationwide level, however, there are numerous other uncertainties surrounding aggregate demand and aggregate supply. One thing about the Consumer Confidence Survey I found interesting was the negative view that many respondents took of the nationwide decline in asset prices. This suggests that a negative wealth effect is operating, with adverse consequences for aggregate demand. On a nationwide level, there has been a pronounced decline in consumption of consumer durables, which may be partly attributable to people postponing purchases after the earthquake. It also remains unclear how the power shortages will play out on a national level. On this point, I think a quick fix for supply constraints is unlikely.

## 2. Currency policy and implications of yen fluctuations

**Inoue (Organizer):**

- Market participants are focusing most on overseas factors as a potential driver of the yen in the short term. In the US, people are watching to see what will happen to monetary policy after QE2 is discontinued at the end of June. The Fed is currently testing methods of sterilizing excess reserves while keeping MBS and Treasury securities on its balance sheet, but it has yet to initiate a dialogue with the market regarding specific strategies. In Europe as well, the ECB hiked rates in April in an attempt to rein in inflation expectations, but with the fiscal problems in certain nations driving increased instability, it is difficult to say whether the ECB will quietly go ahead with rate hikes—after all, it is also responsible for maintaining financial system stability. Market participants are also divided in their views on how the impact of tightening policies in the emerging economies will play out. Purchases of Japanese equities by overseas investors appear to be based on expectations of a recovery. But when I recently visited Europe, the markets seemed to be shifting their attention to the kinds of uncertainties surrounding both aggregate supply and aggregate demand that were discussed today. Meanwhile, it is difficult to come to any conclusions regarding domestic investors if we take sentiment into account, as noted by Mr. Takata. But if the Japanese economy embarks on a gradual recovery, I think enhanced risk appetite will provide support for a revival of overseas portfolio investment.
- The concerted intervention conducted immediately after the earthquake had great significance in terms of curbing further yen appreciation. At the time there were signs of instability in the financial markets of other major economies, and the yen had already climbed to a level that would have made it difficult for Japanese exporters to stay in business. But it is open to argument whether a similar response would be possible in the event of a renewed surge in the yen. If market participants

believe that a widening interest rate differential due to the normalization of monetary policy in Western and emerging nations will lead to a more stable yen rate, one option—barring an acceleration of yen strength—would be to adopt a wait-and-see stance. There is also the question of how to interpret the strong yen's impact on domestic inflation due to rising commodity prices.

- In the longer term, foreign investors in particular are saying that upward pressure on the yen will diminish as Japan's population ages, bringing a decline in the macro-level savings rate and a contraction of the nation's current account surplus. Private-sector businesses, which are the largest savers from a flow perspective, are more likely in the long run to earmark funds for overseas business investment and acquisitions than for domestic investment, and the dominant view is that domestic investors will continue to diversify their portfolios with overseas investments. At the very least, these factors should help ease upward pressure on the yen. Of course, if Japanese companies were able to boost their external competitiveness via innovation - including their response to the earthquake - and lift expected growth rates, this could lift the yen, in part by encouraging foreign investors to buy Japanese equities.
- One point that was also brought up at the last meeting of the Financial Markets Panel is the relationship between exchange rates and long-term interest rates. I think we eventually need to consider how to alleviate the impact on Japan's real economy and fiscal position in the event that yen weakness, whether intentional or not, were to begin affecting long-term interest rates, and how to maintain a balance in terms of administering exchange rate policy.

**Mr. Takata:**

- At the very least, it is a fact that most postwar responses to balance sheet problems around the world have included policies to weaken the local currency. After the latest financial crisis in the US, the central bank quickly supplied large amounts of funds to the financial markets, and I suspect a key objective of this operation was to cheapen the dollar. Throughout the 1990s, in contrast, Japan faced upward pressure on the yen, which placed a heavy burden on a private sector that was in the midst of balance sheet adjustments.
- That is why it is important to prevent further yen appreciation, and why the concerted intervention to drive down the yen was appropriate. But a recent visit to the US confirmed that, inasmuch as balance sheet adjustments have a long ways to go in the US, we are still far from being able to normalize monetary policy. Nor do I think current conditions in the Eurozone are conducive to a weakening of the yen against the euro. And this risk is probably reflected in recent currency market movements.

- Japan's current account surplus is a key basis of confidence in JGBs. The trade surplus may decline, but the current account balance is unlikely to fall into deficit for many years. In any event, this is important not only for exchange rates but also for the stability of the JGB market.

**Mr. Fukuda:**

- The concerted intervention after the earthquake drove the yen down, and it has stayed there ever since. I think there are few measures that Japan can take in terms of currency policy. With monetary policy as accommodative as it is today, the only response to a rapid appreciation of the yen is intervention. In that sense, currency market developments are largely dependent on what happens overseas. We may see a modest downward move in the yen if the Fed ends its easing bias.

**Mr. Fukao:**

- Although I have predicted in my previous speeches that the yen would move higher against other currencies, I now think it is more likely to weaken. First, the shift from nuclear to thermal power plants is likely to mean a substantial increase in imports of natural gas, coal, and oil. Tight global supplies of primary goods also continue to push up import prices in Japan. In addition, the recent nuclear incident will probably lead to a further decline in Japan's external competitiveness. Instead of the weaker yen enhancing Japan's global competitiveness, we will probably have a situation in which waning competitiveness triggers a slump in exports, as a result of which the yen falls against other currencies. I suspect that global manufacturers that depended on made-in-Japan components will wake up to the risk of supply chain disruptions and begin shifting their business from suppliers in Japan to those in China, Korea, or the ASEAN nations.

**Mr. Uchida:**

- Although the yen's real effective exchange rate marked a clear top in 1995, the nominal effective rate has continued to climb because of the inflation rate differential between Japan and other nations. In effect, exchange rates are simply serving to adjust price differentials. Exchange rates, which reflect the actual strength of the Japanese economy, peaked out in 1995, but deflation has pushed the yen higher against other currencies in nominal terms, with occasional disparities due to real interest rate differentials in the economic climate. Market participants have noted that the yen is unlikely to move lower on a nominal basis unless the real short-term interest rate differential between Japan and key overseas economies rises to about 2%.
- When I participated in an international conference in Europe last autumn, a Dutch gentleman who used to work for that country's Ministry of Finance said that one policy response to a strong currency was to encourage overseas investment. Like Japan, the Netherlands has a trade-based economy and

consistently runs a current account surplus. I think Japan needs to take funds that are being supplied at zero interest rates and invest them overseas. For that, we need a structure for the cross-border supply of liquidity. If Japan's economic strategy and global competitiveness are closely tied to Asia, one option might be to create a system that would allow swap agreements in a non-crisis version of the Chiang Mai Initiative for ASEAN+3 or ASEAN+Japan. That would provide a built-in stabilizer against a sharp appreciation of the yen—with all the adverse implications for Japan's economy—by allowing Japanese capital to flow smoothly overseas.

**Mr. Takata:**

The points noted by Mr. Uchida are important ones, but unfortunately the reality is different. While capital flows from Japan overseas are earmarked almost entirely for risk-free assets like US Treasury securities, inward investment to Japan is almost exclusively for equities. In other words, whereas Japan is impairing the economic value in our financial system, other countries are obtaining risk-free funds and investing them in equities, a far more profitable arrangement. Domestically as well, operating companies that obtain low-cost funding and invest in business operations can sustain profit margins, while financial institutions are impairing their business value. I think it will become increasingly difficult for Japan to effectively utilize its accumulated current account surplus as the “capital problem” described earlier becomes more serious.

**3. Outlook for Japan's potential growth rate and prices**

**Mr. Fukao:**

Of the factors determining our potential growth rate, the labor force is shrinking by about 1% a year, lowering potential growth by about 0.6ppt. Capital investment cannot be expected to contribute to potential growth as long as it continues to run below depreciation expense. Even if we add an average contribution from total factor productivity, that would merely offset the negative contribution from labor and bring potential growth up to around zero. The potential growth rate might rise to 0.4%–0.5% if the economy picked up modestly and boosted capital formation. In the US, meanwhile, the labor force is expanding at a rate of about 1% a year, so that alone creates an approximately 2ppt differential in potential growth between the two countries. The growth in our total factor productivity, while reasonably high, cannot offset the impact of the shrinking labor force. And in terms of human capital, we should not overlook the outflow of the many talented foreigners who left Japan after the nuclear incident. The number of graduate students registered at my university has fallen by about 30% compared with last year's autumn term. Although they are slowly returning, a substantial number have transferred to schools in other countries or entered the

workforce. It is hard not to be pessimistic on this point.

- The GDP of the three Tohoku prefectures hit hardest by the earthquake represents some 4% of the nation's total output, and areas directly affected by the quake probably represent about half of that figure. So if production were completely halted in these areas, the hit to GDP would be about 2%. And if we take into account the impact of the supply chain disruptions mentioned earlier, it would not be surprising if GDP contracted by 3–4%, which while less than the 5% contraction that followed the collapse of Lehman Brothers would still be significant.
- With companies struggling to conserve energy in response to expected power constraints this summer, I think it will be difficult to achieve a full recovery in production. At my university priority must be given to the hospital, which consumes a great deal of power, so in order to meet our overall energy conservation targets there will be no trial period. I think there are more efficient methods than across-the-board cuts in energy consumption. For example, I think we could gain substantial leeway by allowing companies with their own generators to lend surplus power to each other, but the wholesale market for electrical power has been shut down just after the earthquake. And if restrictions on power consumption are to be enacted, “cap and trade” or other market mechanisms would probably be more effective. Yesterday I presented a joint proposal with Takatoshi Ito and others in which we argued that a severe impact on GDP could be avoided if businesses able to sharply reduce energy consumption were to pass their power on to companies unable to do so. Unfortunately, there seems to be a lack of the kinds of ideas and leadership needed to put this kind of measure into practice.
- Another problem is that the lack of proper disclosure regarding the effects of radiation is impeding distribution at a time when supporting demand for agricultural products is essential for a GDP recovery in the three Tohoku prefectures. I personally do not think the phrase “reputational damage” accurately describes the situation. I think that if the government provided sufficient disclosure, consumers would be able to make their own decisions based on a rational consideration of price and risk. And the TEPCO could simply compensate producers for any discrepancy between those (lower) prices and ordinary market prices. For products that were too contaminated to be consumed, the entire harvest could be bought up by the TEPCO and disposed of. Milk should not pose any health concerns if the cows are fed imported feed and kept in barns. As long as the milk produced is tested for radiation before shipping and provided with the results of such tests, I think consumers will buy it. Measures like these will help mitigate the production slump in the affected areas.

**Mr. Uchida:**

- After the Hanshin-Awaji earthquake, the Japanese economy embarked on a self-sustaining recovery as the private capital stock was restored. Today, however, the structural deflation plaguing the economy means there are limits to the amount of fiscal stimulus that can be delivered. There is also the risk that even if the government provides fiscal stimulus, agents in the private economy will choose to curtail their own spending in anticipation of higher future taxes. I therefore think it is important that we continue the reconstruction measures—which should consist of well-defined policies to encourage private investment, including urban renewal and housing—in the medium term. While differences in economic structures prevent a simple comparison, I note that the pace of reconstruction after the massive earthquake in China's Sichuan province accelerated after the government unveiled a plan for development of the country's western region. Reconstruction from Hurricane Katrina in the US also progressed in accordance with a large-scale urban development plan called a clustering program. In Japan as well, I think the only way forward is for politicians to exercise leadership and provide support for the economy with a mix of fiscal and monetary policy in the short term while moving towards a self-sustaining reconstruction effort.
- There has traditionally been an excessive dependence on government in Japan, with people believing that, in the end, “the government will take care of us.” That is why government spending has grown to the extent it has. But the limits to this way of thinking will become increasingly obvious five to ten years from now when the population has grown even older and the macro-level savings rate has turned negative. Once the government starts cutting public pension benefits and people begin calling into doubt the sustainability of government finances, I suspect fiscal stimulus will prompt people to save more for their children and grandchildren. This is also an important point to remember in terms of maintaining stability in the JGB market.
- There are limits to what the central bank can do under these circumstances in the sense of directly standing in for fiscal policy. But it can exert a certain amount of influence over asset prices and credit, thereby encouraging private investment and ultimately boosting macro-level productivity. The concept of a Financial Conditions Index (FCI) is once again attracting attention in the debate over macro-prudence, and it is hoped that in a country like Japan, which is characterized by an increasingly stock-oriented economy and an aging population, the central bank will supplement monetary policy—which affects real interest rates and exchange rates—with other tools like the purchase of risk assets.

**Mr. Fukao:**

- Regarding the points noted by Mr. Uchida, the Ricardian equivalence theorem is frequently misunderstood. This theory holds that fiscal expenditures are equally effective whether they are funded by tax revenues or by the issue of government debt.

**Mr. Fukuda:**

- In an extreme case in which funding is raised via taxes and the money is simply distributed as cash, won't the effect of the fiscal outlays be negated?

**Mr. Fukao:**

- That is true if there is only one private economic agent, but ordinarily distributions are made to a large number of agents. Taxing high-income individuals and distributing the money to low-income individuals, for example, is effective because these two groups have different propensities to consume.

**Mr. Fukuda:**

- In that sense, any kind of taxation should have the effect of redistributing income.

**Mr. Fukao:**

- “Equivalence” in the equivalence theorem refers to the fact that the method of funding does not affect the impact of fiscal policy. And if fiscal outlays consist of public works investment, they can always be expected to have a certain impact. They should have at least a temporary economic effect, particularly if they are used to build roads or embankments as part of the reconstruction work.

**Mr. Fukuda:**

- I think the idea that fiscal expenditures will always have a positive impact is a very Keynesian notion. Even if we agree that fiscal expenditures will have an impact in the sense that they are not neutral, it is impossible from a theoretical standpoint to say that this will always be positive.

**Mr. Fukao:**

- Standard theoretical models show that the impact will be positive as long as the money is spent on worthwhile projects.

**Mr. Fukuda:**

- But the funding itself is not without cost, so I don't think we can say a priori that the impact will be positive. GDP will not necessarily increase every time we build a dam for free.

**Mr. Fukao:**

- I agree that there is something wrong with the concept of building statues of Lenin and counting them as part of GDP.

**Mr. Fukuda:**

- I concur with Mr. Fukao that the size of the work force will place a long-term constraint on the economy's potential growth rate, but I do not think the constraint will be that binding in the short term. At present there is substantial slack in the

labor supply due to unemployment. From the perspective of growth accounting, people like Hayashi and Prescott have demonstrated that there are two causes for the nation's stagnant economic growth over the past 20 years: a sluggish rate of technological progress, as measured by total factor productivity, and a small labor contribution. The problem with the latter, however, is not the work force but rather the decline in hours worked. There are a variety of explanations for this decline, including an increase in holiday leave and the growing adoption of a five-day workweek. The recession has also helped reduce the number of hours worked. Accordingly, I think there is some room for restoring working hours to previous levels.

- While it is true that the revival of fishing and agriculture is important to the reconstruction of the affected areas, we also have to remember that the largest industry in the coastal regions of Fukushima prefecture was atomic power. Personally I feel it will be difficult to sustain the nuclear power industry. Nonetheless, I do not think we can suddenly shut all the plants down if we consider the people working there and the stores located near the plants. For better or worse, Fukushima prefecture's economy is highly dependent on the electrical power industry, and unless we come up with an appropriate process for transitioning away from nuclear power, it could have an unnecessarily heavy impact on employment and economic activity in the affected areas.

**Inoue (Organizer):**

- One issue discussed at a previous meeting of the Financial Markets Panel was the possibility that the decline in labor's contribution to the growth rate was attributable to the fact that, faced with a slump in aggregate demand, both employers and employees preferred adjusting working hours while maintaining employment to laying people off.

**Mr. Fukuda:**

- I think that may be the case. Although the unemployment rate has risen since the mid-1990s, this kind of custom persists at Japanese firms, at least relative to overseas companies.

**Mr. Fukao:**

- My point concerned the potential growth rate at a time when both labor and capital are being properly utilized, and at present that rate is around zero. Given the existence of unused labor and capital in the Japanese economy today, I think there is the potential for aggregate demand to expand by about 5% from current levels. However, I project the labor supply will become a bottleneck in two or three years, not 10 or 20 years. Although the output gap had shrunk to about 5% of GDP prior to the earthquake, it is now impossible to calculate at the time when the gap varies for respective industries due to supply constraints. The output gap is calculated from a macroeconomic perspective using labor

and capital. While certain sectors, such as electrical power and auto parts, now have an output gap of zero due to supply constraints, other sectors—such as basic materials—may be characterized by excess supply.

**Mr. Takata:**

- Many US investors have told me that Japan's policy response suffers from gridlock. They argue that in spite of the Japanese economy's inherent potential, the government is effectively tying its own hands. As for balance sheet problems, the important thing for the time being is for the government to take on the liabilities. That is ordinarily the role of fiscal policy. US investors understand the fiscal difficulties Japan faces, but they are starting to wonder why the government does not do anything in response to the crisis.
- In a situation like this, where the nation's rigid fiscal position prevents action and the government itself is paralyzed by political factors, I think the central bank must ultimately play a fiscal role. As Mr. Uchida noted, monetary policy ordinarily consists of adjusting the policy rate, and if any assets are bought they are government securities. But under current circumstances the central bank has to buy a wider range of assets. Japan's fiscal position has deteriorated sharply over the last 20 years, but the private sector still has room to borrow, and to some extent it is a question of sentiment. Too, the BOJ's balance sheet is in better shape than the nation's finances, and the question now is how best to utilize that balance sheet.

**Inoue (Organizer):**

- Many of the participants in the first session seemed reluctant to sanction greater purchases of assets by the central bank. I find it interesting that we are seeing a slightly different perspective in the second session.
- Viewed from the opposite direction, the question is how much importance we place on maintaining a healthy central bank balance sheet. I think Japanese views on this point often differ from those in the West. In the US, for example, many argue that even if the Fed's balance sheet were to be impaired as a result of purchases of MBS or government bonds, it would only be a technical problem that could easily be solved by adjusting the Fed's payments to the Treasury Department. In their view, confidence in the central bank depends not on the health of its balance sheet but rather on the appropriateness of the policy measures that affected the balance sheet. The Swiss National Bank's large holdings of foreign reserves have frequently led to large losses as the Swiss franc has appreciated, but there has been little if any talk of an impairment of confidence in the Swiss franc or the SNB. However, many Japanese market participants would object to this view and have criticized the Fed for adopting this sort of stance at a time when confidence in the dollar has already

been shaken. I think the implications of central bank balance sheet health are not a binary issue but rather one of degree that is also influenced by the environment, including whether or not that nation's economy and fiscal position are in the midst of a crisis.

**Mr. Fukao:**

- Although central banks do have a “hidden reserve” in the form of the banknotes, making them appearing to do anything they want to, utilizing those reserves would be simply passing the fiscal buck to the central bank. Most of the “hidden reserves” discussed in the past involve loaning money to subsidiaries which then return the money in the form of a dividend to make the general account appear in better shape than it actually is. While it would be possible to release a substantial amount of reserves by using the central bank's balance sheet in this way, it would also undermine the Japanese government's credibility. While this might be used as a last resort by the government to make the deficit seem smaller, it should be avoided because it only makes it more difficult to tell where the real problems lie. One possibility is to give the reins of government to politicians who insist a tax hike is unnecessary under the condition that they pursue fiscal consolidation. This would be similar to dealing with a tenant who insists that apartment maintenance fees are unnecessary by making him responsible for managing the apartment, with the condition that he scale back spending. I think this kind of incentive-compatible structure would be useful.

**Mr. Fukuda:**

- History shows that an expansion of the central bank's balance sheet does not necessarily lead to inflation. The empirical research on hyperinflation performed by Thomas Sargent at New York University shows that while a marked expansion of the central bank's balance sheet leads to inflation in the long term, there is no one-on-one correspondence. There have been cases, for instance, in which continuous expansion of the balance sheet results in intermittent bouts of inflation and cases in which a rapid contraction of the central bank balance sheet does not help rein in inflation. Based on those findings, he emphasized the importance of confidence in the central bank. The primary reason why there is no inflation in Japan despite the huge growth in the BOJ's balance sheet is that the general public believes it is safe to hold BOJ banknotes. While such confidence may seem a matter of course, in fact it is something the central bank has earned over a long history of policy decisions, and its importance should not be underestimated.

**Inoue (Organizer):**

- Could we have a comment from Mr. Egawa, who discussed this issue in the first session?

**Mr. Yukio Egawa, Chief Strategist, Research Division, Shinsei Securities:**

- One of the crisis measures adopted in the US was TALF, under which the Fed provided funds against collateral of securitized products on a non-recourse basis. This was a joint policy measure by the Fed and the Treasury inasmuch as any losses would be borne by the government, and it is ultimately expected to generate substantial profits. Inasmuch as central banks tend to buy risk assets at times when asset prices have undershot, the purchases often end up being profitable, removing any initial concerns about a deterioration of the central bank balance sheet.

**Mr. Fukao:**

- As has been pointed out, I think it is possible for the central bank to purchase assets whose prices have undershot. My biggest concern regarding the central bank balance sheet is the idea of issuing government currency. Such currency can be viewed as a perpetual government bond that yields nothing. If the government were to issue large quantities of such currency and force the BOJ to underwrite it, perpetual non-interest-bearing government debt would accumulate on the BOJ's balance sheet. The BOJ's interest income would decline, and it would eventually start losing money. And if the BOJ tried to call in the banknotes or current accounts, the market would be unwilling to accept the government currency, making it difficult for the BOJ to carry out selling operations. While there are rumors of the issue of government currency, I think this kind of action should be avoided because it would lead to significant impairment of the BOJ's balance sheet.

**Mr. Fukuda:**

- The BOJ had substantial unrealized gains on the shares it purchased from financial institutions during the last financial crisis because share prices rose as the economy recovered. The BOJ sold some of those shares as the market rose and continued to hold the rest. Then share prices once again fell steeply, trimming the BOJ's net profit sharply. The BOJ also has a large JGB portfolio, but these securities yield relatively little in the current low interest rate environment, and as a result BOJ remittances to the Ministry of Finance have fallen relative to past levels.

**Mr. Takata:**

- The Fed's purchases of MBS definitely had a major impact. I think there are a variety of opinions on the question of whether the BOJ would do the same thing in the event of a deterioration of economic conditions in Japan. However, having the government take on debts is an important option in terms of moving ahead with balance sheet adjustments.

**Mr. Fukao:**

- A major difference between the US and Japan in terms of fiscal systems is that Japan has a fiscal loan and investment

program, whereas the US does not. The fact that public-sector financial institutions in the US are relatively small forced the Fed to come up with its own measures to address the crisis. In Japan, the public finance-based crisis measures already in place should be sufficient, and I think there was little need for the central bank to enter this realm.

**Mr. Uchida:**

- If we could expect steady upward growth for the Japanese economy, it should be possible for the BOJ to efficiently conduct monetary policy by adjusting the policy rate and liquidity based on a broad view of the macro-economy. At present, however, there is no visible growth path for Japan's economy, partly because of the impact of the 11 March earthquake. A major issue for financial institutions is that the ability to foster new enterprises has been lost. The path to new enterprise has been blocked by the aging of Japanese companies, the lack of a financial culture to encourage start-ups, and heavy-handed regulation. Under these conditions, I suspect the effect of BOJ purchases of either government bonds—which are the starting point for the allocation of funds from a macro perspective—or equities is likely to be limited.
- We need to develop a new economic culture that is conducive to the creation of new businesses, and I think the earthquake reconstruction effort could provide a good opportunity in this respect. The response to the nuclear incident must ultimately involve a new energy policy that leads to new start-ups. One reason why the Fed's provision of funds and purchases of risk assets were effective in the US is the existence of risk money and a framework to channel these funds to fast-growing start-ups, thereby prompting economic growth. In Japan as well, unless financial institutions and policy authorities are able to come up with policies to foster start-ups that will lead to economic growth, debate on growth strategies will continue to go round in circles, and financial institutions will keep investing nearly all their funds in government bonds. Even if the BOJ expands its balance sheet, everything will be dependent on government fiscal policy. If the savings rate turns negative over the next five to ten years as the population ages, forcing the Ministry of Finance to rely on foreign investors to help take up debt issues, rating agencies are likely to take an increasingly severe view of Japan's sovereign debt. The world may well give up on Japan unless it is able to change its economic structure and secure paths for growth.

**Mr. Takata:**

- Japan's flow-of-funds data show that over the past 20 years the only sectors in the economy seeking loans were the government and the rest of the world. The only way that monetary policy could be effective was for it to act on these two sectors. In other words, corporate or household sector

leverage could not be utilized, and the only effective areas for monetary policy were those of debt management policy and foreign exchange policy. Unless we think about ways to restore growth in the corporate and household sectors, as Mr. Uchida pointed out, the central bank will continue to be called upon to fulfill a variety of roles.

**Mr. Fukuda:**

- Japan's households have some ¥1,400trn in financial assets, more than half of which have been channeled to financial institutions in the form of deposits and savings. That leads to a distortion of money flows, with financial institutions' funds flowing to the JGB market because they have nowhere else to go. I think it will be difficult to enhance the Japanese economy's potential growth rate from a financial perspective unless this system is changed. There are companies that, while not seeking bank loans, would avail themselves of risk money if it were offered. I think the question of what kind of policy response the BOJ should implement is a secondary issue compared with this.

**Mr. Fukao:**

- An analysis of financial asset holdings by age shows individuals aged 70 and over holding some 40% of all assets, those in their 50s and 60s holding about 30% each, and those aged 49 and below holding an equal amount of assets and liabilities for a net total of zero. Elderly individuals holding substantial financial assets have probably tried and failed to invest their money in foreign currencies or stocks, before returning in the end to ordinary bank deposits because they had no other option. In order to increase the supply of risk money, as noted by Mr. Uchida, we need to increase the number of people willing to invest in equities. The taxation of equity investments is extremely complex, for example, with almost no one able to understand the system at first glance. If we want to avoid a situation in which investors refuse to buy stocks because paying taxes on them is so difficult, we need to simplify securities taxation and make it easy for the elderly to understand. Another possibility would be to make it possible for people with accounts at more than one securities firm to calculate their tax liability automatically. It is also important to allow to some extent the netting of gains and losses on equities and other financial assets and labor earnings. Personally, I think it would be acceptable to raise the tax on dividends to some extent in exchange for these changes.

**4. Comments from the floor**

**Unidentified speaker:**

- The underlying problem in the response to the earthquake is the question of what to do about the impaired capital stock. Our generation has continued to engage in inefficient public works investment and left the burden of maintaining these facilities to the younger generation. That is why businesses

must use their savings and leave a meaningful capital stock for the next generation. As for the policy response, I think it is more important—as Mr. Uchida pointed out—to focus on taxation and urban planning than to ask what the central bank can do. After that, the nation must ensure that there are meaningful assets for the next generation on the other side of the balance sheet from all the JGBs.

- As for the purchase of assets by the central bank, I think it would be a good thing—given Milton Friedman’s comment that profitable market interventions were efficient—for the central bank to generate profits by buying assets whose prices have undershot.

**Mr. Uchida:**

- I would also like to leave a useful capital stock to the next generation while maintaining intrinsic confidence in the Japanese economy by presenting a meaningful reconstruction plan. That will require special economic zones in the broad sense of the term and industrial policy. One possibility in this regard is private finance initiatives (PFIs), the use of which is increasing—for example, in the post-Katrina reconstruction work. Essentially this involves contracting with the private sector to carry out work the government would ordinarily do. The projects are implemented with private-sector funds or based on a private-sector perspective instead of using fiscal funds. PFIs often run into problems in terms of existing regulation and barriers to entry. This time, however, I can envision a situation in which a wide-area PFI structure is created as part of urban planning, an equity fund is established with funds provided by regional financial institutions, and operating funds are provided using special grants or centralized subsidies with government guarantees.

**Mr. Fukao:**

- I concur with the use of PFIs, but I think we need to give thorough consideration to the question of which sectors to target. In particular, the UK example has demonstrated that the use of PFIs in monopolistic sectors with no competition tends to fail. And in the sense of providing a legacy for the next generation, I think leaving behind a beautiful country is the most important thing. As such, we need to do whatever is necessary to clean up seriously contaminated areas, even if it requires substantial funds.

**Mr. Izuru Kato, Chief Economist and Managing Director, Totan Research:**

- As Mr. Fukao has noted, the fact that one in three graduate students has left Japan is a major problem. It was not too long ago that US president Barack Obama said the US should do whatever is necessary to ensure that the next Google or Intel was not created in China or India. As these companies were created by immigrants, the President’s statement was probably intended as an argument against the Republicans’

attempt to institute new restrictions on immigration. Public opinion in Europe is also shifting towards the right on the political spectrum, with more people supporting such restrictions. In Japan, where the population is expected to decline going forward, it is essential to raise expectations of growth by attracting skilled workers from abroad. If the earthquake has set in motion a trend in the opposite direction, I think it would be of great concern.

**Mr. Fukao:**

- Japanese sumo may suffer from a variety of problems, but I think it should be praised for the way it has brought on foreign wrestlers and allowed them to rise to the top of the sport. If Japanese companies demonstrate to potential foreign hires that they can one day be promoted to high levels within the company, they should have no difficulty attracting skilled employees. There were many foreign students at my university—chiefly Chinese—but few of them wanted to work for Japanese financial institutions. Not only do Japanese companies offer lower salaries than foreign firms, but there are said to be ceilings on the promotion of foreigners within the company. I think it will be difficult for Japan to create companies like Intel as long as these circumstances persist.

**Mr. Fukuda:**

- Japanese views towards the acceptance of foreigners can be divided into two camps. One holds that all immigrants should be forced to assimilate and speak Japanese, including difficult technical terms. This is the traditional way of doing things, and there are structures in place to accommodate this approach. Another view is that Japan should welcome everybody—including those who do not speak Japanese. Although some companies have made English the official language of business, society as a whole is not yet ready to accept English speakers. At my university there were classes conducted in English and instructors who spoke only English, but for administrative staff it was difficult to deal with people who couldn’t speak English. If Japan is to enhance its global competitiveness, it needs to create structures for the acceptance of people who can compete on a global level without regard to their Japanese ability.

**Inoue (Organizer):**

- Since we are now out of time, I would like to call an end to the second session. It is my hope that the views expressed today will serve as useful reference for everyone here.

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