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Stock price targeting and fiscal deficit in Japan: Why did the fiscal deficit increase during Japan's lost decades? ☆

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ABSTRACT

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The purpose of this paper is to explain why Japan's fiscal deficit increased so dramatically in the 1990s and the 2000s. We focus on the role of "stock price targeting" to explain why the fiscal expenditure increased so much. After presenting a simple model to describe government behavior with an optimistic view about stock price and output growth, the paper tests whether the model can explain Japan's fiscal expenditure. The empirical results, using biannual and high-frequency data of the 1990s and the 2000s, show that the stock price targeting can track Japan's fiscal expenditure reasonably well, especially in the 1990s. They imply that without the stock price targeting, the total amount of biannual fiscal stimulus from 1992 to 2000 would have been lower by 2.5 trillion yen on average. *J. Japanese Int. Economies* **25** (4) (2011) 447–464. Faculty of Economics, University of Tokyo, Tokyo 113-0033, Japan; Tokyo Center for Economic Research, Tokyo 102-0072, Japan; Graduate School of Economics, University of Tokyo, Tokyo 113-0033, Japan.

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1. Introduction

After the global financial crisis, accumulated fiscal deficits became one of the most urgent issues to be addressed in most OECD countries. According to the OECD Economic Outlook 89, the OECD average ratio of general government gross financial liabilities to nominal GDP, which was 73% in 2007, is projected to increase to 105.4% in 2012, the highest in the past half century. However, comparing fiscal deficits across countries, one finds Japan has accumulated a much higher deficit than any other OECD country. Measured by general government gross financial liabilities, Japan's fiscal liabilities were twice as much as the nominal GDP in 2010. This ratio suggests that Japan's fiscal deficit is much more serious than that of any of the PIGS countries (Portugal, Ireland, Greece, and Spain) that faced fiscal problems after the global financial crisis. The general government financial liabilities, even after government assets are subtracted from them, are estimated to exceed nominal GDP after 2009. In terms of GDP, Japan's liabilities were the highest among the OECD countries after 2008.

Until the mid-1970s, Japan had been an exceptional country, with little fiscal imbalance. The ratio of government bonds outstanding to GDP was 3.7% in 1970 and 9.9% in 1975. Even in the early 1990s, gross government liabilities were close to the OECD average and net liabilities were far below the average. However, from 1992 to 2000, gross liabilities doubled and net liabilities quadrupled (see Fig. 1). This upward trend was further accelerated after the global financial crisis. Japan's fiscal deficit became exceptionally high in the 1990s and the late 2000s.

The purpose of this paper is to explain why Japan's fiscal deficit increased so dramatically in the 1990s and the 2000s. One of the straightforward reasons for this is that Japan had a prolonged stagnation during this period. However, although this period is sometimes called the "lost two decades," average growth rates in Japan at the time were not exceptionally low compared to other OECD countries. Table 1 summarizes the average annual growth rates of selected OECD countries in the 1990s and the 2000s. Japan's growth rates were lower than the OECD average. They were also slightly lower than that of France, almost equal to that of Switzerland, and slightly higher than that of Italy. Given the fact that these countries' fiscal expansion was much less dramatic than that of Japan, Japan's slow economic growth is not enough to explain the exceptional increases in its fiscal deficit in the 1990s and the 2000s.

In contrast, comparing the stock price indexes of major OECD countries, we see a unique feature in Japan from the late 1980s through the 2000s. The Japanese stock market experienced a "speculative bubble" in the late 1980s: The Nikkei 225 Average Index, which was less than 10,000 yen in December 1984, rose to 30,000 yen in December 1988 and to almost 40,000 yen in December 1989. The overvalued stock prices, however, did not persist. After the burst of the speculative bubble in January 1990, the Nikkei Average Index fell below 20,000 yen in early 1992 and experienced further declines from 1998 to 2003 during the banking crisis. Such dramatic declines in stock price had never been observed in other developed countries in the 1990s and the 2000s before the global financial crisis.

When the stock price is substantially overvalued, its dramatic decline is inevitable. No government policy can stop the decline until the price is adjusted to its fundamental value. This dramatic price decline, however, causes a serious problem from a political point of view. Ordinary people do not have enough knowledge about what is the fundamental value of the stock price or what is the definition of a speculative bubble. The politicians then face pressure from the public to implement expansionary policies to stop the continual asset price decline. In the 1990s, such a situation existed in Japan.[1] This called for excessive expansion of fiscal expenditure despite declining tax revenues. The Japanese government announced a series of fiscal stimulus packages in the 1990s and the late 2000s. These packages were originally motivated by the traditional Keynesian view. However, since the government had set its policy target at a high level, the fiscal stimulus could never achieve the target. The packages, therefore, increased fiscal expenditure during the period, resulting in a huge fiscal deficit.

In the following analysis, we focus on the role of "stock price targeting" to explain why fiscal expenditure increased so steadily after the burst of the speculative bubble. After a brief summary of

[1] For example, the front page article in the *Nikkei newspaper* on August 16, 1992, reported Prime Minister Miyazawa's commitment to Keidanren, the largest business pressure group in Japan. It mentioned that he committed to a new fiscal package in order to stimulate the stagnated stock market in Japan.