Comments and Discussion

Lok Sang Ho: I find myself in agreement with at least 90 percent of the conclusions of Professor Morinobu. In particular, I agree that Japan's 11 fiscal stimulation packages, at a total cost of ¥136 trillion, were misguided, that the situation cannot be sustained, and that fiscal discipline may need institutional backup. I also agree that it is important to distinguish between structural and cyclical deficits and important to have any new expenditures financed by new revenues. Finally, I agree that pension incomes should be treated no differently from other forms of income and should therefore be taxable.

I am not sure whether Morinobu and I really differ about the other 10 percent, but I do have reservations about any suggestions that (1) "fiscal consolidation" will necessarily lead to higher private investment and growth and (2) government expenditures will necessarily crowd out private consumption and/or investment.

Although fiscal expenditures motivated by the desire to stimulate the economy are highly likely to hurt growth and are most probably wasteful, fiscal expenditures that are justified by a careful cost-benefit analysis may improve the business environment and thus be complementary to private investment. They have the potential to promote economic efficiency and growth and may therefore be worthwhile. Fiscal expenditures are not homogeneous and must be treated as such and analyzed carefully.

Morinobu rightly urges us to distinguish cyclical deficits from structural deficits. The so-called Keynesian cross relationship (aggregate income = aggregate expenditures for equilibrium GDP) is an excellent starting point for such an analysis:

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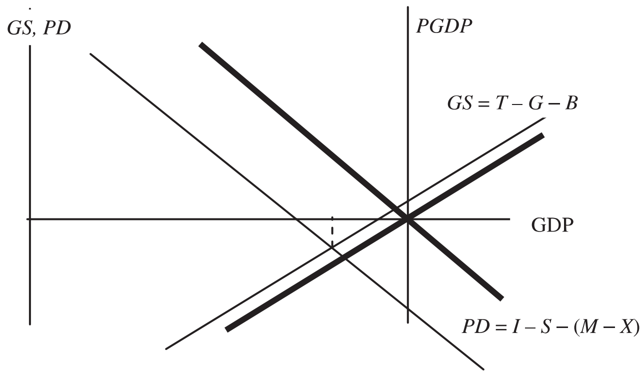
Figure 1. Determination of aggregate demand in GS-PD framework



$$Y = C + I + G + X - M.$$

Note this is the condition for aggregate demand to be in equilibrium. Despite the name, it is really a-Keynesian (i.e., this has nothing to do with Keynesian analysis or prescriptions). Economists of all stripes have no dispute over this relationship. Now write

$$Yd + T - B = C + I + G + X - M$$

Transpose to get

$$T - G - B = I - S + (M - X)\text{, or}$$

$$GS \text{ (government savings)} = PD \text{ (private sector savings deficiency)},$$

which is depicted in figure 1.

In figure 1, the economy would have registered a fiscal surplus under full employment. So there is no structural deficit. There is a fiscal deficit only because the *PD* line is too low.

Even though the government is running a deficit now, a slightly more expansionary fiscal stance, bringing *GS* to the bold line, while a monetary policy bringing *PD* up also to the bold line, will close the fiscal gap and achieve full employment.

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Once fiscal policy has brought *GS* to the full employment budget balance position, it should simply stay there. This is not to say that fiscal expenditure cannot be increased, because both *G* and *T* rise without changing the fiscal stance, but all new fiscal spending should be subjected to careful social cost benefit analysis. Once fiscal policy is well conducted in this way, monetary policy should aim at *PD* being on the thick *PD* line. This means that the interest rate level and exchange rate level (monetary conditions) must compensate for other influences on the *PD.*

To the extent that the economy is growing, the *GS-PD* intersection on the *PGDP* line may allow a small full-employment fiscal deficit, provided that all the major relevant ratios are maintained at the steady state (e.g., debt-servicing cost is a fixed percentage of GDP).

Morinobu's paper did not indicate whether Japan has a full employment budget surplus or deficit and how big it is. This information will be useful in assessing whether more "fiscal consolidation" is in order.

General Discussion

Changyong Rhee expressed puzzlement at how the fiscal situation in Japan could get so out of control. He noted that the issue was followed closely in South Korea, and expressed the hope that the Japanese experience would be a lesson for other counties. The most important question, according to Rhee, is whether the main cause is the economic recession or the poor budget rules. Warwick McKibbin drew parallels to the case of United States, where President Clinton managed to reduce the budget deficit. This development, however, which earned him a great deal of credit and respect, had little to do with budget rules. Instead, strong productivity growth was the single-most-important factor behind strong U.S. growth and the large increase in government revenues. The European experience also shows that rules might be a blunt instrument for fighting fiscal imbalances: the convergence and budget rules in the EU are broken with little effect and no sanctions when large individual countries find it convenient to do so. The lesson is that commitment to budget rules is crucial, but the question is how do countries achieve such commitment. McKibbin related the fiscal situation in Japan with the environmental issues that were discussed during the session on black carbon in China. More precisely, Japan needs to increase public revenues, and one way to do so would be to introduce a carbon tax that would address two important Japanese problems: the fiscal deficit and the deteriorating environment.

Barry Eichengreen followed up by noting that Japan has lower public spending than

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almost any other OECD country. Hence, the problem is not so much on the expenditure side, though this has been widely focused upon, but rather on the revenue side. The main challenge is to increase public revenues without pushing the economy into an economic slump. Robert Dekle agreed and noted that public revenue was roughly 29 percent of GDP in Japan compared with at least 35 percent in other OECD countries.

Eisuke Sakakibara stressed the political-economic aspect behind the situation. First, the balance between bureaucrats and politicians has changed in favor of the latter. This is an important explanation for the fiscal deficit, in light of the large differences between the two groups' views on the use of government expenditures as a means to stimulate the economy or, even worse, to use fiscal policy to gather political support. Second, there is an international dimension where the United States has encouraged Japan to use fiscal policy to stimulate the economy. Eichengreen agreed and noted that the United States was probably worried that the alternative of exchange rate depreciation would be used. This is a common problem for large countries: currency depreciations will have relatively large impacts on international trade balances, which trigger international political opposition. Other participants questioned the use of exchange rate depreciations to stimulate the economy, in light of the low share of export as a share of GDP in Japan.

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