Peterson Institute for International Economics

Comment on Japan Sustainability Report

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Structural Reforms

These are the most important priority.

The Report's suggestions are good ones.

- Stop zombie lending.
- Open protected sectors.
- Expand labor force participation.

Devil is in the details.

Hard to gauge macro effects.

Saving-Investment Puzzles

Both saving and investment have declined.

- Consistent with aging population and slower growth.
- But Japan 2001-10 had highest investment rate of G-7 despite having the second slowest GDP growth rate.

Corporate saving has risen to unprecedented levels.

- Report suggests that households have pierced corporate veil and offset high corporate saving with low HH saving.
- But the mechanism for this should be rising equity values.
  - Japanese equity market capitalization has gone nowhere on net for two decades.

Monetary and Fiscal Policy

Japan has worst fiscal outlook of G-7.

- Make long-run plans for fiscal consolidation now.
- No need to implement them in 2012 or even 2013.

There is **NO** risk of bond market crash if BOJ does its job.

- The most plausible source of higher bond yields is increased domestic absorption – good news!
- Any upward pressure on yields not arising from higher domestic spending can easily be countered by appropriate monetary policy.

BOJ has been far too timid. Get inflation up!

- With 10-year yield at 1%, do massive equity purchase.

External (Yen) Policy

Strong evidence that private capital flows offset only about 1/3 of official capital flows, even in advanced economies.

- Net official flows, including FX intervention, have a large effect on the current account.

- The time-series correlation is weaker in advanced economies, but time-averaged cross-section correlation is very strong.

External (Yen) Policy

Japan's current account has been fairly stable, while its FX intervention has been sporadic.

- This differs from EM experience because Japan has much more open financial markets.

- Nevertheless, FX intervention has been important in maintaining Japan's large CA surplus.
    - CA would have been 1/3 smaller on average.

- This is a beggar-thy-neighbor policy and should not be tolerated.

External (Yen) Policy

Current Account = F [Real Ex. Rate, Other Factors]

Real Ex. Rate = G [RR-RR*, Risk Premium]

Risk Premium = H [Private Portfolios, Shocks]

Private Portfolios = ∑ Curr. Account - ∑ FX Intervention

External (Yen) Policy

Japan has intervened massively when shocks to the risk premium threatened to push the real exchange rate high enough to significantly reduce the current account. It stopped intervention when the portfolio shift was sufficient to offset the shock and it almost never intervened in the opposite direction.

Japan's FX reserves ($1.3 trillion) are large relative to its net private portfolio position ($1.8 trillion).

- The Sustainability Report notes that Japanese investors have a "strong home bias" which suggests that the FX reserves do have an important effect.