Research Department
Federal Reserve
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San Francisco

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FRBSF Weekly Letter

Crowding-Out: Japanese Experience

Many analysts are concerned that large Federal-budget deficits combined with tight monetary policy would spell a crowding-out of private investments from the credit market, and thus would abort economic recovery in the United States. This concern is also widely shared in the rest of the world, as anxiety mounts over the impact of high U.S. interest rates on the world economy. However, will this policy mix inevitably lead to such dire results? A look at other nations' experiences may help provide an answer.

What is "crowding-out"? It may be defined as a state in which, at given market-interest rates, government borrowings pre-empt some private investments in the credit market. By definition, the pre-empted private investments did not take place, so they would be statistically unobservable. Nonetheless, with that caveat, certain plausible inferences can be drawn from the experience of one major nation—Japan—during the 1973-80 period and these inferences are relevant for the assessment of current U.S. economic prospects.

Japan's experience

Japan in 1974, like the United States, was hit hard by a double-digit inflation and a severe recession. Inflation, as measured by the GNP-deflator, increased 20 percent over the preceding year, while real output declined by one percent after rising at a 10-percent average annual rate during the preceding decade.

In this situation, the Bank of Japan drastically reduced the annual money-growth rate—as measured by M-2 plus bank certificates of deposit—from 23-percent during 1971-73 to 12 percent in 1974. Subsequently, the Bank narrowly confined the money-growth rate in a range between 11 and 13 percent in almost every year from 1975 to 1979. In the meantime, the Government ran an increasingly large budget deficit, including off-budget borrowings. The deficit rose from less than one percent of national output in 1973 to nearly 10 percent in 1978, quickly exceeding the comparable U.S. ratios (see Chart 1). Similarly, as a share of credit-market funds, government borrowings in Japan rose rapidly and then hovered between 30 and 40 percent during 1979-80—significantly above corresponding U.S. levels except for 1975-76.

What were the results of this tight money/easy fiscal policy mix? Japan's inflation rate declined sharply and steadily from 20 percent in 1974 to below 2 percent in 1980, while real output recovered from its recession decline, and increased by more than 5 percent annually throughout the 1976-79 period (see Chart 2). The output-growth rate was only one-half of that which prevailed prior to 1974; still, it would be unrealistic to expect Japan, with its heavy dependence on oil imports, to maintain the same rapid growth as it did prior to the oil shock.

Crowding-out?

Some indicators suggest crowding-out during this period. Gross domestic fixed-capital formation, as a ratio to national output, declined steadily from 26 percent in 1974 to 21 percent in 1978. But there was no evidence of this from the movement of real interest rates, as measured by the call-money rate deflated by the GNP deflator. Indeed, real interest rates were lower in 1977-78 than they were on average during the 1965-72 period, when the government budget was in perennial surplus. Apparently, there were more savings than government borrowings and private-investment demand could absorb. Had there been crowding-out, real interest rates should have risen, not fallen.

Another piece of indirect evidence is provided by changes in the nation's current-account balance, which by definition are mirror images of changes in the capital-account balance. An improvement in the current-account balance signifies a rise, and a current-

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account deterioration a decline, in the nation's net investment abroad. Now, had crowding-out occurred, one would expect frustrated borrowers to seek capital from abroad, thus resulting in a decline in the nation's net foreign investment. That situation then would be reflected in a deterioration in its current-account balance. Instead, Japan's current-account balance improved dramatically, from a deficit of one percent of GNP in 1974 to a surplus of nearly two percent of GNP in 1978. The improvement means that the Japanese investors as a whole were holding more foreign assets than before. Since investors had the alternative of holding more domestic assets instead, it appears rather unlikely that domestic business borrowers (and not the foreigners) were pre-empted by the large government borrowings.

Admittedly, this evidence is not conclusive; yet it does suggest that there was probably little crowding-out in Japan during the 1974-78 period. The same cannot be said of 1979-80, when the real interest rate rose sharply and the current-account balance deteriorated. But it suffices to note that during a prolonged period in which rising budget deficits were combined with a very tight monetary policy little crowding-out occurred.

What lessons?
It might be argued that Japan's experience is hardly relevant for the United States, because the two countries have very different economic structures. Japan's personal-savings rate (20 percent in 1980) is several times larger than that of the U.S. (5½ percent in 1980), which suggests that Japan should be more successful than the U.S. in financing a larger deficit without straining the economy and domestic credit markets. However, a high savings rate necessarily implies a high private-investment rate, which means that a rise in the government deficit could just as easily crowd-out private investment in a high-savings economy as in a low-savings economy. The amount of crowding-out of private investment by government borrowing thus does not depend on the size of the savings rate, but rather on whether desired savings rises relative to desired investment.

Japan's experience shows that, with private-investment demand sufficiently weak, a large and rising government deficit need not result in crowding-out and an abortive economic recovery. On the contrary, Japan bounced back from the 1974 recession with a sustained (albeit reduced) growth rate, and with a sharply falling inflation rate.

Still, investment demand declined in Japan during this period, as the nation's growth prospects were lowered by the steep oil-price increases. In the face of unprecedentedly high and persistent unemployment, the monetary authorities resisted the temptation of stimulating demand by relaxing their tight rein on money growth. It was undoubtedly a high price to pay, but the world has not known a less costly way of winding down a prolonged inflation spiral. Japan paid the price and succeeded in getting the inflation rate down from 20 percent to 2 percent in five years' time, without incurring high interest rates and recurrent recessions—and in spite of large budget deficits. The same could occur in the United States as well.

In the U.S. today, crowding-out could occur if private investment demand bounces back vigorously. This need not abort the economic recovery, but it would imply a lowered growth path, with its attendant loss of output and employment. For that reason, policymakers are seeking to find ways to reduce the large budget deficits now facing us. And only in that way could the U.S. obtain a higher output-growth rate that is consistent with the objective of reducing inflation.

Hang-Sheng Cheng

CHART 1

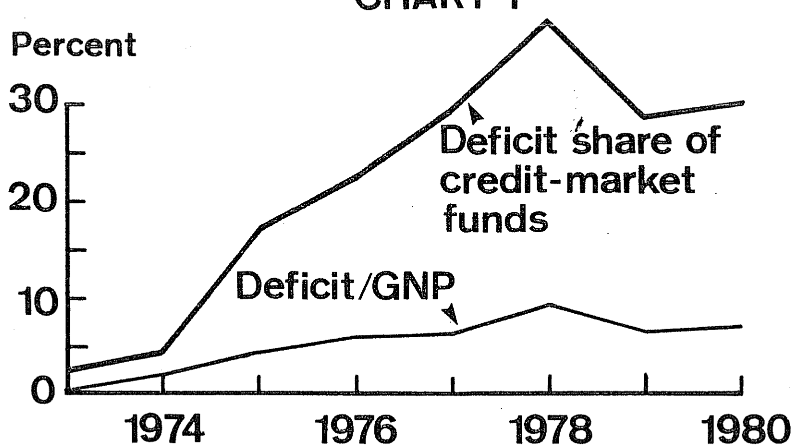
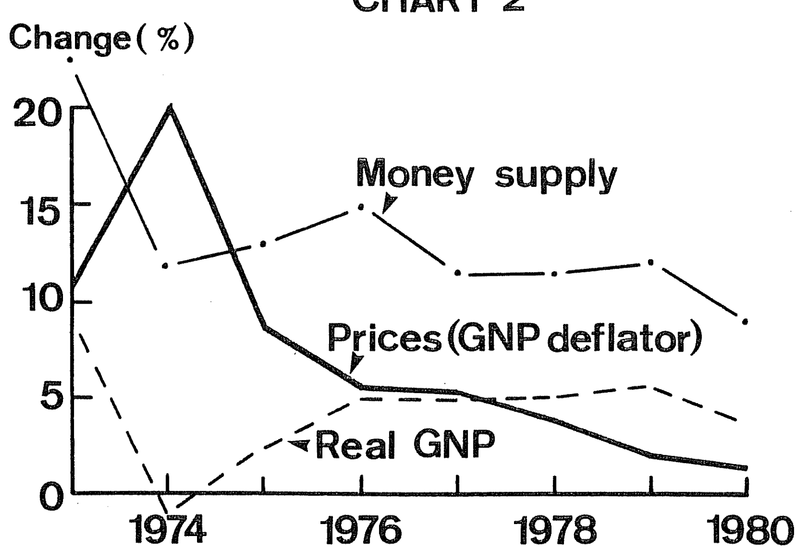


CHART 2



BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/3/82	Change from 2/24/82	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	157,286	– 509	10,238	7.0
Loans (gross, adjusted) — total #	136,168	– 384	11,542	9.3
Commercial and industrial	41,968	– 174	5,231	14.2
Real estate	56,390	62	5,194	10.1
Loans to individuals	23,450	– 42	– 112	– 0.5
Securities loans	2,182	– 217	780	55.6
U.S. Treasury securities*	6,228	– 100	– 470	– 7.0
Other securities*	14,890	– 25	– 813	– 5.2
Demand deposits — total#	40,204	2,540	– 2,486	– 5.8
Demand deposits — adjusted	26,389	336	– 2,985	– 10.2
Savings deposits — total	30,677	604	741	2.5
Time deposits — total#	92,026	– 46	15,357	20.0
Individuals, part. & corp.	82,220	– 56	14,720	21.8
(Large negotiable CD's)	35,894	– 205	6,445	21.9

Weekly Averages of Daily Figures	Week ended 3/3/82	Week ended 2/24/82	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	100	73	104
Borrowings	14	155	27
Net free reserves (+)/Net borrowed(–)	86	– 82	77

* Excludes trading account securities.
# Includes items not shown separately.

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