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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

95-146946

UNDER SECRETARY

June 9, 1995

MEMORANDUM FOR SECRETARY RUBIN

FROM: Lawrence Summers
Under Secretary
(International Affairs)

SUBJECT: Japanese Recession and the Global Economy

The attached note explains in some detail our growing concern about macroeconomic developments in Japan. With strong economic performance in the United States and hopeful signs of a recovery in Japan, macroeconomic issues have fallen out of the spotlight while we have vigorously pursued our structural agenda with Japan. There have been some successes, notably the correction in the Japanese current account. Now, with the emergence of signs of a protracted slowdown in Japan, it would appear to be a good time for a tactical step-up in our attention to the macroeconomic dialogue.

I would recommend the following steps in that connection:

o That you meet with Finance Minister Takemura in Halifax and reinforce your concerns about the macroeconomic situation more explicitly than you have in past meetings. (A slot has been reserved for a 30 minute bilateral on Thursday afternoon after the President's meeting with Prime Minister Murayama.)

o That you send Jeff Shafer or myself to Tokyo later this summer to meet our counterparts (some of whom have just assumed their position) and reinforce your message.

o That you look for an appropriate public forum for expressing the view that it is in Japan's interest, as well as that of its major trading partners, to put in place the policies sufficient to support a strong recovery.

One final caveat: any public statements will need to be handled delicately, to avoid the charge that we are simply finger pointing because of trade disputes or to deflect attention from evidence of a slowdown in the United States.

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Authority:
Date: 4/30/08

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Robert B. Kahn
June 9, 1995

Japanese Recession and the Global Economy

Executive Summary

The major uncertainty affecting our generally positive outlook for sustained expansion in the major industrial countries is the prospect for recovery in Japan. Most private and public forecasts now show weak growth in 1995-96, and there is some concern of a 1930s-type scenario unfolding where high ~~real interest rates, deflation, rising unemployment and yen appreciation~~ reinforce one another and cause sharp declines in activity.

While not the most likely outcome, a downward spiral or "black hole" scenario would have serious consequences for Japan and the United States. A sharp recession in Japan -- or several years of no growth -- could weaken the world economy, ~~harm U.S. trade interests and stir protectionist pressures, and upset~~ financial markets. Japanese firms might be forced to liquidate dollar assets to rebuild balance sheets, weakening the dollar. And we would likely make slower progress on important structural reforms.

We identify three vicious cycles undermining activity in Japan: (i) an interest rate-slowdown cycle, whereby falling prices and high real interest rates contribute to a growth slowdown, which feeds another round of downward price pressure; (ii) an unemployment-confidence cycle, whereby rising unemployment reduces consumer confidence, leading to a further fall in spending and further layoffs; and (iii) a deflation-exchange rate cycle, whereby deflation has effects through the exchange rate channel, leading to downward pressure on the yen price of imports and exports, further contributing to deflationary pressure.

In addition, the outlook is made all the more difficult by the ongoing troubles of banking system. Banks are burdened by rising levels of bad loans, shrinking collateral, and diminished levels of hidden profits available to cover losses. Overall, we are concerned by the possibility of a collapse of the real economy and the financial economy.

Monetary and fiscal policies can and should be used to provide support for aggregate demand and as a precaution against the downside risks. The case is strongest for an immediate further cut in interest rates, which could provide some additional stimulus and which has no cost in terms of inflation risks. Fiscal policy should also contribute, although we need to recognize that it has already moved a good amount.

In light of these considerations, the Treasury should seek, both in private and public statements, to raise the profile of our macroeconomic dialogue with Japan and indicate the importance we place on the Japanese authorities putting in place the policies necessary to assure a strong and sustained recovery.

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Japanese Recession and the Global Economy

Overview

This memo will address four issues. First, it will suggest that there are a number of forces simultaneously working to depress activity in Japan. Second, it will discuss concerns that Japan may be trapped in a number of "vicious cycles", where high real interest rates, deflation, rising unemployment and yen appreciation reinforce one another and cause further declines in activity. Third, we argue that, while not the most likely outcome, a downward spiral or "black hole" scenario would have serious consequences for Japan and the United States. Fourth, monetary and fiscal policies can and should be used to provide support for aggregate demand and as a precaution against the downside risks. For these reasons, the Treasury should seek, both in private and public statements, to raise the profile of our macroeconomic dialogue with Japan and indicate the importance we place on the Japanese authorities putting in place the policies necessary to assure a strong and sustained recovery.

Contractionary forces

A great deal of gloom surrounds the Japanese economy these days. There is growing concern that the economy will experience a triple dip, with output falling or at least failing to recover strongly for a number of years. A number of factors are seen as contributing to the weakening outlook.

- *Deflation*. With prices falling at all levels of production, interest rates -- while low in nominal terms -- are high for this stage of the cycle. Further, continued declines in land and asset prices weaken balance sheets and consumption.

  - The consumer price level has fallen 3/4% since the end of 1994. Given likely mismeasurement of the indices, prices are probably falling in the neighborhood of 1% or more. Consequently, the real short-term interest rate is 2 to 3% and real long rates are 4-5%.

- *Exchange rate woes*. The rise of the yen on a trade-weighted basis -- 11% this year and 27% since the end of 1992 -- has contributed to deflation, reduced consumer confidence, and weakened export and growth prospects.

- *No sign of recovery*. The economy has not grown over the last 10 quarters, net, with private domestic demand falling at a 1 1/4% annual rate. Consumer confidence is low, retail sales weak, and industrial production is below its level of 5 years ago. Unemployment reached a post-war high of 3.2% in April, and is expected to rise further over the next year.

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- o *Survey numbers weak.* Industrial investment plans are restrained by the weak economy and appreciated yen; many firms are looking to move production offshore.

  - MITI projects a 3 percent *decline* in industrial production between April and June based on its survey of manufacturers' intentions.

- o *Investment hangover.* The economy is still working through a stock adjustment on the investment side left over from the easy money period of the late 1980s. (Business fixed investment stabilized late last year after three years of declines.)

  - The strong yen discourages exports and reduces corporate profitability, which could delay an upswing in plant and equipment investment.

- o *Banks continue to struggle.* Weak balance sheets of Japanese financial institutions potentially affect credit allocation and limit the capacity of banks to finance growth.

- o *A few bright notes.* The dramatic decline in long-term interest rates, with 10-year bond yields dropping 185 basis points since the beginning of the year, is a plus for the recovery. And the May Tankan Survey showed a slight improvement in short-term business sentiment, although the index was below earlier expectations and no further improvement is expected over the next three months.

Near-term outlook

Most forecasters expect that, under current monetary and fiscal policies, Japan will have relatively little growth this year and next. The May consensus forecast has growth of 1.3% in 1995 and 2% in 1996, down from 1.9% and 3.3% three months ago. And we expect further downward revisions in the months ahead. (Our own forecast is for growth of 0.9% in 1995 and 2% in 1996.) Growth in the 2% range is not likely to reduce the large output gap in Japan over the next two years. A weak recovery in Japan threatens to spill over to its major trading partners, depressing world wide growth prospects.

The most widely accepted scenario is one of a very moderate upturn, strengthening a bit in 1996. But the recovery is sufficiently fragile that a profound downturn lasting several quarters should not be ruled out. Most of the risks are on the downside. Further, the factors noted above are being propagated by three vicious cycles.

The interest rate-slowdown cycle. Falling prices and high real interest rates for this stage of the cycle are contributing to a growth slowdown, depressing investment and raising credit risk. Reduced aggregate demand leads to lower income and consumption growth, and lower firm profitability, which feeds another round of downward price pressure.

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The unemployment-confidence cycle. There is rising concern about unemployment and the breakdown of Japan's lifetime employment system. Greater job insecurity is contributing to reduced consumer confidence. This curtails household spending, the primary engine of recovery to date, as consumer increase their precautionary saving. This leads to a further fall in demand and further layoffs.

The deflation-exchange rate cycle. Deflation also has effects through the exchange rate channel, to the extent that higher real interest rates lead to an increase in the relative attractiveness of yen assets. The appreciation of the yen leads to downward pressure on the yen price of imports and exports, further contributing to deflationary pressure.

In addition to these three cycles, the outlook is made all the more difficult by the ongoing troubles of the banking system. Banks are burdened by rising levels of bad loans, shrinking collateral, and diminished levels of hidden profits available to cover losses. Most knowledgeable opinion agrees on the following conclusions:

- The Government's estimates of the bad loan problem remain unrealistically low. On June 6, the Government announced that non-performing assets of all Japanese financial institutions are about ¥40 trillion (about $475 billion), equal to about 6% of outstanding loans and 9% of GDP. This estimate includes all the banks, but excludes insurers, which are also major lenders.
    - Conservative non-Government estimates place the bad-loan problem of the banks in the range of ¥60-70 trillion, and some estimates are far larger.
- While reported capital levels are above Tier I/II guidelines, the above figures suggest that Japanese banks are relatively poorly capitalized. Continued weakness in the stock market would further erode the health of the financial system.
- Despite all this, most regulatory (e.g., FRB) and Tokyo-based independent bank analysts do not believe that there is a substantial threat to the viability of the core of financial institutions. Thus, while further bank failures cannot be ruled out, a systemic run on the banks is not expected.
    - There are a number of specialized financial institutions (e.g., credit unions) facing serious difficulties, but their assets are a small share of the financial system.
- Banks are poorly positioned to finance a pick-up in demand, making a normal recovery (with a sharp bounceback and several quarters of above potential growth) less likely. Already, there is general agreement that banks have become more cautious in new lending and are seeking to shrink their overall balance sheets.

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Overall, we are concerned by the possibility of two serious and related risks. The first is the prospect of a collapse of the ***real economy***. The second risk is the collapse of the ***financial economy***.. The Government provides a substantial amount of structural support to the financial sector through the direction of "captured" funds (mainly deposits in postal savings system) towards the purchase of domestic equity. And there is some room for additional discretion on the part of the Government to assist weak and undercapitalized institutions.

Consequences for the United States

The above scenarios would have important consequences for the United States.

o First, a sharp recession in Japan -- or several years of no growth -- would further disappoint the aspirations of Japanese consumers and would have political consequences in Japan. (Already, we are seeing something of a political revolt in the recent elections of anti-establishment figures as mayors of Tokyo and Osaka.)

- Japan is the world's second largest economy, accounting for 8% of world GDP. The economic and political fallout of a failure to achieve a strong recovery would have important spillovers to the rest of the world.

o Second, U.S. trade interests could be harmed. A Japanese economy more insistent on demand and job preservation will be a more forceful adversary on trade issues, and there would be the prospect of slower progress on important structural reforms. The necessary adjustment of external imbalances would be delayed.

- Japan is our second largest export market (after Canada), with U.S. exports of $52 billion last year.

o Third, a collapse poses financial risks for Japanese firms. U.S. assets are relatively liquid, and could be liquidated defensively in order to buttress balance sheets and compensate for losses at home, creating additional pressures in the exchange and bond markets. The investment numbers tell a story of global inter-connectedness.

- Japan is the largest foreign country holder of U.S. Treasury securities, with total holdings (as of March 1995) of $196 billion, 6% of total privately held U.S. Treasury securities and 27% of total foreign holdings. [1] Of this amount, Japanese official holdings were $89 billion. In contrast, U.S. investment in Japanese securities totals over $60 billion.

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[1] This excludes substantial Japanese holdings of Federal agency securities.

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- The stock of direct investment by the Japanese in the United States at end-93 reached nearly $100 billion, the largest of any single country and 22% of the total stock of foreign direct investment in the United States. By way of comparison, U.S. direct investment in Japan totalled $31 billion, 6% of total U.S. outward DFI.

- U.S. bank exposure to Japanese borrowers totalled $45 billion, 14% of total U.S. bank overseas exposure. Japanese bank exposure to U.S. borrowers totals $67 billion.

- Further yen appreciation also causes additional losses for japanese investors (in yen terms) on dollar denominated assets, which one analyst places at $350 billion since the mid 1980s due to the appreciation of the yen alone. In this connection, market commentary has highlighted the recent reticence of some Japanese institutional investors to hold additional dollar investments.

Consequently, we would disagree with those who would prefer that the United States sit on the sidelines, arguing that there is little that the U.S. can or should say or do to support constructive solutions to what are essentially home grown Japanese problems.

What can Japan do?

Our view is that Japan *can* and *should* use monetary and fiscal policy more aggressively to reduce the risk of a free fall of the economy. The case is strongest for immediate further monetary policy moves. But there is also a strong case that fiscal policy could contribute effectively to the recovery, in part because the monetary policy moves under consideration are likely to be small.

<u>Monetary Policy</u>

o ***Possible benefits.*** A further reduction in short-term interest rates in Japan could spur additional investment (although it difficult to argue that the effect of a small cut would be significant) and stimulate aggregate demand through a lower exchange value of the yen and stronger exports. It would also encourage more consumption and investment in Japan, which would tend to increase imports.

  - It is our presumption that the net effect would be a reduction in the external surplus, but in principle the effect of a monetary easing on the current account is ambiguous. We would also expect a modest strengthening of bank profit margins, which would assist in resolving the bad loan problem.

o *Little at risk.* With deflation, a strong yen, and weak activity, it is difficult to see any serious costs associated with an easing of policy at this time.

- The market is now discounting a roughly 25 basis point reduction in official interest rates. (The Official Discount Rate is 1% and the three-month CD interest rate is 1.3%.)

- In the twelve months through April, M1 grew by 5.9% and M2+CDs grew by 3.1%. These growth rates are partly inflated by the increased willingness to hold cash balances when interest rates are as low as they are now in Japan. Thus, they tend to overstate the growth of money demand connected to economic activity.

- Further, options markets may well be assigning some probability to interest rates even going negative in effective terms. A slightly negative interest rate would not be unprecedented and, in fact, may be preferable for lenders to keeping the money "under the mattress."

- The Bank of Japan argues that money supply growth is adequate and that further attempts to ease would represent "pushing on a string" given the weak state of demand.

o *A more aggressive approach?* We would also note the possibility of more aggressive approach, in which the government stands ready to provide sufficient liquidity to target a particular exchange rate (perhaps ¥100:$) or, alternatively, the entire yield curve. While we recognize that attempts to fix rates in this manner is often fraught with difficulty, there is no danger in this case that the Bank of Japan will run out of yen.

Fiscal policy

o It is important at the start to recognize that they have already moved by a significant amount in recent years.

- According to the OECD, the general government deficit shifted from a surplus of 2.5% of GDP in 1989 to a deficit of 3.4% of GDP in 1994, with 3/4 of the deterioration structural (i.e., the result of policy actions).

- Consequently, despite a relatively low net debt/GDP level, Ministry of Finance (MOF) officials are hesitant to do more at this time. They question the efficacy of further fiscal measures to assist in the recovery, given the lags involved and the limited effectiveness of the usual mechanisms (e.g., advancing public works spending), and note the demands of an aging

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population on longer-term fiscal requirements.

- Nonetheless, the government does recognize that fiscal policy may be one of the few tools available to arrest the contraction of the economy, and that some further deviation from the medium-term objectives of policy would appear warranted.

- We share the MOF view that shifting public works spending is a relatively ineffective method of easing fiscal policy, and would look towards additional temporary tax cuts as an alternative approach to spur consumer spending quickly.

o There is no question that the government will introduce a second supplemental in the fall to fill the "hole" created by the May supplemental's commitment to accelerate this year's public works spending, and we will have to be involved and have a view when debate starts later this summer. Consideration also could be given to additional tax cuts.

<u>Structural policies</u> including deregulation are the usual prescription for stimulating demand and reducing external balances, and has been the centerpiece of our efforts under the Framework talks in recent years. The problem that we must confront squarely is that, while it is generally well understood what needs to be done, there is presently no political capacity for moving ahead with the tough measures. Should the government attempt serious deregulation or other measures, public opposition to painful adjustment would mount quickly. Reform is inevitable over the longer term, but there is no quick solution, and structural measures are not a panacea for current macroeconomic difficulties.

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