JAPAN'S CHANGING ECONOMY: CHALLENGES FOR HAWAII'S POLICYMAKERS

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Abstract

This paper analyzes changes in Japan's economy and the implications of these changes for the Hawaii's economic policymakers. The paper first overviews Japan's economic situation paying close attention to the consequences of the collapse of the bubble economy and related phenomena. Japan's fiscal policies are then detailed with a focus on the anticipated effects of the recent fiscal stimulus package. The paper then turns to structural reforms and other emerging trends in Japan and concludes with a summary of the implications of the trends in Japan for the Hawaiian economy. The major conclusion is that Hawaii may find itself in a more favorable external environment over the next couple years but there are risks in the global economy that remain with us and that will require careful economic management.

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By William E. James*

I. An Overview of the Japanese Economic Situation

Japan has experienced eight years of relatively poor economic growth performance beginning in 1991 following the collapse of the bubble in asset prices and continuing through 1998. Economic growth has averaged just about 1.5% in real terms between 1991 and 1997 (IMF 1998). This compares with an average real growth rate of 3.8% in the decade of the 1980s. Japan's weak growth is in sharp contrast to the remarkable U.S. economic expansion that has continued unabated since 1992 and that shows no signs of deterioration as of the third quarter of 1998. Japan and the U.S. therefore are de-synchronized in terms of the business cycle. Hawaii's economic performance as measured by real economic growth appears to be closely linked with that of Japan in recent years. During the bubble period up until the recession of 1991, Hawaii's rate of growth like that of Japan was higher than the real growth of the US as a whole. However, since the bubble collapsed, growth in Hawaii's real gross state product (GSP) has been below 1% per annum and closely tracks Japan's economic growth movements (figure 1). The economic linkages between Japan and Hawaii include the large flows of tourism, financial capital and direct foreign investment from Japan to Hawaii. Hawaii's real estate, banking and relatively large services sectors appear to be sensitive to economic conditions in Japan, though it would be an exaggeration to attribute all of the current economic malaise in Hawaii to problems in Japan.[1]

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[1] Hawaii faces problems similar to other Pacific Island economies in being geographically isolated, with a small land area and a limited domestic market. The Asian Development

In this paper an assessment will be made of the current economic situation in Japan, the prospects for the recovery of the Japanese economy, and emerging new trends in Japan that may influence Japan's economic impact on Hawaii. In particular, trends that may present new opportunities or challenges for Hawaii and economic management in Hawaii will be considered. The implications of these for economic and related policies in Hawaii and Japan will be addressed. The analysis will also attempt to take into account the contentious economic relationship between the United States and Japan, particularly with regard to trade and investment policies.

The Bubble Economy's Collapse: Financial and Real Economy Impacts

The collapse of Japan's asset price bubble is reflected in estimates of the prices of property and equities. Land and equity prices peaked in late 1989 and declined sharply thereafter. Property prices (proxied by an index of prices of land in six major cities) rose three-fold from a base year value (1985=100) to 300 in 1990 and then fell to a value of 125 in 1997. The rise and fall in the prices of equities over the entire period is of similar magnitude as in property. However, stock prices have fluctuated whereas property prices have fallen more or less continuously since 1990 (IMF 1998). In 1998 Japan equities were less than half the value that was attained at the peak of the bubble economy (Figure 2). The movements in the price of foreign exchange in Japan (measured by the yen-dollar exchange rate) during the period have followed a far different path than other asset prices in Japan. For example, the yen appreciated against the dollar between 1990 and 1995, before declining from 1995 to 1998 (using the period average exchange rate as the measure). The issues surrounding the exchange rate movements are complex and are clearly of concern in the context of Japan's tourism expenditures and foreign investment. This problem will be considered below. Whether or not the bottom in both property and equity prices has yet been hit, the decline in asset prices has had serious consequences for the financial system and the banking sector. These consequences include a massive bad loan problem. The banks and other institutions that expanded credit excessively during the bubble period of the late eighties are now extremely reluctant to make new loans,

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Bank (ADB 1997) provides estimates of real GDP growth in 11 Pacific Island nations and growth has averaged 3.2% in 1994, -1.0% in 1995 and 2.8% in 1996.

resulting in a severe credit and liquidity crunch.[2] Japanese banks also have relatively large exposure in the countries of East and Southeast Asia that are now experiencing a severe debt crisis and deep recession. Japanese banks also have a large exposure in domestic equities and the weakness in stock prices (taking the Nikkei index as indicative of the value of the banking sector's share holdings) has weakened the capital base of the banking sector.

The government has belatedly recognized that the banking sector's problems must be firmly and decisively addressed. A proper assessment of the bad loan problem and an accurate evaluation of the capitalization of the banks are necessary to go to the core of the problem. There is much debate and discussion among analysts and economists as to whether the steps currently being taken are sufficient to restore the financial sector to health. In particular, distinguishing between insolvent and simply illiquid institutions and then moving to close the failed institutions without setting off a panic among depositors is a thorny problem. The government made a decision to make large amounts of public money available to the banks in July and the necessary legislation was passed in October 1998. The Bank of Japan has urged the banks to accept these funds as a means of restoring their capital base and resuming credit expansion. The Bank of Japan (BoJ) is presently engaged in emergency measures to expand the monetary base and to provide sufficient liquidity to stem the credit crunch. Interest rates are at historical lows with the BoJ's official discount rate stuck at 0.50%.

A "big-bang" financial liberalization program was announced in late 1996 and is being implemented in several stages. The opening of the financial system to greater competition and foreign investment will have long-term effects on financial markets in Japan. The pace and scope of reforms will be influenced by the ability of the government to resolve the banking crisis. In the past the government was unable to demonstrate its commitment to stronger prudential regulations mainly as a result of the power of the Ministry of Finance. The resistance to strong action in the MoF and the lack of independence of the BoJ prevented resolution of the deep-seated financial sector

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[2] In part, the excessive expansion of credit during the bubble period can be attributed to the pressures created by the massive appreciation of the yen versus the dollar between 1985 and 1987. The ease of monetary policy in Japan following the Louvre Accord of 1987 was justified by the low rate of consumer price inflation. In hind sight, insufficient attention was paid to asset price inflation

problems. However, the MoF has been chastened and the political parties have finally been able to agree on a serious effort to overcome the financial sector's woes.

A start has been made in resolving the banking crisis. First, a "prompt corrective action" mechanism was established in April 1998. This mechanism created an independent Financial Supervisory Agency and provides for banks to undertake certain measures when required levels of capital fall below pre-specified thresholds. A more rigorous self-assessment of loan quality is also required with external auditors providing oversight. A large injection of public funds (17 trillion yen) was provided to the Deposit Insurance Corporation in 1998 and, as was mentioned above, further funds totaling 25 trillion yen have been made available to help re-capitalize the banks.[3] The government has established a bridge bank mechanism and is looking at establishment of an independent agency to oversee the disposal of bad loans and the fate of failed banks along lines of the US Resolution Trust Co. However, as in the US case following the S&L crisis, working out the bad loan problem will take several years.   In the meantime, avoidance of a financial panic while steadily improving the condition of the banking and financial system is of utmost concern.

<u>The Real Economy and Macroeconomic Policies in Japan</u>

In contrast to the other East Asian countries that have experienced an economic free-fall since the onset of the currency and debt crisis in July of 1997, Japan had avoided a deep recession. Japan's economic course has also differed from the pattern that the Nordic countries followed after they experienced an asset bubble collapse in the early 1990s. The Nordic countries plunged into a deep recession but then entered a robust and early recovery in output growth.

Indeed, Japan's economic crisis has been characterized by feeble yet on average positive growth in real GDP. Unemployment did not increase much during the period of 1990 to 1997 (it rose from 2.0% of the labor force in 1990 to 3.5% by the end of 1997). Negative GDP growth was touched briefly in 1993 (first quarter), however growth remained positive until the last quarter of 1997. It appeared that a recovery was well underway in

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[3] Estimates of the amount of bad loans are currently around 80 trillion-yen. The actual amount is sensitive to property values and the business cycle, and hence could improve or worsen.

1995 and 1996 (in the first quarter of 1995, GDP growth briefly rose to nearly 6%). However, the government of PM Hashimoto enacted fiscal measures between mid-1996 and 1997 that had a chilling effect on the recovery. The Hashimoto government adopted a fiscal consolidation policy in order to rapidly close the fiscal deficit. The timing of these moves could not have been worse. These measures included the following:

1) a 2% rise in the General Consumption Tax (from 3% to 5%);
2) a reduction in government support for health and other social services (for example payments by chronically ill patients for doctor visits and medicines were increased);
3) income tax rebates that had been in force since 1994 were abolished; and
4) central government public works expenditures, including those supporting local government projects, were sharply reduced.

A key difference between Japan and the other Asian economies and the Nordic countries is that the decline in aggregate demand in Japan following the asset bubble collapse was muted. In four Asian economies (Indonesia, Korea, Malaysia and Thailand) private consumption expenditures are falling by an estimated 4.1% in real terms in 1998 and will remain a negative source of growth in 1999 (IMF 1998). Growth in real private consumption expenditure remained positive in Japan over much of the post-bubble period. To be sure, personal consumption expenditures have been quite weak and have been under the trend in GDP growth from 1991 until late 1995 and early 1996 (figure 3). Private investment demand is more volatile than consumption. Private business investment turned sharply negative in 1991 and remained negative until the frustrated recovery of 1995. The key factor in preventing a deeper recession is the fiscal stimulus that the government was able to provide. Between August 1992 and September 1995, five fiscal packages ranging from 1.3 to 3.2% of GDP were enacted. Public investment expenditures offset the negative trend in private business investment during these years. The fiscal expansion was possible because Japan entered the post-bubble period with a strong fiscal position. However, after repeated expansionary fiscal packages, the budget position shifted from a surplus position to large deficits. The Hashimoto government came into office pledging to restore fiscal balance and the measures described above were partially successful in that regard.[4]

[4] The IMF (1998), Vol. II, p. 60, estimates that the structural budget deficit was reduced by 1.5% between mid-1996 and mid-1997.

The effect of the fiscal contraction was equivalent to a reduction in annual personal disposable income of 2.5% (PEO 1998). There was a sharp decline in personal consumption expenditures starting in the second quarter of 1996 and continuing into 1998.[5] Private business investment and housing investment had started to boom in 1995, but became sharply negative by the end of 1996, following consumer spending. These data indicate that fiscal policy, far from being ineffective, is able to affect aggregate demand. The government formed by PM Hashimoto worked to convince voters that tightening of fiscal policy was required to secure the economic future in view of the aging population. The fiscal consolidation program was aimed at balancing the budget by 2001 but was implemented in a rush. The collapse of the nascent recovery in 1997 forced the government to change its tune and to call for renewed fiscal stimulus. The policy reversal is argued by some to have further undermined consumer and investor confidence.

A major new fiscal stimulus package was announced in November 1998. This fiscal expansion program is substantial and by some estimates is equivalent to almost 5% of GDP. Before examining the content of the program and its likely impact on the prospects for a recovery of the Japanese economy, however, an effort to understand the role of the exchange rate and expectations about the future value of the yen will be useful.

<u>Recent Movements in the Exchange Rate and Expectations of the Forward Value of the Yen</u>

An unusual feature of the collapse of the Japanese bubble, in marked contrast to the experience in other economies in East Asia, is that it was associated with a prolonged and significant appreciation of the yen (Figure 4) between 1990 and 1996. The yen appreciation and expectations of future increases in the yen's value (reflected in forward rates of exchange) appear to be associated with a low and declining inflation rate. In bursting the bubble economy, short-term interest rates were increased sharply. For example, the discount rate was lifted from 2.25% in 1989 to 6.0% in 1990. Interest rates remained high in 1991 and thereafter started to decline in nominal terms. However, in real terms the average interest rate for new loans remained at or above 5% until 1995. The failure to ease monetary policy before 1995, coupled with large current account

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[5] A small fiscal package of around 4.2 trillion-yen in February 1996 was meant to offset the contraction from the increase in the consumption tax.

surpluses, may account for the expectations of a relentlessly rising yen. The dynamics of movements of the yen exchange rate, the rate of change of prices in Japan and real interest rates may help explain the inability of the government to use monetary policy to support a sustained recovery.[6]

Just as the yen began to weaken in 1996, fiscal policy was shifted from stimulus to contraction. The depreciation in 1996 and 1997 had a positive effect on net exports but this effect was too small to overcome the contraction in demand that resulted from tighter fiscal policy. The growth of imports slowed in 1997 and became negative in 1998. East Asian countries that rely on Japan as a market for exports were adversely affected by this downturn in demand. Meanwhile the yen has strengthened from a low of 147 in 1998 to about 120 (yen per dollar). Interest rates are at historic lows and expectations are for further declines in prices, in contrast with other major industrial countries (tables 1 and 2).

A relatively large increase in the volume of imports took place between 1990 and 1995. Despite this increase in the volume of imports, low import prices and modest growth in the volume and value of exports allowed Japan to maintain a current account surplus that peaked in 1993 and 1994 before falling off somewhat in 1995 and 1996. Japan remained a large net creditor throughout the 1990s and this is reflected in the large gains in Japan's foreign reserve position in the 1990 to 1997 period.

Monetary policy was eased significantly between 1995 and 1998. Nominal interest rates became very low and this imposed a constraint on monetary policy's effectiveness. With a zero nominal return on cash holdings and an expected negative return on other assets

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[6] McKinnon (1998) makes this argument. A coordinated effort between the US and Japan to reduce the expected forward value of the yen would be necessary. In order to "spring the liquidity trap for Japanese interest rates" it is necessary to end the expectation of a higher yen in the future. McKinnon stresses that trade and investment policy liberalization ("stamp out discrimination against imports and direct investment") by Japan coupled with a US commitment to desist from bilateral trade sanctions and antidumping actions and to agree to adhere to WTO rules would also be necessary. Only then could a joint monetary program stabilize the yen at its purchasing power parity value against the dollar. And this would "end the fear of deflation in Japan and . . . spring the liquidity trap . . ."Also see IMF (1998).

due to deflation, investors have a preference to hold cash rather than interest bearing assets, in effect the supply of loanable funds falls to zero as the economy enters a liquidity trap. In this situation, expectations of a positive rate of inflation could be effective in breaking the liquidity trap by lowering real interest rates and thereby making new investments more attractive as product prices would be expected to rise. An inter-temporal substitution effect would then induce consumers to substitute present for future consumption. The downside of this approach is that it would weaken the yen and increase Japanese net exports (reduce net imports). Hence, the weaker yen may have knock-on effects that would undermine the recovery efforts elsewhere in Asia. In this context, it appears the Japanese authorities have decided to give fiscal stimulus a determined push.

II. Massive Fiscal Stimulus and the Prospects for Recovery

The Japanese government has initiated six major fiscal stimulus packages between August 1992 and April 1998 (IMF 1998). Of the six previous programs, five were implemented between August 1992 and September 1995 including two packages in 1993.[7] Temporary personal income tax reductions (implemented through tax rebates) were a significant portion of the February 1994 and April 1998 packages. Public investment or public works dominated five of the six packages. The size of each package has varied (counting the two 1993 packages together) from 10.7 to 19.4 trillion yen. The latest fiscal stimulus of April 1998 totaled 16.7 trillion-yen or about 3.3% of GDP. These fiscal expansions have helped avoid a deeper recession but have failed to put the economy on a sustained recovery path. The festering financial sector problems, investor (and more recently, consumer) pessimism, and the expectations of deflation (a higher yen) have limited the impact of these past expansion efforts. It is also argued that past tax cuts failed to have significant effects on aggregate demand. Instead of temporary cuts economists have called on the government to implement permanent tax reforms, including reductions in average and marginal income tax rates and a broadening of the tax base. This would entail reducing personal and corporate income tax rates, particularly the high marginal tax rates for upper income thresholds. Japan has one of the highest corporate income tax rates among the major industrial countries (table 3). A reduction in the corporate income tax rate that would bring Japan's corporate income tax more in line with the other industrial countries would strengthen profits, encourage corporate investment demand

[7] In April 1995 a small 2.7 trillion yen Kobe earthquake package was also provided.

and help strengthen stock prices. Coupled with tax reform, this would strengthen the incentives for companies to honestly report income and profit. A simplified corporate tax structure would also encourage inward foreign investment. Closing loopholes in tax laws would reduce incentives for large companies to set up numerous affiliates for purposes of hiding earnings and thereby evading taxes.

The November 1998 Fiscal Stimulus Package: Is It Likely to Work?

On November 16, 1998 the Japanese government unveiled a fiscal stimulus package in excess of 20 trillion yen (up to 24 trillion yen or about $200 billion at a yen-dollar rate of 120). This is equivalent to around 4.8% of GDP in current prices.[8] The package, touted in the government's press release as an "Emergency Economic Package," includes a mix of over 17 trillion-yen in new expenditures and over 6 trillion-yen in tax cuts over the coming 18 months. The decision to lower the corporate income tax from 46% to 40% and to reduce the top marginal personal income tax rate from 65% to 50% are significant aspects of the new fiscal package.[9] The expenditure components include (all figures are approximate):

1- new public infrastructure (8.1 trillion yen),
2- additional public money to expand credit for non-housing business investment (5.9 trillion yen),
3- support for housing investments (1.2 trillion yen),
4- an employment program aimed at creating one million new jobs (1.0 trillion yen),
5- a new assistance program for Asian economies (1.0 trillion yen) and
6- issuance of 20,000 yen coupons to elderly and needy households (0.7 trillion yen).

There is nothing new about some facets of the November 1998 package. The

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[8] IMF, *International Financial Statistics*, Yearbook 1998, reports 1997 GDP in current prices as 507 trillion yen. 1998 GDP will be slightly lower given an expected drop of GDP of about 2% in real terms and an inflation rate (CPI) of around 1%. Using 1997 GDP, the package is equivalent to 4.73%.

[9] The corporate income tax rate in table 1 includes local and provincial tax, whereas the 46% rate cited above is the tax rate applied by the central government.

infrastructure/public works component is common to all the fiscal packages, even if this one is hyped for its "focus on social infrastructure". The public works projects are seen by critics to be an LDP pork barrel aimed at winning electoral support from powerful construction unions and companies. The support for housing investment has also been a common element in every previous package as is the increased lending by government affiliated financial institutions, chiefly aimed at supporting new businesses and small and medium-sized firms that are credit constrained.

What is new about the package? It contains a specific commitment of funds to create employment. It also contains an innovation—the "coupon scheme" aimed at bolstering consumption of selected households. Further, it includes assistance to other Asian countries in the form of expanded loans from the Export-Import Bank of Japan and through the establishment of a tentatively named "Asian Currency Crisis Assistance Fund." The most significant innovation in the package is the commitment to reduce the corporate income tax and personal income tax on a permanent basis.

Will the stimulus package work? Critics complain that the package is really not likely to turn the economy around on a sustained basis. The employment aspects of the package are vague. Some skeptics believe the employment fund will simply be funneled into construction companies allied to the Liberal Democratic Party (LDP). The Asian crisis fund is another somewhat vague initiative. How does it relate to the so-called Miyazawa ($30 billion) fund? Is it additional to that fund or counted as part of it? Nearly every government in a position to do so has announced additional trade financing is being made available for the Asian crisis economies, but the terms of such credits have remained unclear and the impacts, if any, have yet to be reflected in import numbers.[10] Most controversial of all is the coupon scheme. Will it really add to personal consumption expenditures? If consumers remain pessimistic, they may simply use the coupons for expenditures they had planned and will save an equivalent amount in their idle bank or postal deposits.

Mr. Taichi Sakaiya, Director General of the Economic Planning Agency (EPA) has

[10] Indonesia has been promised export credits totaling almost $6 billion by donors and foreign governments. Yet the vast majority of Indonesian private exporters have been unable to get access to these funds, prompting the Indonesian government to set up a new export credit agency.

admitted that the on-going fiscal stimulus will not be enough to prevent negative growth in the present fiscal year ending March 31, 1999. The government concedes its forecast of –1.8% growth is likely to be too optimistic as numbers from the July to September quarter show an across the board decline in private demand, with consumption falling by 0.3%. Personal income declined by a record 2.1% during the quarter, reflecting rising unemployment. Net external demand and public investment were positive, but too small to offset the decline in private consumption and investment. However, in the new fiscal year, the fiscal stimulus will lift GDP by at least 3 percentage points according to Mr. Sakaiya and should be enough to push overall GDP back to positive growth.

The Ministry of International Trade and Industry (MITI) has released a more pessimistic forecast than that of the EPA, predicting continuing economic decline for the next four years of a cumulative 7% unless additional fiscal stimulus is provided in each and every year. Even with additional stimulus from government fiscal policy, according to MITI, the economy will only slowly recover until 2002 when growth will finally reach 2%.[11] With Japan's already large fiscal deficit, MITI's call for additional deficit spending for a prolonged period is bound to be controversial.

What is necessary to overcome Japan's prolonged economic agony? Clearly, Japan is mired in the ultimate paradox of thrift. With 1,200 trillion yen ($10 trillion) in personal financial assets, Japan is second to only the United States in personal financial wealth. Almost 60% of this amount is hoarded in cash deposits earning less than 0.5% per annum. In spite of this, personal saving rates remain higher and more stable in Japan than in other OECD countries.[12] The pessimism over the economic outlook and the uncertainty regarding the financial sector undermine consumer confidence in Japan. As long as private consumption demand in Japan is dead in the water, there is unlikely to be any recovery in private business investment. With Asia in crisis, the outlook for export markets is also a source of investment pessimism.

Overcoming the banking crisis is key to ending the credit crunch and restoring confidence in the financial system and the economy. The government as was pointed out above has finally put in place the machinery needed to straighten out the banking mess and now

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[11] *Asian Wall Street Journal*, November 17, 1998, p.1 and 15.

[12] The effect of the aging of the Japanese population on future savings is discussed in the next section of the paper.

some of Japan's largest banks have begun to take serious measures in response. All of Japan's ten largest private commercial banks have recently taken steps to address the bad loan problem and to attempt to strengthen their capital base. They have announced that they will write off a total of over 5 trillion-yen in bad loans in the current fiscal year ending on March 31, 1999. The largest, Bank of Tokyo-Mitsubishi will sell its headquarters building and land (and lease back its main offices) in a move reminiscent of Bank of America's selling off its corporate headquarters in San Francisco in the wake of the Latin debt crisis of 1981. The other 9 banks have said they will draw upon the public funds made available in the government's 25 trillion-yen re-capitalization program that was legislated in October. They have also promised to adhere to new accounting standards for bad loan disclosure six months earlier than required. Many Japanese banks are cutting back on overseas operations and are restructuring domestic operations by streamlining and staff reductions (mainly through attrition). It is too early to judge whether these banks will succeed as there may be more problem loans arising that may off-set the efforts to rebuild the capital base of the banking system through the injection of public money.

One of the fundamental problems in the banking sector is that some large banks may be beyond financial rescue and will have to be closed down. The Ministry of Finance has long resisted closing down insolvent banks and using the deposit insurance fund (which guarantees individual deposits to up to 10 million yen), though additional money has been injected into the deposit insurance fund. Recently a clearly insolvent bank, the Long Term Credit Bank of Japan (LTCB) was declared bankrupt and its operations were taken over by a bank supervisory team. The LTCB is an institution that was in existence for purely political reasons and had little if any economic justification. Rumors that its loan portfolio was rotten have now been verified. There are legitimate concerns about the solvency of some of the large banks. Restoration of confidence in the financial system remains to be achieved and without it, the economic recovery's sustainability will remain in doubt.

The economy's prospects may be boosted by the large fiscal stimulus that is in the works. There is always a lag between announcement of fiscal stimulus packages and the realization of the increased fiscal expenditures. In this context, the large fiscal package announced in April 1998 is now beginning to kick in. The combined amount of the April and November 1998 packages is around 40 trillion-yen or 8% of GDP—a strong increase in aggregate demand will inevitably occur over the next 6-18 months. This double fiscal stimulus may be enough to kick start the economy. If private consumption starts to rise, private investment is likely to follow. A recovery in Asia would give a further boost to the economy. The government aims at restoring positive growth in the 1999 fiscal year and to an acceleration of growth in FY2000 and beyond. It has frozen the Fiscal Structural Reform Law until 2005, allowing the central government to maintain expansionary policies as long as necessary to bring about recovery.

Is it realistic to expect a full recovery by FY2001?[13] Economic growth has been well below potential for 7 of the last 8 years. Provided the government takes the necessary steps to solve the banking and financial crisis in the coming two years, it is possible that real GDP growth could rise to 5% once the recovery is fully underway. Economic growth after the turn of the century should settle in at the normal rate of between 2 and 3% per year. Assuming that the economy does recover in the next 2 or 3 years, what are the longer-term trends that one should pay attention to in Japan?

III. Structural Reform and Emerging New Trends in Japan

Structural Reforms and Trade Frictions

The prolonged nature and depth of Japan's economic collapse in the 1990s have convinced business leaders, economists and a younger generation of political aspirants alike that the problems are structural rather than merely cyclical. The crisis in the banking and financial sector is indicative of the structural nature of the economic malaise. Other indications of structural economic ills are not difficult to point out:

1-the low share of manufactures in merchandise imports,
2-the imbalance between outward and inward foreign direct investment,
3-the persistent and huge current account surplus, and
4-the continued high protection of agriculture.

Markets for labor, housing and land, credit, medical and health services, transportation,

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[13] It is estimated that, on average, three years are required for a country to recover its normal rate of economic growth following a banking crisis (IMF 1998). With the large stimulus packages and a commitment to restructuring the banks, it is possible that Japan can recover a year sooner.

insurance and telecommunications and other types of services have been too heavily regulated, limiting competition and creating large inefficiencies. In contrast to these sectors, in manufacturing tariff and non-tariff barriers are low and Japanese firms are highly competitive. Under pressure from abroad and at home, reforms are advancing (the financial "big-bang", for example) spurring more competition and greater openness, but the progress has been insufficient to put the economy back on track.

The potential for trade friction and a protectionist backlash against Japan in the United States has mounted since the Asian economic crisis began in mid-1997. With private domestic demand faltering in Japan and booming in America, the current account positions of the two countries have moved dramatically in opposite directions. Even as the US market absorbs increasing volumes of imports from the hard-hit countries like Korea, Thailand, Indonesia, the Philippines, Hong Kong, Singapore and Malaysia, import demand in Japan has declined sharply. Japan has increased shipments of steel, chemicals and machinery to the US and Europe, leading to a rash of demands for antidumping investigations in industries ranging from steel to supercomputers.

The recent trade clash in the Asia Pacific Economic Cooperation (APEC) summit in Kuala Lumpur between Japan and the US over "Early Voluntary Sector Liberalization" (EVSL) in forestry and fishery products has once again put Japan's trade policies in a bad light.[14] Japan's stance of refusing to agree to lower tariffs in these sectors and of seeking backing in the APEC forum from some of the developing countries that are grappling with trade reforms reflects poorly on Japan's leadership ability. The US, for its part, is in no position however to offer to implement tariff cuts as no fast-track authority currently exists. Hence, there was the compromise solution to seek to liberalize the sectors under the auspices of the World Trade Organization (WTO) in the near future.

In fairness to Japan, it should be pointed out that it is the largest importer of food products in the world. Imports also supply over 40% of fish consumption and 80% of forestry product consumption, with average tariffs on these items less than 5%. Japan has steadily increased the share of manufactured products in its import basket both globally and in Asia and such imports now account for almost 60% of total merchandise, up from just

[14] EVSL includes nine sectors: environmental products and services, energy, fisheries, forestry, toys, jewelry, medical goods, chemical products and telecommunications.

40% in 1987.[15]

Trade frictions also spill over into the investment arena. In the past, Japanese real estate acquisitions in the United States dominated the news and nearly provoked a nationalistic response. However, between 1993 and 1996, Japanese citizens have divested $20 billion in US real estate holdings (including in Hawaii), and lately it is US citizens that are on a buying binge in Japan's depressed real estate market. It is estimated that US citizens or companies have purchased $6 billion worth of property in Japan in 1998 alone, prompting concerns that America is buying up Japanese real estate at bargain prices.

The trade frictions and the implicit threat of retaliatory actions may have served some positive purpose in the past in helping to open the Japanese market. However, aside from some agricultural products, medicine, finance and petroleum refining, Japan has already liberalized trade and has largely deregulated its economy. Further bilateral conflicts are unlikely to produce much more benefit in terms of market access and may now pose an obstacle to Japanese recovery. Commercial policy conflict with the US is likely to be a prime source of the expectations of an ever-appreciating yen. Why? The threat of US trade sanctions against Japan, through antidumping or other means, leads one to suspect that the US will almost always be willing to let the dollar slide down against the yen in support of its trade complaints. With Japan's mounting current account surplus and the rising US current account deficit and concern that raising US interest rates would harm the fragile world economy, it is difficult to conclude anything except that the yen should appreciate. Removing this source of the expectation of a higher forward value of the yen would help unlock Japanese private demand and allow interest rates to recover to normal levels as the price level rises some in Japan.

The Aging Population: Implications for Savings and Economic Growth in the 21st Century

Rapid population aging in Japan is expected to lead to lower savings and economic growth and to force radical changes in the country's social security system. In Japan the

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15 James and Sugawara (1998) provide a detailed analysis of changes in Japan's import demand between 1986 and 1996.

population over 65 years of age will more than double between 1990 and 2020, rising from 12 to 25% of the total. In comparison, in the United States the over 65 population will increase from 12 to 16% of the total over the same period.[16] The implications of population aging are vast for almost all aspects of the Japanese economy. One of the most carefully studied impacts is that on the national savings rate (and by implication on investment and economic growth). Studies indicate that the aging phenomenon will lower national savings but the magnitude of the decline and its impact on investment is less than certain. At one extreme, Horioka (1991 and 1992) predicts personal savings will decline sharply (beginning in 1990) and become negative by year 2007. Projections of private savings based on alternative assumptions (extending the age of retirement) predict that the savings rate will remain positive until 2015 and will be as much as 10% above Horioka's projected rates between 2015 and 2025 (Yashiro and Oishi 1997). Investment need not drop as much as saving, as it is likely Japan's current account balance will shift from surplus to deficit. The impact on economic growth will also depend on technical progress and the efficiency of allocation and productivity of the labor force. Technical progress in the area of robotics and automation will help to increase productivity and offset the decline in the labor force. If agricultural employment is phased out through consolidation and mechanization of farming, some additional labor can be reallocated to more efficient uses. Immigrants could also be employed in occupations that lack appeal for Japanese workers. Liberalization of immigration laws therefore could change the projections on the labor force and economic growth.

Other demographic and wealth related aspects of aging will have impacts on the prospects of the Japanese economy and on Hawaii. Will more Japanese retirees choose to live apart from their extended families? Currently a very low percentage of Japanese aged persons live alone or just with their spouse compared with the US. This could change depending on preferences and economic conditions.

A rising excess fiscal burden will be placed on the future generations of Japanese workers unless there is reform of the public pension system. Reforms would include extending the retirement age, reducing the tax on wage and salary earnings of those eligible for pensions and reducing the amount of public pension benefits through taxation or reduction of payments. The reform of public pensions may induce changes in Japanese saving behavior.

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[16] Hurd and Yashiro (1997). Also see James (1998).

In Japan in 1992, private pension plans accounted for just 2.2% of Japanese personal wealth, while demand and time deposits accounted for over 25%. Financial assets accounted for only 45% of household wealth (housing and land accounted for the majority). In the US in 1992 financial assets holdings comprised 75% of household wealth, with demand and time deposits share at 12.5% and pensions 21%. In future, the wealth holdings of Japanese pensioners may also change into more liquid forms than housing and property, enabling them to more easily consume and travel. The decline in land and housing prices since the collapse of the bubble has probably shifted the composition of wealth holdings in Japan. Japanese financial institutions have been able to collect the savings deposits of households and earn profit by lending or investing abroad, particularly in US treasury bonds and stocks.[17] However, the competition between bank and non-bank financial companies will heat up with financial reforms. The big bang financial reform is likely to spur Japanese households to shift savings from low yield savings deposits to higher yielding assets. The memories of losses suffered by Japanese who invested in mutual funds during the bubble period have made it difficult to entice conservative Japanese investors to accept the risk associated with mutual fund investments during a time of economic hardship and rising unemployment. A recovery that is sustained, however, should restore the tendency of Japanese to build up their savings through mutual funds and foreign exchange deposits.

Social and Political Change in Japan: Decentralization and Individualization

Three broad potential changes are on the horizon in Japan that could profoundly influence the economic and social conditions of Japan in the coming century: educational reform, decentralization, and political change. Educational reforms are now under consideration that will place greater emphasis on individual responsibility and initiative rather than the past emphasis on rote learning and conformity. These reforms are being experimented with locally and regionally at the primary school level. The Ministry of Education has approved a national policy to allow greater local autonomy in curriculum design that will be implemented in 2002. Already primary school teachers are being given greater freedom in the classroom in seeking to spur creativity and critical thinking. Proposals for local control over schools and for relaxation of the college entrance examination system

[17] The Postal Savings Deposits remain popular and the government has been unwilling to test the patience of voters by privatizing or otherwise taxing postal savings.

are being considered as well. The educational reforms reflect a growing trend towards decentralization that is looming on the political level.

The regional, provincial and municipal governments have been driven by the economic crisis to recognize that they can no longer rely on the central government in securing the economic future. Local governments are becoming more active in seeking to find new directions for the local and regional economy. Fiscal emergencies have been declared in municipalities from Kansai to Hokkaido. Aggressive and innovative regions and municipalities are likely to attract new industries and to internationalize the economy at a more rapid pace in coming years. Urban taxpayers have been hard pressed by the economic crisis and provide fertile ground for opposition political parties. The crushing electoral defeat suffered by the LDP in the upper house last summer may be repeated in the coming election. With economic hardship, the traditional LDP-policy of milking urban taxpayers to pay for income and welfare support in rural areas is coming under increased pressure. The possibility that there will be a reconfiguration of Japanese politics and a realignment of political parties is becoming a popular topic of discussion in the local press. The Democratic Party has a good chance of unseating the LDP as the largest party in the coming parliamentary election. The differences in positions are likely to become more clearly defined in coming elections as the opposition presents voters with clearer choices based on policy differences with the LDP. While it is very difficult to predict where things might be headed politically, change is definitely in the making.

Decentralization and political change will in turn have profound effects on Japanese business. The economic crisis has put severe strains on the traditional approach to resolving business disputes through consensus. The once all-powerful bureaucracy in the Ministry of Finance has been rocked by scandal. MoF is still very powerful because of its role in controlling most government revenue and expenditure, even down to the local level. However, MoF may be challenged by local governments seeking to increase their fiscal autonomy. Companies are finding that legal institutions are too slow and cumbersome and are demanding change. Commercial law and institutions are facing major challenges with numerous bankruptcies and disputes created by the banking crisis. The weakness of the commercial legal institutions has led to criminal elements offering their “services” to settle private commercial disputes. In future, business in Japan is likely to become more rule-based as the bureaucrat-dominated “informal guidance” mechanism is breaking down. Reform of bankruptcy laws and much clearer and stricter prudential regulations and company financial disclosure are all in the works. These changes will make it easier for foreign companies to do business in Japan as well.

IV. Implications of Japan's Changing Economy for the Hawaiian Economy and Economic Policy in Hawaii

The Japanese economic recovery and the changing trends in Japan may influence the economic interactions between Japan and Hawaii through travel and tourism, investment and other factor flows, and foreign trade in goods and services other than tourism. These issues and possible policy initiatives and responses to the opportunities and challenges presented by economic change in Japan will be considered.

Travel and Tourism

The impact of the downturn of the Japanese economy on the Hawaii State economy has been substantial. Receipts from visitor expenditures fell from 36% of Gross State Product (GSP) in 1990 to 32% in 1996 and further to 31% in 1997. During the one year Japan had negative growth between 1990 and 1995 (1993) visitor receipts fell to just under 28% of GSP. Visitor receipts were $10.6 billion in 1991 and fell to $8.7 billion in 1993. Visitor receipts rebounded in 1995 to $11.4 billion but fell in 1996 as the Japanese recovery faltered. In 1997 and 1998 visitor receipts will be hurt by the deepening recession in Japan.[18] Visitor receipts were essentially flat in 1997 compared with 1996 even though there was a 16% increase in the number of westbound visitors from the mainland US. It takes almost two westbound visitor days to make up for the loss in of one day's visitor receipts from Japan, as Japanese tourists spend nearly twice as much per day as visitors from the mainland ($280 vs. $157). In 1997 Japanese visitor expenditures fell by 8.3% from 1996 levels. The negative impact on visitor receipts from the current recession in Japan will continue be felt in the coming year. By the year 2000, a rebound in visitor arrivals and receipts from Japan may be forthcoming. Eastbound visitor arrivals and receipts are likely to stagnate for the next few years until there is a sustained recovery in the Asian economies.

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[17] Understandably, the Japanese domestic travel industry is attempting to spur Japanese vacationers to spend their vacations in Japan. A recent government-industry promotion to lower hotel room rates by half if a visitor stays an extra day is an example of this effort.

From Hawaii's standpoint, a major question is how will "graying" population phenomenon influence Japanese demand for international travel? A recent study using cohort analysis of the propensity to travel in Japan reveals that aging will not lead to a decline in Japanese international travel in the coming century (Sakai, Brown and Mak 1998). However, the growth rate of tourism from Japan will slow down. Thus, while Japan will remain one of Hawaii's key tourism markets, other countries in East Asia are likely to provide stronger growth in the 21st century.

Hawaii is still perceived as a hospitable destination by Japanese travelers. With the prolonged downturn in Japan there is some evidence that Japanese consumers are becoming more price sensitive and this may influence the choice of vacation destination. With the exchange rate changes in Korea and Southeast Asia, however, these destinations have become comparatively inexpensive. Thus, to succeed under present market conditions, Hawaii must be able to compete on quality and price.

Investment and Factor Services Flows

The property market in Hawaii has been among sectors of the economy hardest-hit by the economic stagnation in Japan. While housing and land prices have been very buoyant in the mainland states, they have been quite soft in Hawaii. Prices may now have bottomed out, but are unlikely to rebound to the heights attained during the bubble period in Japan. Residential property investment in Hawaii peaked in 1991 at $1.2 billion but fell to less than $1 billion in 1996 and plunged further to less than $0.7 billion in 1997.[19] The weakness in residential investment has also been felt in the non-residential sector, where investment also peaked in 1991 at $3.4 billion and fell to a little under $3 billion in 1996 and to just $2.7 billion in 1997. The depressed construction sector has been a leading cause of rising unemployment in the state in recent years.

Ramstetter (1998) provides analysis of the role of Japanese multinational enterprises and foreign direct investment (FDI) in Hawaii and selected other western states. The stock of Japanese FDI (defined as the gross property, plant and equipment of nonbank affiliates) in Hawaii rose from $374 million in 1977 to a peak of $13.9 billion in 1994. The stock of Japanese FDI fell between 1994 and 1996 to $13.2 billion. Japanese FDI stock accounts

[19] Data from DBEDT.

for about 85% of the total FDI stock in Hawaii in recent years. The dominant position of Japanese affiliated companies in foreign investment in Hawaii is noted in Ramstetter (1998) who points out Japanese affiliates in 1995 accounted for 84% of FDI stock in Hawaii, but just 21% for the nation as a whole.

It is interesting to note that between 1987 and 1992 there was a huge increase in foreign affiliates' stock of FDI in Hawaii, with the bulk of the increase in commercial property including hotels and other tourism-related facilities in Hawaii. After 1992 inflows of FDI into commercial property slowed greatly. In 1993 and 1995 inflows of FDI in commercial property became negative.

European and Canadian affiliates have very small shares of the stock of FDI in Hawaii, despite their relatively large share in the country as a whole. As Canada is the second largest source of foreign visitors to Hawaii after Japan, it may be possible in future for the state to attract more investment from Canada as well.

The outlook for recovery of Japanese investment in Hawaii is not very promising in that Japanese investors are likely to have rather large holdings of real estate and commercial property and are not likely to expand such holdings under the present circumstances. As Japanese financial companies and banks are reducing their presence overseas it is not likely that FDI can be expected to increase there either. It is possible that Japanese interest in other service sectors, particularly in business, professional, transportation and health related services could expand. This should not be of particular concern, as there will remain a relatively large presence of Japanese FDI in Hawaii. Provided the state creates an environment that is market-friendly and attractive to investors whether they are from Japan, the mainland US or any other location the natural attractions of Hawaii will serve to continue to attract visitors and investors alike.

Hawaii may gain as well from efforts in the WTO and APEC to facilitate trade in factor services globally and in the region. Global easing of restrictions on trade in commercial services will allow business managers, scientific, professional and technical workers improved market access through allowing national treatment and the right of commercial presence. Hawaii should strive to keep up with global trends in the liberalization of trade and investment in commercial services.

Foreign Trade in Goods and Non-Factor Services Other than Tourism

Hawaii exports of merchandise to Japan have been concentrated on food and agricultural products, apparel, and miscellaneous manufactures (surfboards and sports equipment). Merchandise trade will definitely benefit from the recovery of the Japanese economy, but can not be a major source of economic growth for the state. Services will be a more important source of future jobs and income growth and that will be reflected in the state's foreign trade as well. Some of the service areas that are key to the future are discussed below.

Opportunities and Challenges for the Hawaii Economy

Four areas of existing and emerging comparative advantage for the Hawaiian economy will be briefly be considered in the context of the opportunities and challenges created by economic change in Japan:

1-tourism and tourism-related services,
2-high technology,
3-education and learning in Hawaii, and
4-health and medical services.

Tourism

Hawaii has a continued strong comparative advantage in tourism and tourist-related services. The quality of Hawaii's environment, particularly its beaches, reefs and ocean environment is crucial to the long-term strength of the tourist industry. While Hawaii as a small open economy can do little to control outside developments, it can do much to enhance its own environment. The supply side of the tourist industry in Hawaii is very important. Hawaii's cost competitiveness has improved in recent years and maintaining the high quality of daily life here is a key to remaining one of the world's premier destinations. I don't wish to preach but it is important that Hawaii doesn't price itself out of the market. If the tourist industry can keep prices and costs competitive, and improve amenities and diversify activities and experiences for visitors it will remain very competitive well into the 21st century.

A renewed effort to promote Japanese tourism aimed at the young 20-40 age cohorts (singles and families) may be an idea worth considering. A advertising campaign in Japan that offered a drawing awarding free air tickets coupled with carefully planned advertising and events to plant the idea of travel to Hawaii broadly among the younger age cohorts could produce long-term benefits if done properly. Advantages from such an approach appear to be found in repeat visits as cohorts age.

Another possible niche is in professional meetings and conventions. Hawaii is one of the world's premier gathering places and the new convention center is an important part of Hawaii's infrastructure.

It is also important to recognize that future tourism growth in Asia may shift from Japan to the newly industrialized economies and ultimately to China. Once the Asian economies recover it is very likely Korea, Taiwan, Hong Kong and China will be the key sources of visitor growth. With rapidly rising incomes, these economies are catching up with Japan and should be given due attention.

In the context of the aging of the population in Japan, Hawaii might also develop a niche in attracting prosperous retirees to the islands.[20] If it is possible to attract wealthy Japanese retirees, it should also be possible to attract well to do US or Canadian retirees as well. Other East Asian retirees may also present a potentially good market opportunity. Though competing with Florida and other mainland locations may be difficult in attracting mainland retired people, Hawaii has advantages in cultural affinities and language that can help it compete in Asia.

High Technology

Hawaii can use its beautiful environment to attract certain activities that only require telecommunications links to be performed in the high technology context. It appears the state has been active in this area. The various technology parks reflect this trend. It is apparent that locational advantages in scientific fields such as oceanography, marine biology, and astronomy will be important in pursuit of this vision. The Japanese scientific community would almost certainly be interested in conducting research and innovation in these fields in Hawaii.

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[20] This assumes legislation is passed that eases the visa requirements for foreigners in the United States.

Education

Hawaii has several assets in the field of education that makes it one of the strongest centers for learning and research on the Asia-Pacific Region. The University of Hawaii, with its large resident faculty of Asianists and the Asia Collection in its main library coupled with the adjacent East-West Center is clearly at the center of this strength. In future, more Japanese may choose to study abroad, particularly in view of the more competitive job market and the educational reforms in Japan. Hawaii is well positioned to capture a larger inflow of undergraduate students from Japan with its relatively well-developed Japanese language capabilities (compared with other US states).

Health and Medical Services

Aging in Japan also presents an opportunity for Hawaii in the health care field. Medical costs are likely to rise for pensioners in Japan in future. Hawaii may find niche markets in the medical services area that will be of interest to Japanese elderly citizens. Though I lack the expertise to provide much commentary, the idea of attracting Japanese patients to recuperate from serious illness or to seek treatment for certain illnesses may be valid.

Economic Policy Challenges

The economic slowdown of the 1990s has forced Hawaii to make some difficult choices and, by and large, economic policy has risen to the challenge. A huge fiscal deficit has finally been closed and a modest surplus in the state budget has been achieved in the most recent fiscal year. The inflation rate has been reduced from around 6% during 1988-1993 to about 2% in recent years. Tax reform and other cost reductions have vastly improved Hawaii's business image and prospects. More can and should be done to improve the overall investment climate: corporate income tax reduction, improvements in the public school system, and continued efforts to reduce the size of the government in the state economy.

The state government is keen to promote investment, particularly in high-technology ventures in biotechnology, information technology, and in commercial applications of research in medicine and other fields. The attraction of Hawaii is largely in its beautiful climate and environment, its high quality of life and its friendly and well-educated populace. The success Hawaii has will depend largely on preserving these strong advantages and building upon them. Keeping the costs of doing business down is a must if Hawaii is to compete with other locations with larger markets and a larger pool of capital and other factors of production. Special incentives to attract high technology investors are under consideration. Tax and other fiscal incentives can be matched by other locations. They are also discriminatory in nature. Provision of too many incentives may adversely impact the tax base and lead to outcomes that were unintended. Hence, I would caution against reliance on fiscal incentives and focus on improving fundamentals in the economy.

Hawaii's economic growth has been anemic as a result of lower rates of capital investment and labor inputs in the 1990s compared with the previous decade. It is also likely that the productivity of resources employed has been lower in recent years.[21] As a small open economy, Hawaii has to focus on the supply side as it has little control over demand. In the coming year, Hawaii's economy will be helped by the lowest petroleum prices since the first oil shock of 1973. Lower energy prices should help keep travel costs down and encourage tourist arrivals. Interest rate reductions should also stimulate the housing market and the sale of consumer durables. Economic policy should concentrate on further improvements in the business climate, protection of Hawaii's beautiful environment, and efficient allocation of government expenditures.

In the longer-run improving the education and skills of Hawaii's labor force will be the fundamental factor in economic growth.

Recovery in Japan and more generally in East and Southeast Asia will be a positive factor for Hawaii. Taiwan and China have continued to experience positive and fairly robust growth. The Philippines and Singapore have slow growth but have been able to avoid a severe downturn. Many observers feel that Korea and Thailand are likely to recover in the coming two years. Indonesia's outlook is still clouded by political uncertainty, but the establishment of election dates should help restore stability there as well. Malaysia remains a wild card.

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[21] Naya (1998) reports a residual representing productivity of –0.4% during 1990 to 1996 compared with 0.3% during 1970-1990.

Hawaii may find itself in a more favorable external environment over the next couple years. There are risks in the global economy that remain with us and that will require careful economic management. With sound economic management, economic growth and employment are likely to recover as the external environment improves.

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Table 1. Comparison of Interest Rates

Country	Prime Lending	Money Market	Government Bonds
Australia	**8.8**	**4.8**	**5.1**
Canada	**7.0**	**4.8**	**5.2**
France	**6.6**	**3.5**	**4.2**
Germany	**4.9**	**3.6**	**4.1**
Japan	**1.5**	**0.5**	**0.9**
U.K.	**8.3**	**7.0**	**5.1**
U.S.A.	**8.0**	**5.1**	**4.9**

Source: The Economist, Nov. 7-13, 1998.

Table 2. Inflation Forecast: 1998 and 1999

Country	Consumer Prices	
	1998	1999
Australia	**1.1**	**2.2**
Canada	**1.0**	**1.5**
France	**0.8**	**1.0**
Germany	**1.0**	**1.2**
Japan	**0.3**	**-0.5**
U.K.	**3.1**	**2.3**
U.S.A.	**1.7**	**2.3**

Source: The Economist, November7-13, 1998

Table 3. Comparison of Corporate Taxation

Country	Corporate Income Tax Rate (%)
France	**33**
Germany	**50**
Japan	**50.0**
United Kingdom	**33.0**
United States	**41**

Note: Tax inclusive of national and local rates.

Source: Ministry of Finance, Japan.

Figure 1: Real Economic Growth, 1985-1997 (% annual change)

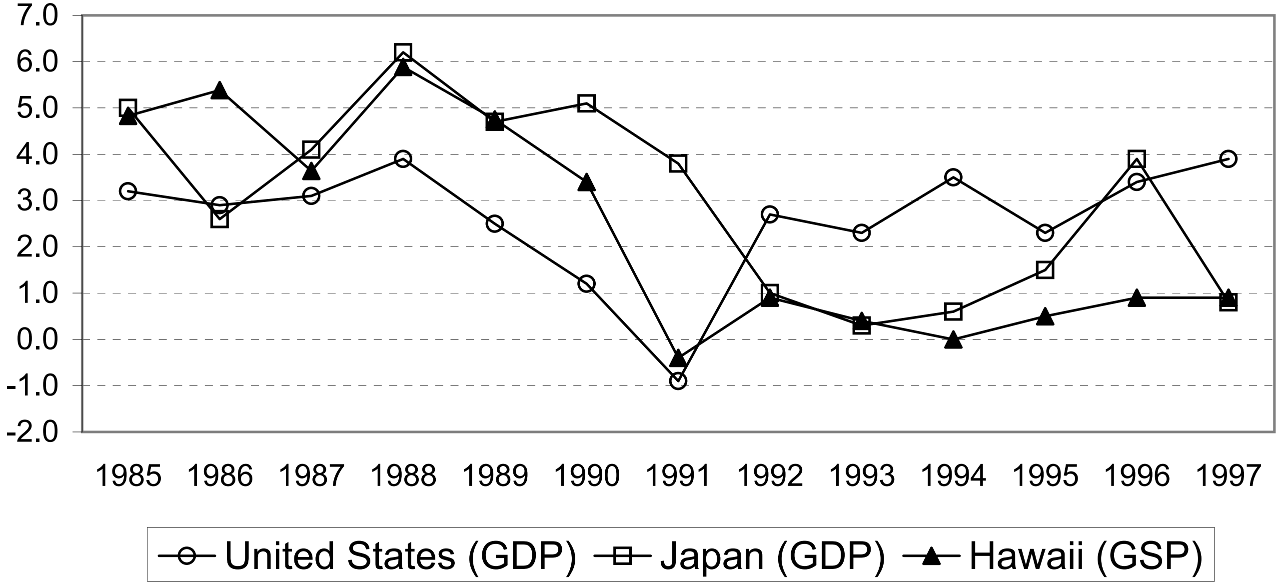


Figure 2: End of Period Stock Prices in Japan (1990=1)

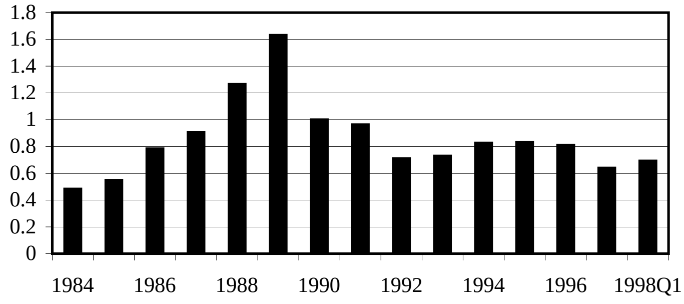
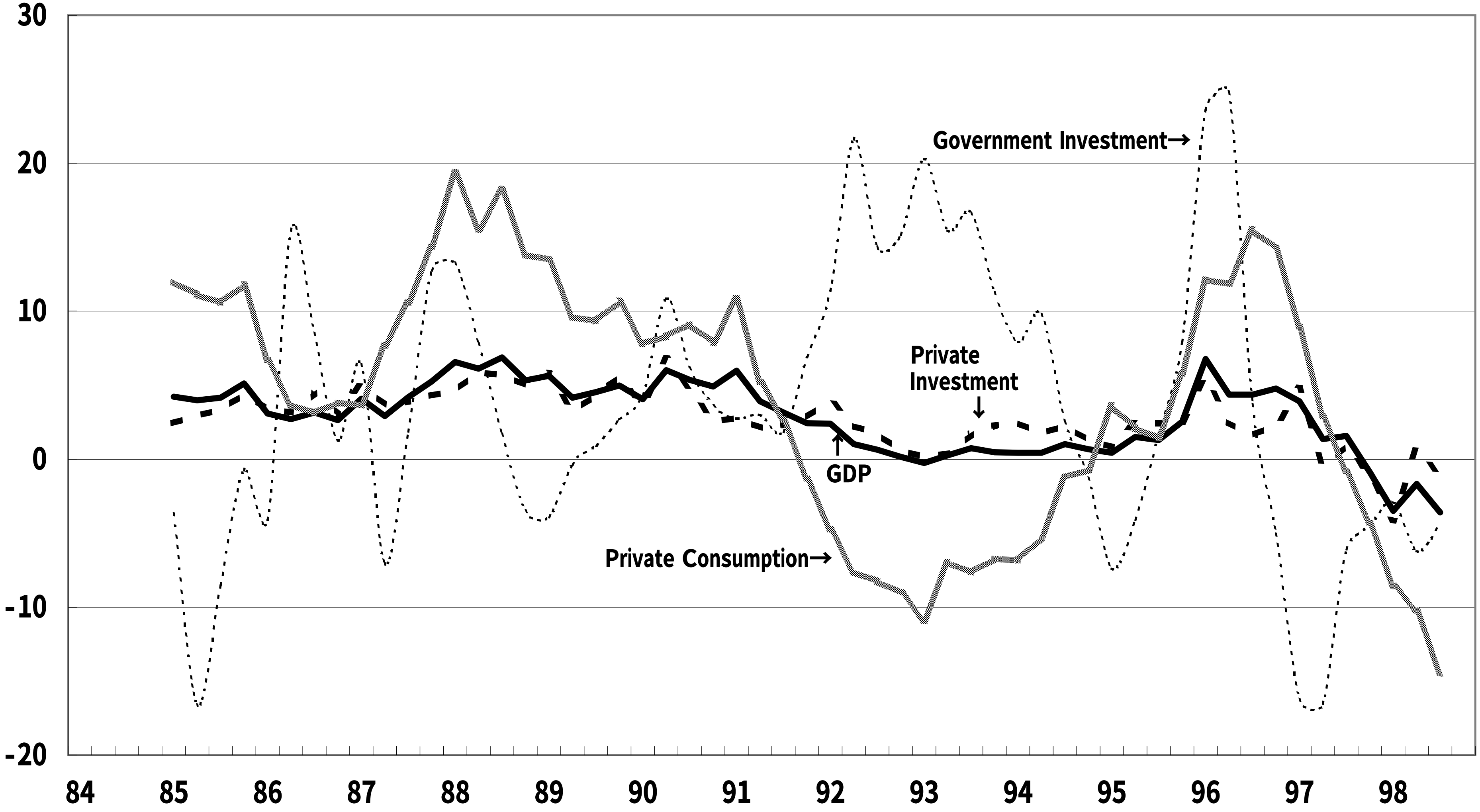


Figure 3: GDP Components(four quarter percent change)



Source: Economic Planning Agency, Japan, 1998.

Figure 4: End of Quarter Exchange Rates,
US$ per Japanese Yen (1990Q4=1)