Problems and Prescriptions for the Japanese Economy:

An Overview

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Abstract

The bursting of the asset and real estate market bubbles in 1990 and 1991 marked the conclusion of Japan's momentous postwar economic growth and ushered in a new period of economic stagnation and malaise. This paper serves as an overview of the forthcoming 11 chapter publication: *Reviving Japan's Economy: Problems and Prescriptions*, co-edited by Takatoshi Ito, Hugh Patrick, and David Weinstein. Here we provide a brief summary of the stagnation and offer some broad policy recommendations derived from the analysis contained in the volume. The 14 years, from 1991, of economic malaise characterized by falling prices, worsening deflation, failing banks and life insurance companies, and rising unemployment and underemployment must be understood in the context of a long-term, multifaceted, national transformation process- economic, demographic, social, and political. Economic underperformance was exacerbated by poor policy decisions, notably the premature tightening monetary policy in the midst of ongoing deflation. The very slow rate of corporate and government restructuring, and the protracted evolution of institutional and corporate governance also played a significant role. The economy recovered well between early 2002 and the first quarter of 2004 but subsequently stalled during the year. Japan's economy has yet to return to a path of full-employment and self-sustained growth. The highest priorities are to achieve sufficient aggregate demand, essential to restore full employment growth; to end persisting deflation; and to promote both private sector and governmental institution restructuring. There will be no economic basis for a fiscal crisis so long as Japan commits to restoring fiscal balance in the very long run. Because the nation's economic and social fundamentals remain strong, we are optimistic that Japan will emerge from this transformation stronger than ever.

Introduction

With the bursting of its asset and real estate market bubble in 1990 and 1991, Japan's economy entered into a long period of mediocre performance that by 2002 and early 2003 was accompanied by growing pessimism about Japan's future among scholars, policy makers, and economic commentators, both inside and outside Japan. 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 a decade earlier. Deflation seemed to be worsening, while the unemployment rate was increasing to an unprecedented level. Monetary policy seemed impotent after the benchmark interest rate became zero. Fiscal policy seemed to be powerless as large government spending and tax cut packages failed to lift the economy long enough to generate a self-sustaining recovery.

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

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 this recovery was no more than a cyclical upturn. Earlier recovery attempts in 1996 and 2000 had been followed by disappointing recessions. This proved to be true once again, as a strong first quarter in 2004 was followed by three quarters of essentially flat growth. While the economy will probably recover once again in 2005, it seems unlikely that the recovery will be sufficiently strong or durable to get back onto the path of sustained growth to achieve the economy's full potential. Our deep concern is that fundamental economic and institutional problems will remain inadequately address, possibly inducing another crisis (see Patrick, 2004).

Japan does have feasible, optimal economic policy solutions to the major economic problems and issues that have undermined its 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 its people's quality of life, 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 to return Japan to long-run sustainable economic growth. The following chapters, written by outstanding Japanese and American economists are forward-looking, but founded on a careful analysis of Japan's recent economic history.

As general context for the following chapters, in this introduction we outline the long-term economic transformation now underway and relate the major economic problems in Japan's 14 years of malaise to that extended process. Subsequent chapters in the book 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 found in subsequent chapters are incorporated into this overarching discussion, which ends by summarizing 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.

1.0 Japan's 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 long-term forces at work. Three major economic transformations have been underway: the completion of the catch-up process of fast growth as Japan changed from a low income country to a mature economy with a high per capita GDP and standard of living; the ongoing demographic transition to long life expectancy, low fertility, and an aging population; and the 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 extraordinarily 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's productivity frontier. This was achieved through the effective utilization of an initially cheap, abundant and skilled labor force; entrepreneurial business investment that applied newly available technologies; a rapidly increasing (and ultimately) very high saving rate that provided domestic financing for the burgeoning rate of business investment, the development of synergistic postwar economic institutions and supportive government economic policies. By the mid-1970s, Japan had caught up with the West, becoming the world's second largest economy with European levels of per capita GDP and a high standard of living. From

1980 on, Japan became an increasingly large foreign investor, both direct and portfolio, and by the 1990s by a wide margin had become 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 economy (characterized by companies like Microsoft, Goldman Sachs and CNN).

In the high growth, catch-up era, from the early 1950s to the mid 1970s, Japan's 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 then and still now are controlled by entrenched professional managers, trained and promoted from within to serve as chief executive officers and board members. Any weak firms and banks were merged with healthy ones through backroom discussions and the encouragement of regulators. Declining industries, such as coal, changed through a very gradual process; a few industries that were obviously uncompetitive, such as aluminum, shrank much more rapidly. The economic 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 inception until 1993, and since 1996 has continued to be the dominant leader in a series of coalition governments.

In some respects, by the late 1980s Japan had become a victim of its own economic success. The economy grew too large to be managed effectively based on personal relationships.

Japan was gradually moving toward a more market-based, open economic system. For good domestic and foreign policy reasons, the government initially reduced its early postwar controls over prices, then foreign exchange rates, foreign capital flows, and trade in manufactured goods. Piecemeal financial deregulation, a twenty-year process, began in the mid-1970s. Many government enterprises were partially or totally privatized in the 1980s. Airlines are now 100% privately owned; railway companies are partially private; 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.

In Japan, as in other countries, development and growth brought major changes in the economic structure. Agriculture declined to minor economic significance (but remains politically potent); the share of the manufacturing sector rose sharply and then gradually declined; and the portion of the economy centered on 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 wide gap suggests both a potential for better growth through more effective resource reallocation and the real difficulties of major structural adjustment for low-productivity service industries, especially retail and wholesale trade, and construction.

It is our view that Japan successfully overcame several economic challenges in the past, but since the 1990s Japan has really stumbled. We should not forget how Japan overcame difficulties in the 1970s and 1980s (for a comprehensive review of the Japanese economy before the bubbles burst in 1990 and 1991, see Ito 1992). The economic turmoil of the 1970s brought on the first set of challenges, and the mid-1970s was the first inflection point for the Japanese economy. The yen had just been floated for the first time since World War II. Inflation reached 30% in 1973, due partly to monetary easing the year before but particularly due to the quadrupling of oil prices. Strong tightening to halt inflation caused negative growth in 1974 for the first time in the postwar period. Following the first oil crisis, business optimism and investment slowed more than the gradual reduction in household saving rates. The energy resource constraint and increasingly obvious pollution problems put a brake on the overwhelmingly 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 regain its growth path. Private sector aggregate demand was no longer excessive relative to supply, and weakened sufficiently to require government macroeconomic stimulus. Credit rationing was no longer necessary, and credit became easy; the Keynesian paradox of excess saving, initially perceived to be cyclical, became long-term and structural. Japan, as the world's second largest economy, has from the 1980s been unable to export all of its excess domestic savings because the requisite concomitant huge trade (and current account) surpluses were and are unacceptable to the United States and Europe.

The second big challenge the Japanese economy faced was in 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 soared and the economy enjoyed rapid growth. By 1984 Japan's current account in its balance of payments had turned to substantial surpluses, while that of the United States had turned to large deficits. The Plaza Accord of September 1985 was supposed to correct exchange rate misalignments and restore equilibrium exchange rates for the major OECD countries. The yen appreciated from 260 per dollar in February 1985 to 240 just before the Plaza Accord in September, and 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 yen per dollar by the fourth quarter of 1986.

Given the severe appreciation in the yen's value, fears arose about the collapse of Japanese exports and the economy in general, but the economy was more resilient than expected. Monetary policy was greatly eased from 1985, and the economy embarked on rapid growth based on private demand. Accordingly, the government was able to pursue fiscal consolidation throughout the 1980s, and achieved a balanced, even surplus, budget by the end of the decade. Japan recovered from the yen appreciation of 1985-86, and from spillover effects from the American 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 and real estate bubbles. Land and stock prices had risen four-fold in 6 years. No one would dare to forecast those gains would be erased in the following 13 years.

The bursting of the bubble and the ensuing stagnation of the 1990s through 2004 has been the third and biggest challenge faced by postwar Japan, and it has been much more protracted than necessary. Asset price declines resulted in huge amounts of non-performing loans, giving rise to 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 attained the status of myth before being seen as mistaken. The two 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 twin bubbles shattered the land price myth, and raised doubts about maintaining an annual growth rate greater than 4%. 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 through much of the 1990s. We are concerned that excessively optimistic perceptions are widely voiced once again in early 2005.

1.1 Demography

Japan's long-term demographic transformation is as profound as its economic one. Over the 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 a nation of very low death rates, even lower birth rates, and the longest life expectancy in the world. As a result, Japan has a rapidly aging population. Since 1995 there has been an absolute decline in the working-age group (15-64), and by 2007 population size will peak. Population stability occurs when the completed fertility rate is about 2.1; currently it is only 1.29. The Japanese level is comparable to Italy's very low fertility rate, both of which are among the lowest of OECD countries.

In this volume Broda and Weinstein cogently point out how unrealistic is the common assumption that Japan's low birth rates will persist indefinitely; that means that the Japanese eventually will disappear. 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. Demographic assumptions are important in analyzing long-run issues of fiscal sustainability, namely how much government revenues will have to be raised as a share of GDP to meet social security commitments to the elderly.

High or low dependency rates -- the number of children and elderly as a percentage of the working-age population -- provide information on growth prospects and the needs for government expenditures (including income transfers), but depending on the characteristics of the social security system these dependency rates do not necessarily imply fiscal and economic problems. However, the current Japanese social security system, designed as a pay-as-you-go program, 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, an issue we stress even though it transcends the topics of this book.

1.2 Transformation Policy Choices

One key issue for Japan's long-term economic performance is the degree and nature of the factors determining potential growth: changes in labor supply, capital investment 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 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.

What proportion of GDP will the Japanese be willing to transfer to their 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? As economists, we are good at making recommendations on efficiency issues, but are hesitant to make recommendations about these important social choices.

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' experiences in a war-ravaged 1940s Japan and their parents' experience in the 1950s and 1960s. In contemporary Japan young adults are considerably better educated, have more international awareness and experience, and aspire to realize their own career goals. Today's young adults have a wide range of interests and lifestyle opportunities, although they have been constrained by their poor employment situation. We do not know what figures most importantly in their life-cycle decisions, but the fact is that they are postponing marriage: half the Japanese women and men aged 30 are not married.

Given that the current young adult generation is affluent and behaves quite differently than previous generations, Japan's economic structure, as well as its 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 their first professional positions. Higuchi and Hashimoto find this trend very unsatisfactory for effective career development, as discussed in chapter 10.

The postwar Japanese family model -- analogous to the American 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 Japanese men have always worked for small- or medium-sized 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 start school. However, Japan is the only advanced country that has had a significant drop in the female labor force participation rate for the child-bearing and child-caring age group. It is debatable whether this is a voluntary choice or involuntary.

1.3 Political Change

In the 1990s there was a significant change in the political environment. 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 splinter groups formed coalitions 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 the

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 the coalition government in the early 1990s, but later 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 splinter groups that did not rejoin the LDP.

In the November 2003 House of Representative election and the July 2004 House of Councilors election, the DPJ actually gained more votes in total than the LDP, but these victories 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 prefectual.

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. Prime Minister Junichiro Koizumi’s term as LDP president and hence as prime minister ends in September 2006. His successor is far from certain. The possibility of further party member realignments based more on common policy positions than on history is real.

1.4 International Context

Japan's demographic and political transformation is not unique, and not isolated. The world has changed dramatically as well. The cold war confrontation between the United States and the former Soviet Union 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 American foreign policy, with repercussions for all countries.

The world trading system has been strengthened by the creation in 1995 of the World Trade Organization (WTO) out of its forerunner, the General Agreement on Trade and Tariffs (GATT), despite its remaining limitations. Global financial markets 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 nations. 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 versus 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 of these is the North American 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 regional trading 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 economic rise of China. The Chinese economy has grown at almost 10 percent annually over the past two decades, just like Japan in the 1950s and 1960s. 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 with 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 capability have added a new security dimension to regional cooperation. If anything, the North Korean issue has strengthened the security alliance between Japan and the United States. 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 its past.

2 Economic Malaise Since 1990

The Japanese economy has performed poorly over the 14 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, sub-optimal resource allocation, and slow, protracted institutional and structural reforms. Despite immense macroeconomic stimulus, policies of forbearance, relationship-based inertia and 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 stalled period of economic growth. 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 Japanese economy in 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.) Indeed, the succession of recoveries and recessions in the first five years of the 21st century undermine predominant focus on the 1990s; we now have to think of Japan's underperformance extending at least 15 years rather than 10.

While certainly influenced by the specifics of Japan's long-run transformation process, all the problems recounted above have been made substantially worse by poor economic performance since 1991. A variety of forces have been at work to undermine Japan's economy. 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 bursting of the bubbles. An increasingly huge non-performing loan problem was hidden for too long, and has been addressed in wrong ways; 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 declared that none of Japan's 20 major banks would fail, but Hokkaido Takushoku Bank suddenly failed in November 1997. Subsequently, the Ministry of Finance's regulatory functions were separated out into the new, cabinet-level Financial Supervisory 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. While the economy cyclically rebounded between the early 2002 trough and the first quarter of 2004, the subsequent abruptly stalled economic performance for the rest of 2004 is indicative of the reality that 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.

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 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. 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.

Japan's macroeconomic difficulties have been deeply intertwined with the weakening of the Japanese 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, these financial institutions are still huge, but recognized as the weakest of any advanced industrial nation. Bank lending to business has declined steadily. Banks hold a large amount of government bonds and equities, but have failed to develop fee businesses sufficiently. Their balance sheets are still greatly at risk from securities market fluctuations. Japan’s government is an exceptionally large financial intermediary, crowding out private-sector institutions, rather than complementing them by serving areas characterized by market failures. Government financial institutions, with a huge share of household deposits and life insurance policies held in the postal savings system, account for some 40% of all loans, and are especially important mortgage lenders to households and to smaller business enterprises. As Japan’s private sector financial system has been fundamentally deregulated and liberalized, many government financial institutions have been rendered weak and redundant as their economic rationale has evaporated.

While moving ahead slowly and cautiously on domestic structural reform, the Japanese government has embarked on a bold new foreign trade policy, 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 by Urata in chapter 11. Whether this new approach is an appropriate trade 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 North American and European Union 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 The Costs of Japan's Long Malaise

The costs of Japan's poor economic performance and slowness to adjust since 1991 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 call 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 that might precipitate a 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. Its high standard of living could be 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 4.5% in January 2005 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 chapter 10, 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, from 1997 full-time regular employment until the beginning of 2005 continually decreased, while part-time and temporary employment has risen steadily and now comprises more than a quarter of total employment. Compared to full-time male employees, the hourly wages of part-time male workers are only 51%, full-time female workers only 66%, 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; whereas part-time employees comprised 3.9% of their workers 1995, this ratio increased to 8.6% in 2002, and is even higher today. The Japanese economy has been experiencing de facto wage reduction, reflecting weak labor demand and slow productivity growth. This wage reduction 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 being realized because of inadequate demand for labor.

In longer-term perspective, the weak labor market has harmed the young - those aged 15 to 24 years - disproportionately. The unemployment rate for 20-24 year olds not in school in 2002 was 9.3%, but in 1990 this rate was only 3.8%; for those aged 15-19 years, the corresponding figures are 12.8% in 2002 versus 6.6% in 1990. The "idle labor" rate, measuring those neither in school nor in the labor force, for those aged 20-24 years was 17.0% in 2002, up from 11.3% in 1990; for those aged 15-19 years, 24.3% in 2002, up from 14.6% in 1990. Equally serious has been the increase in young part-time workers. In 2003, male part-timers aged 20-24 comprised 28.3% of their employed age group, up from 14.9% in 1990 and even lower levels from earlier periods. Some 35.2% of female workers aged 20-24 were part-timers in 2003, up from 18.4% in 1990 and lower ratios earlier. 54.5% of these 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 people would prefer full-time regular jobs. The significant rise in the proportion of part-time workers, a category especially comprised of young people, reflects the still weak demand for labor. In the longer run, this underemployment means that 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 contained in this book make it clear that Japan's most important economic policy objective is to achieve good, sustained, full employment growth. This theme runs throughout this chapter as well. Certainly, while some of Japan's slower growth has been due to changes on the supply side, a main thesis of this book is that Japan's poor macroeconomic performance has been largely due to inadequate aggregate demand necessary 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 this has been insufficient in what have become 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 chapter 2, the net debt actually 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 debt 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 American federal funds rate, at zero. Yet these macroeconomic policies have not been sufficient to prevent deflation, albeit mild, since the mid-1990s. Even more importantly, between 1992 and 2003 Japan's GDP averaged only 1.2% annual growth, substantially below its potential. During that time there were three recessions followed by inadequate recoveries, including slightly negative growth (technical recession) for the middle two quarters of 2004, and only a slightly positive fourth quarter (though Japan's quarterly GDP data are weak, and subsequent adjustments so substantial, that they are only rough indicators).

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

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

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

Although some policy analysts have continued to propose an even more aggressive short-term cyclical fiscal stimulus in order to revitalize the economy and ensure sustained recovery and growth, many observers consider increased government spending economically very inefficient, with too many wasteful pork-barrel public works projects. Building bridges, tunnels, dams, and reclaimed land in sparsely populated areas with little future demand for these 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 in Japan; most voters, even in areas where the 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, the share of GDP devoted to public infrastructure investment has declined steadily since the mid-1990s.

Fiscal stimulus proposals through tax cuts have gone nowhere because of deep Japanese anxiety about the persistent huge government budget deficits and the high gross government debt-to-GDP ratio. The specter 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 on 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 task is a matter of timing between 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, restoring normal aggregate demand and full employment growth without requiring huge budget deficits. Eventually as well, 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 Japanese government will be able to achieve fiscal sustainability, namely to 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 government tax revenues will have to increase as a share of GDP to meet societal commitments; or how much these existing commitments will have to be cut in order to maintain incentives for firms and workers to stay in Japan; or how to alter income distribution.

In one of the most important and controversial studies in this volume, Broda and Weinstein in chapter 2 present a careful empirical analysis that argues Japan does not face a future fiscal crisis. They found that the potential tax burden of long-term fiscal sustainability is much less dire than the Japanese government currently projects. Broda and Weinstein estimate that, in due course, government revenues as a share of GDP will have to increase only modestly unless Japan decides to increase welfare levels to the equivalent of current European levels.

Broda and Weinstein base their analysis 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 the Japanese government's financial assets from its liabilities, and Japanese government institutions hold more than half the outstanding gross government debt. For example, the government holds some $840 billion in foreign exchange reserves, which represents about 18% of GDP; these reserves are financed by government borrowing; and are basically a wash on the balance sheet of the government special accounts. Broda and Weinstein estimate that the government's net debt as of March 2002 was 64% of GDP. They then use a more comprehensive public sector definition of the net debt, consolidating the central bank's assets and liabilities (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 for all Japanese, old and young, increase at the same rate as GDP growth, Broda and Weinstein estimate that in the long run government revenues will have to be only 34.6% of GDP, almost the same ratio as in 1990 before tax cuts were enacted. The OECD estimates that the average ratio of Japanese government revenues to GDP for 1980-2000 was 30.9%, and forecasts 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, that population decline will level off by 2060 and that the share of elderly will then remain constant. The fiscal costs of paying benefits to the elderly during the period of demographic transition will be spread over 100 years, meaning that several Japanese generations will share these costs. This assumption implies that the ratio of net (and gross) government debt will continue rising for some years before beginning to decline, but this increase is manageable. Broda and Weinstein note that while the share of expenditures on 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 upon reducing government debt, everything else remaining equal. Inflation does not solve the long-run government debt problem since it only reduces the value of accumulated past government debt, not the government's future liabilities embedded in its commitments to all Japanese, but especially to the elderly. 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 reduction would be relatively small.

While fiscal stimulus may be desirable in the short-run, 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 primary budget balance by 2012. Broda and Weinstein assert that this goal is too extreme a tightening path, especially if the economy grows below potential. As with all long-term policy pronouncements, this may well be altered by changing events or new analyses.

4 Monetary Policy

This volume includes two important complementary chapters on monetary policy. Inadequate monetary policy is one of the most important factors in understanding the Japanese economy's malaise in the 1990s and early 2000s. The Bank of Japan was consistently behind the curve from 1993 to 2000, and made a key policy error in August 2000 by tightening money while deflation persisted. Harrigan and Kuttner in chapter 3 convincingly argue that the Bank of Japan could have done better, if only it had known what the United States Federal Reserve would have done in a similar situation, as did indeed begin to occur in America in the early 2000s. Ito and Mishkin in chapter 4 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 mild deflation in the mid-1990s, the need for more effective monetary policy increased. Most mainstream economists believe that inflation and deflation are monetary phenomena in the long-run, and that a central bank can influence the course of the inflation rate, not by fine-tuning, but by achieving a medium-run average. From this general viewpoint, the Bank of Japan's failures to prevent deflation from setting in and then allowing it to remain for a prolonged period represent mismanaged monetary policy. Specifically, the timing of adopting the zero interest rate policy (ZIRP) was late; additional actions while ZIRP was in place were taken too late, only sending tentative and at times inconsistent messages; and premature tightening in the midst of ongoing deflation was a major mistake. Even with a zero interest rate, a 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 burst bubbles were similar in both countries. Japanese fiscal balances improved during the boom years, but deteriorated in the down years, and the United States showed a similar pattern with even less favorable fiscal consequences. One substantial difference is that Japan has been running current account surpluses in its balance of payments while the United States has been running increasingly large current account deficits in the years following the peak of its bubble.

Harrigan and Kuttner argue that monetary easing by the Bank of Japan after the bubble's peak was slower than in the United States when measured by the respective actual interest rates adjusted for the inflation. Japan's delay in cutting the interest rate in the early post-bubble stages very likely contributed to the start of the long stagnation. One mitigating factor is that in 1991 and 1992 actual disinflation exceeded expectations, so that failing to cut the interest rate more aggressively may be somewhat excused. However, this excuse does not hold after 1993. In particular, the Bank of Japan's decision to keep the call rate unchanged at

2.25% in 1994 and in the first quarter of 1995 actually contributed to a further decline in economic activity by slightly tightening monetary policy in real terms. If in 1991-94 the Bank of Japan had acted like the Federal Reserve in 2001-04, disinflation may not have set in as rapidly as it did, and more aggressive interest rate cuts in 1994 and 1995 might have even prevented the eventual deflation that occurred and still persists.

Harrigan and Kuttner apply an econometric model of a central bank setting the interest rate in reaction to the gap GDP and the expected inflation rate, the so-called Taylor equation. Then they fit the Japanese data with the estimated American coefficients to determine what would have happened if the Bank of Japan 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 the Bank of Japan's monetary policy from 1995 to 2003 and find its response to deflation has been misguided, notably the rate hike in August 2000, or long overdue, as evinced by the quantitative easing beginning only in March 2001.

There is no question the Bank of Japan's very easy monetary policy currently in place should continue until sustained growth is restored and deflation ends. 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 chapter 4. Ito and Mishkin 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 in fact maintains price stability.) This policy is history-dependent: the longer deflation continues, the higher the average inflation rate will need to be during the catch-up period. By committing to such a strategy, inflationary 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 a period of deflation. Once the price level catches up with the targeted trend line, Ito and Mishkin propose that the Bank of Japan shift 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 the Bank of Japan's independence in 1998, especially under Governor Masaru Hayami, relations between the Bank of Japan and its former master, the Ministry of Finance, were not smooth (see Ito, 2004). Bank of Japan executives resisted suggestions from the Ministry of Finance to ease monetary policy more aggressively as a threat to its independence, arguing instead that the Ministry's fiscal policies should be more expansive. However, the Ministry of Finance's monetary policy suggestions turned out to be correct, and resisting them was a costly mistake. Since April 2003, under Governor Toshihiko Fukui, 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 coordinated 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 it's financial system, and this problem is analyzed in three related chapters: Hoshi and Kashyap consider the banking system, Fukao examines the life insurance industry, and Doi focuses on the government financial institutions. What once was considered to be an extraordinarily large, strong and effective financial system has become one of the weakest among advanced industrial nations. Virtually every Japanese 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.

In chapter 5 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. Through mergers and failures the reduction from 20 big banks in 1990 to 8 in 2004 has created even larger but not stronger banks. Mergers have not yet resulted in substantial cost cutting or in the development of new, more effective business models. Moreover, bank lending policies have worsened asset quality. While total bank loans have decreased significantly, loans to very weak, large borrowers (called “zombie firms”) have been maintained and in some cases even increased. Hoshi and Kashyap emphasize that under Minister Heizo Takenaka supervisory and regulatory reforms by the Financial Services Agency (FSA) to restructure bank balance sheets and identify and deal with non-performing loans have been a substantial improvement over the past, but should be further strengthened and pursued even more vigorously. Nonetheless, these are only the first steps to restoring competitiveness and strength to Japanese banks. Hoshi and Kashyap 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 financial system’s stability or in regional banks to support the local economy, as has been done in the past. If injected as shares, the government can sell these in the market, rather than having the bank pay the capital back to the government, in order to maintain capital.

Japan's banking system continues to be plagued by overbanking, resulting in very thin lending spreads and low profitability. As Hoshi and Kashyap make clear in their policy recommendations, even ending deflation and restoring 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, Japanese 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 these losses. The major Japanese banks need both to improve their information technology infrastructure and to develop new, fee-based sources of income, still extraordinarily low by international comparison. The traditional bank model of accepting deposits and lending these funds is no longer profitable since large, sound firms can raise funds and borrow through the capital market. Japan's banks are slow to adapt to a new deregulated environment by changing their business model, and this needs to change (see Hoshi and Kashyap, 2001; Hoshi and Patrick, 2000; and Ishigaki and Hiro, 1998).

Bank restructuring has progressed more slowly for regional and local banking institutions, especially second-tier banks and credit associations, many of which 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 needed capital without declaring them insolvent signals that the Financial Services Agency is finally prepared to tackle regional bank balance sheet problems. How strongly and effectively this agency will move, and how the politically powerful local banking institutions will respond, remains a serious concern.

In Japan the government is an exceptionally large financial intermediary. The post office system, through postal savings accounts, holds some 30% of total household deposits and

37% of the life insurance industry's gross assets, both far larger amounts than held by any private financial institution. Some of these funds are invested in government bonds, but a significant portion, together with government-controlled monies, are transferred to a host of government financial institutions and special public corporations through the Ministry of Finance's Fiscal Investment and Loan Program (FILP) and other channels which have recently been put in place by FILP reforms introduced in April 2001. Nonetheless, these financial flows, and government financial institutions and special public corporation activities, have been very opaque.

In chapter 6 Doi provides the first careful, detailed English-language analysis of government financial institutions and special public corporations, each of which is a major source both of the burgeoning government debt and increases in government financial claims on the private sector. However, these entities have huge non-performing loans (on the order of 36 trillion yen) which are yet to be addressed. Doi focuses on 10 major government financial institutions and special public corporation, which together make about 20 % of total loans to the private sector and an even larger share for small business and for household mortgages.

As the economy has matured and the financial system has been fundamentally deregulated and liberalized, Doi stresses that many government financial institutions have become weak and redundant, and their economic rationales have evaporated. Government financial institutions 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, as there are no clear bankruptcy statutes for the government financial institutions or the special public corporations.

Doi identifies the specific set of problems for each major government financial institution or special public corporation 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 these bonds as having at least an implicit government guarantee. Doi 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.

Reforming 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). How this will play out politically and economically is not at all clear. Assuming some bill will be passed, what will be the specific details of privatization embodied in the legislation? How effective will they be? How will the post-Koizumi government actually implement or alter any policies enacted by the Koizumi administration. In our view, this will continue to be a contentious yet important issue for several more years. Nonetheless the major economic issues are clear.

Japan’s postal system has three business lines: mail delivery service, postal savings accounts, and postal life insurance. Each function 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, separating each business line into regional divisions could reduce the value of the services provided to households.

The incumbent provider of postal delivery services, 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. This stance would make 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 because it does not pay taxes on their real estate holding or profits.

The postal savings and postal life insurance systems 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 it should have to pay the same deposit insurance premium as banks. This change would achieve a level playing field and eliminate the government's current free guarantee of deposits. The postal savings 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 of Finance wants the postal system to expand into lending operations. Doi proposes that the system be transformed into a narrow bank, that accepts savings deposits but only holds government bonds as assets. This would obviate any increases in banking services in an already over-crowded financial system, and eliminate the need to develop expertise in providing lending 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 of which many are new entrants, both Japanese and foreign firms, following reduced entry restrictions 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, these firms were deeply insolvent when they went bankrupt and were sold off.

Fukao focuses on the 10 major companies that together now have a dominant market share of the life insurance industry. 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 current 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 go bankrupt or be forced to reduce the guaranteed rates to policyholders, the latter of which is now allowed but will have adversely affect their reputations in increasingly competitive markets.

Fukao also analyzes the problems of this industry's 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 the measurement of their capital, and the prohibition of double gearing.

Chapters 5-7 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 is essential to overcome distortions in resource allocation and economic activities.

6 Corporate Restructuring and Financing

All sectors, companies, and households have suffered through Japan's long period of economic malaise. Credit is the life blood of all businesses, and the banking system's profound weaknesses 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.

Although corporate restructuring has made some progress, much remains to be done before Japan can become a normal, efficient economy based on competitive markets unimpeded by large amounts of 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-sized enterprises remain weak due to a combination of still-huge debt burdens and lost competitiveness in a changing domestic and global business environment. The government made progress on this front by creating the Industrial Revitalization Corporation Japan in April 2003, a semi-public arm of corporate restructuring. Together with the main banks, it takes stakes in and restructures the overly-indebted companies. Firms with good cash flow have focused primarily on paying down debt to restore balance sheets. However, too many firms have yet to develop, much less implement, more effective business models. Restructuring inefficient government special corporations and agencies so far has been quite slow. These problems will endure 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. Iwaisako 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, termed 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 this 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.

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

Iwaisako considers two important cases of government intervention in restructuring corporate debt. One is the nationalization of the Long-Term Credit Bank, the terms of its eventual sale to Ripplewood, and its re-establishment as Shinsei Bank. He notes that the government and business community were implicitly expecting Shinsei to play according to the existing game, in effect to keep lending to existing borrowers regardless of quality, not to exercise the put option on non-performing loans they had taken on, and in general not to rock the boat. Instead Shinsei behaved as a rational economic actor. This incurred the wrath of traditionalists, but was ultimately a successful strategy. The second case was the placing of the excessively diversified, heavily indebted Kanebo into the Industrial Revitalization Corporation Japan process in mid-2004. Management was changed, equity was written off as were a considerable portion of the bank loans, the successful cosmetics division is being sold, and the non-profitable divisions are being restructured, sold or closed.

Iwaisako draws several conclusions. Restructuring often needs a third, outside, party that is not involved in embedded and 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, as generous government bail-outs come at the expense of taxpayers and healthy competitors. He judges the Industrial Revitalization Corporation Japan to have been successful. However, Iwaisako is more skeptical of the increasingly extensive restructuring activities of the Development Bank of Japan, which 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 in chapter 10, 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 also 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 Japanese corporate finance has continued to be provided by banks and, especially for small- and medium-sized enterprises, government financial institutions. The government's Big Bang policies of the late 1990s have accelerated the development of capital markets. Nonetheless, the Tokyo capital market is still relatively costly, and the legal framework does not adhere to international best practices. Its 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.

In chapter 9 Fujii analyzes the development of Japan's corporate bond market since the late 1990s, which is important because bond issuance will become a significant source of business finance, as it is in other advanced countries. She uses her own survey of participants in the Tokyo capital 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 financial reforms, regulations restricted corporate bond issues 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 evolved for more risky bank loans. Fujii concludes that corporate bond market pricing is working reasonably well because prices and their credit-default swaps 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 Japan's 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 the first General Agreement on Trade and Tariffs and how its successor the World Trade Organization; 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 American macroeconomic policies taken from Japan's experience with deflation. These approaches and commitments have not changed. However, a new strategic dimension has emerged in response to the increasing reliance on regional trading arrangements by the United States and the European Union, and due to China's rise as an economic power. Japan also has embarked on a new trade policy, one of bilateral cooperation under free trade agreements or, more comprehensively, economic partnership agreements.

Traditionally, Asian countries have not formed significant preferential trading arrangements. The ASEAN Free Trade Area is a regional trade agreement, but the lowering of tariffs among its 10 Southeast Asian members has been slow. Japan, Korea, and China were the only three outliers, as they had not joined any regional preferential agreements. Japan's first free trade agreement, with Singapore, became effective in 2002. Korea concluded its first negotiated free trade agreement, with Chile, in 2004. Now there are frenzied free trade negotiations among all the Asian nations. China has just signed a free trade agreement with ASEAN. Thailand is negotiating more than a dozen free trade agreements. The United States has negotiated a free trade agreement with Singapore and Australia. Japan signed one with Mexico in 2004, and is negotiating separately 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 chapter 11 Urata explains Japan's trade policy motivations and strategy, and strongly recommends that Japan pursue free trade agreements in a manner complementary to the World Trade Organization. One reason is defensive. In the worst case scenario, Japan may become isolated from a world characterized by three dominant free trade zones --the greatly expanded European Union; the North American Free Trade Agreement (NAFTA) governing Canada, Mexico and the United States, the proposed Free Trade Area of the

Americas and ongoing American bilateral free trade negotiations; and an expanded ASEAN Free Trade Area with an increasingly powerful China. Another motivation arises from Japan's increasing policy focus on East Asia, the world's most rapidly growing economic region. The 1997-98 currency, financial, and economic crisis greatly increased East Asian interest in greater regional economic cooperation. Urata argues that free trade agreements will both expand Japan's market access in trade and investment and contribute to Asian economic growth. Japan's policy approach is more comprehensive than liberalizing trade barriers; it focuses on investment, movements of skilled workers, and facilitation and cooperation in a range of areas. In this respect, Japan aims to support the global system by addressing and testing solutions to a range of international economic issues not currently covered by the World Trade Organization. At its best, in Urata's view, an effective policy of free trade agreements can be a catalyst for Japan's economic revitalization.

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

8 Major Policy Recommendations

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, but offer a few broad near-term and medium to long-term policy recommendations based on the analyses provided in this volume.

Japan's highest priority in the near-term is to end deflation and put its economy back on a good, sustainable growth track, still far from being achieved as of the beginning of 2005. Since a substantial output gap still exists, growing above its long term 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 United States 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 task to getting the economy back on track. Hoshi and Kashyap, and Fukao, in their respective studies, emphasize the importance of rigorous supervision and regulation, together with rigorous implementation by the Financial Services Agency 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 allocations and bring about adequate structural reform, and indeed Japan’s past 14 years of malaise indicate that is not the result. As the economy recovers, reforming 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 younger Japanese workers is essential to maintaining a highly skilled labor force. In addition, existing market and social norms have meant that in Japan 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 relative to gross domestic product. As Broda and Weinstein show, fiscal sustainability can be achieved without huge increases in taxes so long as the transition costs are financed over a sufficiently long time period. Structural reforms of the government financial institutions and special public corporations, and of local government institutions, as Doi forcefully argues, are essential in order to allocate resources more efficiently and to reduce the government's contingent liabilities inherent in the existing soft budget system. For social and political reasons, reforming government institutions cannot be accomplished quickly, but the process has to begin and be strengthened now. The Japanese 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 these economic benefits. The other aspect is for Japanese to decide what is the appropriate role of foreign workers in their economy. In an immediate context, in free trade agreement discussions with Japan, the demands of Thailand and the Philippines for liberalized worker visas are stimulating Japanese debate over these issues, with a generally positive view. But in the longer-run with Japan's aging and declining population looming, the issue of how and to what degree to allow and even encourage foreign-worker immigration must be squarely faced.

We are confident that in due course the Japanese economy can and will rise again. The nation's economic and social fundamentals are still strong. As the government and private sectors accept and implement the policy recommendations contained in this volume, the economy will do better on both the demand and supply sides. While Japan's 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 the Japanese will achieve per capita GDP growth rates at least as good as is the average for the other G7 countries. Japan will continue to be a major global economic player and technology leader, far ahead of the rest of Asia and second only to the United States. And the standard of living and economic well-being of Japan will continue to improve, a fundamental objective of this and indeed all economic analysis.

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