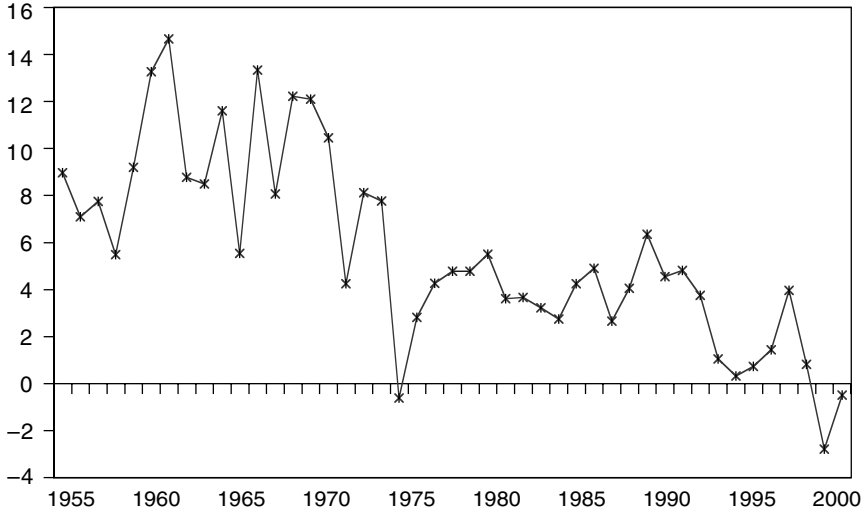

The Japanese Economic Malaise

Japan's macroeconomic performance affects its relative standing in the world and its bilateral relationship with the United States in a variety of ways. Domestic demand-led growth and a strong yen encourage imports, strengthening the economies of Japan's neighbors in Asia and contributing to a reduction in the politically sensitive bilateral trade imbalance with the United States. A growing economy makes Japan a more attractive destination for investment as well.

Beyond these direct trade and investment linkages (which will be discussed in detail in chapter 4), a prosperous, self-confident Japan is more likely to work in partnership with the United States to address pressing global issues. In contrast, for both economic and political reasons, a Japan mired in the malaise of continued poor performance is unlikely to play a constructive role in world affairs. Already, the implications of Japan's "lost decade" are beginning to be felt in the development and security spheres, as Japan cuts its budget for development assistance and considers reducing financial support for US military bases on its soil.

Some in the United States would regard Japan's relative weakness during the past decade as a desirable development. As a consequence of its superior economic performance, the United States has enhanced its status relative to Japan, and Japan's comparatively weak performance has undercut the ideological appeal of the "Japan model." Although such sentiments are understandable, and although the (at least temporary) interruption of Japan's increase in its relative economic prominence has helped to ease tensions with the United States, the advantages of a strong, stable Japan overwhelm such considerations.

Figure 3.1 Real GDP growth in Japan, 1955-2000 (percent)



Source: IMF, *International Financial Statistics*.

In this chapter, we examine the recent macroeconomic performance of the Japanese economy, focusing on three key issues: the condition of the financial system, and the conduct of both monetary and fiscal policy. (Some of the discussions of structural issues are deferred to chapter 4.) The chapter concludes with policy recommendations to spur improvement in Japan’s macroeconomic performance.

The Lost Decade

The growth of the Japanese economy during the past decade has been the slowest 10-year performance of any large industrial country in the postwar period, averaging about 1 percent a year, in dramatic contrast with its previous performance (figure 3.1). Between 1992 and 2000 (except 1996), the growth rate each year has been less than 2 percent, and the growth rate in 1998 was –2.5 percent (later revised to –1.1 percent when the price deflators used to calculate the national accounts were rebased), the worst in the postwar history of Japan. And not just the growth rate was low; the financial system weakened as well. Three of the top 20 banks failed in 1997-98, and there was genuine concern about a possible financial system implosion in 1998. The prolonged recession, with only tentative, short-lived recoveries, gradually raised unemployment, and by the end of the 1990s, the unemployment rate had become higher in Japan than the United States—which would have been unthinkable just several years earlier. In Japan, the 1990s are now known as the lost decade.

The core problem of the slow growth in the 1990s was nonperforming loans (NPLs) in the financial sector. As stock and land prices fell, the construction and real estate sectors were caught with overvalued inventory of land and structures. As real estate failed to produce profits, developers suspended payments to banks. Banks' provisioning for NPLs had lagged behind the pace of rising NPLs. It was widely believed that banks often lent more so that companies could appear to pay interest (a practice called evergreening). As the banks failed to produce profits, they started to restrict lending.

In an attempt to lift the economy from recession and deflation, 11 economic stimulus packages were put together and implemented between 1992 and 2000. However, much of the touted stimulation proved to be illusory: some of the claimed spending simply amounted to asset transfers, and in other cases the fiscal stimulus was offset by tax or fee increases or cuts in spending elsewhere in the budget. Indeed, Japanese fiscal policy was so opaque as to require a small cottage industry of private-sector analysts in Tokyo trying to divine what the government's fiscal policy stance actually was. Moreover, to the extent that additional spending was undertaken, project selection was atrocious, and the multiplier effect on these projects was low (see box 3.1).

Because of shortfalls in tax revenues from the negative growth in 1998 and large discretionary fiscal expenditures from 1998 to 2000, Japan's debt-GDP ratio has increased sharply. The IMF projects that its gross debt-GDP ratio will rise to 150 percent by 2005. This will be the highest level—surpassing Italy—among the Group of Seven (G-7) countries. The challenge of fiscal policy is to keep the level sustainable, which requires substantial consolidation—in total, 10 percent of GDP—in the next 10 years, but without triggering a recession.

Monetary policy during the period 1989-91 was tightened aggressively in an attempt to stop asset price inflation and burst the bubble. After the economy turned precariously weak in 1992, monetary policy was eased to support an economic recovery. However, in 1993-94, the economy did not recover as it normally would have after a recession. The rate of growth remained relatively low, and rather than accelerating as the economy picked up, the rate of inflation continued to decline, eventually turning into deflation. Although by 1999 monetary policy loosened with the introduction of the so-called zero interest rate policy, real interest rates (the difference between the nominal rate and the rate of inflation) remained high due to deflation. Japan was caught in a liquidity trap—a situation not observed in an industrial country since John Maynard Keynes first diagnosed the syndrome during the Great Depression.

Box 3.1 The road to nowhere

The construction industry is the single largest source of Japanese political campaign funds. The industry in effect acts as an intermediary, recycling public tax revenues and postal savings funds to politicians for private use through excess profits generated through bid rigging (*dango*).

Perhaps nothing better illustrates the political ties that bind the Liberal Democratic Party and the construction industry than Japan's virtual obsession with pouring concrete. Although, as Mulgan (2000) observes, the ratio of paved to unpaved roads in Japan is higher than in the United States, the Japanese government perennially invests almost 30 percent of its public works budget in pavement. Despite the government's rhetorical nods to information technology infrastructure and quality-of-life programs in public investment, these initiatives are dwarfed by traditional road building.

The gasoline tax is earmarked for constructing roads, regardless of efficiency. Unless this linkage is severed, road construction is automatic. In 2001, the Koizumi cabinet made ending this practice one of its highest reform priorities.

Bridges are another favorite. In a famous case, the government spent more than \$7 billion on a gigantic suspension bridge linking the islands of Honshu and Shikoku, despite the fact that the existing ferry service was used by only a few hundred cars daily. And in addition to the ferry service, two other bridges already connect Honshu and Shikoku. The decision to build three bridges was made in the 1970s at the strong urging of politicians from Shikoku and never reversed.

Ports and harbors provide yet another opportunity for pork-barrel largesse. For some fishing ports, expenditures on port improvements exceed the value of 10 years' worth of catches from the harbor.

For inland locations, bullet trains are a preferred vehicle for public spending. While Yoshiro Mori was secretary-general of the LDP, he secured funding for a new bullet train line that would cruise his bucolic home region of Hokuriku. Price tag: \$19 billion. Passenger projections: unavailable.

(box continues next page)

In sum, easy monetary and fiscal policies have been applied, without lasting effects on growth. By the end of the decade, government debt had become very high, and it constrained additional fiscal stimulation. Structural reforms in the financial sector may put additional downward pressure on economic activities, as the resolution of bank NPLs leads to more corporate bankruptcies and unemployment. The policy debate has moved to whether fiscal deficits can be reduced without too much of a negative impact on the economy, rather than providing further stimulation, and whether "unconventional" monetary policy may be needed if deflation continues.

Only 10 years ago, the Japanese economy was hailed, and often feared, for its strength. High economic growth, excellent manufacturing companies, large current account surpluses, and large, strong banks seemed to dominate the world. After 10 years, some manufacturing sectors are still strong, and current account surpluses are still large, but the banking sector has crumbled, and economic growth has slowed to a crawl.

Box 3.1 *(continued)*

The problem, of course, is that these white elephants generate operating deficits in addition to their initial costs. In 2000, the Ministry of Finance estimated that it would have to inject about \$47 billion in taxpayer money to cover the hidden losses associated with these investment projects. For example, later that same year, it was reported that the MOF had to inject more than \$7 billion into the Shikoku bridge project, for which interest payments are double the meager toll collections. The Hokuriku bullet train line is also expected to end up on the public dole, despite the privatization of the railroads. The government has already absorbed more than \$20 billion in theoretically privatized railroad debt (Tadaaki Ito 1996).

Unfortunately, questionable spending is not confined to physical infrastructure. In October 1998, the government began extending emergency loan guarantees to small and medium-sized enterprises (including construction companies) that have been plagued by high default rates. Central and local governments have also invested \$32 billion in nearly 10,000 so-called third-sector public-private partnership companies. The best known of these, the Sea Gaia luxury resort in Miyazaki, collapsed in 2001 with ¥326 billion in liabilities.

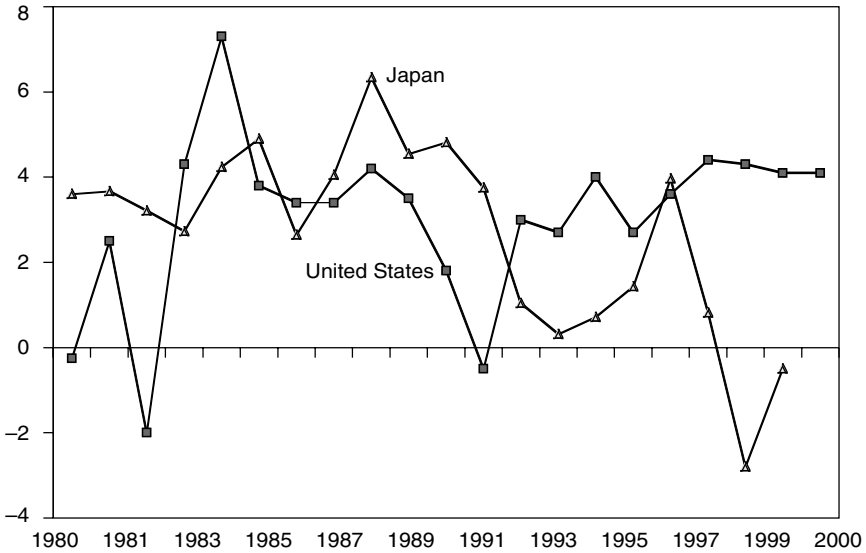
Faced with this mounting tab, the public is beginning to revolt. Public opinion polls indicate that the opposition to wasteful public spending is coming not only from urban voters, but even bedrock rural LDP constituencies. In January 2000, the population of Tokushima, a small southern city, voted a resounding “no” in a nonbinding referendum on the central government’s plan to provide the region with yet another billion-dollar dam. The local governments are saying no to these projects because they have to shoulder some of the costs, typically 10-30 percent. This means that local governments, businesses, and residents—the principal beneficiaries—assess the prospective benefits of the projects at less than 10-30 percent of costs. This is remarkable testimony to how truly wasteful some of these projects are. Indeed, the political popularity of Prime Minister Koizumi can be interpreted as a more general, though possibly transitory, revolt against the status quo.

Economic Developments and Policy Reactions

It is hard to argue that the growth slowdown was produced by changes in fundamental economic factors, such as technological change and changes in factor (labor and capital) accumulation. Investment still has been high relative to that in other countries and, although Japan’s labor force will soon decline, this cannot explain past performance.¹ However, it could be argued that in about 1990 Japan reached a technological turning point associated with a natural slowing of growth. Its very high economic growth during the 1950s and 1960s, and moderately high growth—much better than that of other G-7 countries—in the 1970s and 1980s, are often explained by a natural “catching-up” process to the most advanced coun-

1. The Japanese fertility rate has fallen to 1.4, and this, combined with a demographic bulge, will soon lead to a decline in the workforce and eventually the population in about 10 years. This will have macroeconomic consequences, unless the female labor participation rate is raised or more immigration is allowed. See Kasa (1997), Matsunaga (1997), Dekle (2000), Faruqee and Mühleisen (2001), and Seike (2001) for further discussion.

Figure 3.2 Real GDP growth in Japan and the United States, 1980-2000 (percent)



Source: IMF, *International Financial Statistics*.

tries in technology (especially in the 1950s and 1960s) and in per capita income, and by Japan's own innovative efforts in manufacturing processes (especially in the 1970s and 1980s) (cf. Eaton and Kortum 1997). According to this explanation, once the Japanese economy fully caught up with the Western countries in technology, say by the mid-1980s, its slower growth rates were inevitable, because "easy" opportunities for technological progress had been exhausted.

The difficulty with this explanation is that the United States, the putative technological leader, grew much faster than Japan during the 1990s. In fact, the United States enjoyed its longest peacetime boom in the 1990s, leaving Japan and the European countries behind. As was seen in chapter 2, one explanation for this growth is the advent of the "new economy."² However, Japan's economic troubles appear to have started earlier than the United States' information technology-induced productivity spurt (1995-2000) (figure 3.2). Many economists estimated Japan's potential

2. The contrast between Japanese dominance in manufacturing and financial sectors in the 1980s and US dominance in the 1990s is remarkable. As was demonstrated in chapter 2, the strong performance of the US economy in the 1990s was in part due to the success of the new economy—sectors that are related to information technology and its application to "old" industries. In Japan, reallocation of resources from the old economy to the new economy did not proceed well, due to capital-market inefficiencies and regulatory problems. The Japanese economy failed to exploit the opportunity of the information technology

growth rate in the 1990s at 2.5 percent a year (about the average among the G-7), so the difference between this potential rate and the roughly 1 percent actually achieved remains a puzzle.

There is little reason to believe that the potential growth of Japan suddenly became lower in the 1990s. The reasons for the lost decade, and its cures, must be found elsewhere. The slow growth of the 1990s can be attributed to a series of negative shocks to the economy, most conspicuously in the financial sector; inappropriate or insufficient policy responses to these shocks; and structural rigidities, which prevented the economy from achieving its full potential.

The Bubble Economy

The recession of the early 1990s was an inevitable retreat from the speculative boom of the late 1980s. (By the late 1980s, the Tokyo stock market had become the largest in the world, and the land under the Imperial Palace in Tokyo was worth as much as all the land in California, or all the land in Canada, or all the land, houses, and factories in Australia!) Firms leveraged these apparent gains to finance an investment boom. In retrospect, some of this investment was ill-advised.

Land and stock prices, which had risen three- and fourfold between 1985 and 1990, subsequently plunged by as much as 50-60 percent in a few years. The gains in stocks and land between 1985 and 1990 were completely wiped out between 1990 and 2000. Official National Accounts statistics indicate that Japanese households lost approximately ¥500 trillion (more than 100 percent of GDP) of their net wealth between 1990 and 2000.

At the beginning of the 1990s, it was thought that it would be necessary to treat the overheated economy of the late 1980s with a cold shower. From the end of 1989 to the beginning of 1990, stopping the ever-rising land prices took the center stage of policy. The burst bubble was partly a natural reaction to excessively high prices and partly due to policy measures—such as a series of official discount rate hikes (from 2.5 to 6.0 percent in 15 months in 1989-90) and the regulatory measures on bank lending to real estate sectors (introduced in March 1990).³ When land

revolution in the 1990s—the Internet, personal computers, and information technology industries. Without a remedy for its structural barriers to information-based industries—more labor mobility, merit-based pay, as well as competition in the communications and broadcasting industries—the Japanese economy will continue to lag behind the US economy. The potential growth rate of Japan will never come close to the US rate unless regulatory and legal reforms unleash the full potential of information technology industries (Murakami 1998).

3. Rising land prices were regarded as an enemy of public policy to provide affordable housing. Several policy measures were taken to stop land prices from rising, some constructive (raising the interest rate; changing tax provisions, which impeded the conversion of agricultural land in urban areas to other uses; and imposing a ceiling on banks' lending)

prices started to fall after the fall of stock prices in 1990-91, there was a sense of relief among the policymakers. As a result of price declines, housing became more affordable for first-time buyers by the end of the 1990s.

However, as asset prices declined, the economy went into a self-reinforcing downward spiral. Stock and real estate holdings had been used extensively as loan collateral in the bank-centered Japanese financial system; and, as asset prices plunged, bank lending was squeezed.⁴ The economy weakened, but monetary policy remained inappropriately tight and, with the benefit of hindsight, amounted to overkill.⁵ Monetary easing was behind the curve in 1992 and 1993, aggregate demand for consumption and private fixed investment collapsed, and a full-blown recession developed.

Sasaki-Smith describes the “self-righteous jubilation of the entire nation that falling asset prices would rectify the disparity between the haves and have-nots of land which was caused by the asset price inflation of the 1980s” (1999, 17). Virtually unnoticed amid the celebration, however, was the fact that the hard landing had put many construction and real estate firms into de facto bankruptcy. Banks threatened to repossess the collateral, although large borrowers could threaten to bring banks with them, if they were driven to bankruptcy.⁶ However, it turned out to be very costly to repossess the collateral of bankrupt borrowers; and, in a kind of truce, banks began evergreening loans in the hope that land prices would rise.⁷

and some questionable (suspension of auctions of government land and an approval system for land and housing sale prices).

4. Shimizu (2000) presents evidence indicating that the fall in land prices had a much bigger impact on the volume of bank lending than did the decline in stock prices. See also Ueda (1996) and Kwon (1998). However, as Fukao (1998) points out, the banks’ enormous holdings of stocks and bonds in effect represent off-balance-sheet lending and a potential concentration of lending risk. He gives the example of Sanwa, Tokai, and Sakura banks, whose holdings of Toyota stock in 1997 respectively represented 37, 79, and 40 percent of their capital.

5. Jinushi, Kuroki, and Miyao (2000) provide a sophisticated econometric demonstration of the Bank of Japan’s (BOJ’s) tardy reactions. The peak of the boom, officially dated by the Economic Planning Agency, was February 1991. However, monetary policy was not loosened until July 1991, when the official discount rate was reduced from 6.0 to 5.5 percent. The BOJ was too preoccupied with making sure that stock and land prices would not go up again. Unfortunately, commercial banks and real estate companies were behaving as though land prices would stop declining. The land holding companies kept hoarding land, so that the land prices declined only gradually.

6. Under the accounting and bankruptcy rules in effect at the time, NPLs had to meet rigorous criteria to be declared tax-free write-offs. At the same time, under the bankruptcy code, restructuring could not proceed without the approval of the principal creditors, and hence the banks exercised considerable influence over the timing of bankruptcy applications. Reputational concerns encouraged evergreening to forestall bankruptcy (Shikano 2001).

7. There are three issues. Consider the case of a single parcel of land used to secure six equally valued loans from six banks. Suppose the property falls to one-sixth of its original

There was no winner in this silent war of attrition that produced large macroeconomic costs. Provisioning and business as usual, paying dividends by realizing large but dwindling latent capital gains, continued in the meantime. The capital bases of banks were seriously damaged by draining resources that could have been used more productively to get rid of NPLs.

There could have been possibly two ways to manage the macroeconomy during the period 1992-95, after the bubble burst. Monetary policy could have been more accommodating to support stock and land prices.⁸ The aggressive easing of interest rates by the US Federal Reserve after the US technology bubble burst in 2000-01 suggests that it learned from the Bank of Japan's (BOJ's) mistakes. In addition, if land prices had been judged as absolutely overpriced, real estate companies and banks could have been forced to dispose of nonperforming loans right away, forcing distressed companies to sell some unused land (which became commonplace only after 1998). Even if land prices had plummeted due to rapid sales, it would have been better in the long run. Realizing potential losses in, say, 1995 would have been much better than the gradual squeezing of remaining assets in the following years. Neither route was chosen. The health of financial institutions and the macroeconomy sank gradually.

Financial-Sector Problems

Almost immediately after the bubble burst, problem loans to the real estate sector and illegal lending activities began surfacing.⁹ The first institutional failures were among local credit cooperatives, and in 1991 the deposit insurance fund was tapped for the first time since its establishment in 1971. The following year, the government established a Credit Cooperative

value. If the owner is forced into bankruptcy and the land sold, under Japanese law only the first lender would be repaid. Any decision to foreclose, however, requires the assent of a majority of the creditors. The result is gridlock. Second, it is difficult under Japanese tenant law to evict tenants from a building that is being sold or repossessed. Third, many of these properties had been occupied by *yakuza* (gangsters), impeding sales or conversion to new uses. See Wanner (1998a) and Lincoln (2001) for further details. Gillian Tett and Fiona Graham, *Financial Times*, 6 June 1998, give specific examples.

8. Unfortunately, part of the slowness of the BOJ to react could be blamed on the poor quality of Japanese consumer price statistics. The statistics were constructed by a government agency from observations taken from Japan's traditional rigid-price retailers and missed the major shift in spending toward new discounters in the late 1980s and early 1990s. When the BOJ did its own survey in 1995, it found that deflation was running at more than 3 percent a year (Makin 1996).

9. In 1991, executives of the Fuji, Tokai, and Kyowa Saitama banks were arrested for fraud. The most spectacular case involved the Industrial Bank of Japan, which participated in lending a reputedly gangster-connected Osaka restaurant owner more than \$2 billion on the basis of forged documents.

Purchasing Company to buy their dud loans. In a decade-long recurring pattern, the government either underestimated or simply refused to acknowledge the magnitude of the problem (Packer 1999). A turning point came in December 1994, when the two credit cooperatives (*shinyo kumiai*)—Tokyo Kyowa Credit Union and Anzen Credit Union—in Tokyo were found to be in trouble.¹⁰ During the period of rapid growth, failure among Japan’s highly regulated financial institutions had been relatively rare, and the ones that occurred had been more or less successfully handled by merging distressed institutions into healthier ones.¹¹ The supervisory framework was built on the assumption that no institution would fail in the traditional environment of heavy regulation. However, financial liberalization had been proceeding since the mid-1980s, and the regulatory framework was outdated.¹²

The handling of these cases was further complicated by two factors. First, the primary responsibility for supervising credit cooperatives was vested in the prefectural government, the Tokyo metropolitan government in this case. However, the prefectural government possessed even less institutional capacity than the Ministry of Finance (MOF) to deal with the situation. Second, the effective owners of these two institutions were heavily involved in connected lending and political corruption.¹³ Indeed, it was later revealed that MOF officials had been wined and dined and even flown to Hong Kong on a private jet by one of the key figures in the collapse of the two credit cooperatives (Hartcher 1998; see box 3.2).

When the MOF and the Tokyo metropolitan government arranged a plan to take over assets of the two institutions and to use “public money” to create a new financial institution, the Tokyo Kyodo Bank, the plan was met with strong opposition from a public that regarded it as a bailout for crooked bankers. In early 1995, the Tokyo metropolitan assembly

10. O. Ito (n.d.), and Cargill, Hutchison, and Ito (1997, chap. 6) provide a detailed account of the credit cooperative failures.

11. Four assisted mergers occurred between 1991 and 1993. Regulations on branching made the going-concern values higher than otherwise. The network of branches in a particular area was valued highly by institutions that wanted to expand operations in that area, sometimes an institution in the same area and sometimes an institution from another area. See Hutchison (1997).

12. No other institutions were interested in merging with these institutions, and losses that were estimated in these institutions exceeded what the deposit insurance corporation could inject to help a merger. Conversely, there was little formal regulatory power (other than *gyosei shido*—administrative guidance or jawboning) in the Ministry of Finance to supervise effectively or to force an institution to shut down.

13. Fukao (1998) argues that the frequent presence of *sokaiya*, or corporate racketeers, in financial-industry scandals indicates the need for improved internal and external accounting and auditing standards backed up by enforcement either through improved supervisory regulation and/or shareholder lawsuits.

Box 3.2 Corruption, accountability, and credibility

The Japanese government has been dogged by a series of financial corruption scandals since the Recruit shares-for-influence affair of the late 1980s that brought down the Noboru Takeshita cabinet. In 1997, the formerly untouchable Ministry of Finance was ensnared.

Beginning in March 1997 a probe by the Tokyo Prosecutor's Office found that the Big Four brokerage houses (Nomura, Daiwa, Nikko, and Yamaichi) and the Dai-ichi Kangyo Bank had paid more than \$100 million to racketeer Ryuichi Koike in an attempt to prevent the disclosure of embarrassing information. The scandal eventually spread beyond the financial sector to involve Mitsubishi, Toshiba, Hitachi, and other corporate giants.

As the Prosecutor's Office continued its investigation, it found evidence of collusion between the financial firms and their putative regulators at the MOF, including coverups of illegal financial activities by Japanese firms in the United States, such as in the case of the 1995 Daiwa bond-trading scandal. On 18 January 1998, two Nomura Securities executives and the finance director of the Japan Highway Public Corporation (a former MOF bureau chief) were arrested on charges that Nomura had expended nearly \$3 million on bribes and entertainment to win business. A week later, for the first time in 50 years, the MOF was raided by 100 prosecutors, and two relatively low-ranking officials were arrested.

The scandal would go on to involve additional financial institutions, the resignations of the minister of finance and two MOF mandarins, the suicides of one sitting MOF employee and a former MOF official (at that time a member of the Diet), and tawdry revelations. In the end, 44 officials received "severe" reprimands for their wrongdoing, with 17 forced to take pay cuts. Eisuke Sakakibara—the vice minister for international affairs and the MOF's face to the world—and 13 others received warnings. (Sakakibara voluntarily accepted a temporary cut in pay.) Fifty-eight other officials received lighter reprimands. See Hartcher (1998) for a critical look at the light punishments.

Beyond providing fodder for the tabloids, the MOF prosecutions arguably had two important effects on policy. First, the scandals sent the ministry reeling and inhibited its ability to deal proactively with domestic and international issues, such as the brewing commercial banking crisis and Asian financial crisis.

(box continues next page)

rejected the funding for public money to the resolution plan, and new Governor Yukio Aoshima was elected on the platform that no financial assistance be provided to these institutions. The Tokyo Kyodo Bank was then established with Deposit Insurance Corporation and BOJ capital subscription, and without money from the Tokyo metropolitan government. This case established the precedent that, in the absence of genuine reform, it would be very difficult to use public money. It also encouraged other local governments to oppose central-government initiatives.

A second sign of financial trouble came later in 1995, when private-sector nonbank institutions that were supposed to have specialized in housing loans, known by their Japanese language acronym as "*jusen*," became a focus of concern (see box 3.3). The *jusen* sector had accumulated large nonperforming loans from lending to real estate developers. Rehabilitation plans from 1992-93, which had assumed a recovery in land prices,

Box 3.2 Corruption, accountability, and credibility (continued)

Second, the scandals made vividly clear to the public that, in the clubby world of Japanese finance, regulatory forbearance ruled—encouraged by corruption, close *amakudari* (golden parachute) relationships between the regulators and the firms that were under their supervision, and a reluctance to recognize losses and admit, implicitly, to bungling. By comparison, during the US savings and loan debacle, the US government obtained 1,850 indictments, eventually securing 1,600 criminal convictions. During Japan’s massively larger crisis, there have been roughly 100 indictments.

The apparent inability or unwillingness of the MOF to seriously regulate the financial sector directly led to the establishment of an independent financial regulatory agency, the Financial Services Agency (FSA). This body got off to a good start under its reformist leader, Hakuo Yanagisawa. However, after Yanagisawa was removed in a cabinet reshuffle, the agency rapidly frittered away its credibility. One of Yanagisawa’s successors (he had five) was forced to resign in a bribery scandal (unrelated to his role at the FSA); another was forced to quit after being taped telling bankers that they should come to see him if faced with an unduly harsh inspection and implying that additional capital injections would be available, no strings attached; and a third formally proposed that credit cooperatives, where much of the rot lies, be held to lower standards than the large banks. After a 14-month absence, Yanagisawa was brought back for a second tour of duty in July 2000.

This track record raises basic questions about the credibility of Japanese prudential supervision, both internally and internationally, and the extent to which the political elite comprehend this credibility problem. As *The Economist* editorialized in 1997, “For eight years, the financial authorities have lied, dissembled, and fudged in the hope that they could muddle their way out . . . but confidence has been sapped by dissembling” (29 November 1997). We would add that nothing has fundamentally changed with the shift in supervisory responsibility from the MOF to the FSA. The politicization of the regulatory function remains undiminished. One avenue for improvement would be to establish the legal independence of the agency, and to replace its politician chairman with a respected technocrat, along the lines of the US Securities and Exchange Commission.

had collapsed by 1994. By 1995, the *jusen* were thought to account for one-third of the banking sector’s NPLs, which amounted to ¥8 trillion (about 1.5 percent of GDP). Because some banks and agricultural cooperatives had established these *jusen* companies and/or lent to *jusen*, problems were cascading through the financial system, and there were systemic risks if the *jusen* failed outright.

The burden-sharing rule was unclear, and it took several months to find a compromise solution among stakeholders. After acrimonious negotiations, an accord was reached, under which banks were asked to surrender their claims and fill the balance-sheet holes, while the politically well-connected agricultural cooperatives and their prefectural organizations got back most of their lending, and the public supplied the rest. This established a precedent that the major nonbank institutions would be

Box 3.3 The *jusen* problem

The seven *jusen* companies, financed and largely staffed by large commercial banks, life insurance companies, and securities firms—with former MOF officials in high-ranking *amakudari* positions—were established in the 1970s to provide individual housing loans, while the commercial banks concentrated on lending to large corporations. When demand for commercial loans declined, the commercial banks entered the housing loan business, squeezing the *jusen*. In the second half of the 1980s, the *jusen* started to lend to riskier customers, namely, real estate developers. When the land price bubble collapsed, the real estate developers stopped servicing debts, and the *jusen* were hard hit.

Commercial banks that founded the *jusen* were major lenders to the *jusen*, as were agricultural cooperatives. When the time came to write off the debts and close down the *jusen*, the Ministry of Finance and the banking community insisted on proportional burden sharing, whereas the Ministry of Agriculture, Forestry, and Fisheries and agricultural cooperatives insisted that the coops should not bear any losses. The final resolution was closer to the agricultural cooperatives' position: The coops lent ¥5.5 trillion to seven *jusen* companies, and shouldered the burden of only ¥0.53 trillion, while the banks lent ¥1.45 trillion and took losses of ¥1.17 trillion. During the debate, it was revealed that the director general of the Banking Bureau of the Ministry of Finance had sent a memorandum during the negotiation of the first rehabilitation plan of 1992-93 to a counterpart in the Ministry of Agriculture, Forestry, and Fisheries indicating that the coops would not be held responsible in any future *jusen* resolution. This memo was crucial in getting the coops off the hook. (See Takatoshi Ito 2000 and Cargill, Hutchison, and Ito 1997 for more details; Saeki 1997 provides the agriculture sector's view.)

treated more leniently than the big banks.¹⁴ The banks were outraged—having been encouraged into the *jusen* venture, they felt forsaken by the MOF. The injection of public funds (¥685 billion) was small relative to either total *jusen* losses or the amount that would have to be injected into the commercial banking system 3 years later. Nevertheless, as in the earlier case of the credit cooperatives, the public was outraged that taxpayers' money had been used to clean up a mess associated with shady characters and their extravagant lifestyles.

The *jusen* imbroglio clearly showed that the Ministry of Finance was not prepared for situations that required closing financial institutions. The existing legal framework was inadequate; the MOF lacked the political clout to engineer a fair resolution; and the MOF itself was compromised by cozy regulator-regulated relationships through *amakudari*, the practice of bureaucrats retiring to positions in institutions that their ministry regulated.

The MOF, the overseer of the apparently mighty Japanese banks, did not have a strategy or political power to restructure financial system. In the markets, this apparent inability to resolve the financial sector's troubles

14. See Cargill, Hutchinson, and Ito (1997, table 6.2) for the exact burden sharing.

Box 3.4 The Daiwa scandal

Problematic Japanese financial-market regulation spilled onto the front pages of US newspapers in the autumn of 1995. In September, it was revealed that during a period of 11 years, Toshihide Iguchi, then the head of Daiwa Bank's New York operations, had engaged in 30,000 fraudulent trades, losing the firm \$1.1 billion in the process. The following month, the former car salesman pleaded guilty to numerous criminal charges totaling up to 90 years in prison and implicated a number of his superiors in an illegal coverup. US regulators closed Daiwa's US operations, and federal prosecutors would eventually obtain criminal convictions against another Daiwa executive and fines of \$340 million against the firm after it pleaded guilty to 16 criminal charges associated with the coverup.

The real bombshell came in October, when it was revealed that MOF officials had known about Daiwa's illegal activities for more than a month before Daiwa officials informed US regulators of the problem. During this period, Daiwa was permitted to raise money in capital markets on more favorable terms than it would have otherwise gotten if the truth had come out. The former director general of the Banking Bureau, Yoshimasa Nishimura, reports without apology in his memoir that, when first notified by the Daiwa Bank, he was unaware of the international agreement (known as the Basel Protocol) that stipulates prompt reporting of any irregularities to the relevant foreign authorities (Nishimura 1999). According to Nishimura, the Daiwa Bank was to give him a detailed report, and there is no evidence that he consulted other MOF officials on this matter before the Daiwa Bank reported back several weeks later.

Western press sources reported that Ministry officials requested that Daiwa officials continue their coverup. However, the gap in notifying the US authorities is less evidence of conspiracy than of the sheer incompetence of the MOF's Banking Bureau at the time. Either way, the result was to increase the "Japan premium" (see the text for a definition of this term), as doubts deepened about the state of Japanese banking.

MOF officials lamely explained that their failure to alert the US bank supervisors to criminal activities being perpetrated on US soil was due to "cultural differences." This led a well-known commentator to write that "the persisting illusion has been that somehow Japan can engineer international engagements entirely on its own terms" (Samuelson 1995). Another longtime observer commented that "the MOF does not appreciate the enormity of its blunder in its handling of the Daiwa bank scandal . . . Financial systems are based on confidence . . . Such trust comes from personal contact, and being told the unvarnished truth. When the Japanese rely on studied ambiguity so that they can avoid making real disclosures, they undermine this process" (Krause 1995). See Mizuno (1996) for further details on how the MOF manipulated the Japanese press while infuriating Western policymakers.

contributed to a growing awareness of the possibility of a financial crisis. Skepticism regarding the MOF's ability to prevent financial crisis was reinforced by its mishandling of the 1995 Daiwa Bank scandal that touched the United States (see box 3.4).

After seeing public resistance to injecting fiscal money into troubled financial institutions, even a debate on considering the use of government money to clean up the financial sector was sealed. A comprehensive framework to deal with contingencies was badly needed. As early as

1995, a clearly desired policy response would have been to establish a framework to shut down weakening institutions before they became insolvent, and to devise a least costly way to liquidate or rehabilitate the financial institutions. This policy failure of not establishing a financial-supervision framework early enough—even with strong signs of need—cost the Japanese economy dearly. By not taking forward-looking actions in 1995, when the weakness was obvious, Japan wasted at least 3 years in dealing with weak financial institutions.¹⁵ Hutchison and McDill (1998) estimate that the temporizing cost Japan approximately 1 percent of GDP annually. In effect, Japan had engaged in regulatory triage, first allowing credit cooperatives to fail, then small banks (Spiegel and Yamori 2000). Large banks would be next.

Failures of major financial institutions occurred in November 1997. Yamaichi Securities, one of the Big Four securities houses, and Hokkaido Takushoku Bank, one of the 20 big banks, failed in that month. The failure of Yamaichi, with its revelation of large previously undisclosed losses, generated a spike in the “Japan premium”—the higher interest rate that Japanese banks had to pay on their interbank eurodollar and euroyen borrowing relative to their US and European counterparts.¹⁶

At the time, these were by far the largest financial-institution failures of the postwar period. Moreover, the failures were accompanied by disclosure of incompetent or duplicitous behavior on the part of the regulators and criminal behavior by the financial institutions. Yamaichi was forced to admit that it had engaged in *tobashi* (the illegal concealment of losses through the use of multiple offshore accounts and accounting periods) and made large payments to *sokaiya*, or corporate racketeers.¹⁷ Fukao (1998) reports that at the time of its bankruptcy, the brokerage was carrying ¥260 billion in losses on securities investments—more than half of its capital—that neither MOF nor BOJ examinations had uncovered. It emerged that the authorities knew of Yamaichi’s imminent collapse for 10 days before revealing the information publicly. It was alleged that company insiders sold the firm’s stock during this period.

The fear of financial fragility shook consumers’ confidence as well as institutional investors’ and, although all deposits were guaranteed by the government, business sentiment turned sharply negative. Financial institutions became skeptical of each other about their counterparts’ viabil-

15. See Cargill, Hutchison, and Ito (2000, chap. 3) for more details.

16. Peek and Rosengren (1999) find that financial-market disruptions, government policy actions, and changes in financial-market conditions had an impact on the Japan premium. Government announcements not backed by concrete actions had little impact. The revelation of previously undisclosed losses, as in the Yamaichi case, had a major impact.

17. Similarly, the earlier collapse of Sanyo Securities, Japan’s 7th largest broker, had been accompanied by the losses in 14 previously unknown affiliate companies not listed in the company’s financial statements.

ity after the collapse of formerly reputable institutions. Japanese financial institutions were squeezed out of international lending by the Japan premium and withering credit lines.

From December 1997 to March 1998, the financial markets remained weak and credit remained tight. The government pushed through necessary legislation for a ¥30 trillion coffer for bank recapitalization, and at the end of March all 18 major banks (together with 3 regional banks) received ¥2.1 trillion in public money for a capital increase (in the form of subordinated loans and preferred stocks). The government abandoned any pretense of realistic accounting when it permitted the banks to value their landholdings at their relatively high market valuations while valuing their stocks at their relatively high book values. The chairwoman of the committee handling the banks' applications later admitted that she had not looked at their balance sheets. Managements were left intact—in stark contrast to the experiences of South Korea and the United States during similar banking crises. The fiscal injection was met with howls of public criticism.¹⁸

This package was widely regarded as insufficient to resolve the NPL problem, and did not stem the deterioration in business sentiment and consumers' confidence. Aggregate demand fell, and the crisis deepened in 1998. The public was further outraged by the revelations of bribery scandals in the banking sector, involving public officials, and resisted additional injections of public funds. Prices were falling, and a deflationary implosion became a realistic possibility. Norio Ohga, the chairman and chief executive officer of Sony, publicly compared Prime Minister Ryutaro Hashimoto to Herbert Hoover.¹⁹

The Japanese financial system was on the verge of collapse. In the spring of 1998, it was widely rumored that the Long-Term Credit Bank of Japan (LTCB), a large, publicly financed institution, would fail, despite the fact that the government had reported that its capital-adequacy ratio was more than 10 percent at the end of March.²⁰ It seems that the market

18. Resistance to the bailouts was understandable. The government had to budget ¥685 billion for the resolution of *jusen*. In return, the banks merely pledged to try to increase profits and tax payments. Supervision was weak, so it was unclear that a limit to injection was not guaranteed; disclosure of true states of nonperforming loans was inadequate; and incompetent bank executives were not held accountable.

19. According to Ohga, "If you look at what Hoover was saying at the start of the Great Depression and what Mr. Hashimoto is saying at this moment, they are very similar" (Paul Abrahams, Michiyo Nakamoto, and Gillian Tett, *Financial Times*, 3 April 1998).

20. Shimizu (2000) argues persuasively that the long-term credit banks (of which LTCB was the most prominent) had occupied a privileged position in the "convoy system" of financial regulation of the postwar period, and as such had been disproportionately disadvantaged by the gradual financial liberalization of the 1980s. LTCB's reputation had been tarnished by its involvement with the failures of the Tokyo Kyowa and Anzen credit coops and the associated improprieties.

had correctly determined what the government auditors had missed: the LTCB's subsidiaries had huge hidden losses. The bank's stock price collapsed, falling below the psychological barrier of 100 yen on 19 June, and deposits (in the form of bank debenture) were withdrawn. The LTCB announced that it would merge with the Sumitomo Trust, but this did not materialize, because the Sumitomo Trust insisted on full disclosure of the subsidiaries' balance sheets. There was real uncertainty as to how this case and others would be resolved. Seiroku Kajiyama, a prominent LDP politician and government advisor, declared that weak banks "should be crushed," while the MOF's Eisuke Sakakibara averred that Japan "can't allow failures."²¹

The Diet (Japanese legislature) debated through the summer how to reform financial supervision and deposit insurance, with an immediate application to the LTCB in mind. In early June, the cabinet resolved to pass two pieces of special legislation. One hived off the regulatory functions from the MOF, establishing the independent Financial Supervisory Authority (later renamed the Financial Services Agency, or FSA), and specified a "prompt corrective action" procedure. The second piece of legislation provided for a second capital injection.

In October, after a long debate in the Diet, two new laws were enacted, one to reform the deposit insurance corporations and one to establish a recapitalization fund. A total of ¥60 trillion was pledged to protect depositors from failed institutions, fill the losses in failed institutions, and help recapitalize banks. The LTCB applied for nationalization under the new law on 23 October.

Failures in the financial sector were not limited to banks and other deposit-taking institutions. Life insurance companies began failing as well.²² The pessimism about the Japanese economy hit the bottom in the fourth quarter of 1998.²³ GDP growth had turned negative, and the economy was shrinking. In December, the Nippon Credit Bank (Nippon Saiken

21. Peter Landers, *Far Eastern Economic Review*, 8 January 1998. Sakakibara's statements were meant to indicate that LTCB had extensive international dealings so that a sudden collapse could set off a chain reaction internationally. A compromise was nationalization and reorganization rather than a precipitous closure.

22. Nissan Life failed in April 1997, and Toho Life failed in June 1997. The root problem for life insurers was the low return for their portfolio relative to their promised payouts. The companies had promised a guaranteed minimum rate for long-term life insurance policies with a savings feature (a universal-life type). The guaranteed rate for policies written at the beginning of the decade was 4 percent, whereas the current return is less than 2 percent. The bad fundamentals encouraged further bad investment—a familiar moral hazard in the financial sector. Life insurance policy holders had to accept lower benefits for their existing policies.

23. Stock prices slumped, as did the yen. On 9 October, the Nikkei 225 (stock price index) went below ¥13,000 for the first time in about 13 years. On 16 November, Moody's downgraded Japanese government bonds from Aaa to Aa1.

Shinyo Ginko, or NCB) was suddenly declared insolvent by the FSA.²⁴ This action was viewed as a signal of the FSA's independence, inasmuch as the bank's survival had generally been regarded as politically determined.

During the first quarter of 1999, a battle ensued to put the financial system back on track, starting with the "zero interest rate policy" introduced in February. Because the short-term interest rate cannot become lower than zero (otherwise, people will use and hoard cash), many consider the zero interest rate as the limit to which the Bank of Japan can extend its loose monetary policy. In addition, on 16 February, the MOF reversed an earlier decision to stop buying the long-term bonds that had riled the market. These steps lowered the long-term interest rate.

Recapitalization of major banks was done at the end of March. A total of 15 banks received ¥7.46 trillion in public money.²⁵ Unlike the year earlier, the March 1999 action was enough to convince the markets that the financial crisis was over. In April, the Japan premium that plagued Japanese banks virtually disappeared, and the prices of Japanese bank stocks rose sharply.

An obvious question is why the authorities could not have carried out a correct capital injection—massive capital infusions, with strict rehabilitation plans varying from one bank to another—back in 1998. Japan had wasted another year.

Rehabilitation of the Banking Sector

One result of the collapse of real estate prices in the early 1990s was the de facto bankruptcy of many Japanese firms, especially in the real estate sector. However, Japanese accounting rules and bankruptcy procedures gave banks an incentive to engage in evergreening, which they did with enthusiasm (Shikano 2001). A combination of recession, deflation, and a revision of the bankruptcy law in April 2000 significantly reduced the incentive to evergreen, and as might be expected the number of bankruptcies and bad loans has increased.

Considerable uncertainty remains as to the magnitude of the bad loan problem in Japan. The FSA puts loans into four categories: healthy; in

24. The reputation of the FSA received a further boost when it declared in December 1998 that Nippon Credit Bank (NCB) was undercapitalized and nationalized it, under the new power the FSA acquired. According to the FSA, problem loans accounted for nearly half of NCB's lending. Japanese newspapers reported that the unreported dud loans had been parked in affiliates through *tobashi* deals (*The Economist*, 19 December 1998). Because the NCB had earlier received a capital injection from the Bank of Japan and other banks that had been arranged by the Ministry of Finance, it would have been difficult to take strong action if the FSA had not been created.

25. This time, Bank of Tokyo-Mitsubishi did not apply for the capital injection, citing its healthier balance sheet.

need of attention (interest payments have been in default for more than 3 months); in danger of bankruptcy; and, finally, loans to bankrupt companies. No provisions are necessary for healthy loans; provisions must be made for the other three categories on a sliding scale. As of the summer of 2001, total loans outstanding are estimated to be ¥455 trillion. Of these, the FSA estimates that on a gross basis ¥151 trillion fall into categories two, three, and four, or ¥80 trillion net of any collectible collateral. (Category-three and -four loans combined are ¥34 trillion.) The FSA vehemently disputes the notion that the ¥151 trillion figure should be regarded as “bad loans,” because it does not include collectable collateral, and in any event, not all category-two loans will turn bad. Indeed, the FSA argues that Japanese banks have already adequately provisioned for the category-two loans (at a rate of 15 percent). Five largely nontradable sectors—construction; wholesale trade; retail trade; finance, insurance, and real estate; and other services—account for 85 percent of the bad debt.

Outside observers are considerably less sanguine. The Democratic Party, the largest opposition party in the Diet, puts the number of category-three and -four loans at ¥150 trillion (in comparison with the FSA’s ¥34 trillion), whereas other unofficial estimates typically have been in the range of ¥40-80 trillion.²⁶ One can point to several pieces of evidence that suggest the higher unofficial estimates are probably more accurate.

In June 2001, the *Nikkei* carried a report on the prior categorization of loans for 605 firms that had filed for bankruptcy in the previous 6 months. They found that, 1 year before bankruptcy, 70 percent of the loans carried by these firms were classified as either category one (healthy, 7 percent) or category two (needing attention, 64 percent), implying that the existing FSA categorization was a poor indicator of reality. For example, when the retailer Sogo went bankrupt, it was discovered that loans extended to Sogo by LTCB and NCB, two nationalized banks that in principle had been stripped of bad loans, were classified as category two (“loans to be watched closely”) and, as a consequence, were underprovisioned.

To cite another case, in March 2000, Sumitomo Bank reported only ¥265 billion of questionable loans to the construction industry, less than its total exposure to Kumagai Gumi, a troubled builder. A few months later, when Kumagai Gumi requested that Sumitomo and three other banks restructure its debts, Sumitomo was forced to write off ¥260 billion in an effort to avert Kumagai Gumi’s bankruptcy.

Similarly, it has been reported that when Fuji, Dai-ichi Kangyo, and the Industrial Bank of Japan merged to form Mizuho Holdings, their internal evaluations of borrowers were disparate, with lenders with little at stake more likely to place a loan in the problem categories three and four. Likewise, in a number of instances, banks have continued to catego-

26. Gillian Tett, *Financial Times*, 20 April 2001; Nakamae (2001).

size loans to certain firms, such as Mycal and Daiei, as “healthy” or “needs attention” when debt issued by these firms is trading at a huge discount in the capital markets. This would also be consistent with the valuations of distressed assets in the secondary market, where they trade at fractions of their face value.

Finally, econometric modeling by Shimizu (2000) suggests that the volume of bank lending, especially to small and medium-sized enterprises, remains high relative to the level of asset prices (collateral), implying that more bad loans have yet to be recognized. In light of this sort of evidence, the BOJ has reportedly urged the FSA to develop better methods of measuring questionable loans.²⁷

The following month, Goldman Sachs issued a report putting the total level of risky loans at ¥237 trillion, or about 50 percent of GDP, with category-three loans—those to virtually bankrupt firms—at ¥170 trillion. The FSA, in contrast, puts this figure at ¥24 trillion.²⁸ The government’s reaction was to shoot the messenger. FSA Minister Hakuo Yanagisawa was quoted as saying, “It is unfortunate that someone should throw doubt on the government’s numbers. This situation should never arise.”²⁹ The FSA then let it be known that it was scrutinizing the research reports of foreign bank analysts and subsequently penalized ING-Barings over an unflattering report about Daiwa Bank that contained several factual errors.³⁰ In August 2001, the IMF’s annual review of Japan cited the higher estimates of NPLs produced by private-sector analysts, and the FSA again complained, with Commissioner Shoji Mori stating, “It is irresponsible of an international organization of authority to use what market analysts said.”³¹

27. Moreover, as Fukao (1998) observes, private-sector accountants and auditors have a financial incentive to turn a blind eye to window dressing to get work.

28. David Atkinson, the author of the Goldman Sachs report, argues that the FSA is ignoring deflation. In particular, with interest rates virtually zero, the ability to make interest payments is not a useful indicator of borrowers’ ability to repay principal. Instead, he argues that the ability to repay principal out of operating profits should be the relevant criterion. On this basis, he obtains the much higher bad loan figures. Of course, operating profits are not the only means of repaying principal—presumably, these loans are at least partly backed by collateral.

29. Gillian Tett, *Financial Times*, 27 July 2001.

30. In May 2001, ING-Barings sent to clients a report with a “sell” recommendation for Daiwa Bank. The report contained a misprinted capital ratio of 4.79 percent, whereas the actual ratio was 7.49 percent. After protest from Daiwa Bank, ING-Barings subsequently took out full-page ads apologizing for the mistake.

31. Japan Economic Newswire, 20 August 2001. The substance of the dispute is that private-sector analysts attach a higher likelihood of failure to category-two (“needs attention”) loans than does the FSA, which (following international practice) counts only categories three and four as nonperforming. This, of course, begs the question of how the loans are classified in the first place.

The obvious implication of the higher figures produced outside the FSA is that Japanese banks may be grossly underprovisioned.³² Despite writing off ¥60 trillion in bad loans since the burst of the bubble—a figure greater than the sizes of the Canadian, South Korean, or combined Belgian and Dutch economies—the outstanding amount of nonperforming loans has not markedly declined. Indeed, new “bad loans” are appearing at roughly the rate at which banks are writing them off. For example, with the banks generating profits of about ¥2.5 trillion a year, it would take them 3-4 years to write off existing “official” bad loans out of earnings, or perhaps 10 years if the commonly reported ¥40-60 trillion figure is accepted. If the actual level of bad loans is much higher than the official numbers indicate, abrupt provisioning could push banks below their Bank for International Settlements (BIS) capital-adequacy guidelines or into outright insolvency, or make them unable to make dividend payments on preferred shares owned by the government (from the previous capital injection)—triggering their effective nationalization (through the conversion of preferred to voting shares).

With this background, on 6 April 2001 the Yoshiro Mori government announced an emergency economic package sometimes called the Yanagisawa Plan (after FSA Minister Hakuo Yanagisawa), an emergency measure to strengthen the financial sector, in particular the banks. The plan has two pillars:

1. Removing nonperforming loans from the balance sheets. Existing nonperforming loans should be removed from the banks’ balance sheets within 2 years, and new NPLs should be dealt with within 3 years.
2. Equities on the balance sheets of banks should be reduced, and the Banks’ Shareholding Acquisition Corporation will be established to purchase equities from banks.

For the first pillar, “final disposal” is an official code word for removal of NPLs from bank balance sheets. It reflects official recognition that having sufficient provisioning (on the asset side) is not enough to prepare for losses from NPLs.³³ Banks are expected aggressively to remove NPLs

32. This suspicion was amplified when the Tokyo-Mitsubishi Bank Group sharply increased provisioning for the period ending March 2001. In August 2001, Mizuho, Daiwa, Asahi, and Chuo Mitsui increased their provisioning by 25-60 percent in an effort to regain investor confidence.

33. There have been three kinds of problems with the just-provisioning strategy. First, provisioning is for possible losses that are supposed to be the difference between the size of loans and collateral recovery values. However, as land prices have continued to decline, possible recovery values have declined continuously. Past provisioning thus becomes insufficient. This problem could have been (and can be) avoided if loans were (or are) foreclosed and sold to the market. Second, even if provisioning is sufficient, having both provisioning and bad assets on the balance sheets will be a drag on bank management, because it lowers

from their balance sheets by arranging debt-equity swaps with some haircuts (for viable companies), forgiving debts, or foreclosing loans with sales of collateral assets (for nonviable companies). Banks have hesitated on these actions, partly due to political and social repercussions. The new policy may provide them with the political cover to act.

As for the second pillar, Japanese banks' equity holdings have become risky assets. Until the beginning of the 1990s, banks' equities were a source of confidence. Banks had purchased those equities for cross-shareholding (*keiretsu*) purposes in the 1950s and 1960s. By the end of the 1980s, their market value was much higher than their book value. A portion (45 percent) of the latent capital gains was allowed to be counted toward tier II capital in the Basel capital-ratio calculation. When stock prices plummeted from 1990 to 1992, however, Japanese banks had to issue subordinated debts to make up losses in tier II capital by declining latent capital gains. Latent capital gains further declined in the second half of the 1990s. Due to further declines in stock prices, banks increased book values by realizing remaining latent capital gains to cover losses.

By March 2001, almost all latent capital gains had been wiped out among major banks. There are variations among the banks, so that some have latent capital losses and some gains. Those banks with losses must deduct the losses from tier I capital. Moreover, mark-to-market accounting has been introduced (as of 1 April 2001, with the first semiannual reporting at the end of September). Therefore, at this point in time and with this level of stock prices, any risk models would tell the banks to get rid of equities. Stock prices are extremely volatile, and the downside risk is enormous. When stock prices decline further, the damage to the balance sheet as well as to the risk ratio will be large. If one bank is smart enough to sell all its equities between March and September 2001, the bank may be able to clean up its balance sheet without too much damage. However, if banks sell these equities simultaneously, then it would be a large disruption to the equity market. This is a coordination failure. On that ground, public intervention can be justified. The question is, what kind of public intervention?

The operational details of the Yanagisawa Plan remain unclear. With respect to the disposal of NPLs, banks may not follow the wishes of the FSA. The standard answer is that the FSA will monitor progress, and with a threat of nationalization (by converting preferred shares to common shares), the FSA can influence commercial banks' behavior.³⁴ If banks were hesitant in the past to deal with NPLs squarely (e.g., pushing compa-

the risk-based capital ratio. Having got rid of both assets and liability of the same size will improve the capital ratio and the return on capital. Third, loan classification has been too optimistic.

34. This "threat" is rapidly becoming an empty one as the FSA chooses not to exercise its right to nationalize banks that have not achieved their rehabilitation plans.

nies into bankruptcy to resolve the case) due to a fear of social and political repercussion, the 6 April decree gave the banks political cover. However, in the absence of obvious carrots and sticks, we are not confident that the banks will proceed to deal with nonperforming loans just because of the 6 April announcement.

Details on the second pillar can also be questioned. Will the Banks' Shareholding Acquisition Corporation be established with private (bank) financing only? As of the summer of 2001, the plan is that only private-sector capital will be used to purchase equities from the banks. If this is the case, the banks' risk exposure will not change on the consolidated basis. If not, then the government has to put up some capital to take some risks from price volatility—but, after the two previous capital injections, bailing out banks is politically unpopular.

Another issue is whether all or part of the shares (if partly, who decides which shares and at what prices?) should be removed from balance sheets. According to the current plan, banks are supposed to be banned from holding equities altogether or up to the amount of bank capital. If only part of portfolios is sold to the corporation, there is a problem of adverse selection—banks sell only bad stocks with bleak futures, with their better knowledge of borrowers. Therefore it is only fair to purchase all banks' holding of stocks, yet this would require funding so large as to strain credulity. Rather, this appears to be yet another ill-conceived "price-keeping operation" measure designed to prop up the banks by buying their stock holdings. As such, it amounts to a transfer from the taxpayer to the stockholders of the banks.

The more fundamental problem of the existence of too many banks is not addressed. Even if banks do not follow the guideline of disposing of their NPLs within 2 years, there will not be a penalty. For the disposal of bad loans, the FSA should take examination seriously, and make sure that provisioning is sufficient. If collateral values decline or are even expected to decline, then additional provisioning should be required. If banks are discovered to have hesitated to classify particular loans to be less serious so as to avoid provisioning, the FSA should force the appropriate provisioning or write-offs. If the FSA allows banks to "waive" or forgive loans, as has been mooted, this will amount to a cost-free transfer from the taxpayer to these failing firms. This maintenance of capital-eating zombie firms will adversely impact their otherwise viable competitors, and retard the efficient reallocation of capital. The amount of NPLs among the largest 16 banks has been constant, at about ¥19 trillion from 1999 to 2001. This is despite increasing provisioning and writing off.³⁵ Clean bank

35. E.g., for the semiannual accounting period ending March 2001, losses from NPLs (provisioning and removal from balance sheets) amounted to ¥4.4 trillion for the 16 banks. Conversely, the operating profits of these banks are ¥3.6 trillion. Those loans newly classified as nonperforming amounted to ¥3.4 trillion. Because more loans become nonperforming

balance sheets, with capital injection if necessary, will be the key to a vital economy.³⁶

The banking sector in Japan is too crowded for all existing banks to flourish in the future. A revival of the Japan premium could act as a permanent drag on the competitiveness of Japanese banks until questions about the stability of the Japanese financial system are resolved (Spiegel 2001). Indeed, it is virtually certain that the sector as a whole will shrink. Posen (2001) recommends that the FSA close or merge half the banks. Megamergers—such as those between Tokyo-Mitsubishi Bank, Mitsubishi Trust and Banking, and Nippon Trust Bank; or between Dai-ichi Kangyo, Fuji Bank, and the Industrial Bank of Japan; or those to come in the future—may perversely be creating institutions that politically are too big to fail. As Kashyap (2000) observes, throughout the 1990s, Japanese banks were simultaneously among the largest banks in the world and the least profitable—surely an unsustainable state of affairs. Moreover, the mergers appear to have done little to achieve cost savings or efficiency improvements. The banks seem to have learnt their lesson: “survival of the fittest.”

Unfortunately for the banks, a slim-down is on the way. More businesses have moved to the capital markets, where larger companies can obtain necessary funding through corporate bond issues and equity issues. Even smaller companies are now able to do initial public offerings at fairly early stages. Banks are left with less creditworthy borrowers. The deposit-loan spread remains too narrow for banks to earn healthy profits. Several major banks are withdrawing from overseas operations, and domestic markets are getting more crowded. A major reduction in the number of banks, branches, and employees is in the offing.

To stop the cycle of debt deflation and nonperforming loans, what is needed is a package of demand-stimulation policies and supply-reform policies. A once-and-for-all removal of NPL assets from banks' balance sheets would obviously be good for the long-term revival of the banking sector, and in turn for the expansion of loans for investment on the supply side. But final resolution of NPLs will have a negative short-term impact on the demand side.

as more loans are written off, the outstanding amount of NPLs appears to be constant. The past trend of ever-increasing NPLs cannot be ignored.

36. If final disposal does not proceed as expected, a more drastic measure should be considered. The Asset Collection Agency (ACA) can be established with a government equity injection, and nonperforming assets should be bought from banks with discounts. The ACA can be operated as is the Housing Loans Collection Agency, which was established after the *jusen* industry debacle. The ACA can sell assets to the market or to any investors willing to pay a fair price. When weaker banks are nationalized due to poor performance and declining capital, then bad assets can be separated and moved to the ACA, and a good bank (without nonperforming loans) should be sold with a premium. Due diligence is a key.

The bottom line is that the measures announced on 6 April 2001 are inadequate. History suggests that the government has erred on the side of regulatory forbearance, and there is no convincing reason to believe that this will not continue. The initiation of mark-to-market accounting will be a shock to the banking sector, and may provide an entry point for more drastic action. We will return to this in chapter 7, in our policy recommendations.

Monetary Policy

Having missed its cue, Japanese monetary policy returned to center stage toward the end of the 1990s. In response to declining output and signs of a credit crunch in 1998, the BOJ relaxed monetary policy.³⁷ Traditional open market operations provided liquidity to the banking system, but banks were reluctant to lend to corporations, and instead fattened cash reserves to keep capital-adequacy ratios high in the wake of failures of large financial institutions. Indeed, as Morsink and Bayoumi (2000) observe, the fact that the impairment of the banks hampered the transmission of monetary policy reinforces the urgency of addressing the financial questions discussed in the previous section. Moreover, as noted above, Japan had entered into deflation.

Table 3.1 shows the major macroeconomic statistics from 1996 to 2000. The GDP growth rates are shown in two series, an old System of National Accounts (SNA) based on 1990 prices and a new SNA based on 1995 prices. Because the new SNA became available only in December 2000,³⁸ policy judgments during this period were based on the old statistics available at the time. The new SNA includes new methods in measuring

37. On 9 September 1998, the Bank of Japan lowered the operating interest rate target (overnight call rate) from about 0.45-0.50 percent to 0.25 percent, while the official discount rate was kept at 0.5 percent. On 13 November 1998, the BOJ added new instruments, such as commercial paper (CP) and corporate bonds (CBs), to the list of eligible securities for market operations. These corporate securities held at commercial banks were discounted at the BOJ. This helped provide liquidity to corporations that had difficulties in issuing, or rolling over, these CPs and CBs at favorable rates, or borrowing from banks.

38. As observed by the IMF (1999), the methods used to compile Japanese government economic data are rather opaque. Some analysts have attributed the volatility of Japanese quarterly GDP data to improper deseasonalization of the data. The 1996 and 2000 first-quarter figures were clearly affected by the extra day in the leap year. However, most of the quarterly fluctuations are due to the volatility of some of the underlying supply-side data series, and in this regard Japan is quite different from other countries. Annual figures are compiled from value-added data, similar to the procedures in other countries. In 2000, the method of calculating GDP was brought more closely into line with international standards to treat, e.g., investment in software as an investment rather than an expenditure. In addition, the base year for the price deflator was changed from 1990 to 1995. These changes resulted in a significant revision of the GDP series.

Table 3.1 Macroeconomic data for Japan by quarter, 1996-2000

Year, quarter	GDP growth rate		GDP growth rate (1995 prices)	Inflation rate (percent)	Yen/dollar exchange rate	Short-term interest rate		Long-term interest rate (percent)	Stock prices (Nikkei 225) (yen)
	(68 SNA, 1990 prices)	(1995 prices)				(call rate) (percent)	(percent)		
1996, 1	2.6	1.0	0.0	105.8	0.46	3.32	20,516.7		
1996, 2	0.5	0.8	0.2	107.6	0.48	3.35	21,928.3		
1996, 3	0.4	-0.4	0.2	108.9	0.46	3.08	21,084.2		
1996, 4	1.6	1.5	0.3	112.8	0.48	2.69	20,768.0		
1997, 1	1.3	2.9	0.4	121.2	0.50	2.55	18,290.0		
1997, 2	-2.0	-3.2	0.2	119.6	0.50	2.66	19,576.5		
1997, 3	0.9	0.4	0.4	117.9	0.49	2.27	19,162.4		
1997, 4	-0.6	0.7	0.5	125.2	0.45	1.95	16,431.8		
1998, 1	-1.2	-0.6	0.1	128.1	0.43	1.95	16,522.6		
1998, 2	-0.2	0.1	0.1	135.9	0.44	1.67	15,562.3		
1998, 3	-1.2	-1.1	-0.2	140.1	0.39	1.26	15,251.6		
1998, 4	-0.5	0.1	-0.3	119.8	0.23	1.41	14,102.9		
1999, 1	1.5	0.5	-0.1	116.7	0.15	1.92	14,476.7		
1999, 2	1.0	1.5	-0.1	120.9	0.03	1.58	16,772.9		
1999, 3	-1.0	-0.1	0.0	113.7	0.03	1.77	17,728.3		
1999, 4	-1.6	-1.5	-0.2	104.5	0.02	1.77	18,176.1		
2000, 1	2.5	2.4	-0.2	107.1	0.02	1.76	19,487.3		
2000, 2	1.1	0.2	-0.3	106.6	0.02	1.70	17,842.3		
2000, 3	-1.2	-0.6	-0.4	107.6	0.14	1.79	16,486.0		
2000, 4	-0.3	0.8	-0.5	109.8	0.25	1.69	14,827.4		

SNA = System of National Accounts.

Source: IMF, *International Financial Statistics*.

some commodities and services. The GDP growth rate is measured quarter to quarter, whereas the inflation rate is measured by the change in consumer prices (excluding fresh food) from the same quarter of the previous year. The inflation rate from the second quarter of 1997 to the first quarter of 1998 is lowered by 1.80 percentage points to eliminate the effect of the consumption tax rate increase (from 3 to 5 percent).³⁹

On the basis of a very fragile financial system and weak demand in 1998, a large supplementary budget was introduced in the fall of 1998.⁴⁰ In February 1999, the Bank of Japan lowered the call rate to zero, and then announced that its zero interest rate policy would continue “until the deflationary fear is dispelled.” This contributed to flattening the yield curve.

The negative growth rate in 1998 and the BOJ’s responses in 1999 attracted attention from economists inside and outside Japan (e.g., Krugman 1998; Hoshi and Nagaoka 2000; Bank of Japan 2001). Paul Krugman (1998) argued for “unconventional” monetary policy—purchase of long-term bonds—aiming at an inflation rate of 4 percent for 15 years. Because the nominal interest rate is bounded from below at zero, deflation means high real interest rates. Many economists debated what would be appropriate economic policies to get out of deflation at a zero interest rate—or out of a liquidity trap.

In 1999, the first-half growth was again positive, reflecting a large fiscal package and a special credit guarantee program for small and medium-sized companies. The effects from the zero interest rate policy also were taking effect. However, the second half of 1999 was weak, recording negative growth rates. Deflation continued. In September 1999, there was an expectation that the monetary stance would be further relaxed—“quantitative easing” became a topic of debate. However, the Bank of Japan did not adopt this approach. Instead, BOJ Governor Masaru Hayami indicated that he was disposed toward *raising* the interest rate.⁴¹

In 2000, the growth rate was again very high (2.4 percent) in the first quarter. The Nikkei 225 stock index rose from ¥13,000 in January 1999 to ¥20,000 in April 2000, spurred by a worldwide boom in the information technology sector.⁴² The second-quarter growth rate was moderate (0.2

39. The reason that the adjustment is not 2 percentage points but 1.8 points is incomplete pass-through. The continuity of the rate changes appears to suggest that 1.8 points may be a good number. No sophisticated modeling was done to infer the adjustment amount.

40. The magnitude of negative growth in 1998 was first thought to be 3 percent (in 1999), and then revised to be 2.5 percent. When the new SNA became available, the growth rate of 1998 was –1.1 percent. (Compare the old SNA and new SNA in table 3.1). The severity of the 1998 downturn was thought to be extremely serious at the time.

41. News conference on 21 December 1999.

42. However, the drop in the NASDAQ from April to December 2000 also brought down the Nikkei index. The composition of the Nikkei index was changed in April 1999. A direct comparison therefore is not appropriate.

percent). However, it was thought to be 1 percent at the time. It was said at the time that the supply side was bright but the demand side was sluggish. Optimists believed that the supply-side indicators were acting as leading indicators, so that the economic situation would continuously improve.

With this information, the BOJ raised the interest rate, with a 7-2 vote in its Monetary Policy Committee on 11 August, stating that the economy was recovering and deflationary fear was dispelled.⁴³ Other interest rates, including the commercial lending rate and the 3-month repurchase rate, moderately increased after the August move.⁴⁴

Economic activity in the second half of 2000 was at best sluggish. The external environment also had deteriorated. The US economy was weakening, and exporters that rely on US markets were becoming more cautious on production and investment. The magnitude of deflation was becoming larger. With this added information, the BOJ again eased monetary policy on three decision dates in February and March 2001. The BOJ has effectively gone back to the zero interest rate policy, and declared that the policy will remain in force until the inflation rate becomes positive. This is a significant policy change, as will be discussed below.

However, the point at this juncture is that, by raising the interest rate in August 2000, the Bank of Japan did not support economic recovery. Its refusal of quantitative easing in 1999-2000, and its decision instead to raise the interest rate in 2000, are regarded by many as assertions of its independence rather than sound monetary policymaking. Although the interest rate was brought down to zero again in March 2001, monetary stimulus was not in its full thrust between August 2000 and March 2001, and deflation worsened.

The Liquidity Trap

At the beginning of 2001, Japan was faced with a difficult macroeconomic environment. Its recovery from the recession of 1998 had been very weak.

43. The government opposed the decision to raise the interest rate. According to the April 1998 BOJ law, the government submitted a motion to delay the voting on raising the interest rate, but it was voted down in the Monetary Policy Committee. Some observers regard the interest rate increase at the earliest opportunity as a political act aimed at demonstrating the BOJ's "independence" under the new law.

44. Those who advocated the increase in the interest rate in August 2000 cited the following reasons: (1) the zero interest rate policy is an extreme measure aimed at an extremely weak economic condition; (2) the economy is on the way to recovery and deflation fear is dispelled; (3) the zero interest rate might induce moral hazard, i.e., undisciplined fiscal deficits and irresponsible bank lending; and (4) raising the interest rate by 0.25 percent is by no means tightening. (See Posen 2000, 205, for quotes from Governor Hayami to the effect that raising the interest rate would encourage structural reform by the private sector.) On the contrary, those who opposed lifting the interest rate argued that (1) with the large GDP gap, a little

Its annual GDP growth rate was less than 1.5 percent, with no sign of acceleration. Its output gap was estimated to be anywhere between 4 and 6 percent of GDP.⁴⁵ Prices—measured by any of the indices—have been declining in the past 3 years. The unemployment rate has risen to near 5 percent, a record high for the Japanese economy, with no sign of declining. Moreover, after two capital injections, banks' balance sheets are still plagued by NPLs, and the resolution of the banking crisis has become a highly politicized issue.

In normal circumstances, these conditions would call for stimulative monetary and fiscal policies, namely, lowering the interest rate and increasing government expenditures. However, Japan's room to maneuver is limited on both fronts. Five big fiscal packages have been introduced since the tax increase of 1997, so that the debt-GDP ratio has reached about 120 percent, and is rising. If current levels of budget deficits (6 percent of GDP) continue, the debt will eventually become unsustainable (see box 3.5). The interest rate has been virtually zero since the spring of 1999. At the zero interest rate, Japan is in a liquidity trap, where the conventional channels of monetary transmission do not work.

The nominal interest rate cannot be negative. Otherwise, people will keep assets in the form of cash rather than deposits.⁴⁶ Therefore, there is an absolute lower bound at zero on the nominal interest rate. As deflation continues, the real interest rate (the nominal interest rate minus the inflation rate) increases. Rising real interest rates discourage investment (including in consumer durables) and dampen aggregate demand. The fall in demand encourages further price cutting, setting off a self-reinforcing deflationary spiral.

Similarly, declining asset prices, and expectations of further decline, will impede consumption and investment through negative wealth effects. As goods and asset prices go down together, the real debt increases. That is, the real burden on borrowers (holders of nominal contracts, e.g., borrowers with a fixed nominal interest rate) will increase. The increase in the real debt burden discourages consumption and investment. This is called debt deflation.

Successful macroeconomic management requires the avoidance of deflationary spirals and debt deflation. This, in turn, becomes a question

bit of economic recovery would not cause inflation; and (2) there is no rush to raise the rate when a full recovery is doubtful.

45. Some think that the GDP gap is much larger. An estimate depends on an assumption of the potential GDP and a judgment as to how unused capacity might disappear rather than accumulate for a GDP gap; see Bayoumi (2000b).

46. To enforce a negative interest rate without causing a massive shift to currency holdings, some effective way to "tax" cash holdings would have to be devised. One way for such a tax is that currency (e.g., 10,000 yen notes) would have to be approved for circulation with stamps every, say, 6 months. Because such taxation on cash would be a complicated and costly operation, it is regarded as unrealistic.

Box 3.5 Sorting out Japan's government finances

Japan's public finances are a source of considerable controversy and potential importance to the world economy. The controversy emerges from the complex, some would say opaque, nature of Japan's government accounting. Japan's gross government debt-GDP ratio stood at roughly 120 percent in 2001, with the IMF predicting that it would rise to 150 percent by 2005. This makes Japan's situation the worst in the OECD, and puts it in the same league with Italy and other countries that have experienced debt crises.

However, Japan's debt, net of government assets, is claimed to be far lower—about 100 percent of GDP excluding its social security system, and about 50 percent of GDP if social security is included (IMF 2000). However, because the social security assets are more than offset by pension liabilities, the IMF argues that social security assets should be excluded when assessing Japan's situation. The Bank for International Settlements believes that “the net government debt/GDP ratio is on an unsustainable upward path, even if its level is still modest by international standards” (BIS 2000, 20). Technically, unsustainability arises when interest payments to existing bonds have to be financed by new issues of bonds and the level of taxes cannot be raised for economic and political reasons. However, it could become an issue earlier when investors, in anticipation of a crisis, demand higher interest rates to refinance the debt.

Moreover, there are reasons to believe that these net debt figures overvalue government assets, and hence understate the severity of the problem. For one thing, Japan maintains an extensive network of public corporations and public-private partnerships (e.g., the Japan Highway Public Corporation and the Honshu-Shikoku Bridge Authority; see box 3.1). As the OECD observes, “the economic value of financial assets in public corporations is partly supported by future payment of subsidies by the government which should be registered as liabilities and offset against assets” (OECD 2000b, 65).

(box continues next page)

of whether there is a policy instrument to generate inflation when the interest rate is at zero. Because this situation had not been observed in an industrial country since the 1930s, this used to be an academic question asked only in the classroom. But now it is one of the most relevant policy questions in Japan.

Inflation Targeting

Under a policy of inflation targeting, a central bank announces a target (range or point) for the inflation rate and commits to use its policy instruments to achieve that target. In the 1990s, many central banks—including those of New Zealand (1990), Canada (1991), the United Kingdom (1992), Sweden (1993), and Australia (1993)—adopted inflation targeting, typically as a means of providing a policy mandate to newly independent central banks in countries with histories of inflation. Experiences with inflation targeting have been generally favorable, in that the central bank managed to reduce the inflation rate to the target range within a few years.

Box 3.5 (continued)

In addition, both gross and net debt become larger if implicit liabilities—such as social welfare expenditures and civil servant pensions (for which the government has no reserves)—are included. According to the OECD (2000b), these alone would increase Japan's gross and net debt figures by 150 percent of GDP, although, as the IMF observes, recent pension reforms have reduced future liabilities by perhaps 20 percent of GDP. Contingent liabilities (e.g., government guarantees on private financing of public and parastatal corporations, and private small and medium-sized enterprises) could also be large, as demonstrated in the Japan National Railway Settlement Corporation case. Tadaaki Ito (1996) extensively discusses these "hidden losses" and their use to minimize current apparent liabilities through "financial manipulation."

The ¥64 trillion question is if and when this will begin to bite. Views are mixed. One analysis is colorfully titled "Could Japan's Financial Mount Fuji Blow Its Top?" Answer: Yes (Asher and Dugger 2000). Ninety-five percent of Japanese government debt is held by Japanese residents, and they have shown no indication of shifting out of it. This could change if there were a revival in the stock market prompting a portfolio shift from bonds to stocks, or if investors began to flee yen-denominated assets more generally. This uncertainty has led the ratings agencies, initially Moody's, followed by Fitch-IBCA and Standard and Poor's, to downgrade Japanese sovereign debt from AAA to something on a par with Spain's.

The real economic implications of a stock market rally and capital flight are quite different. A market rally might signal a revived Japanese economy and increased tax revenues that would permit Japan to grow its way out of its debt, absorbing the increased interest-servicing costs associated with higher interest rates on Japanese government bonds. Capital flight would be a different story, however. A precipitous shift out of yen-denominated assets could cause the yen to crash and disrupt financial and trade ties with the rest of the world, especially with the United States. A yen crash would also create inflation in Japan. This would be one way of ending the country's deflation, though not the way the authorities had in mind.

In principle, inflation targeting would also be one way of getting out of a deflationary spiral.⁴⁷ Advocates of inflation targeting in Japan typically list four major reasons for adoption. First, the intention and objective of the Bank of Japan will become clearer, independence from political pressure will be strengthened, and accountability will be enhanced. With an explicit policy of inflation targeting, the BOJ can fend off "pressures" from politicians by citing that it has committed to produce price stability. In return, the BOJ will be accountable for achieving this target.

Second, monetary policy may become more flexible and forward looking, because inflation targeting gives a clear policy objective and communication with the market will be easier with the announced target. Third,

47. For the case in favor of inflation targeting, see Takatoshi Ito (1999); Posen (1998); Bernanke et al. (1999); and Cargill, Hutchison, and Ito (2000, chap. 5). See Okina (1999), and Fujiki, Okina, and Shiratsuka (2001) for a contrary view.

the BOJ can clearly define and enhance instrument independence—its freedom to choose its policy instruments. Fourth, the inflation target provides an anchor for expectations. Indeed, by announcing that it will target a range of positive inflation rate, say 1-3 percent in 2 years, the BOJ may raise the expected inflation rate, a step toward getting out of a deflationary cycle (e.g., by encouraging the purchase of consumer durables). The benefit of inflation targeting may be realized even before all the right policy measures take effect through the real side of the economy.

Skeptics counter, first, that the mere announcement of adopting inflation targeting may not lift expectations out of a negative inflation rate. Second, there is no obvious tool to inflate the economy, once the interest rate is zero. They argue that the interest rate is the only channel of monetary policy, and once it reaches the lower bound of zero, monetary policy is completely ineffective. Moreover, by announcing something that it may not be able to achieve, the BOJ may actually lose credibility. Third, there is no perfect measure of the price index, and it is difficult to determine the correct range for the target.

Fourth, once inflation starts (i.e., the economy successfully gets out of deflation), it is difficult to stop it. Sooner rather than later, the inflation rate will become too high. Governor Hayami stated that setting a target for inflation was a dangerous policy that “could cause uncontrollable inflation” (quoted in Posen 2000, 200). Finance Minister Masajuro Shio-kawa, a former BOJ official, said that inflation targeting would “cause runaway inflation and send the economy spinning out of control” (David Ivison, *Financial Times*, 22 August 2001). Even Prime Minister Koizumi got into the act, claiming that “this policy [inflation targeting] is difficult, as we could not control it” (Caroline Batt, *The Daily Telegraph*, 24 August 2001). Fifth, there is no precedent for inflation targeting being introduced to increase the inflation rate. All recent cases of inflation targeting involve an operation to reduce inflation—not to reverse deflation.

This skepticism can be rebutted as follows. First, the experience of the United Kingdom shows that the introduction of inflation targeting and the independence of the Bank of England have resulted in a significant drop in inflation expectations. Second, there are ways to cause inflation even if the interest rate is zero. Quantitative easing (further increasing the monetary base at the zero interest rate) would encourage economic activity directly, or at least encourage activity indirectly through an increase in prices.⁴⁸ Theoretically speaking, if people’s holdings of money

48. Operationally, this could be achieved in a variety of ways. Quantitative easing through increasing purchase of long-term bonds would likely lower the full spectrum of interest rates. That would encourage bondholders to purchase riskier assets (e.g., asset-backed securities, equities, and foreign-currency-denominated bonds). Increased demand for asset-backed securities would help to increase real estate investment. Increased demand for equities would tend to increase equity prices, and result in wealth effects to stimulate aggregate demand. An increased demand for foreign-currency-denominated bonds implies

double, they will spend it, at least partly, to increase consumption. That would stimulate economic activity (if the economy is under capacity) or increase prices (if the economy is over capacity). Either one would contribute to extricating the economy from its deflationary spiral. Of course, whether such an unconventional step is needed or not depends on output and price developments.

Third, the issue of imperfections in price indices is well understood, and not a serious hindrance to the implementation of a successful inflation-targeting policy.⁴⁹ Fourth, it is inconceivable that the inflation rate would jump precipitously without time for a policy reaction in an economy such as Japan's. Indeed, the upper bound of the inflation target would act as a natural restraint on policymakers. In any event, it is strange to worry about too much inflation when deflation is at issue.

Fifth, inflation targeting is as effective in increasing the rate of inflation as in reducing it. The experience of price targeting in Sweden in the 1930s is credited with having prevented deflation in the wake of large depreciation resulting from a collapse of the gold standard (Berg and Jonung 1999). Even in more recent experiences of inflation targeting in Canada and New Zealand, the inflation rate did go below the floor of the target and policy was adopted to move back up to the target range. Having a target must have helped inflation expectations not to be too low in the stage of a declining actual inflation rate.

The Bank of Japan law was revised and the new law became effective in April 1998. There were two major changes, among others, that the BOJ had long wanted (Cargill, Hutchison, and Ito 2000, chap. 4). First, legal independence from the Ministry of Finance was established. Earlier, the governor could have been dismissed at any time, but under the new law, the governor's tenure is guaranteed. Second, price stability was established as a primary BOJ objective. Earlier, the BOJ was to help the economy achieve its maximum strength (a very vague concept), whereas Article 2 of the new law gives price stability as the BOJ's objective.

One may be skeptical of the additional benefit of announcing a numerical target, given that Article 2 sets price stability as the objective. However,

yen depreciation. That would help export industries. Although exact channels cannot be known beforehand, quantitative easing, even at the zero interest rate, would have positive effects on the economy.

49. One technical question in practicing an inflation target is which price index should be adopted, and what range should be specified. Many countries use the consumer price index (CPI) as the price index, for its widespread use and familiarity among consumers and corporations. Target ranges are different from one country to another, but they are quite similar. The Bank of England targets 2.5 percent (with a tolerance range of 1 percent), whereas the Bank of Canada targets the 1-3 percent range. It is well known that price index contains an upward bias, due to the fixed base-year weights and inadequate adjustment to quality improvements, and an inflation rate of 1.0-1.5 percent corresponds to true price stability. Although there is no perfect index to represent inflation, the CPI inflation rate is an acceptable indicator, if the upward bias is taken into account when the target is determined.

it was clear that when the BOJ tolerated deflation (a sustained negative CPI inflation rate), which started just after the new law became effective, it had no coherent notion of price stability. Governor Hayami and other members of the bank's Policy Committee argued that price declines may not necessarily be a bad thing (after all, price declines resulting from innovations in computer technology or in the distribution system may be regarded as good), confusing relative price changes with a disastrous fall in the absolute price level.⁵⁰ Numerically defining a target of inflation, say 1-3 percent, might have prompted the BOJ to ease earlier and to do so more aggressively. For example, the short-term interest rate might have approached zero earlier than February 1999. With independence should come accountability.

One might question a narrow focus on targeting the inflation rate. However, inflation targeting does not mean only targeting the inflation rate of the near future. Policies should be formulated to maintain price stability for a long time. If the inflation rate is increasing, one must predict and prevent the rate from going above the target range. Because it takes time for monetary policy to take effect on the economy, it must be conducted in a forward-looking manner, that is, to predict the future inflation rate with currently available information. Obviously, the GDP growth rate, GDP gap, and the exchange rate, among others, should be taken into account in formulating monetary policy. The bottom line is that there are and were credible alternatives to the policy that the Bank of Japan has followed.

Has the Bank of Japan Embraced Inflation Targeting?

In three meetings in February and March 2001, the Bank of Japan took measures to ease monetary policy.⁵¹ In the third meeting, on 19 March, the bank moved again to ease its monetary stance. The decision consisted of three items: (1) The monetary instrument was changed from the call rate to reserves (balance of the current accounts) at the BOJ, with the reserve target being ¥5 trillion. (2) If there is any difficulty in providing liquidity, the amount of purchases of long-term government bonds will be increased. (3) The policy stance will be maintained until inflation—

50. See Posen (2000) for specific quotes. It is natural that prices of goods and services that benefit from innovation and productivity increases will fall relative to other goods. Monetary policy would be neutral to such relative price movement. However, inflation or deflation is a phenomenon of average price movements, and this is a result of monetary policy.

51. The BOJ also issued a statement that acknowledged deflationary pressure, reflecting weak demand. This was new. BOJ officials previously had insisted that some of the deflationary force was prompted by supply-side conditions, e.g., innovations in the distribution system. The BOJ also emphasized the importance of structurally reforming the financial system.

measured by the current consumer price index (excluding fresh food-stuffs) in comparison with that 12 months ago—becomes stable above zero.⁵² Moreover, the decision was accompanied by a statement that the BOJ “strongly hopes” that structural reforms, including addressing the NPL problem, would be advanced by leadership of the government.

Among the decisions made on 19 March, the most important item is the commitment to maintain relaxed monetary policy until the inflation rate becomes positive (item 3 above). This could be interpreted as a shift by the BOJ toward embracing inflation targeting. However, proponents of this view were disheartened when Governor Hayami, answering questions, denied this.⁵³

However, the new policy does have an element of inflation targeting. It would be preferable to set the floor inflation rate at 1 percent instead of zero, and it is better to have a ceiling as well as a floor. Moreover, by denying that it is inflation targeting, the BOJ is not reaping the benefits of expectation effects.

We strongly recommend that inflation targeting be adopted, so that monetary policy can become transparent and so that the Bank of Japan can adopt an aggressive policy, if necessary. The present zero interest rate policy, although an improvement over the policy undertaken between

52. The change in the instrument from the interest rate to the reserve at the BOJ, with a target of ¥5 trillion (item 1) simply means that the zero interest rate policy is reintroduced because the required reserve is about ¥4 trillion, and a ¥1 trillion excess reserve is only possible with the call rate being driven down to zero. Therefore, in essence, item (1) means that monetary conditions will revert to the position that was in effect prior to the lifting of the zero interest rate policy in August 2000. One may conclude that, in this sense, calling it a change in the monetary instrument is rather a red herring. However, one may see the change in instrument is significant, because it might mean that the amount of reserves can be flexibly changed if an environment becomes weak, e.g., deflation becomes worse.

Some economists argued that monetary easing that would go beyond zero interest rate policy was needed to combat deflationary forces and to lift economic activities. The most frequently proposed measure was to increase the amount of government long-term bond purchases. Item (2) means that, in case the BOJ finds it difficult to achieve a ¥5 trillion reserve by purchasing treasury bills from financial institutions, it would purchase long-term bonds in the secondary market. This seems to have some common thread with an earlier argument, although there is a proviso. Putting items (1) and (2) together, the BOJ seems to have opened a possibility that it has made clear how it might use the monetary tool in the near future. However, this is still only one possible interpretation of items (1) and (2), and not a sufficiently concrete one.

53. Nevertheless, the commitment is much better than a previous promise, “the zero interest rate policy until the deflationary fear would be dispelled.” Previously, the BOJ was reluctant to choose a particular price index and to set a numerical target. Worse still, it tended to argue that there could be good deflation. Therefore, this is a major shift in the commitment to combat deflation with a transparent target. E.g., with this commitment, lifting of the de facto zero interest rate would not happen while the CPI inflation rate is still negative. That is to say that the August 2000 interest rate increase could not have happened if item (3) had been in force.

August 2000 and March 2001, is a decidedly poor substitute for an explicit policy of inflation targeting. Monetary instrument independence should be respected, with an accountability of the results placed on the BOJ. Inflation targeting is a good framework for achieving this balance.

Fiscal Policy

Fiscal policy, especially fiscal spending with new issues of government bonds, is a traditional discretionary, countercyclical tool that can be used to lessen the magnitude of an economic downturn. Japan used this tool frequently in the 1980s and 1990s, with uncertain results. Some question the effectiveness of fiscal policy by citing a prolonged recession despite repeated fiscal policy packages. Yet other critics argue that the fiscal tightening in April 1997 was at least partly to blame for the severe recession in 1998.

Although the official dating of the trough of the business cycle was October 1993, the economy hardly recovered from the fall of 1993 onward. In response to the sagging economy, the government introduced a series of economic stimulus packages. The packages of August 1992 and April 1993 were significant, their combined size being ¥26 trillion (5 percent of GDP). However, only ¥10 trillion (2 percent of GDP) was net incremental expenditures, the true stimulus or the so-called *mamizu* portion (Posen 1998, table 2.4).⁵⁴ The announced “size of the package” is usually deceptive, because the Japanese government, trying to impress the public with “announcement effects,” puts in items that had been already budgeted or had no budget consequences. This is to say that the estimated real additions to spending in 1992 and 1993 were only 40 percent of their advertised value. As the Japanese government replayed this tactic time and time again from the mid-1980s on, its credibility eroded like that of the boy who cried “wolf.” Indeed, McKibbin (1997) argues that these exaggerated announcements actually had a perverse effect: by contributing to yen appreciation and long-term interest rate increases without delivering additional demand, they actually depressed real GDP.

With these gentle fiscal nudges, the economy started a recovery, albeit slowly, in 1993-94. Additional stimulus came through the special income tax reduction introduced in 1995 (with a precommitment of reversing it and of increasing the consumption tax rate in 2 years). The size of the total package of April 1995 was ¥4.8 trillion, whereas the net incremental expenditures (*mamizu*) share was higher than previous packages at 56 percent, amounting to 0.6 percent of GDP. With the strong performance of the economy in 1996, the precommitment to a tax increase was carried out in April 1997.

54. See also Mühleisen (2000) for further discussion of Japanese fiscal policy.

Tax increases in April 1997 pulled back the economy: The consumption (value-added) tax rate was raised from 3 to 5 percent, a special income tax cut made a few years earlier was repealed, and contribution rates to social security were increased. The tax burden (including the social security contribution) increased by about ¥9 trillion (nearly 2 percent of GDP).

As one long-time observer of Japan declared, “in retrospect the Japanese government made its worst macroeconomic mistake in fifty years when it decided in early 1997 to give top priority to budget deficit reduction and shifted from an expansionary fiscal policy to a strongly restrictive fiscal policy (Patrick, 2001, 22). Another observed, “The result was disastrous for Japan. It also contributed to the Asian financial crisis later that year, when Japanese imports collapsed and distressed Japanese banks withdrew loans to other Asian countries” (Shafer 2000, 211). In anticipation of the consumption tax increases, consumers shifted their timing of consumer durable purchases forward to the fourth quarter of 1996 and the first quarter of 1997. The result was a temporary boom in 1996 and a sudden decline in consumption in the second quarter of 1997.⁵⁵

Did the tax increase cause a recession in 1998? It was certainly a contributing factor. Given the falling asset prices and the weakness of the financial sector, the ¥9 trillion withdrawal at once was too much. The long-run need for fiscal consolidation was and remains understandable, but under the circumstances this fiscal contraction was too much and premature.

Owing to the large fiscal stimulus packages in the second half of the 1990s, Japan’s debt-GDP ratio has rapidly risen to a level that is the worst among G-7 countries (tables 3.2 and 3.3). Unless its budget deficits are contained soon, the country’s fiscal debt will become unsustainable. A quick withdrawal might be detrimental to the economic recovery that is needed to get it out of the deflation cycle. However, gradually withdrawing deficit spending would not have too much of a negative impact. It is necessary to avoid the catastrophic collapse of the government bond market down the road. (Such an apocalyptic scenario was the theme of a popular best-selling novel, Ma-in Koda’s *Nihon Kokusai*, or *Japanese Government Bonds*.) The withdrawal should be carried out with a careful medium-term strategy, with a waiver clause—in case of a severe negative shock, fiscal tightening can be shelved.

One way to achieve gradual fiscal tightening without much withdrawal of support is to design a cutback in fiscal spending in the areas that do not affect other activities—namely, bridges and tunnels to nowhere. In fiscal 2000, the government deficit (on the SNA base) was about 6 percent of GDP. Having deficits means that the fiscal stance is supportive. But the magnitude of the deficits has to be lessened gradually. We propose

55. To see consumption shifting due to the consumption tax increase, quarterly GDP growth rates can be examined. The quarter-to-quarter growth rates were negative in the second quarter of 1996 (1996:2Q) and 1996:3Q, but turned to 4.4 percent (annualized rate) in 1996:4Q and 8.4 percent in 1997:1Q. The growth rate plunged to -6.4 percent in 1997:2Q. Consumption started to recover in 1997:3Q. A predicted pattern of the effect of the consumption tax increase is evident in the data. What was unexpected was that the consumption sank again in 1997:4Q.

Table 3.2 Government deficits (SNA-based, central and local government consolidated), as a ratio of GDP

Country	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Japan	-2.0	-4.8	-5.1	-6.4	-6.9	-5.9	-7.1	-8.8	-7.8	-7.7
Japan ^a	1.5	-1.6	-2.3	-3.6	-4.2	-3.3	-5.0	-7.0	-6.0	-6.0
United States	-6.7	-5.7	-4.5	-3.9	-3.1	-2.0	-0.9	-0.4	0.8	1.0
United States ^a	-5.9	-5.0	-3.6	-3.1	-2.2	-0.9	0.3	1.0	2.3	2.6
United Kingdom	-6.5	-8.0	-6.8	-5.8	-4.4	-2.0	0.4	1.3	2.7	2.2
Germany	-2.5	-3.1	-2.4	-3.3	-3.4	-2.7	-2.1	-1.4	1.4	-1.7
France	-4.2	-6.0	-5.5	-5.6	-4.1	-3.0	-2.7	-1.8	-1.4	-0.1
Italy	-9.5	-9.4	-9.1	-7.6	-7.1	-2.7	-2.8	-1.9	0.1	-1.0
Canada	-9.2	-8.7	-6.7	-5.4	-2.8	0.2	0.2	2.2	2.5	2.1

a. With social security accounts.

SNA = System of National Accounts.

Source: Organization for Economic Cooperation and Development, *Economic Outlook*, December 2000.

Table 3.3 Government debt (SNA-based, central and local government consolidated), as a ratio of GDP

Country	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Japan	59.3	63.7	68.8	76.2	80.5	84.6	97.4	105.3	112.3	118.6
United States	74.1	75.8	75.0	74.5	73.9	71.4	68.4	65.3	59.5	54.6
United Kingdom	49.4	58.4	56.1	61.1	60.6	60.9	62.0	57.0	53.5	50.7
Germany	41.8	47.4	47.9	57.1	60.3	61.7	63.0	60.6	59.6	57.8
France	44.7	51.6	55.3	59.3	62.3	64.7	65.2	65.0	64.6	63.6
Italy	116.1	117.9	124.0	123.1	121.8	119.8	117.7	116.6	112.0	108.3
Canada	110.3	116.9	117.5	120.6	120.9	117.4	116.2	111.6	105.9	100.5

SNA = System of National Accounts.

Source: Organization for Economic Cooperation and Development, *Economic Outlook*, December 2000.

a medium-term strategy to lower the deficit-GDP ratio by 1 percentage point every year (so that the deficit-GDP ratio will be lowered to 5 percent in 2001, 4 percent in 2002, etc.), with a waiver in the case of unforeseen negative shocks. The primary balance will be restored by 2006 or 2007. The debt-GDP ratio will be at about 160 percent by then.

The Koizumi government has made a promise to keep a cap on new government bond issues at ¥30 trillion for fiscal 2002 (April 2002-March 2003). If no reforms are made, new issues are expected to be ¥33.3 trillion. Therefore, the government pledge of ¥30 trillion can be translated as a 10 percent cutback in government bond issues. The withdrawal is about 0.7 percent of GDP, and well in line with a medium-term strategy of a 0.5-1.0 percentage-point withdrawal each year, which is roughly what the United States accomplished in fiscal 1993-2000.

Ideally, the government should develop a comprehensive medium-term plan, including a cap on borrowing and spending by local governments. A cutback on government-affiliated corporations should be considered, in addition to the cap on the central government's bond issues. However, the ¥30 trillion cap on government bond issues may be simple enough to send the message to the public, and is a constructive first step.

The dampening effect of the reduction in fiscal spending could be offset by shifting spending from low- to high-multiplier projects. Three to 4 percentage points of this decrease may be achieved by cutting back public works budgets that were added in the fiscal stimulus packages in 1998, 1999, and 2000. Public works composition should be drastically shifted from traditional projects (highways, bridges, tunnels, agricultural roads, dams, concrete riverbeds, etc.) to urban infrastructure (making roads wider, better city planning, expanding fiber-optic cable networks and cable television networks, etc.) where higher multiplier effects are expected. Also, tax rules, deregulation of housing, and other policy measures can complement public spending.

We believe that building larger, more comfortable houses in urban areas (close to work) will lead to more private consumption (i.e., a higher multiplier) than construction of bridges and tunnels that almost no one will use. The impact on the construction industry (which politicians worry about) is minimal if houses are built instead of bridges.

However, if the cutback in public spending is delayed, this would have large long-term costs. Currently, the high debt-GDP ratio is a concern, although it is not yet reflected in the level of the long-term bond rate. It would be costly to adjust the fiscal situation once the interest rate started to rise due to the unsustainability concern.

In sum, we recommend gradually withdrawing fiscal support by reducing deficit spending, starting now. A 0.5-1.0 percentage-point improvement in fiscal deficits (SNA base, central and local government consolidated) every year for the next 7 to 8 years should be kept on track, with

an escape clause that deficit reduction may be shelved if the growth rate is expected to become negative due to external negative shocks. A natural way of doing this would be to define the fiscal targets in terms of the full-employment budget position.

Trade Conflict and Yen Appreciation

During the 1990s, the yen-dollar exchange rate fluctuated between 80 and 150. The yen appreciated from 140 yen per dollar in 1991 to 80 yen per dollar in April 1995, and then depreciated to the weakest point of the decade, 147, in August 1998, before turning around to start an appreciation phase. The yen reached near the 100 mark again in January 2000, before easing back to the 120s.

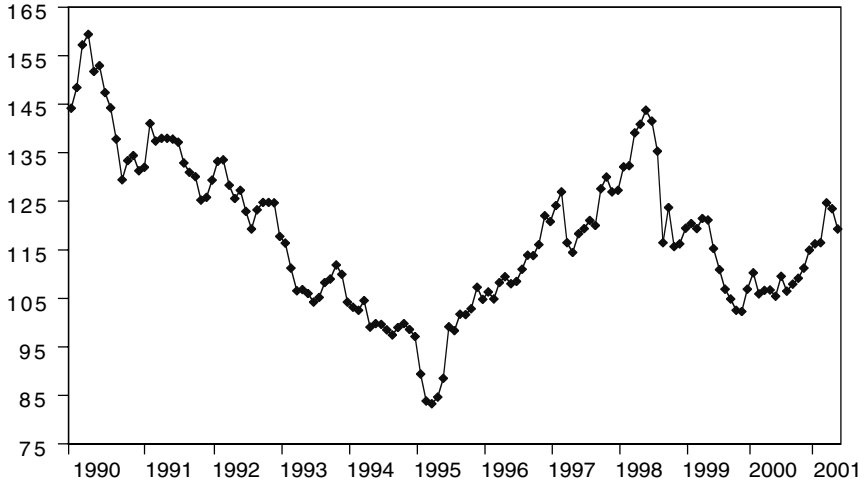
In the 1980s, movements in Japanese and US current account balances mirrored each other. Increases in the Japanese current account surplus were accompanied by increases in the US current account deficit from 1980 to 1987. This development was partly caused by the dollar's appreciation from 1980 to February 1985, and was partly due to increasing fiscal deficits in the United States. The dollar's depreciation in 1985-87 resulted in some, but not all, correction of the external imbalance.⁵⁶

The inauguration of the Clinton US presidential administration in January 1993 ushered in a particularly contentious period of trade relations between Japan and the United States (as will be discussed in greater detail in chapter 4). The failure to reach an agreement on trade issues during the February 1994 summit between President Clinton and Prime Minister Morihiro Hosokawa was unprecedented in postwar history. Hosokawa's refusal to accede to US demands (which will be described in more detail in chapter 5) was widely supported in Japan. The US administration subsequently ratcheted up the pressure on Hosokawa's immediate successors, culminating in a confrontation over automobiles in the spring of 1995. As the Japanese economy went into a recession, the yen appreciated from 125 in January 1993 to about 105 in the summer of 1993 (figure 3.3).

It was rumored in the market that the United States would talk the yen up to put pressure on Japan, especially in regard to the auto dispute (E.

56. The external imbalance in the two countries increased again in the first half of the 1990s. But in the second half of the 1990s, the movements of the Japanese and US current accounts were somewhat delinked. Japanese current account surpluses decreased sharply in 1996, from a \$110 billion surplus in 1995 to a \$66 billion one in 1996. The level of the surplus in Japan increased to \$110-120 billion in 1998-2000, but this is less than the record surpluses of \$130 billion in 1993-94. However, US deficits increased sharply, from \$109 billion in 1995 to \$435 billion in 2000. In other words, for this increase in US current account deficits in the second half of the 1990s, the contribution of the Japan-United States bilateral imbalance was negligible.

Figure 3.3 Yen-dollar exchange rate, 1990-2001



Source: IMF, *International Financial Statistics*.

Sakakibara 2000), although in fact it never did so.⁵⁷ It would be very difficult to explain, on the basis of economic fundamentals, the yen's appreciation from 100 yen per dollar in January to 80 yen per dollar in April 1995.⁵⁸ This rapid appreciation by 20 percent caused a sense of panic among exporters and their suppliers.

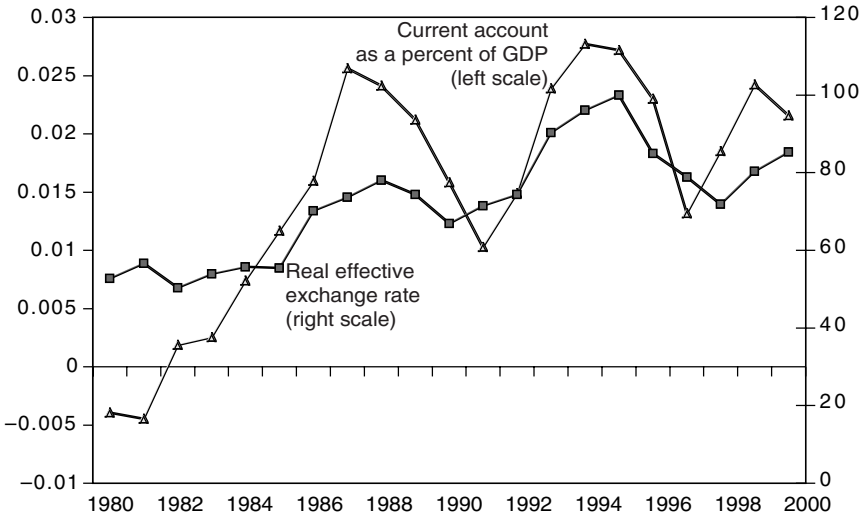
Japanese monetary authorities clearly viewed any yen value higher than the level of 100 yen per dollar as misaligned, under the macroeconomic circumstances of the time.⁵⁹ On a number of occasions, US and Japanese

57. Former Clinton administration officials deny that there was any such policy, and point to the fact that the United States did not make such public statements. The media interpreted the yen's appreciation as being in response to large trade imbalances, and US officials did not dispute these interpretations. The yen's appreciation might then be regarded as a tacit or implicit stick to increase pressure on the Japanese government in the auto dispute.

58. Both interest rates and growth rates were changing in ways to encourage the yen's depreciation: The interest rate in Japan was lowered much faster than in the United States, so that the Japan-United States interest rate differential was increasing, and the growth rate had been declining in Japan from 3 percent in 1991 to 1 percent in 1995, while it had been increasing in the United States. However, the current account surplus movements may have explained the yen-dollar movements: The Japanese surpluses grew from \$68 billion in 1991 to \$131 billion in 1994, while the US current accounts went from a \$4 billion surplus in 1991 to a deficit of \$121 billion in 1994.

59. The official discount rate was lowered from 1.75 to 1.00 percent on 14 April 1995, the first move in 2.5 years. The Ministry of Finance and the BOJ intervened massively from January to April 1995, but in vain. The market turned around in April, after hitting the record high of 79.75 yen per dollar after the United States joined the Japanese authorities in a joint intervention. The intervention continued until August 1995 to push back the yen over the 100 level. The official discount rate was again lowered, from 1.00 to 0.50 percent,

Figure 3.4 The Japanese current account balance (t) and real exchange rate (t-1), 1980-2000



Source: IMF, *International Financial Statistics*.

monetary authorities conducted joint market interventions in 1994 and 1995.⁶⁰ Both interventions and lowering of the interest rate were instrumental in firming the trend of yen depreciation from the fall of 1995.

The lagged impact of exchange rate movements on trade balances is well understood, although the relationship between the exchange rate and other macroeconomic aggregates in the United States and Japan is at best uncertain (Noland 1989a, 1989b). As an illustration, in figure 3.4, real exchange rate appreciation tends to lower current account surpluses in the following year, especially in the 1980s.⁶¹

Indeed, some even make the extreme claim that Japan's poor macroeconomic performance can be attributed entirely to the secular appreciation

on 8 September 1995. This was in response to weak economic news due to the strong yen, and in accordance with a massive intervention in August.

60. The US monetary authorities intervened jointly with the Japanese authorities in the yen-dollar market 5 days in 1994 and 8 days in 1995. The Japanese authorities intervened unilaterally 50 days in 1994 and 32 days between February and November 1995.

61. After the Plaza Agreement in 1985, Japanese multinational firms began moving substantial portions of their production offshore. E.g., automakers such as Toyota shifted production facilities to North America to avoid trade restrictions, and consumer electronics producers such as Sony shifted production to compete with rival producers. As a result, the sensitivity of profits (on a globally consolidated basis) to exchange rate fluctuations declined. Once Japanese exporters saw that it was possible that the yen could go to the 80 level, they hesitated to increase production capacity at home. Repeated episodes of yen appreciation in the 1980s and 1990s accelerated foreign direct investment, which contributed to the diversification of production locations.

of the yen due to trade friction (cf. McKinnon and Ohno 1997, 1998; McKinnon 1998). Yet, although trade tensions and yen appreciation may have played a bit part in Japan's macroeconomic tragedy, it strains credulity to give them top billing over the financial, monetary, and fiscal mishaps reviewed above.

As will be discussed in chapter 4, trade plays a relatively small role in the Japanese economy, and trade with the United States a smaller role still. For bilateral trade relations to determine macroeconomic outcomes in Japan, the tail would truly have to wag the dog. Bayoumi (2000a) confirms that it does not. Second, as is shown in figure 3.3, the yen has not appreciated secularly—it has gone through intermittent periods of appreciation and depreciation. Nor, for that matter, do surveys of market participants indicate that they always expect the yen to appreciate (whether these expectations are fulfilled or not).

Third, the existing econometric evidence generally rejects the hypothesis of unidirectional causality between the Japanese exchange rate and other relevant macroeconomic variables (Noland 1989b). Indeed, a sophisticated econometric analysis of the 1991-93 recession found that most of the yen's appreciation during this period was predictable on standard macroeconomic grounds, and although unpredictable movements in the exchange rates accentuated the downturn, the impact of the exchange rate was small relative to other forces, such as the collapse of investment following a period of excessive capital accumulation and decline of asset prices (Brunner and Kamin 1996). Ramaswamy and Rendu (2000) similarly find that a fall in investment due to overaccumulation of capital was the predominant cause of Japan's slowdown in the 1990s, and that the external sector had no impact, despite the yen's appreciation. The bottom line is that (as will be detailed in chapter 5) trade tensions cooled noticeably after 1995—but the deterioration of the Japanese economy did not.

Structural Reforms

In Japan's period of high growth, it was fashionable to ascribe its superior economic performance to the unique institutional characteristics of the Japanese economy, such as the *keiretsu* system, the bonus payment system, the main-bank system of corporate governance, and the system of lifetime employment (see box 3.6). Now that Japan is having economic difficulties, it has become fashionable to claim that these institutions are impediments to growth. If anything, these institutions were weakening in the 1990s, and if they are a source of the problem, the growth rate should have accelerated.⁶²

62. These institutions appear to be a relatively recent (i.e., postwar) phenomenon (T. Okazaki 1993; Noguchi 1995). Japanese institutions are not immutable—they have changed in the past and undoubtedly will change in the future.

Box 3.6 Keiretsu

Keiretsu are networks of affiliated firms that typically have long-standing financial, managerial, and product market interlinkages. A *keiretsu* might consist of a group of large core firms (including financial firms) linked across markets, together with their vertically linked input suppliers, and possibly a captive distribution network. *Keiretsu* are a multifaceted phenomenon, but two aspects of this form of industrial organization can be distinguished in this context: so-called vertical *keiretsu*, which involve vertical supply relationships in product markets; and horizontal *keiretsu*, which involve many firms in different sectors. The former are sometimes called distribution *keiretsu*, and the latter financial *keiretsu*. However, as Matsushita (1997) observes, the term is rather vague and does not necessarily involve contractual relationships between the affiliated firms. Instead, these may be de facto relationships based on repeated transactions.

Vertical *keiretsu* may involve considerable cross-ownership, as well as product market linkages. Sheard (1997) notes that Toyota owns 25 percent of the stock shares of its top suppliers, which in turn sell 43 percent of their output to Toyota; likewise, at one time Nissan owned 30 percent of its suppliers' stock, and they sold 55 percent of their output to Nissan (Dodwell Marketing Consultants 1997). However, foreign penetration (notably Renault's takeover of Nissan) indicates that vehicle assemblers are encouraging their suppliers to diversify their customer bases, and the introduction of an online automobile parts exchange are expected to weaken these links in the auto sector even further. In the electronics sector, Matsushita owns 54 percent of the stock of its primary suppliers, which sell 51 percent of their output to Matsushita; and Hitachi owns 50 percent of the stock of its principal suppliers, which sell 30 percent of their output to Hitachi.

According to the IMF (1998), these cross-holdings are "pervasive" and higher than those observed in other industrial countries. According to the Nomura Research Institute, the ratio of shares reciprocally held by listed Japanese companies declined throughout the 1990s, reaching 11 percent in March 2000. Since then, distress sales have probably reduced this figure further. The anticipated sales of stocks held by banks spurred by changes in accounting rules effective in April 2001 will in all likelihood contribute to additional erosion in horizontal cross-holdings. Bank sales of equity holdings were given another push by the emergency measures announced in April 2001.

Although there may have been some unwinding of horizontal cross-holding due to bank consolidation or distress sales, the decline of the Japanese stock market in the 1990s has actually afforded large, better capitalized firms the opportunity to tighten their control over suppliers, suggesting that vertical integration may actually be increasing.

Evolving Institutions

Lifetime employment means that jobs for "core employees" (regular workers, excluding part-time workers) are almost guaranteed, unless the company experiences extreme hardship such as a bankruptcy or takeover (e.g., the Long-Term Credit Bank and Nissan). This makes labor a quasi-fixed factor of production. Moreover, to the extent that remuneration is determined by tenure and seniority, this provides an incentive

against employees changing jobs and contributes to rigidity in the labor market.⁶³

At the same time, however, lifetime employment encourages firms to invest in the development of their employees' human capital, because they are confident that they will be able to capture the return on that investment—rather than watching their investment depart for greener pastures. Discretion in job assignments, including assignment to subsidiaries and affiliated companies, and flexible net pay (including bonuses) and overtime hours by management, accompany the implicit commitment of lifetime employment. Flexibility in pay and hours as well as job assignments well serve large companies with many divisions and diversified products. Deferred payments in the form of severance pay at retirement (prevalent among all types of Japanese firms) and nonportable pension schemes also well serve companies that are expanding their businesses. The commitment to lifetime employment was not too large a burden for companies in a growing economy.

The reason that these institutions (lifetime employment, large deferred payments, flexible hours and job assignments) became a problem is twofold: They are problematic when growth slows and internal opportunities are no longer expanding; and they do not suit the new economy, where innovation rather than skill accumulation is essential.

On the capital-market side, the new technology rewards investors that accept high risks for high returns. Equity financing fits well. However, the strength of the Japanese financial markets was patient, relationship-based banking, and not (NASDAQ-like) equity financing, much less venture capital operations.

Similarly, *keiretsu* may be good or bad in the new century, depending on the rationale for the institution and the changes in the environment. Vertical *keiretsu*—parts to assembler, and manufacturing to retail distribution—may survive in the new economy, although exclusive parts suppliers and exclusive dealerships are fading away. Moreover, with the Internet revolution, channels of parts procurement and retail distribution are becoming shorter and more competitive. Some vertical *keiretsu* will have to transform significantly.⁶⁴ These issues can largely be addressed through rational decision making in the private sector.

63. The Miyauchi Committee, chaired by Orix head Yoshihiko Miyauchi and coordinated by subsequent Koizumi cabinet Economy Minister Heizo Takenaka, concluded that “[the] lifetime employment and the seniority-based wage system, which have played a key role in building a stable employment relationship, undermine corporate profitability and competitiveness. They also hinder labor market fluidity and prevent the appropriate transfer of human resources into growth fields, while being an obstacle to workers’ displaying their ambitions and capabilities” (JERI 2001, 4-5).

64. With regard to vertical *keiretsu*, the Miyauchi Committee observed that they “were effective in reducing business risk and promoting the stable expansion of business, but in an increasing number of cases, such entrenched ties have been a hindrance when a company

Horizontal *keiretsu* are much more endangered. Because latent capital gains from equity holdings by banks have disappeared (as explained above, as a result of realizing gains for offsetting losses from nonperforming loans and preparing to introduce mark-to-market accounting), banks have been selling equities from cross-share holdings in the past few years and are expected to continue doing so in the coming years. Although stocks from horizontal *keiretsu* companies may be the last to be sold, the attraction of horizontal *keiretsu* is diminishing. As the banks are at the center of horizontal *keiretsu*, dissolving cross-share holding from banks will imply less of whatever power (benefits or costs) there was in keeping horizontal *keiretsu* together. Enterprise groups among the manufacturing groups may remain strong, but relationships with banks will be weakened. Some (e.g., the Miyauchi Committee) believe that the net effect of the dissolution of these ties will be to improve the efficiency of capital allocation. As Fukao (1998) observes, the dissolution of these ties and their replacement by more performance-oriented capital markets will encourage the abandonment of lifetime employment practices as well, as has occurred in continental Europe.

We agree that these institutions are problematic in the new century. However, just destroying old institutions may not serve the economy at large. Japan's institutions per se may not be the source of the problem of low growth, except that traditional labor relations—including lifetime employment, the seniority wage system, and the like—may not be suitable for the new economy. It is important to create new opportunities not bound by old conventions.

Chronic Housing Problems

One of the most unsatisfactory aspects of the lifestyle of a typical Japanese citizen is the size, quality, and cost of housing. Floor space for a typical Japanese house, controlling for income level of households and commuting distance, is smaller than European counterparts, not to mention US counterparts. Poor durability has become a concern. Misguided regulations encourage extremely inefficient land use and urban sprawl. Employees face lengthy commutes, and despite the enormous geographical dispersion of Japanese cities, parks and other public green spaces are in short supply—per capita municipal park space in Tokyo is one-fifth that of Paris, one-fifteenth that of London, and one-twentieth that of Washington. These long-standing problems are well recognized in Japan, and, for example, were highlighted by an important official panel on economic

attempts to slash costs under global competition. The recent growth of e-commerce on the back of the Internet and other areas of IT innovation is giving even greater momentum to this trend" (JERI 2001, 4). Also see Hoetker (2001) for a discussion of this phenomenon in the notebook computer industry.

reform, the Maekawa Commission, which in 1987 called for “a revolutionary improvement in the quality of life.”

Although housing and related land-use issues are primarily microeconomic, they have macroeconomic implications. Household consumption could increase if floor space became larger, because space would be provided to install consumer durables. Women’s labor participation rates could increase if labor-saving appliances or a nanny could be accommodated in a house. If all family members could have their own rooms, that would allow more productive activities at home, including home offices with computers with Internet connections. If the relative price of housing could be reduced, the accumulation of savings to finance housing purchases would fall, possibly reducing excess household savings as well (Balassa and Noland 1988).

To put an end to deflation, it is essential to have consumption growth. After all, 60 percent of GDP is household consumption. Consumption has long been stagnant, even when there was some glimpse of high growth in investment. The best bet for increasing consumption is in the area of housing.

Problems in the housing market stem from several sources. First-time visitors to Japan are typically stunned to find small agricultural plots under cultivation in the inner suburbs of urban areas. This pattern of land use has been encouraged by policies such as trade protection, which artificially boost the rate of return in agriculture, whereas property and inheritance tax policies discourage the conversion of agricultural land to alternative uses. Changes in the tax law introduced in the early 1990s were supposed to resolve this problem and encourage the conversion of urban agricultural land to more efficient uses, but little conversion actually has taken place.⁶⁵

A second source of problems in the housing market are zoning regulations—including “sunshine laws”—that ostensibly were enacted to ensure access to sunlight for homeowners, which effectively limit the height of buildings in many urban neighborhoods to a few stories.⁶⁶ These

65. Traditionally, a greatly reduced real estate rate on agricultural lands was applied to these agricultural patches. Once converted to residential lands, they were subject to high capital-gains taxes. The law was revised to equalize the rate of taxation on agricultural and nonagricultural lands, and to provide relief from the capital-gains tax at the time of conversion. However, the law contained a grandfather provision: If the owner elects to keep the agricultural land for the rest of his or her life, and the heir also will keep it as agricultural land, the reduced rate still applies. These lands thus were “locked in” for agriculture. Otherwise, the higher rate will apply (and presumably the land will be converted to residential land, sooner or later). Although it was a smart idea to attempt to tax agricultural land in the residential area, the options made things worse by locking away some agricultural lands forever.

66. The height of detached houses (as well as high-rise condominiums) is regulated. The size of floor space of a detached house is regulated in the multiple of square meters of land

regulations represent a highly inefficient way of handling what, in economics terminology, is an externality—that is, when the welfare of one agent is dependent on the activities of another and private costs do not reflect this dependency. In the case at hand, the construction of a new high-rise would adversely affect the welfare of existing homeowners by reducing their access to sunlight, increasing congestion and so on. If current homeowners are able to prevent new construction, through legal obstacles, however, a less than socially optimal quantity of housing will be built. This is what has happened in Japan. Yet if developers are not required to compensate current homeowners, then too much housing will be constructed because the losses of existing owners are not properly taken into account. The task is to devise a system of incentives that yields the socially optimal amount of housing.

Two standard ways of dealing with externalities are internalization and compensation. A variety of solutions are imaginable. For example, residents on a block could jointly decide to accept taller houses, recognizing that though sunlight might be limited on the lower floors, the existing access to sunlight could be preserved on upper floors.⁶⁷ Voluntary initiatives of this sort by local districts should be encouraged to reform restrictions on houses. Another approach would be to formally revise existing regulations. The sunshine laws could be repealed, and a law modeled after those in other countries could be enacted that requires developers to purchase additional surrounding tracts on a per-unit basis, and to convert a specified percentage of the land into public parks and playgrounds. Instead of buying a single plot and building a single high-rise amid smaller homes, developers would be required to purchase additional plots and develop a residential complex, thereby internalizing the true social cost of development.

Alternatively, one could revise the sunshine laws to permit new construction, but require developers to compensate those adversely affected. A simple rule might require developers to compensate affected homeowners for the value of their structures (but not of their land). Land and structures are contracted for separately in Japan, so it would be relatively easy to assess the value of the structure. Current homeowners would be

lot (the cubic restriction). Even within this constraint of the cubic restriction, the shape of the house has to be configured, subject to other restrictions, not to cast shadows onto neighboring plots.

67. Alternatively, one may go underground. The proportion of houses with a basement is not very high in Japan (relative to the United States, where land prices are comparatively low). The high land prices and height restrictions should encourage building basements. Of course, construction costs of basements are about 50 percent higher than those of above-ground buildings—even if a basement is counted as a part of floor space for real estate tax purposes and the cubic restrictions. However, given the scarcity of land in Japan, basements should be encouraged by tax incentives and a relaxed cubic restriction.

free to remain and suffer the discomfort of reduced sunshine, or to sell their land and relocate.

These considerations relate to the quantity of housing. Other aspects of public policy contribute to the poor quality of the housing stock in Japan. Houses are valued at about half of market value for inheritance tax purposes, whereas liability (mortgages) are fully deducted. Financial assets are assessed at their market values for inheritance. Hence, the elderly with large assets have an incentive to acquire houses (owner occupied, second houses, and rental properties) in planning to pass assets down to heirs. Houses that are most suitable for this strategy are apartment buildings with wooden structures (and fast depreciation) with lots of tenants (and lower valuations as rental properties). To minimize financial assets and to maximize rental properties and associated mortgages is a valid inheritance-tax-saving strategy. This has contributed to the building of poor-quality rental properties.

Existing tenant laws also discourage the construction of high-quality housing. The traditional tenant (land and structures) law in Japan gives strong rights to tenants. Even when a lease expires, a landlord cannot terminate a lease unless the tenant agrees to move out or the landlord has a reason to demand termination of the lease; "a reason" is interpreted by a court that the landlord has no other place to go but to reclaim the place for his or her own living space. There have been cases of professors subletting their houses to go abroad for a year who could not move back in. Naturally, landlords of apartments do not build first-rate structures, fearing that their tenants may not move if they need to reclaim the unit or the whole building.

The new tenant law was introduced in 1993, and contracts written under it now can be terminated without "a reason." However, the old tenant law remains in force, and all existing contracts under it are grandfathered. The penetration of contracts under the new law is not widespread.

Yet another tax distortion exists for company and government housing. Employees' housing can be built at the company's expense, whereas subsidized rents in company housing are not taxable as income. Employees of large corporations are offered corporate housing, and government employees are offered their housing. Corporate and government housing is justified on the ground that employees are frequently moved around for jobs and assignments. However, the quality of this housing is not high. If firms offered first-class housing, then they would be criticized for extravagance, so subsidies in fact contribute to the proliferation of poorly constructed housing. The irony is that the company housing subsidy (a nontaxable pecuniary perquisite) is contributing to smaller than optimal, substandard housing (typically 4- to 10-story buildings with tens of small family units) all over Japan.

In addition to zoning changes, tax changes can also be undertaken to stimulate the housing sector. The consumption tax can be eliminated on new structures. The size ceiling (currently 240 square meters) on existing tax relief measures (e.g., reduced real estate tax rates and real estate registration taxes) could be raised or eliminated completely. The existing income ceiling for those who claim the tax credit for owner-occupied housing could be raised or eliminated as well.

In summary, land use and housing are the source of deep-seated problems in Japan, relating primarily to a variety of tax and zoning issues. And despite their microeconomic nature, problems in the housing market have macroeconomic implications. (Indeed, they were even the subject of bilateral discussion between Japan and the United States during the Structural Impediments Initiative of 1990-91; and they were the subject of an expert group under the Enhanced Initiative of 1997, which was disbanded in 2001, "given the progress made in addressing housing issues.") As we have indicated, a number of reforms could be adopted to address these issues that could improve both the macroeconomic performance of the Japanese economy and the quality of life in Japan.

Assessment

After the lost decade of the 1990s, the weaknesses of the Japanese economy are obvious. The first problem is mounting nonperforming loans in the financial sector. The profit base of banks is thin, and new nonperforming loans emerge as soon as old ones are provisioned for. A second problem is deflation, and although there is no guaranteed cure for deflation, the Bank of Japan seems to be unwilling to use all the weapons in its arsenal. The third problem is fiscal—at 140 percent of GDP, government debt is the highest among the G-7 countries. Although net debt is estimated to be much lower than gross debt (50 percent of GDP, comparable to that of European countries), the quality and reliability of net debt estimates are highly doubtful.

The growth prospects for the Japanese economy in the next few decades are mixed. Its traditional strength has been its high household savings rate, highly educated and motivated workforce, and well-managed manufacturing sector. Excellent corporations such as Toyota and Sony are as strong and innovative as ever, and relatively new industries, such as mobile phone services and computer hardware makers, are thriving. Renault's rehabilitation of Nissan suggests yet another avenue for industrial resurgence. Although the Internet has been slow to develop in Japan, it is changing quickly as Internet technology expands through cable television and optic fibers, as well as via faster connections through telephone lines, and wireless technology quickly penetrates urban areas.

Reviving growth potential through changes in tax structures, regulations, and other aspects of social policy is necessary. Economic recovery and the revival of growth are not impossible, but the road to recovery is narrow, and driving down it must be done carefully.

Aggregate demand must be stimulated in an environment where the nominal interest rate is already zero and fiscal stimulation is not possible without raising further concerns about debt sustainability. In short, it is important to stimulate private-sector aggregate demand—household consumption, fixed investment, and housing investment. However, to enable short-run recovery, a medium-run policy commitment needs to be laid out now. A credible medium-term vision—how to reduce fiscal deficits and how to get out of deflation—is needed to generate optimistic expectations, because confidence in medium-run policy success is important to stimulate aggregate demand in the short run.

In the medium run, supply-side policy is critical, especially because the rate of growth must be increased to “grow out of debt,” but also because demographic changes, specifically a shrinking labor force, will tend to depress Japan’s growth potential. Monetary policy must be based on a principle that price stability—no inflation and no deflation—needs to be maintained in the medium run. In the medium run, financial policy—including bank and insurance company supervision—needs to be strengthened, and Japanese financial institutions, with a tremendous home-court advantage with their large deposit base, should regain strength. Microeconomic policy needs to be employed to promote productivity and growth. More effective use of female labor is desirable, and an increased role for immigrants or “guest workers” also may become important. Labor relations and the pension system need to be reformed, so that workers can move from low-productivity firms to growing ones. Workers need to be flexibly trained in marketable skills in the education system, so that they can use their skills in any organization, not just in a particular firm.

During the next few years, Japan must achieve several intermediate objectives to put its economy back on the potential growth path: (1) Stop deflation. (2) Restore fiscal sustainability. (3) Solve the financial-sector fragility problem. (4) Implement structural reforms in sectors such as telecommunications, housing, and agriculture. These objectives should be adopted as a package, because policies under (2), (3), and some aspects of (4) tend to be contractionary, whereas those under (1) and other aspects of (4) may be stimulating, offsetting the other effects.

This is not simply a matter of interest to Japan. The financial turmoil described in this chapter has had a direct impact on real economic activity in the United States (Peek and Rosengren 1997, 2000), and continued malaise in Japan will affect its capacity and willingness to address broader global responsibilities. It is to these issues that we now turn.