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Chapter 1 - Solutions for the Japanese Economy: An Overview

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With the bursting of its asset and real estate bubble in the early 1990s, Japan's economy entered into a long period of mediocre performance that was accompanied by growing pessimism in 2002 and early 2003 among scholars, policy makers, economic commentators, both inside and outside Japan, about Japan's future. This pessimism was shared by the Japanese public. The growth rate had become negative again, banks were failing, and stock prices were plummeting to the level of ten years earlier. Deflation seemed to be worsening, while the unemployment rate was increasing to an unprecedented level. Monetary policy seemed powerless after the benchmark interest rate became zero. Fiscal policy seemed to be powerless as large fiscal packages failed to lift the economy long enough to generate autonomous recovery.

Moreover, Japan is in the midst of a profound transformation--economic, demographic, social, and political-- process that will take several decades to complete. These fundamental forces are deeply intertwined with cyclical and structural difficulties of Japan's malaise since 1990.

By mid-2004 there was growing optimism that the economy was finally emerging from its 13 years of poor performance to return to sustained growth, but also nagging doubts persisted that it was no more than a cyclical upturn. Earlier recovery attempts in 1996 and 2000 had been followed by disappointing recessions. We are not yet convinced that Japan has

returned to a path of self-sustaining growth based on full and efficient utilization of its own resources. Achieving sustained growth makes it easier for Japanese policy makers to address the fundamental economic issues that we identify in this study, though growth alone cannot solve them. Unfortunately, recovery also encourages excessive optimism, the still widespread, often deeply held, belief that things will get better on their own. Our fear is that government and business policy makers will once again become complacent and continue policies of forbearance and all too slow, incremental reform. At best that means it will take even longer to get back onto a path of sustained growth to achieve the economy's potential. Less optimistically, complacency means yet another recovery will sputter out and the fundamental economic and institutional problems will remain inadequately addressed, and possibly another crisis. (See Patrick, 2004.)

Japan does have feasible, optimal economic policy solutions to the major economic problems and issues that have undermined Japan's fundamental economic strengths since the early 1990s. Even if Japan has entered a period of improving economic conditions, and that is not to be taken for granted, it has not yet adopted the kinds of policies that would maximize its growth potential, improve the quality of life of its people, and contribute to strengthening the global economy. The basic purpose of this book, and the two-year research project on which it is based, is to develop and recommend policy solutions. The following chapters, written by outstanding Japanese and American economists are forward-looking, while founded on a careful analysis of Japan's recent economic history.

In this introductory chapter, as general context for the following chapters, we outline the long-term economic transformation now underway and relate the major economic problems in Japan's 13 years of malaise to that process. Subsequent sections cover the costs of the

economic malaise, aggregate demand and macroeconomic policy, monetary policy, financial system difficulties, corporate restructuring and financing, and Japan's new trade policy. Some of the analyses of subsequent chapters are incorporated into this discussion. Finally, we summarize a few of the major conclusions reached by the authors.

This collaborative project has involved deep and sustained interactions among the 15 well-known Japanese and American economists who authored these 11 chapters. We share a high degree of agreement but certainly not complete consensus on all the proposed policy solutions to Japan's economic problems, and there has been no effort to force consensus. The authors are responsible for their own studies, and we bear sole responsibility for this chapter.

Ongoing Fundamental Transformation

While a great deal of analytical emphasis has appropriately focused on the cyclical and structural difficulties of Japan's malaise since 1990, it is important to recognize the more fundamental forces at work. Three major economic transformations have been underway: the completion of the catch-up process of fast growth as a low income country to a mature economy with a high level of GDP/capita and standard of living; the ongoing demographic transition to long life expectancy, low fertility, and an ageing population; and evolution from a system of relational capitalism to market-based capitalism. (For an even longer-term history of the evolution of Japan's economic system, see Teranishi 2005.)

Japan's extraordinary successful postwar economic growth was based significantly on its ability to close the huge gap between the Japanese level of productivity and technology and the world productivity frontier. This was achieved through the effective utilization of an

initially cheap and abundant, but quite skilled, labor force, entrepreneurial business investment embodying newly available technologies, a rapidly increasing and ultimately very high saving rate to finance domestically the burgeoning business investment rate, development of synergistic postwar economic institutions, and supportive government economic policy. By the mid-1970s, the Japanese economy had caught up with the West, becoming the world's second largest economy with European levels of GDP per capita and a high standard of living. From 1980 on, Japan became an increasingly large foreign investor, both direct and portfolio, and by the 1990s had become by far the world's largest creditor nation. Japanese banks were the largest in the world and had very high credit ratings, and Japanese institutions were buying prime properties worldwide. Now, after more than a decade of stagnation, there is a widespread sense in Japan that it has failed to make a transition from a super-effective manufacturing economy (exemplified by firms such as Toyota, Sony, and Nippon Steel) to a high-tech service-oriented (Microsoft, Goldman Sachs and CNN) economy.

In the high growth, catch-up era, the postwar economic system developed and flourished. It was founded, especially for big business, on the permanent employment system of industrial relations, the bank-based system of corporate finance, and the separation of shareholder ownership and management control. Large firms were and are controlled by entrenched professional managers, trained and promoted from within to serve as CEOs and board members. Any weak firms and banks were merged with healthy ones through backroom discussions and encouragement of regulators. Declining industries, such as coal, did so through a very gradual process; a few that were obviously uncompetitive, such as aluminum, shrank much more rapidly. The system was opaque and cozy, with power centered on business leaders, central government officials, and Liberal Democratic Party (LDP) leaders.

The LDP was the sole governing party from its 1955 creation until 1993, and since 1996 has continued to be the dominant government leader in a series of coalitions.

Japan became a victim of its own economic success. The economy grew too large to be managed effectively based on relationships. For good domestic and foreign policy reasons, the government gradually reduced its early postwar controls over prices, then foreign exchange, foreign capital flows, and trade in manufactured goods. Piecemeal financial deregulation, a twenty-year process, began in the mid-1970s. Many public enterprises have been partially or totally privatized. Airlines are now 100% privately owned; railway companies are partially privately owned; and the formerly monopolistic domestic and international telephone companies are substantially privatized and compete against private communication companies. Other deregulation has taken place, though many regulations persist. Japan has gradually been moving toward a more market-based, open economic system.

As in other countries, economic development and growth brought major changes in the economic structure. Agriculture declined to minor economic significance (but remains politically potent); the share of manufacturers rose sharply and then has gradually declined; and the share of business and personal services naturally rose. With wages increasing continually and the yen appreciating, by the 1980s Japan no longer was a cheap-labor economy; labor-intensive industries, facing the onslaught of cheap imports, increasingly invested abroad while declining at home. One of Japan's major anomalies is that the productivity gap between manufacturing, especially of exports, and services, mostly non-tradables, has remained very wide, and still is the most extreme of any major OECD economy. This gap suggests both a potential for better growth through more effective resource reallocation and the realities of major structural adjustment difficulties for low-productivity services, especially retail and

wholesale trade, as well as construction.

It is our view that Japan successfully overcame several challenges in the past, until the 1990s; this time, Japan really stumbled. We should not forget how Japan overcame difficulties in the 1970s and 1980s. (See Ito (1992) for a comprehensive review of the Japanese economy before the bubble burst.) The mid-1970s was the first inflection point for the Japanese economy. The yen had just been floated for the first time since the World War II. Inflation had gone up to 30% in 1973, due partly to monetary easing the year before and especially to the quadrupling of oil prices. Strong tightening to halt inflation caused negative growth in 1974, the first time in the postwar period. Following the first oil crisis, business optimism and investment slowed, more so than the gradual reduction in household saving rates. The energy resource constraint and problems with pollution put a brake on the overwhelming growth-oriented focus of corporate management and government policy.

Deficit-financing government bonds were issued in increasingly large amounts for the rest of the 1970s to help the economy get back on its growth path. Private sector aggregate demand was no longer excessive relative to supply, and became weakened sufficiently to require government macroeconomic stimulus. Credit rationing was no longer necessary and credit became easy; and the Keynesian paradox of excess saving, initially perceived to be cyclical, became long-term and structural. As a very large economy, Japan from the 1980s has found it is unable to export all of its excess domestic savings because the requisite concomitant huge trade (and current account) surpluses were unacceptable to the United States and Europe. Fiscal consolidation during the 1980s achieved a balanced, even surplus budget by the end of the decade.

The second big challenge for the Japanese economy was the mid-1980s, when yen

appreciation brought about another big shock to the Japanese economy. The first half of the 1980s were marked by dollar appreciation vis-à-vis all other currencies. Japanese exports, as well as European exports, soared and the economy enjoyed rapid growth. By 1984 Japan's current account in its balance of payments had turned to substantial surpluses, and that of the United States had turned to large deficits. The Plaza Agreement of September 1985 was supposed to correct exchange rate misalignments and restore equilibrium exchange rates for major countries. The yen appreciated from 260 per dollar in February 1985 to 240 just before the Plaza Agreement, to 200 in December 1985. It then kept appreciating, in part because of the collapse of oil prices, and reached a then record high of 150 by the fourth quarter of 1986.

The collapse of Japanese exporters and the economy in general was feared, but the economy was more resilient than most thought. Japan recovered from the yen appreciation of 1985-86, and from the spillovers of the US stock-price declines of late 1987 (Black Monday, October 19, and its aftermath). At the end of 1989, the Japanese economy was at the peak of its asset-price bubble. Land and stock prices had risen four-fold in 6 years. No one would dare to forecast those gains to be erased in the following 13 years.

The burst bubble and stagnation of the 1990s has been the third and biggest challenge faced by postwar Japan, and it has been much more protracted than necessary. Asset price declines have caused non-performing loans to become huge, resulting in the banking crisis of 1997-98. After the basic interest rate became zero, monetary policy was a much less effective tool since 1995. Fiscal deficits and government debt have become so large that further fiscal stimulus has not seemed feasible to policy makers.

Japan's decades of success led to some fundamental assumptions that became mythical, and then mistaken. The myths of the late 1980s were that land prices would never decline,

since they never really had for the entire 40-year postwar period; and that rapid GDP growth would continue indefinitely. The 1990-91 bursting of the bubble shattered the land price myth, and raised doubts about maintaining a more than 4% growth rate. Nonetheless, faith in naturally renewed growth led to mythical expectations during the 1990s that growth would be restored fairly soon and the economy would recover. Thus, it was felt that painful business and government structural adjustments could be postponed until conditions improved, and that was how decision-makers behaved.

1.1 Demography

Japan's demographic transformation is as profound as its economic one. Over the long course of its modern economic development, Japan has transited from relatively high birth and death rates, low life expectancy, a young population, and moderate population growth to one of very low death rates, even lower birth rates, long life expectancy (the longest in the world), and, as a result, a rapidly aging population. Since 1995 there has been an absolute decline in the working-age group (15-64), and by 2006 population size will peak. Population stability occurs when the completed fertility rate is about 2.1; currently it is only 1.29. The level is comparable to Italy, and about the lowest among OECD countries.

Broda and Weinstein in this volume cogently point out that the common assumption of a continuation of fertility below the replacement level means that Japanese eventually will disappear, which is unrealistic. Changes in demographic behavior are typically long run, but it is reasonable to assume that some decades hence, the ever-richer Japanese will desire to have more children and the population will stabilize. Or perhaps Japan will decide to give up

ethnic homogeneity and accept large numbers of permanent immigrants, as Higuchi and Hashimoto suggest in their chapter.

High or low dependency rates -- the number of children and elderly as a percentage of the working-age group -- provide information on growth prospects and the needs for government expenditures (including income transfers), but they do not necessarily imply fiscal and economic problems, depending on the characteristics of the social security system. However, the current social security system, designed as a pay-as-you-go system, is already in deep trouble. Too many of the young are not paying in premiums, and corporations are exiting the corporate part of the social security system when possible. Clearly the institutional arrangements and the implementation of policies have to be improved.

1.2 Transformation Policy Choices

One key issue is the degree and nature of the factors determining potential growth: changes in labor supply, capital per worker, and technological change (total factor productivity increase). Another key issue is what portion of GDP society decides to have the government spend on its people – elderly, young, and those of working age. The ratio can be high, as in Scandinavia, quite high as in many other European countries, or more modest as in Japan and the United States. A third issue is how to pursue policies that assure labor, capital, and other resources are fully and efficiently utilized. We, as economists, are good at making recommendations on efficiency issues, but hesitant to make recommendations about these important social choices.

What proportion of GDP will Japanese be willing to transfer to its elderly in the form of public pensions and health care? Should Japan maintain high ethnic homogeneity, or should it encourage substantial permanent immigration? Should it provide incentives to

increase fertility, including more adequate support structures for working mothers and their children? How much should politically-important but economically-inefficient sectors and activities be subsidized, and how can such programs be made more efficient given appropriate transfer programs?

While beyond the scope of this study, social and political changes are a major component of the transformation process. We note several important trends. Today's young Japanese grew up in relative comfort, in contrast to their grandparents in a ravaged 1940s Japan and their parents in the 1950s and '60s. They are considerably better educated, have more international experience and knowledge, and aspire to realize their own career goals. Today's youth have a wide range of interests and lifestyle opportunities, although they have been constrained by their poor employment situation. We do not know which factors are more important in their life-cycle decisions, but the fact is that they are postponing marriage; half the women (and men) aged 30 are not married.

Given that the current young generation is affluent and behave quite differently, the Japanese economic structure, as well as social structure, may well change in the future. The saving rate may drop in addition to a natural decline due to an aging society, and employment practices may change as more young people, voluntarily and involuntarily, find only temporary, part-time jobs as first positions. Higuchi and Hashimoto in this volume find this very unsatisfactory for effective career development.

The postwar Japanese family model -- analogous to the US model of the 1950s -- of the husband working permanently for a large organization and the wife at home raising their two or three children was always an inaccurate stereotype. Most men have always worked for small or medium enterprises and changed jobs from time to time; some two-fifths of married

women re-enter the work force, usually part-time, once their children enter school. However, Japan is the only country that has had a significant drop in the female labor force participation rate for the child-bearing and child-caring age group. Whether this is a voluntary choice or involuntary is debatable.

1.3 Political Change

There was a significant change in the political environment in the 1990s. The Liberal Democratic Party (LDP), always a collection of factions, began to split. In the July 1993 elections, the LDP lost its majority in the Lower House. LDP splinters formed a coalition with other parties to obtain a majority in the Diet, and in August Morihiro Hosokawa became the first non-LDP prime minister since 1955. However, that coalition collapsed after 20 months. The LDP first managed to form a coalition with the Socialist Party (now Social Democrat Party of Japan) yielding the prime ministership to its leader, Tomiichi Murayama. Since January 1996 the LDP has formed coalitions with several smaller parties, including now the New Komei Party, and regained the prime ministership.

The major opposition party in the 1950s through 1970s, the Socialist Party (later renamed the Social Democrat Party (SDP)) participated in coalition government in the early 1990s, but subsequently essentially disappeared. By 2003, the Democratic Party of Japan (DPJ) had emerged as a rival to the LDP. The DPJ is an amalgam of members of most pre-1993 opposition parties (other than the SDP and Communists), newly elected members, and those LDP splinters that did not rejoin the LDP.

In the November 2003 House of Representative election and July 2004 House of

Councilors election, the DPJ actually gained more votes in total than the LDP, but this did not convert to control of either house. (For both houses, most members are elected by districts, the rest proportionally. For the lower house since 1994 the districts are single-seat (replacing multi-member districts); for the upper, they are prefectural.)

While many commentators observe that Japan is approaching a “two-party system” like the United States, one conspicuous difference is that currently the small, but well organized New Komei Party holds balancing power in the Diet.

1.4 International Context

Japan’s transformation is not unique, and not in isolation. The world has changed dramatically as well. The cold war confrontation between the United States and the USSR ended in the late 1980s, and the United States has emerged as the sole military hegemon. The September 11, 2001 terrorist attacks on New York and Washington fundamentally altered US foreign policy, with repercussions for all countries.

The creation of the World Trade Organization (WTO) out of its forerunner, GATT, has strengthened the world trading system despite all its limitations. Global financial markets, essentially market-driven, have become increasingly important: huge short-term and long-term capital flows, exchange rate movements, and expectations about interest rates now strongly affect the economic policies of all major economies. The creation of the system of arbitration panels under the WTO has significantly decreased the chance of unilateral actions in bilateral trade disputes. Some prominent trade disputes between Japan and the United States, such as the Fuji vs Kodak film case, were settled under the WTO panel in favor of Japan.

In addition to these global multinational approaches, regional approaches to trade have proliferated. One of the most important is NAFTA, the free trade agreement among the United States, Canada, and Mexico. Moreover the Free Trade Agreement of the Americas (FTAA) is being negotiated. The FTAA will cover the entire western hemisphere from Canada to Argentina. An even more important group is the European Union; with its 2004 expansion from 15 to 25 members, most of Europe and much of its periphery are now one market.

In East Asia, while Japan remains the largest and by far the most technologically sophisticated economy, the big change is the rise of the Chinese economy. The Chinese economy has grown at about 10% annually over the past two decades, just like Japan in the 1950s and '60s. China has joined the WTO, and has become a major factor in regional and global trade. Given its still low level of income and its still huge numbers of rural workers, China has the potential to continue to grow rapidly for another two decades. China provides Japanese companies both great economic challenges and opportunities. As the Japanese experience over the past two decades well demonstrates, a rapidly growing large economy is better for the world economy than a slowly growing one.

The prospects of North Korean nuclear weaponry and proliferation have added a new security dimension to regional cooperation. If anything, it has strengthened the US-Japan security alliance. At the same time, the six-party talks under Chinese leadership are a new approach to regional security cooperation. However, each country - North Korea, China, the United States, Japan, South Korea, and Russia - has its own interests and anxieties. With a strong economy, many South Koreans now have little sense of military threat from North Korea and are increasingly sympathetic to their North Korean brethren, as reflected in the last

presidential election. We live in an uncertain world and, as various pundits have articulated, the future of East Asia is more uncertain than the past.

2 Economic Malaise Since 1990

The Japanese economy has performed poorly over the 13 years since 1991. It has suffered the malaise of inadequate growth, a soaring unemployment rate and deepening under-employment, bank failures, slow and inadequate corporate restructuring, suboptimal resource allocation, and slow, protracted institutional and structural reforms. Despite immense macroeconomic stimulus, policies of forbearance and relationship-based inertia, as well as policy mistakes, have contributed to the lengthy persistence of this poor performance, termed by many as stagnation, though certainly not collapse. The “lost decade” became a popular nickname for this. We prefer to term the 1990s as a decade of underperformance and malaise, since in fact many institutional and other changes took place. (There are many studies of the 1990s; see for example, Blumstrom et al, 2003; Cargill et al 1997, 2001; Katz 1998, 2003; Lincoln 1999; OECD, 2004; Porter et al, 2000; Posen 1998; and Saxonhouse and Stern, 2003.)

While certainly influenced by the specifics of Japan’s long-run transformation process, all the problems have been made substantially worse by poor economic performance since 1991. A variety of forces have been at work. The bursting of the huge real estate and stock market bubbles in 1990-91 resulted in severe balance sheet and non-performing loan problems for banks, other financial institutions, and corporations. Given the excess of borrowing and

irrational exuberance over real estate and stocks in the 1980s, the collapse of asset markets was inevitable, but major policy mistakes were made in handling the bubble and its bursting. An increasingly huge non-performing loans problem was hidden for too long, and has been addressed in a wrong way; a new financial regime, based on an arm's length relationship between the regulator and the regulated, has been very slow to emerge. In 1995 the Ministry of Finance (MOF) declared that none of the 20 major banks would fail, but Hokkaido Takushoku Bank suddenly failed in November 1997. Subsequently, MOF's regulatory functions were separated out into the new, cabinet-level Financial Services Agency (FSA). Several more big banks failed, and others merged. Japan will soon have three major banking groups representing most banking sector assets, in addition to the still huge postal savings system.

Japan has been caught in the combination of these inadequacies and of the long-run fundamental transformation discussed above. Despite cyclically improving economic performance since the early 2002 trough, major economic problems persist. As discussed below, aggregate demand remains inadequate; deflation has yet to end; land prices continue to decline; corporate, financial institution, and public sector restructuring is far from completed; and unemployment, under-employment, and misallocated labor and capital are particularly serious.

Corporate restructuring destroys jobs in the short run while creating them in the long run. This means social safety nets need to be better designed and deployed. It is clear that solid aggregate demand and good, sustained growth will contribute significantly to the solution of Japan's economic problems. Growth reduces adjustment costs, undergirds financial restructuring, and enhances the effectiveness and efficiency of markets for goods, services,

labor, land, and capital. However, growth alone will is not enough. Supply-side improvements – efficiency-enhancing deregulation and restructuring – must go hand in hand with development and maintenance of inadequate aggregate demand, in both the near term and the longer run.

Japan's macroeconomic difficulties have been deeply intertwined with the weakening of Japan's financial system. In 1990 Japan's banks and life insurance companies were considered to be not only the largest but the strongest in the world. Today, they are still huge, but recognized as the weakest of any advanced industrial nation. Bank lending to business has declined steadily. They hold a large amount of government bonds and equities, but have failed to develop fee businesses. Their balance sheets are still greatly at risk from securities market fluctuations. The government is an exceptionally large financial intermediary, crowding out private-sector institutions, rather than complementing them in the areas of market failures. Government financial institutions, with a huge share of household deposits and life insurance held in the postal savings system, make some 40% of all loans, and are especially important lenders to households (mortgages) and to smaller enterprises. As the Japanese private sector financial system has been fundamentally deregulated and liberalized, many government financial institutions have become weak and redundant, their economic rationale evaporated.

While moving ahead slowly and cautiously on domestic structural reform, the government has embarked on a bold new foreign trade policy approach, initiating negotiations for bilateral (and perhaps eventually regional) free trade areas (FTAs) or more comprehensive, regional trading agreements. These new policies and the issues they raise are discussed in Urata's chapter. Whether this is an appropriate strategy, and whether it will be complementary

to, or competitive with, Japan's global commitments and objectives under the WTO remains to be seen; certainly it is parallel to the earlier NAFTA and EU regional trade policy commitments. The major stumbling block for (Japanese) trade policy continues to be the still-high degree of protection provided small and very inefficient, but politically powerful, agricultural, forestry, and fishery interests.

2.1 Costs of the Malaise

The costs of Japan's poor economic performance and slowness to adjust since 1990 are not hidden but are not necessarily obvious. Despite widespread fears and even dire predictions, the economy did not collapse. While there certainly have been crises for individual companies and even some government institutions, no systemic crisis has occurred. The closest was in the banking and financial systems between September 1997 and March 1998, but a full-fledged crisis, such as a widespread bank run, was averted. Nonetheless, we can conceive of possible adverse scenarios in which large unexpected shocks could _____ create conditions approaching collapse, such as another major Tokyo earthquake, hyperinflation, or war.

Probably the greatest cost of the economic malaise has been the GDP foregone due to below-potential growth for so many years. Japan's GDP could be on the order of 25% higher today if the economy had achieved its growth potential. The high standard of living could have been significantly higher.

In human terms, Japan's most serious problem is a combination of unemployment, under-employment, and misallocated labor. The recent reduction in the reported

unemployment rate from the 5.5% peak in 2002 to 4.6% in September 2004 is an improvement, but it masks major declines in the quality of jobs and in the withdrawal of persons of working age (15-64) from the labor force. As Higuchi and Hashimoto emphasize in their chapter, between 1997 and 2003 the labor force participation rate dropped to its lowest level ever. During this period, employment declined by 2.4 million persons: 1.2 million withdrew or never entered the labor force, and 1.2 million became unemployed. Worse, since 1997 full-time regular employment has continually decreased, while part-time and temporary employment has risen steadily and now comprises more than a quarter of total employment. The hourly wages of part-time male workers are only 51% of full-time males; full-time female workers make only 66% of males, and part-time female workers only 44%. Large department stores now rely predominantly on part-time workers; more broadly firms with more than 1000 employees are replacing retiring full-time workers with part-timers, from 3.9% of their employment in 1995 to 8.6% in 2002, and higher today. The Japanese economy has been experiencing de facto wage reduction, reflecting weak labor demand and slow productivity growth. This is good in the sense that the unemployment rate is less high than otherwise, but bad in the sense that the full potential of the work force is not realized.

In longer-term perspective, the weak labor market has harmed the young - those 15 to 24 - disproportionately. The unemployment rate for those aged 20-24 not in school in 2002 was 9.3%, in 1990 only 3.8%; for those aged 15-19, 12.8% versus 6.6%. The "idle labor" rate - those neither in school nor in the labor force - for those 20-24 was 17.0% in 2002, up from 11.3% in 1990; for those aged 15-19, 24.3%, up from 14.6%. Equally serious has been the increase in young part-time workers. In 2003, young male part-timers comprised 28.3% of their age group, up from 14.9% in 1990 and even lower levels earlier. Some 35.2% of young

female workers were part-timers in 2003, up from 18.4% in 1990 and lower ratios earlier. Most (54.5%) young part-time workers are female.

Some of these young people have voluntarily chosen alternative lifestyles made possible by high wages in an affluent society. The estimates of the non-accelerating inflation rate of unemployment (NAIRU) has risen from its exceptionally low earlier levels, but at about 3.5% it remains significantly below the actual unemployment rate. Survey data indicate most young would prefer full-time regular jobs. The significant rise in the proportion of part-time workers, not limited to but especially among young people, in large part, reflects the still weak demand for labor. In the longer run, this means young workers are not obtaining the benefits of skill development through on-the-job training. This is a major hidden cost of Japan's mediocre economic performance since 1991. (In addition to the Higuchi and Hashimoto chapter, see Sato and Sato, 1997.)

3 Aggregate Demand and Macroeconomic Policy

All the studies in this book make clear that Japan's most important economic policy objective is to achieve good, sustained, full employment growth. That theme runs throughout this chapter as well. While certainly some of Japan's slower growth has been due to changes on the supply side, a main thesis of this study is that Japan's poor macroeconomic performance has been significantly due to inadequate aggregate demand to maintain full utilization of labor and other resources. (See, for example, Amyx, 2004; Ihori and Sato, 2002; Mikitani and Posen, 2000; Posen, 1998.)

Japan's macroeconomic policy since 1991 has been one of extraordinary stimulus, but

even that has not been sufficient in what have been even more extraordinary circumstances. The government has run budget deficits of close to 6 - 8% annually since 1997. Gross government debt now exceeds 161% of GDP though, importantly, as Broda and Weinstein stress in their chapter, the net debt is much lower because the government both owns substantial financial assets and on a consolidated basis owns a significant proportion of its own debt. Nonetheless, both gross and net levels will continue to rise for some time. The Bank of Japan has reduced interest rates as much as possible, with the benchmark overnight bank call rate, analogous to the US federal funds rate, at zero. Yet these macroeconomic policies have not been sufficient to prevent deflation, albeit mild, since the mid-1990s. Relatedly and even more importantly, between 1992 and 2003 Japan's GDP growth averaged only 1.2%, substantially below its potential. In that time there have been three recessions followed by inadequate recoveries in the first two at least.

While it is true this macroeconomic stimulus prevented a full-fledged financial crisis and collapse into 1930s-style depression, that is no great achievement. Other rich, advanced nations have gone through difficult times in the last half-century, but none has done so poorly for so long relative to its potential as Japan. The lack of a successful macroeconomic policy has harmed all parts of the economy, and continues to do so.

The economy was particularly hurt by two major macroeconomic policy mistakes involving premature tightening. The first, in early 1997, was to raise the consumption tax and other taxes while cutting government expenditures, a fiscal tightening swing of some 2 percentage points of GDP. The second was the August 2000 ending of monetary ease when the Bank of Japan raised interest rates in the midst of deflation; while the size of the increase was small, that action had a huge adverse effect on expectations.

Aggregate demand expansion continues to be essential. Only that will narrow the supply-demand gap, restore true full employment, and bring about more positive expectations about Japan's economic future, key to ending deflation. And, as must be repeatedly stressed, growth is necessary both to affect the short-term contractionary effects of industrial restructuring and to provide the foundation for the restructuring of still weak banks, life insurance companies, and other financial institutions.

Although some analysts have continued to propose an even more aggressive short-term cyclical policy of fiscal stimulus in order to revitalize the economy and ensure sustained recovery and growth, many reject increased government spending as politically inspired and economically very inefficient, wasteful pork-barrel public works projects. Building bridges, tunnels, dams, and reclaimed land in sparsely populated areas with little future demand for their services is worse than tax cuts, because the infrastructure investment not only results in construction debt but requires maintenance costs and labor misallocation for years to come. Overspending on public works, partly due to collusion in bidding, is widespread; most voters, even in areas where proposed infrastructure is located, have become skeptical of the value of public works. There has been little domestic call for fiscal stimulus through public works and, indeed, its share of GDP has declined steadily since the mid-1990s.

Proposals of fiscal stimulus through tax cuts have gone nowhere because of deep Japanese anxiety about the persisting huge government budget deficits and the high gross government debt-to-GDP ratio. The spectre of a fiscal crisis sooner or later looms large in the media and the public consciousness, but apparently not in the presumably more sophisticated financial markets, where long-term interest rates (20 year government bonds) remain very low, around 2% or less.

A key policy dilemma is how to increase aggregate demand while curbing government budget deficits and the high government debt-to-GDP ratio. Essentially this is a matter of timing: the near-term versus the long-term. Over the longer term Japanese saving rates will continue to decline and private business investment and personal consumption demand will rise sufficiently to end the output gap and restore normal aggregate demand and full employment growth without requiring huge budget deficits. Also eventually, further near-term increases in the government debt ratio will end and then decrease. These problems are manageable, both in the near- and long- term. A key fiscal issue is whether in the long run the government will be able to achieve fiscal sustainability, namely finance increasing expenditures as a proportion of GDP for the rising elderly share of the population while providing government services to the rest of its citizens as well. The economic issue is how much taxes (government revenues) will have to increase as a share of GDP to meet societal commitments, or to renege on existing commitments in order to maintain incentives for the firms and workers to stay and work in Japan, or to alter income distribution, or other possible reasons.

In one of the most important and controversial studies in this volume, Broda and Weinstein present a careful empirical analysis that argues Japan does not face a fiscal crisis. They found that the potential tax burden of long-term fiscal sustainability is much less dire than the government projects. They estimate that, in due course, government revenues as a share of GDP will have to increase only modestly unless Japan decides to increase levels of welfare to current European levels.

Their analysis is founded on several key points. First, net government debt, not gross, is the correct measure of the government's financial position. It is necessary to subtract Japanese government financial assets from its liabilities, and Japanese government institutions

hold more than half the outstanding gross government debt. For example, the government holds some \$828 billion in foreign exchange reserves, about 18% of GDP; they are financed by government borrowing; and are basically a wash on the balance sheet of the government special accounts. Broda and Weinstein estimate that net debt as of March 2002 was 64% of GDP. They then use a more comprehensive public sector definition, consolidating the central bank (which reduces the net debt ratio to 46%) and the government's unstated liabilities (based on the estimates of Doi and Hoshi, 2003) to arrive at a net public sector debt of 62%, which they use as their baseline estimate for long-term sustainability. They argue there is no need to reduce this level; net debt can rise as rapidly as nominal GDP without causing problems.

In order to have government expenditures in the long term for all Japanese, old and young, increase at the same rate as GDP growth, Broda and Weinstein estimate that government revenues will have to be only 34.6% of GDP, almost the same ratio as in 1990 prior the subsequent tax cuts. The OECD estimate of the average ratio for 1980-2000 was 30.9%, and forecast the ratio for 2004 to be 29.8%.

The Broda and Weinstein estimate of fiscal sustainability is based on reasonable assumptions. These include the population projections made in an IMF study that fertility rates will eventually rise, the population will level off by 2060, and the share of elderly will become constant. The fiscal costs of paying benefits to the elderly during the demographic transition period will be spread over 100 years, which means several generations will share those costs. This implies that the ratio of net (and gross) government debt will continue to rise for some years before beginning to decline, but that is manageable. Broda and Weinstein note that while the share of expenditures in the elderly will increase as they become a larger part of the population, total government expenditures on children will decrease as their numbers

decline. They also estimate sustainable tax rates under alternative, more stringent assumptions.

These relatively optimistic projections are indeed good news. A fiscal crisis will not occur so long as people and institutions continue to believe that Japan can restore fiscal balance in the long run. Tax revenues will have to rise, but only moderately, as a share of GDP. Normal growth will help to increase tax revenues from their current cyclical downturn, but tax rates will have to increase somewhat, though not a great deal unless Japan moves to a European-style welfare state or decides to finance the transition process for the elderly in a much shorter time frame.

Broda and Weinstein also make the important point that inflation has only a temporary effect. It does not solve the long-run government debt problem since it only reduces the value of accumulated past budget-deficit induced government debt, not the government's future liabilities embedded in its commitments, especially to the elderly, but also to all Japanese. Moreover, although an inflationary doubling of the price level would halve the government's gross debt, because so much debt is held by the government itself, the net effect would be relatively small.

While fiscal stimulus may be desirable in the short run, politically it is difficult to cut taxes now while planning to raise them later. The political reality is that the LDP coalition government, which seems likely to remain in power until 2007, has rejected any additional fiscal stimulus measures. Instead it has consistently attempted to keep the annual budget deficit to GDP level more or less constant, and has announced a medium-term goal of achieving a budget primary balance by 2012. In their view that is too extreme a tightening path, especially if the economy grows below potential but, as with all long-term policy

pronouncements, it may well be altered by changed events or new analyses.

4 Monetary Policy

This volume includes two important complementary papers on monetary policy. Inadequate monetary policy is one of the most important factors in understanding the malaise of the Japanese economy in the 1990s and early 2000s. The Bank of Japan (BOJ) was consistently behind the curve from 1993 to 2000, and made a key policy error in August 2000, tightening while deflation persisted. Harrigan and Kuttner convincingly argue that the BOJ could have done better, if only it had known what the US Federal Reserve would have done. Ito and Mishkin provide a comprehensive set of policies for ending Japan's sustained deflation. (See also Cargill et al, 1997 and 2000; OECD, 2004; and Mikitani and Posen, 2000.)

As the Japanese economy fell into deflation in the mid-1990s, the need for monetary policy to do more increased. Most mainstream economists believe that inflation and deflation are monetary phenomena in the long run, and the central bank can influence the course of the inflation rate, not in terms of fine-tuning, but as a medium-run average. From this general point of view, BOJ failures to prevent deflation from happening and then allowing it to be prolonged for so long have been a mismanagement of monetary policy. The timing of adopting the zero interest rate policy (ZIRP) was late; additional actions while ZIRP was in place were taken too late and sent only tentative and at times inconsistent messages; and premature tightening in the midst of ongoing deflation was a major mistake. Even at a zero interest rate, the central bank should influence expectations by promising a credible course of

monetary policy and target inflation rates.

Harrigan and Kuttner compare the macroeconomic situations and monetary policy responses to the ending of asset price bubbles in Japan in 1991 and in the United States in 2000. Growth acceleration and stock price increases prior to the bubbles bursting were similar in the two countries. Japanese fiscal balances improved during the boom years, but deteriorated in the down years, and the US showed a similar pattern with less favorable fiscal consequences. One substantial difference is that Japan has been running current account surpluses in its balance of payments while the US has been running large, increasing current account deficits in the years following the peak of its bubble.

Harrigan and Kuttner argue that monetary easing by the BOJ after the peak of the bubble was slower than in the United States when measured by the respective policy interest rates adjusted for the inflation. Japan's delay in cutting the interest rate in the early stages of the bursting bubble very likely contributed to the start of the long stagnation. One mitigation is that in 1991 and 1992 actual disinflation exceeded expectations, so that a failure to cut the interest rate more aggressively may be somewhat excused. However, that excuse does not apply after 1993. In particular, the BOJ decision to hold the call rate unchanged at 2.25% in 1994 and the first quarter of 1995 actually contributed to a further decline in economic activity by slightly tightening monetary policy in real terms. If the BOJ in 1991-94 had acted like the Federal Reserve in 2001-04, disinflation may not have been as rapid as it was, and more aggressive interest rate cuts in 1994 and 1995 might have prevented the eventual deflation that has occurred.

Harrigan and Kuttner apply an econometric model of the central bank setting the interest rate in reaction to the GDP gap and the expected inflation rate, the so-called Taylor

equation. Then they fit the Japanese data with the estimated US coefficients to determine what would have happened if BOJ had acted like the Federal Reserve. They find that the interest rate would have been reduced to zero by mid-1993, and remained there at least through 1995. They also critically review BOJ monetary policy from 1995 to 2003 and find BOJ response to deflation to be misguided, notably the rate hike in August 2000, or long overdue, as in quantitative easing only from March 2001.

There is no question the current very easy monetary policy should continue until sustained growth is restored and deflation ended. Once sustained good economic performance is achieved, the appropriate monetary policy - when and how to exit the current policy of quantitative easing and zero overnight call market interest rates - is addressed in the Ito and Mishkin chapter. They argue for price-level targeting to catch up with the hypothetical trend line of 1% core CPI increases extending from the 1997 level. (Given the upward bias of the CPI, a 1% rise is in fact price stability, not inflation.) This policy is history-dependent: the longer deflation continues, the higher the average inflation will need to be during the catch-up period. By committing to such a strategy, inflation expectations will become higher as deflation persists (since the requisite “catch-up” will become greater). This aspect of price-level targeting is particularly attractive in the case of deflation. Once the price level catches up with the targeted trend line, Ito and Mishkin propose that the BOJ shifts to regular inflation-rate targeting, for the sake of simpler communication to the public.

The effective coordination of fiscal policy and monetary policy is a key for success in maximizing policy efforts. In the early years following Bank of Japan independence in 1998, especially under Governor Masaru Hayami, relations between the BOJ and its former master,

the Ministry of Finance, were not smooth. (See Ito, 2004.) BOJ executives resisted suggestions from MOF to ease monetary policy more aggressively as a threat to its independence, arguing instead that MOF fiscal policies should be more expansive. However, MOF monetary policy suggestions turned out to be correct, and resisting them was a costly mistake. Under Governor Toshihiko Fukui, since April 2003 the relationship has improved. When the same message is sent both from the government and the Bank of Japan, and when fiscal policy and monetary policy actions are presented as a package, the effects on the economy will be maximized.

5 Financial System Difficulties

Japan's macroeconomic difficulties have exacerbated the prolonged and profound weakening of Japan's financial system, as is analyzed in this volume in three related chapters: on banks by Hoshi and Kashyap, on the life insurance industry by Fukao, and on government financial institutions by Doi. What was considered to be an extraordinarily large, strong and effective financial system in 1990 has become one of the weakest among advanced industrial nations. Virtually every financial institution has been overwhelmed by the major declines in stock and real estate prices, non-performing loans, very low interest rate spreads for banks, negative carry for life insurance companies, persistent if mild deflation, and the consequences of management mistakes.

Hoshi and Kashyap stress that, despite huge write-offs of non-performing loans and improvements in the last few years, the capital position of almost all Japanese banks remains

extraordinarily weak. The reduction through mergers and failures from 20 big banks in 1990 to 8 in 2004 created huge but not stronger banks. Mergers have not resulted in substantial cost cutting or in the development of new, more effective business models. Moreover, bank lending policies worsened asset quality. While bank total loans have decreased significantly, loans to very weak, large borrowers (zombie firms) have been maintained and in some cases even increased. They emphasize that supervisory and regulatory reforms by the Financial Services Agency (FSA) under Minister Heizo Takenaka to restructure bank balance sheets and identify and deal with non-performing loans have been an improvement over the past, but should be further strengthened and pursued even more vigorously. Nonetheless, these are only the first step to restoring bank competitiveness and strength. They stress the reality that many banks remain undercapitalized and need to be recapitalized. Several ways to capitalize banks have been proposed and implemented. The government can inject capital into weak but solvent banks that are essential to the systemic stability or the local economy where the bank is based, as has been done in the past. If injected as shares, the government can sell them in the market, rather than having the bank pay the capital back to the government.

The banking system continues to be plagued by overbanking: very thin lending spreads and low profitability. As Hoshi and Kashyap make clear in their policy recommendations, even the ending of deflation and restoration of good economic growth will not be sufficient to create a competitive banking system within a reasonable time period. Moreover, once the economy returns to normal and interest rates rise, banks will suffer losses on their immense government bond portfolios; it is not certain that gains in their stock holdings will be sufficient to cover those losses. The major Japanese banks need both to improve their IT infrastructure and to develop new, fee-based sources of income, still extraordinarily low in international

comparison. Traditional bank deposit-taking and lending is no longer profitable since large, sound firms can raise capital and borrow through the capital market. Banks are slow to adapt to a new deregulated environment by changing their business model. (See Hoshi and Kashyap, 2001; Hoshi and Patrick, 2000; and Ishigaki and Hiro, 1998.)

Bank restructuring has gone much less far for regional and local banking institutions, especially second-tier banks and credit associations. Many continue to have severe non-performing loan problems. The June 2004 legislation providing 2 trillion yen (about \$18 billion) of government funds to facilitate bank rescues and mergers by injecting capital as needed and requested without declaring them insolvent signals that the FSA is finally prepared to tackle regional bank balance sheet problems. How strongly and effectively the FSA will move, and how the politically powerful local banking institutions will respond, remains a serious concern.

The government is an exceptionally large financial intermediary in Japan. The post office system, through postal savings accounts, holds some 30% of household total deposits and 37% of life insurance industry gross assets, both far larger than any private financial institution. Part of these funds are invested in government bonds, but much, together with government-controlled monies, are transferred to a host of government financial institutions (GFIs) and special public corporations (SPCs), through the Ministry of Finance's Fiscal Investment and Loan Program (FILP) and other channels which have recently been put in place in FILP reforms introduced in April 2001. Nonetheless, these financial flows, and GFI and SPC activities, have been very opaque.

Doi in his chapter provides the first careful, detailed analysis in English of GFIs and SPCs. They are a major source both of the burgeoning government debt and increases in

government financial claims on the private sector. However, they have huge non-performing loans (on the order of 36 trillion yen) yet to be addressed. Doi focuses on 10 major GFIs and SPCs. Together they make about one-fifth of total loans to businesses and households, especially smaller firms and housing mortgages.

Doi stresses that, as the economy has matured and the financial system has been fundamentally deregulated and liberalized, many government financial institutions have become weak and redundant, and their economic rationales have evaporated. They distort markets by competing unfairly with the private sector. They are inefficient because their activities are explicitly or implicitly guaranteed by the government; this soft budget constraint means that deficits are inevitably covered by government subsidies. The potential liabilities of the government are open-ended: there are no clear statutes for bankruptcy of GFIs or SPCs.

Doi identifies the specific set of problems for each GFI or SPC and proposes appropriate solutions. More broadly, he recommends that these government institutions be required to raise funds by selling their bonds in the market, as has only just begun, in order to impose market discipline. However, so far the spreads show the market views their bonds as having at least an implicit government guarantee. He also recommends that some institutions be closed and that the others be transformed into state-owned companies with limited liability and a hard budget constraint.

Reform of the postal system through privatization has long been a major priority for Prime Minister Junichiro Koizumi, despite opposition from many of his fellow LDP politicians who benefit from the local power of the special postmasters in some 24,000 post offices. The Koizumi government now has underway proposals for major privatization of the postal system

over a long-term (17-year) period. (See Cargill and Yashiro, 2003.)

The postal system has three business lines: mail delivery service, postal savings, and postal life insurance. Each is a giant in its respective industry, so simple privatization will create huge institutions with strong market power, in conflict with a good solution in terms of competition policy. Moreover, as Doi points out, cross-subsidies are a source of unfair competition. However, a separation of each business line into regional divisions could reduce the value of the services provided to households.

Regarding postal delivery services, the incumbent provider - the Ministry of Public Management, Home Affairs, Posts and Telecommunications - argues that mail service should be universal, and that private-sector entrants should be required to provide universal service. That makes new-entry prohibitively expensive. Package deliveries are competitive markets as several private-sector delivery services and the postal system compete with each other. Private companies argue that the postal system has an unfair advantage that it does not pay taxes on their real estates or profits.

Postal savings and postal life insurance compete directly and powerfully with private financial institutions. In an effort to deregulate and privatize postal financial services, there are several absolutely necessary requirements, and others that are more controversial. The first requirement in reforming the postal saving system is that the system should have to pay the same deposit insurance premium as banks. This is both to achieve a level playing field and to eliminate the government current blanket guarantee of deposits. The system may be effective in collecting deposits, but it has little expertise in the portfolio management of these funds; it has no capability to make efficient, informed loan decisions. However, the Ministry wants the postal system to expand into loan businesses. Doi proposes that the system be transformed

into a narrow bank, accepting savings deposits but holding only government bonds as assets. That obviates any increases in banking services in an already over-banked financial system, and eliminates the need to develop expertise in providing bank services. It also eliminates the threat of market power, while providing depositors with safe assets and the government with continued ready access to household savings.

In his chapter on the life insurance industry, Fukao incorporates an analysis of the government postal life insurance system (*Kampo*), which controls more assets than the five largest private companies combined. *Kampo* receives substantial government subsidies, explicit and implicit, including tax exemption, government guarantees, and cross-selling with deposits. These subsidies should be addressed first. How to privatize postal life insurance while ending its excessive market power is one of the key challenges of any privatization program.

Fukao paints a stark picture of the life insurance industry from the 1990s to the present. The private-sector now comprises some 40 companies. Many are new entrants, both Japanese and foreign, following reductions of restrictions on entry in the 1990s. Seven traditional companies failed in the 1990s due to weak management of interest-rate risks, excessive exposure to stock market declines, perverse incentives, and lax regulatory supervision; in fact, though not reported at the time, they were deeply insolvent when they became bankrupt and were sold off.

Fukao focuses on the 10 major companies that together now have a dominant market share. The fundamental problem for all these firms is negative carry, the fact that the guaranteed rates of return on policies sold prior to the mid-1990s are substantially above the

rates of return on company assets in Japan's low interest-rate environment. As a consequence, these life insurance companies are suffering losses and depletion of their capital. Fukao shows that the adjusted solvency ratios are substantially weaker than reported, and several companies are in considerable difficulty. If negative carry persists, more firms may become bankrupt or be forced to reduce the guaranteed rates to policyholders, which is now allowed but will have adverse effects on their reputations in increasingly competitive markets.

Fukao also analyzes the problems of poor asset-liability management, weak corporate governance, weak regulatory supervision, double-gearing between life insurance companies and banks, and the market distortions generated by Kampo. He proposes a range of policies to restore the industry's strength, including more effective supervision and regulation, ending the inclusion of deferred tax assets in capital, and prohibition of double gearing.

These three chapters make clear how significant the remaining problems of financial system reform are, and propose what should be done. Structural reform of Japan's banks, life insurance companies and, especially, its government financial institutions are essential to overcome distortions in resource allocation and economic activities.

6 Corporate Restructuring and Financing

All sectors, companies, and households have suffered through the long period of malaise. Credit is the life blood of all businesses, and the profound weaknesses of the banking system have had great adverse spill-over effects on all economic activity, as Iwaisako discusses in his chapter analyzing business investment and restructuring. Well functioning, competitive

banking and financial systems are essential to allocate resources more efficiently so as to increase GDP growth.

Although corporate restructuring has made some progress, much remains to be done before Japan can become a normal, efficient economy based on competitive markets without large nonperforming assets. The average return on equity remains low in international comparison, and the gap between strong and weak firms in all size categories has widened. In addition to the highly publicized cases of very large, inefficient, heavily indebted zombie firms subsisting on credit rollover and new injections from main banks, many small and medium enterprises remain weak due to a combination of still-huge debt burdens and loss of competitiveness in a changing domestic and global environment. The government made progress on this front by creating the Industrial Revitalization Corporation Japan (IRCJ) in April 2003, a semi-public arm of corporate restructuring. Together with the main banks, it restructures the overly-indebted companies, taking stakes in the company. Firms with good cash flow have focused primarily on paying down debt to restore balance sheets. All too many firms have yet to develop, much less implement, more effective business models. Restructuring of inefficient government special corporations and agencies so far has been quite slow. These will be enduring problems even after the private-sector economy returns to a stable equilibrium growth path.

Iwaisako notes that business investment has slowed to about 15% of GDP, but is still higher than in the United States and certainly high relative to the GDP growth rate. The slowdown in business investment was due primarily to lack of business demand and the need to restore balance sheet equilibrium by paying down debt, despite a brief credit crunch in late 1997 and early 1998. He identifies as a major problem the slowdown in productivity growth,

due in part to the slowdown in the reallocation of capital and labor across industries. He identifies the misallocation of bank credit as a serious problem. Because banks are weak and insiders in the non-performing loan problems, they have continued lending to weak borrowers (evergreening). Banks have not been able to engage in their earlier monitoring and restructuring roles as outside, objective arbiters.

New private financial institutions engaged in business restructuring have developed only since the late 1990s. Not surprisingly, restructuring brings to the fore conflicts between conventional business practices based on management control and the painful requirements of restructuring and of new corporate governance modes. Most restructuring has been taking place through normal private-market mechanisms and that is desirable. Government policies have been supportive, especially in legal and institutional changes to make management decision choices, corporate governance, and capital markets more effective.

Government policies to deal with the asset management difficulties of large, virtually insolvent companies have been ad hoc and partial, unlike countries such as Korea in which a government asset management company was established and required to purchase bank bad loans, with the government temporarily taking over majority ownership of the banks. The Japanese government established the Reconstruction and Collection Corporation (RCC) in the mid-1990s, but it has served mainly to take over non-performing loans of financial institutions in difficulty, and not so much in the restructuring of the corporate borrowers. The IRCJ is more active in restructuring large companies but inevitably will have a relatively limited direct role since it has only a five year life.

Iwaisako considers two important cases of government intervention in restructuring. One is the nationalization of the Long-Term Credit Bank, the terms of its eventual sale to

Ripplewood, and re-establishment as Shinsei Bank. He notes that the government and business community were implicitly expecting Shinsei to play according to the existing game -- to keep lending to existing borrowers regardless of quality, not to exercise the put option on non-performing loans they had to take on, and in general not to rock the boat. Instead Shinsei behaved as a rational economic actor. That incurred wrath from traditionalists, but was ultimately successful. The second case was the placing of the excessively diversified, heavily indebted Kanebo into the IRCJ process in mid-2004.

Iwaisako draws several conclusions. Restructuring often needs a third, outside, party that is not involved in embedded, tangled long-term relationships among the company, its main banks, and other interested players. Government intervention should be limited in order not to crowd out private market restructuring efforts; it is desirable only when there are obvious market failures, and generous government bail-outs are at the expense of taxpayers and healthy competitors. He judges IRCJ to have been successful. However, he is more skeptical of the increasingly extensive restructuring activities of the Development Bank of Japan (DBJ); it is more problematic because the DBJ is more vulnerable to political pressure, and because its objective to ensure its own survival may be more important than efficient resource allocation.

Efficient corporate restructuring usually involves downsizing, including reducing the numbers of employees. In Japan, job cuts have been mostly through natural attrition and, in extreme cases, early retirement buy-outs. As Higuchi and Hashimoto discuss, labor market adjustments inevitably are specific, depending on age, skill, gender, and geographical location. They propose programs to enhance labor mobility, including training programs to ensure the smooth transition of workers to new employers rather than trying to protect existing jobs. They, too, emphasize the importance of good GDP growth to reduce unemployment, increase

labor force participation rates through new employment, and make the reallocation of labor easier.

Most corporate finance has continued to be provided by banks and, especially for small and medium enterprises, government financial institutions. Japan's financial system Big Bang policies of the late 1990s have accelerated the development of capital markets. Nonetheless, the Tokyo capital market is still relatively costly. The legal framework is not up to international best practices, and rules and regulations are not foreigner-friendly. Prospectuses and balance sheets have to be written in Japanese. Stock transactions and registrations are now electronically based, registration of ownership can be done with the stock depository, and changes in ownership are much easier than before. Further development of the Tokyo capital market is necessary.

Fujii in her chapter analyzes the development of the corporate bond market since the late 1990s, which is important because bond issue will become a significant source of business finance, as in other advanced countries. She uses her own survey of participants in the Tokyo market, and analyzes market effectiveness through bond pricing models. Respondents identified taxation issues and lack of human capital (professional expertise) as major problems.

Prior to deregulation culminating in the Big Bang, regulations restricted corporate bond issue to only a few top-class companies. Now government restrictions on corporate bond issuance are minimal, and previously high issuance costs have been reduced substantially. However, a market has not yet developed for high yield, below investment-grade, bonds. Nor has an appropriately priced middle-market for more risky bank loans. Fujii concludes that corporate bond market pricing is working reasonably well in that prices and their credit-default swaps (CDS) are consistent based on monthly data. Estimates of changes in the implied

ratings by credit rating agencies and their actual bond ratings move together quite closely. Nonetheless, liquidity remains low.

Fujii recommends that the government encourage the private market by leaving it alone, while making appropriate changes in the tax code to ensure that tax treatment is equal and neutral. Market participants, Japanese and foreign, have to develop and apply increasingly sophisticated financial technology, rather than relying on government policy prescriptions. She recommends that the government stay away from attempting to regulate high-risk markets, such as venture capital, distressed assets, and high-yield bonds. Of course there are areas where the government regulators should take useful initiatives, such as providing a more efficient settlement system and specific measures to reduce barriers that raise administrative costs.

7 Japan's New Trade Policy

Japan's foreign economic policy has long been founded on its comprehensive security, political, and economic alliance with the United States, its commitment to an open, globally multilateral trading system under GATT and its successor the WTO, and the market-based system of global financial and direct investment flows. (See Lincoln, 1999.) Japan and the United States have provided learning experiences and models for each other, as exemplified in this volume by the Harrigan and Kuttner chapter on lessons for US macroeconomic policies from Japan's experience. These approaches and commitments have not changed. However, a new dimension has emerged in response to the increasing reliance on regional trading arrangements

by the United States and the European Union, and due to the rise of China as an economic power. Japan also has embarked on a new trade policy, one of bilateral cooperation under free trade agreements (FTAs) or, more comprehensively, economic partnership agreements (EPAs).

Traditionally, Asian countries have not formed significant preferential trading arrangements. The ASEAN Free Trade Area (AFTA) is a regional trade agreement, but the lowering of tariffs among the 10 members has been slow. Japan, Korea, and China had been the only three outliers - not joining any regional preferential agreements. Japan's first FTA is with Singapore, effective from 2002. Korea concluded its first FTA negotiation with Chile in 2004. Now there are frenzied FTA negotiations among Asian nations. China has proposed an FTA with ASEAN, followed by Japan's proposal. Thailand is negotiating more than a dozen FTAs. The United States has negotiated an FTA with Singapore and Australia. Japan signed one with Mexico in 2004, and is negotiating with the Philippines, Thailand, Malaysia, and Korea, as well as with ASEAN as a group. How these will shape trading arrangements in Asia remains to be seen.

In his chapter, Urata explains Japan's policy motivations and strategy, and strongly recommends Japan pursue the FTA path in a manner complementary to the WTO. One reason is defensive. In the worst case scenario, Japan may become isolated from a world of three dominant FTAs --the EU and its expansion; NAFTA, the proposed FTAA, and ongoing US bilateral FTA negotiations; and an expanded AFTA with an increasingly powerful China. Another motivation arises from an increasing economic policy focus on East Asia, the most rapidly growing region of the world. The 1997-98 currency, financial, and economic crisis substantially accentuated East Asian interest in greater regional economic cooperation. Urata argues that FTAs will both expand Japan's market access in trade and investment and contribute

to Asian economic growth. Japan's approach is more comprehensive than liberalizing trade barriers; it focuses on investment, movements of skilled peoples, and facilitation and cooperation in a range of areas. In this respect, it aims to support the global system by addressing and testing solutions to a range of international economic issues not currently covered by the WTO. At its best, in Urata's view, an effective policy of FTAs can be a catalyst for Japan's economic revitalization.

Urata recognizes that the strongest opposition to this new FTA policy are powerful domestic protectionist forces and lobbies, particularly in agriculture, fisheries, and other labor-intensive sectors. These sectors are by far Japan's most inefficient economically. The conflicts between them and other business and industrial interests have become increasingly open and pronounced, in part due to the FTA negotiation realities. For some, the FTA approach reflects a foreign pressure (*gaiatsu*) to force change in the overdue domestic issues. Japan needs a fundamental reform in its approach to these sectors, perhaps by shifting to a system of guaranteed income subsidies for existing farmers combined with free imports and acceptance of world prices, much to the benefit of consumers. Even without dramatic policy solutions, these sectors will gradually weaken due to a lack of interest among young people in working in them, and policies will have to move toward a more efficient resource allocation. The question is how soon and how efficiently. Until policy makers can overcome the protectionist forces, it will be very difficult to pursue and implement a comprehensive FTA strategy because Japan's trading partners will insist on access to these markets.

Comprehensive and detailed policy recommendations are made by the chapters' authors, founded on their careful analysis. We do not attempt to summarize their recommendations here.

We recommend the following policy actions in the near term. The highest priority is to end deflation and put the economy back on a good, sustainable growth track. Since a substantial output gap still exists, growing above potential for a few years will not cause substantial inflation. Growth should be supported by monetary and fiscal policy to ensure adequate aggregate demand. Until the price-level target described by Ito and Mishkin is achieved, continuing the zero interest rate policy and quantitative easing is appropriate. The Bank of Japan should learn from the US Federal Reserve Board in carefully avoiding deflation as well as inflation, as suggested by Harrigan and Kuttner. Once sustained growth is achieved, the fiscal situation can be dealt with in the medium and longer run, as Broda and Weinstein show.

Restoring health to banks and insurance companies is another key to getting the economy back on track. Hoshi and Kashyap, and Fukao, emphasize the importance of rigorous supervision and regulation, together with rigorous implementation by the FSA to restore financial institution balance sheets and to create the right incentives. Regional and local banking institutions in particular need to reduce their still-high non-performing loans, which entail substantial restructuring, merger and consolidation. Solvency margin regulations and rules for life insurance companies have to be tightened, as Fukao strongly asserts.

We do not endorse the “cleansing view” that recessions effectively and naturally improve resource reallocations and bring about adequate structural reform, and indeed Japan’s

past 13 years indicate that is not the result. As the economy recovers, strong reform and restructuring policies and efforts should be strengthened for all financial institutions and businesses, private and governmental. The full and effective utilization of labor in appropriate jobs, as detailed by Higuchi and Hashimoto, and the effective reallocation of capital as emphasized by Iwaisako, is the way to enhance productivity improvements and achieve better growth in both the near and medium terms. In particular the creation of better job opportunities for young Japanese is essential to maintain a highly skilled labor force. In addition, markets and social norms have meant that female labor is not allocated well. Institutional support for child-bearing and child-caring women is essential to take advantage of their potential productivities, and appropriate policies could increase the incentives to have children, thereby raising the fertility rate. Better-functioning capital markets, especially the further development of the corporate bond market, will contribute to the more effective allocation of resources, as Fujii argues.

In the medium to longer term, once deflation is over and sustained growth is achieved, the Bank of Japan should adopt some form of inflation targeting, preferably explicit, as is proposed by Ito and Mishkin. Then it will be possible to reduce, even eliminate, government budget deficits, and stabilize the government gross and net debt ratios to GDP. Fiscal sustainability can be achieved without huge increases in the share of taxes in GDP so long as the transition costs are financed over a sufficiently long time period, as Broda and Weinstein show. Structural reforms of the government financial institutions and special public corporations, and of local government institutions, are essential in order to allocate resources more efficiently and to reduce the government's contingent liabilities inherent in the existing soft budget system, as Doi forcefully argues. For social and political reasons, reform of

government institutions cannot be achieved quickly, but the process has to begin and be strengthened now. The government's fiscal difficulties provide policy makers an incentive to make the difficult decisions the governmental reforms necessarily entail.

Two aspects of Japan's relations with other countries, particularly those in Asia, are especially significant in the medium to longer term. One is the development of free trade agreements and, more precisely, economic partnership agreements to liberalize trade and investment flows, as Urata argues. The deepening of Japan's economic integration with its neighbors has significant political and security implications that probably exceed the economic benefits. The other is for Japanese to decide the appropriate role of foreign workers. In an immediate context, the demands of Thailand and the Philippines in FTA negotiations with Japan for liberalized worker visas are stimulating debate in Japan, with a generally positive view. In the longer run, how and to what degree to allow and even encourage foreign-worker immigration must be debated.

We are confident that in due course the Japanese economy can and will rise again. The economic and social fundamentals are still strong. As the government, and private sectors as well, accept and implement the policy recommendations embedded in this volume, the economy will do better on both the demand and supply sides. While near-term growth potential is quite high because of under-utilized labor and other resources, even in the longer run it is not only quite likely but probable that Japanese will achieve per capita GDP growth at least as good as the average for the other G7 countries.

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There is an extensive professional literature in Japanese and English on various aspects of Japan's economy over the past 15 years. Most is in the form of journal articles. Since the authors of the other chapters refer to the literature in their respective fields, we limit our references primarily to relevant books in English as general background.

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