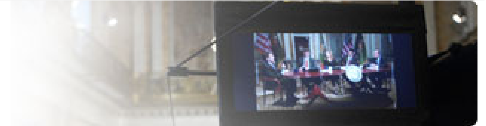
U.S. DEPARTMENT OF THE TREASURY

Press Center



Remarks of Under Secretary Sheets at the Harvard Law School Japan-U.S. Symposium on Building Financial Systems for the 21st Century

10/28/2016

KARUIZAWA – Let me thank you for the opportunity to participate in this year's Symposium, particularly alongside my Japanese Ministry of Finance counterpart Vice Minister Asakawa. Masa and I have gotten to know each other quite well over these last several years through G-7 meetings chaired by Japan, G-20 meetings, and frequent bilateral interactions, including a stream of late night and early morning telephone calls. But I believe this is the first time for us to share a podium together.

This Symposium started in 1998 against the backdrop of the Japanese financial crisis, and it is fair to say that Japan of that period played a defining role in my own career. I was the Japan desk officer at the Federal Reserve Board from May 1997 to October 1999, and was heavily involved in Japan issues at the Fed in the following years as well, including when I headed the International Finance division under Chairman Bernanke.

Of course the late nineties was an exceptionally busy time to work on Japan, with substantial demands from the leadership of the Federal Reserve. But, truth be told, it was the substance of the issues that often kept me in the office until late at night. These issues were just deeply engrossing – what monetary policy options existed beyond the level of liquidity required to bring interest rates to zero? Was the Japanese recovery strong enough to withstand the increase in the consumption tax in 1997? Was government debt best measured on a gross or net basis? What combination of fiscal stimulus, financial and corporate restructuring, and structural reform would be required to sustain a healthy rate of Japanese growth in a period of weak external demand?

If those questions sound relevant and topical even today, that is because they are – and not just for Japan, but increasingly for the world. In fact, many of these same questions have framed Abenomics, which has roughly coincided with my term as Under Secretary of the Treasury.

I say roughly, because when Abenomics was first launched, in early 2013, I was still working as an economist in the private sector. In that capacity, I wrote several detailed pieces, including a 16-page report entitled, "Abenomics—Will It Really Cure What Ails Japan's Economy?", which addressed questions I was fielding from investors at the time. I think the basic conclusion of that work stands up well – that monetary policy alone cannot bear the full burden of the Japanese policy response, and that structural policies especially are critical to a durable exit from deflation. But neither could I fully anticipate how Abenomics would develop, from the seemingly endless capacity of the Bank of Japan to innovate to the stubborn challenge of calibrating fiscal consolidation in the context of weak consumption and domestic demand.

For the remainder of my remarks, and with the benefit of a bit of hindsight, I would like to draw some preliminary lessons from the first stage of Abenomics – for Japan, but also for the global economy.

Monetary Policy

The most effective and intensively deployed component of Abenomics has unquestionably been monetary policy. But before addressing the Bank of Japan's substantial innovations under Governor Kuroda, I think it is only fair to recognize how long the BOJ has pioneered the monetary policy frontier. How many of you remember the sci fi-sounding "ZIRP" for the zero interest rate policy introduced in February 1999? You get extra credit if you remember "Son of ZIRP" after a brief rate hike in 2000. Japan then introduced quantitative easing from 2001 to 2006, an experience that has been particularly useful to other major central banks since the outbreak of the Global Financial Crisis. And it was under Governor Shirakawa that the BOJ set a 2 percent inflation target, initiated open-ended asset purchases, and released a joint statement with the Abe government on overcoming deflation and achieving sustainable economic growth.

The Bank of Japan under Governor Kuroda continued to innovate by launching "Quantitative and Qualitative Easing" in April 2013. More recently, the BOJ introduced a negative interest rate policy in January of this year. And just last month, it committed to overshoot its inflation objective, and set an explicit policy target for the long-term interest rate. The latter move is remarkable in that central banks have typically targeted short-term interest rates, leaving long-term interest rate determination to the market. These bold innovations have been accompanied by an effort to strengthen communication with the public about policy intentions.

I would like to offer two thoughts here from the perspective of the Obama Administration. A repeated question that we have faced since the Global Financial Crisis – one raised by Brazil, India, and others – is where does legitimate domestic monetary policy end and objectionable spillover begin? This issue came to the fore just as the Abe Administration was taking over. In late 2012 and early 2013, market participants speculated that monetary easing measures could include direct BOJ purchases of foreign assets financed by printing yen, the functional equivalent of unsterilized foreign exchange intervention. G7 Finance Ministers and Central Bank Governors issued an important statement in February 2013 to clarify that "… monetary policies have been and will remain oriented towards meeting our respective domestic objectives using domestic instruments, and that we will not target exchange rates." We continue to be guided by this principle. Notably, the G20 countries this year committed to refrain from competitive devaluation, to not target exchange rates for competitive purposes, and to communicate closely as we formulate exchange rate policies. Japan in its role as this year's G7 chair and as an advanced Asian economy has been an important contributor to these discussions. We look forward to continuing our engagement on these key issues with Japan and our other G7 and G20 partners in the years ahead.

Second, Governor Kuroda is no doubt correct that central banks never run out of tools, and that they can always find more, but it is also true that there is a risk of overdependence on monetary policy – not just in Japan but globally. Monetary policy has been highly supportive in many economies, especially in Japan and the euro area, and remains supportive in the United States. Both nominal and real interest rates are exceptionally low, but inflation is nevertheless below target in most major economies, reflecting weak demand in many parts of the world. Forceful monetary policy responses need to be supported with appropriate fiscal actions to deliver a sufficient boost to domestic demand.

Fiscal Policy

This brings us naturally to fiscal policy under the current Abe administration. Abenomics included an upfront dose of fiscal stimulus in 2013. But, given Japan's high public debt, fiscal policy was always meant to be "flexible" – initially stimulative, but then moving toward contraction once sustainable inflation of 2 percent had been achieved.

There can be no doubt that Japan's debt is high, at 250 percent of GDP in gross terms, according to the IMF. However, Japanese *net* debt, or gross debt minus government financial assets, is about 130 percent of GDP. That is 120 percentage points lower than gross government debt, largely due to Japan's sizeable Social Security Fund assets, foreign exchange reserves, and government shareholdings in public and quasi-public companies. And, that doesn't include the roughly 70 percent of GDP held in the form of JGBs by the Bank of Japan. In short, a variety of nuances must be taken into account in assessing Japan's debt position, and the situation does not seem acute with the JGB yield curve near historical lows, but fiscal consolidation is clearly necessary over the medium-term.

On the revenue side, Japan's principal tool for fiscal consolidation is, as we all know, the consumption tax. Few Japanese economic policy measures have been as controversial or as consequential as the consumption tax – starting with its introduction at 3 percent in 1989 after 10 years of political discussions. It was then increased in the spring of 1997 to 5 percent, just as Japan was entering its financial crisis and emerging Asia its balance of payments crises. The consumption tax was increased again to 8 percent two years ago. The last two of these increases have had particularly outsized effects on Japanese private spending; for example, household consumption today is still below its level before the latest hike. Japan's recent experience with the consumption tax is, amongst other things, a reminder of the power of fiscal policy when monetary policy is at – or near – the zero lower bound. For this reason, Secretary Lew has welcomed Prime Minister Abe's decision to postpone the further increase to 10 percent until October 2019.

By my reckoning, the best path forward is for Japan to focus on the overall fiscal impulse, that is, the change in the cyclically adjusted primary balance. In periods when domestic demand and global growth are weak, it makes sense for Japan to keep its fiscal impulse positive or at least neutral. But that objective does not preclude flexibility in the timing and composition of fiscal policy. An eventual increase in the consumption tax could be offset – or *more* than offset – by short-term fiscal stimulus measures that would roll off over time. Under present circumstances, providing net short-term fiscal stimulus would be wise, given the ongoing fight with deflation and that some of the public investment offsets planned in 2014 failed to materialize on a timely basis.

Structural Policy

In discussing the three arrows of Abenomics, structural reform usually comes third and last in order, which is ironic because it is arguably the most important. Monetary and fiscal policy can support demand, thus closing the output gap and helping eliminate deflation, but only structural policy can raise the *trend* rate of economic growth that Japan will achieve over the medium term.

Structural reform policies tend to be microeconomic, institutional in nature, and intricately interwoven with a set of societal choices made by a given country. Therefore, it is often hard to speak in general terms. But my many visits to Japan over the last several years have left me impressed with the progress that has been made on corporate governance reform; struck by the further steps needed in promoting greater competition and productivity in the services sector; and convinced that the Trans-Pacific Partnership is critical not just for the *external* markets it will open for Japan but for the *internal* liberalization that it will bring about. Given TPP's importance for Japan, as well as for the Asia-Pacific region and the U.S. economy, President Obama has made clear his commitment to see TPP approved.

I would offer a further thought – it is increasingly important to pay attention to the interplay between structural reform and domestic demand. Specifically, in current circumstances it makes sense to focus on those structural reforms that will best support Japanese domestic demand. Priorities here would be policies that raise labor force participation to help offset the negative impact on growth from Japan's aging demographics. One thinks immediately about further removing barriers to women in the workplace. This is of course good policy, but as my own research has shown, the female labor force participation rate – the fraction of women who work – is already comparable in Japan to that in the United States and Europe. The real issue surrounds the quality and not the quantity of women's work. Women are much less likely to be regular workers – in part because the tax system discourages work by spouses – and wages are lower than for men; and also because child care options in Japan are limited. Japan will also need to allow greater and more flexible participation by older workers, who will progressively occupy a larger share of the work force. Building on recent reforms, consideration should also be given to additional efforts to boost foreign workers' role in the economy. Finally, regulatory reforms to open up sectors to new entrants and new products, as well as encouraging more efficient use of land, could all increase investment and economic activity in the short term, as well as growth in the long term.

Conclusion

When I first started working on Japan in 1997, there was a sense that Japan and its economic problems were *sui generis* – the result of particular Japanese institutions and practices, a delay in responding forcefully to the banking sector crisis, and a series of monetary policy mistakes. Most of us were convinced that definitive steps to strengthen banks and deal with bad loans, coupled with appropriate stimulus from macroeconomic policy, was all that was needed to resuscitate Japan's economy.

Yet, today, many of the characteristics that were once viewed as uniquely Japanese problems have now come to characterize to varying extents many of the major advanced economies: sharply reduced investment, even when corporations are flush with cash and face near zero interest rates; high levels of public debt; and inflation falling consistently below target, even with extremely aggressive monetary policy.

So, after nearly 20 years, Japan has never been more relevant and the lessons from Japan's experience have never been more important. In this respect, every participant at this conference is wrestling with issues that are at the forefront of economic policy. I thank you for having me, and look forward to learning a great deal over the course of the evening.

Thank you.