COLUMBIA BUSINESS SCHOOL

日本経済経営研究所

Solutions to Japanese Economic Problems

CENTER ON JAPANESE ECONOMY AND BUSINESS JUNE 2004

Japan's decade of economic underperformance and malaise appears to be coming to an end. The economy is experiencing its third round of recovery, this time without the marked use of fiscal stimuli. Is this, in fact, a "genuine recovery?" Does the Japanese public, as well as the business sector, perceive the recovery as real? Has structural reform addressed the problems confronting Japan sufficiently for a real recovery to continue? What problems persist even if recovery proceeds? What policy prescriptions are being utilized by Japanese policymakers and business leaders? Are they appropriate? What is being overlooked? Are we operating under any misconceptions regarding current and future economic conditions and trends? What lessons can be learned from the experiences of other advanced economies? This symposium endeavors to answer these questions, tackling two major themes: Japan's macroeconomic policy issues, including both monetary policy and the long-run fiscal sustainability of the Japanese budget; and the reform of Japan's banking system and government financial institutions.

On June 21, 2004, the Center on Japanese Economy and Business of Columbia University and the Research Center for Advanced Science and Technology of the University of Tokyo sponsored a symposium focusing on the theoretical approaches of macroeconomics to Japan's recession at Roppongi Academy Hills Auditorium in Tokyo, Japan. The symposium brought together academics, business leaders, and public officials from both the United States and Japan in order to ensure a comprehensive approach to the resolution of the problems confronting the Japanese economy today. This report represents excerpts of the symposium, accompanied by highlights of exchanges with the audience that day.

Research Center for Advanced Science and Technology, the University of Tokyo, and Center on Japanese Economy and Business, Columbia University, present

SOLUTIONS TO JAPANESE ECONOMIC PROBLEMS

June 21, 2004
Roppongi Academy Hills Auditorium
Roppongi Hills, Mori Tower

1:30–1:45 p.m. **Opening Remarks**
Hugh Patrick
Director, Center for Japanese Economy and Business, Columbia Business School
Kazuhito Hashimoto
Director, Research Center for Advanced Science and Technology, University of Tokyo

1:45–2:15 p.m. **Keynote Speech**
Kakutaro Kitashiro
Chairman, Japan Association of Corporate Executives (Keizai Doyukai)

2:15–3:10 p.m. **Session 1: Macroeconomic Policy**
Chair: Hugh Patrick
Presentations: Takatoshi Ito, *University of Tokyo;* David Weinstein, *Columbia University*
Discussant: Kazumasa Iwata, *Bank of Japan*

3:25–4:30 p.m. **Session 2: Reforms of Banks and Government Financial Institutions**
Chair: David Weinstein
Presentations: Anil Kashyap, *University of Chicago*; Takeo Hoshi, *University of California, San Diego*
Discussants: Makoto Hosomi, *Financial Services Agency;* Naoyuki Yoshino, *Keio University*

OPENING REMARKS

HUGH PATRICK
Director, Center on Japanese Economy and Business

Today we focus on two major themes. The first is Japan's macroeconomic policy issues, notably monetary policy, and the fiscal sustainability of the Japanese budget in the long run as the population ages. The second is the reform of the Japanese banking system and of government financial institutions.

Our project addresses other important themes as well: capital markets, the life insurance industry, business investment and corporate restructuring, labor markets, and the political economy of trade policy and free trade agreements (FTAs). In addition, we have concentrated on looking at some of the lessons for U.S. policymakers from Japanese monetary and fiscal policies.

This project has involved 15 outstanding Japanese and American economists and scholars, who have collaborated to prepare 10 substantive, analytical papers with clear-cut policy recommendations. Our goal is to contribute to the discussion of these policy issues in the public policy debate in Japan, and to enhance understanding abroad of these important issues, both in America and in other countries. To highlight this project, we will publish academic books in both English and Japanese.

Of course, we are delighted that the economy has been doing so well in the past six months, even in the past year. In a sense, it means that the policy conclusions and recommendations that we have been making are even more important. As the economy does better, it is easier to overcome some of the economy's continuing difficulties. However, if the fundamental problems are not attacked, we are somewhat doubtful that the current good growth prospect will be self-sustaining in the long run. That is my own judgment—each of the project participants has a different judgment on this. My personal feeling is that Japan is close to being in a self-sustaining-growth phase, but it is not there yet—and this is the wrong time to be relaxed and complacent. Continuing policy efforts are necessary to solve the problems that remain; they will not be solved simply by continued economic recovery.

KAZUHITO HASHIMOTO
Director, Research Center of Advanced Science and Technology, University of Tokyo

It has been said that the Japanese economy has lost an entire decade. How can Japan's economic problems be solved? This is a subject of intense discussion among Japanese and American scholars. Based on the policies prescribed in these papers, this conference will be helpful in facilitating understanding of the issues, both in the public and private sector. This conference encompasses both Japanese and American perspectives, in order to have a comprehensive discussion that will generate concrete prescriptions and solutions.

Japan has the second largest GDP in the world, so a single prescription is not enough to generate a full recovery of the Japanese economy.

—Kakutaro Kitashiro

KEYNOTE SPEECH
"CHALLENGES FOR REHABILITATION OF THE JAPANESE ECONOMY"

KAKUTARO KITASHIRO
Chairman, Japan Association of Corporate Executives (Keizai Doyukai)

Is growth of the Japanese economy sustainable? Last week, I attended the Asian version of the World Economic Forum in Seoul. The greatest point of concern among the attendees of that conference was the recovery shown by the Japanese economy—whether it is real or not. A year ago, there was not much interest in the Japanese economy, but now interest is returning. This is the third round of economic recovery. In the previous two rounds, public spending stimulus was used, but it was not this time, and so, perhaps, now we can say that Japan's economy is making a real recovery.

We have surveyed Japanese entrepreneurs. Last year, 2 percent of the respondents said that the Japanese economy was expanding. By March 2003, Japanese companies announced increases in both profit and sales, but not many Japanese entrepreneurs felt that the Japanese economy was actually expanding. Since then, we have seen rising stock prices in Japan. Also, including pension fund management and as in terms of balance sheets, there has been a positive impact. Gross domestic product (GDP) indicators have also improved. Rapid recovery was made from September through December 2003, so that in terms of March and June 2004, many entrepreneurs in Japan are saying that they think the economic expansion is in fact genuine.

Personal consumption accounts for 60 percent of the Japanese GDP, and it has been showing improvement; on an annual basis, there has been 3-4 percent growth in consumer spending. So it may be that individual spending is improving a bit, although real income has not gone up that much recently in Japan. However, if you look at personal financial holdings, stocks represent about 5 percent, and more than 50 percent is in the form of savings and deposits. People have not gone into stock investment. They are not willing to take risks. That is the situation in which we remain. It has been a long-standing issue and has not yet improved. Individuals have started to take part in the trading of stocks, but stock holding has not really taken root. In terms of direct investment, not much money has come in here either.

Japan has the second largest GDP in the world, so a single prescription is not enough to generate a full recovery of the Japanese economy. There are many pending issues. First is the large fiscal deficit. Another is the falling fertility rate, which is an issue for all of Asia; it has fallen to 1.29, and the population is aging rapidly. Then there is concern about international competitiveness. According to an IMD study, Japan ranks 9th out of 30 major countries in this area. There are concerns specifically about labor productivity. Some manufacturers show very high figures, but on average, it is low. The financial system in Japan also faces problems. The combined debt of the local and the national governments is 150 percent of the GDP. Clearly, the Japanese situation is worsening rapidly. Other countries are also seeing their situation worsening, but they are making more effort to combat it. In terms of the GDP, the U.S. fiscal deficit is 7–8 percent, while the European is about 3 percent, thanks to the countries' remedial efforts.

At the World Economic Forum conference, one non-Japanese attendee said that the Japanese fiscal position cannot recover, and the only way out for Japan is to have inflation. Japan is now likely to have a very large inflation. An economist made that statement, and economists are now responsible for the management of the economy. They have the freedom to say anything they like, and it does not mean much if their guesses turn out to be wrong. However, that is not the case for entrepreneurs like ourselves, who have to take responsibility when economists' predictions are wrong. We need to recognize the problems and act. We have had a great deal of action vis-à-vis the resolution of nonperforming loans (NPL) and others. I hope this continues.

With regard to the birthrate, it has become so low that it is really difficult to expect much improvement in the short run. How we can have sustainable pension funds is a major issue. We have seen a slight improvement in competitiveness (e.g., the *IMD World Competitiveness Yearbook)*. What about institutions of higher education? Japan ranked 30th out of the 30 major countries for the contributions made by the higher educational institutions to the Japanese economy. Further, when we examined entrepreneurship and corporate governance, Japan ranked very low. We cannot be complacent about Japan's number nine position. Based on the Organisation for Economic Co-operation and Development (OECD) figures and the graph by McKinsey, which looks at primary industries, Japan ranks 11th. Productivity is very low in Japan for agriculture and other sectors.

What about manufacturing? Japan scored 93, while the United States scored 100, which is not bad. If you look at manufacturers with good export competitiveness (for example, the automobile, digital appliance, and steel-making industries), the score is actually 120, which is ahead of the United States. The overall manufacturing competitiveness is about 93, nonetheless.

What about the service industry? Sixty percent of the people in Japan are employed in services, but productivity for the service industry is 61, which is very low. Many businesses are highly regulated. Much improvement is needed here.

Looking ahead, what steps should we take? Until recently, after the bubble economy burst, it was said that we experienced a "lost decade." Under Prime Minister Koizumi, we are seeing many reforms, particularly with regard to nonperforming loans. According to the prime minister, there is no economic growth without structural reform. The NPL disposal is a thing of the past. We have to consider what we should do in the coming decade. While it is painful, we must continue implementing structural reform. Companies that are weak cannot go through restructuring. In order to restructure, there should be fiscal and financial backup to support the weaker companies, as well as a greater sense of urgency for restructuring.

I think the Japanese economy has had a sense of crisis since the bubble economy burst, but now Japanese businesses are gaining more power, so it is time to implement structural reforms to help the economy recover, and we need to sustain the momentum. Reforms in the public and private sectors—privatization, deregulation—are important. Also, government-affiliated financial institutions, particularly the postal savings system, have to be reformed. We need to reform fiscal investment and loan programs as well, and a shift has to be made from state to region. Social security reform must be made sustainable, and medical insurance and pension reforms are needed as well. Tax reform, primary balance surplus, and fiscal reconsolidation are also important. The government has targeted 2013 as its date for fiscal reconsolidation, but a set path toward that end has not yet been defined. What specific government measures are needed to achieve this 10-year program? We should also try to move away from export

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—Kakutaro Kitashiro

dependence to encourage domestic demand.

We need entrepreneurs to start up new businesses. We need to have enterprising people generate innovation in the economy and in business. We need that kind of mechanism, that environment. to grow further as a nation. We also need educational reform. If we carry out educational reform today, the effects will come only later, so we need to have a long-term perspective, targeting 10, 20, 30 years ahead, in order to carry it out. British Prime Minister Tony Blair has stated as his priorities: "First, education; second, education; and third, fourth, and fifth are again education."

Various approaches to reform are possible. In the case of the United Kingdom, the Ministry of Education allocates funds for decentralization. Therefore, each individual school has an initiative to improve academically. Testing provides needed assessment. An inspection system has also been introduced, where inspectors visit schools to assess the results of the reforms.

We at the *Keizai Doyukai* have also studied Finland. In contrast to the UK, Finland does not conduct nationwide scholastic tests. The government creates an overall policy. The curriculum and textbooks are selected by each school, in each region. Decentralization is promoted to give more power to regional teachers. This is approach is being adopted in Japan, as well. This year, the universities have become independent organizations. However, in Japan there is a large gap between what is being advocated and what is actually happening. In the case of Finland, teachers of primary and secondary schools have master's degrees. We must also try to educate Japan's teachers further. Parents should be more involved, as well.

With regard to new ventures, Silicon Valley in the United States is famous for its many start-up businesses. Many nations want to encourage their own "Silicon Valley." In order to support entrepreneurs, Singapore's government, for example, has created a venture fund. It is a sort of matching fund—if there is private sector investment, the government will provide an equivalent amount of funds. Ventures can make investment in government-designated areas. If losses occur, they can be compensated by the government with a deduction from taxable income. Singapore is also implementing a tax incentive system.

Finland is trying to promote venture businesses as well. Before we went to Finland, we thought that it had many start-up businesses. However, when we visited that country, we discovered that the pension system is well established and the income tax rate very high. Therefore, rather than starting up businesses, people want to become schoolteachers in order to reach a certain level of income. They are very aware that when they work very hard, the income tax on their earnings is very high. It is the predominant mental ity. Likewise, in Japan, we, too, have to change social values in order to stimulate venture business. Society needs to honor, approve of, and support entrepreneurs.

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Entrepreneurship has to be instilled in the educational system. Of course, scholastic achievement is very important, but at the same time, starting a business is admirable, which students need to know. Teachers do not have experience with starting up businesses, and, therefore, they should perhaps invite entrepreneurs to their schools as a stimulus to the students.

There are many things that can be done in Japan in order to stimulate venture businesses, which can in turn stimulate innovation. Of course, major companies have a role to play. However, often major companies come up with innovations, but because the innovations do not benefit the companies directly, they do not exploit these innovations, which impedes the innovation process. For example, in high-speed communication, we have IP telephony using ADSL, where one is always connected to the network. NTT, however, has a fixed telephone line, and those with a fixed line network as an infrastructure do not want to promote IP telephony. IP telephony, however, can be promoted by venture businesses because they do not rely on past investments or old infrastructures. This is why venture innovation is very important.

At *Keizai Doyukai,* we conducted a survey on the challenges facing entrepreneurs. The biggest problem is funding. It is difficult to get funds from banks because new ventures are highly risky. Personal guarantees are required of the business owners. Then, should the business fail, the owners are deprived of their personal assets, not an encouraging environment for entrepreneurs.

The second biggest problem is finding customers. Even should an entrepreneur develop a new program or product, there is no ready market. Recruiting employees is another problem. We need to support venture businesses in all these difficult areas.

The year 2004 is the new dawn of the Japanese economy. It is about to rebound, and innovation is key to growth. We should not procrastinate. This should be the year for decision and action.

DISCUSSION

Q: It is really hard to implement educational reform. Our university is now an independent agency, but all the funding comes from the Ministry of Finance. To get external funding, we would have to accept a reduced subsidy from the Japanese government. What do you think about that?

Kitashiro: It is the university itself that is going to be the promoter of reform, so the president or the dean of the university has to be a competent person. You have to be very careful about selecting someone to the top post. Election by professors may not be best, because those people elected by their colleagues tend to be more conservative. (I am not talking specifically about the University of Tokyo.) The top person needs to be reform minded. Private sector people can offer advice, but we need a competent person at the top who is willing to go ahead with reform. I think the mechanism has been put in place, and so as long as the president of the university is willing to undertake reform, I think that person will succeed.

Q: I work at a Silicon Valley company headquarters. I am very interested in this issue of innovation and venture capital. I think it is pretty clear that many of the issues that you discussed, such as funding, getting customers, and recruiting good people have to do with risk aversion in Japan. What is your recommendation for getting people in Japan to be less risk averse? In my Silicon Valley company, the attitudes, values, and culture are completely different. What kind of incentives are needed in Japan? What is your recommendation to create an environment that allows for more risk-taking?

Kitashiro: We are talking here about the values of society or of the social system. There is a good reason for Japan not producing many entrepreneurs in the past; it was economically irrational for Japan! Of course, you can make money, but you will not be praised by society. People get suspicious if you are too successful. They will not trust you. That is the cultural setup of Japanese society.

If you are going to start up a company and you are very rich, or your parents are rich, it is okay. If you are not, you need to rely on loans to start up a new business. You need to borrow money from a bank. Of course, there is the People's Finance Corporation, which could lend you money with no collateral, but that is not the usual practice of financial institutions. You have to have previous experience, and you have to have good financial standing. Otherwise, you will not be able to get the loan from a bank. An enjo type of tax incentive needs to be given in Japan. Also, if there were more success stories, then people would feel like emulating the entrepreneurs. Mr. Son of Softbank and Mr. Mikitani of Rakuten are the only people we can think of who have become successful entrepreneurs. We need more good examples so that people feel like emulating other peoples' successes.

Patrick: I appreciate Mr. Kitashiro's comprehensive and insightful comments, especially his emphasis on education, education, education. Since we are providers of educational services, we are particularly appreciative of that perception. As I heard the debate about American-style and Japanese-style venture capital, I would suggest that the differences are even greater between American-style and Japanese-style universities. The problems of adjustment are going to be even more difficult because the market works less well.

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—Kakutaro Kitashiro

SESSION I: MACROECONOMIC POLICY

TAKATOSHI ITO
University of Tokyo

For the past year, I have been collaborating with Professor Frederic Mishkin of Columbia University on my research on Japanese monetary policy. I will begin by reviewing the status of the deflationary problem. As a result of deflation, our monetary policy is limited, as you know. The nominal interest rate comes down to zero, and at that point in time, monetary policy cannot be taken through interest rate management. These are the constraints generated by the zero nominal interest rate. As a result, investment and consumer spending are restrained as the real interest rate goes up. Another result of deflation is that the value of the money debtors have to repay continues to rise. Therefore, real indebtedness expands. As a result, it would seem that debtors lose and creditors win. In fact, that is not the situation, because the debtors' balance sheet would come down to nonperforming loans, and they would then go bankrupt. Thus, the nonperforming loans issue becomes even more serious. As deflation lingers, a new nonperforming loan issue arises. This is what we have been experiencing for the past few years, a vicious cycle of deflation, a deflationary spiral.

Japan is experiencing a "deflationary trap."

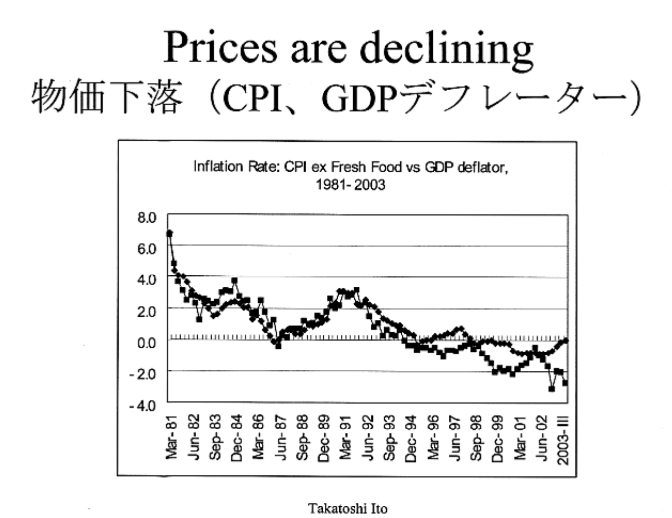
—Takatoshi Ito

Japan is experiencing a "deflationary trap." Let's examine the consumer price index (CPI), excluding food, vis-à-vis the previous year, along with the GDP deflator based on the inflation rate. As you know, these two lines do not necessarily match all the time because of technical issues. Most likely, the real inflation rate, in this case deflation, can be found somewhere between the lines formed by these two indices. Therefore, the consumer price index being zero percent does not necessarily mean the end of deflation. Perhaps the CPI has an upward bias, and, therefore, a negative 1 percent deflation situation is lingering (see Table A, below).

In the interest of time, I will limit my focus to the period of 1998 and after, when the new Bank of Japan (BoJ) law was implemented. In February 1999, the so-called "zero interest rate" policy was introduced. Some say we should have implemented a zero interest rate policy earlier. The condition for the policy was such that until the deflationary expectation was dispelled, the policy would be in place. In August 2000, the zero interest rate was removed because deflationary pressure was seen to have been eliminated. I think this was a mistake on the part of the BoJ. The Information Technology (IT) bubble had already burst, and the U.S. economic recession had begun. Knowing that, BoJ still removed the zero interest rate policy, which was too early. Then, the zero interest rate was reinstituted, and quantitative credit easing was introduced.

This is a highly accommodative policy. The precondition for that policy to continue is that the consumer price index, excluding food, move above zero percent in a stable man-

TABLE A



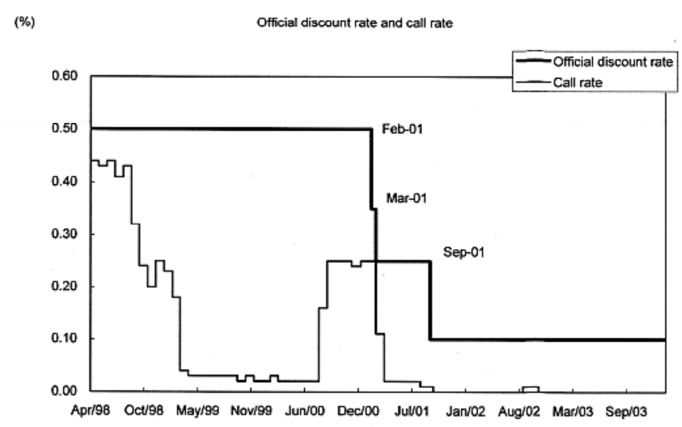
ner. At the time, what this stability meant was not clarified.

Between 1998 and 2003, we analyzed BoJ monetary policies, because the zero interest rate was something the BoJ wanted to eliminate as quickly as possible. Therefore, the long-term interest rate was not actually lowered. Since 2001, the BoJ purchased long-term Japanese government bonds (JGBs) on a larger scale. However, the BoJ did not strongly indicate the continuation of the low interest rate policy in the beginning. The messages issued by the BoJ were that deflationary policy was not necessarily wrong, and, also, that there were no other alternatives. I think this was a policy mistake that prolonged the deflationary pressure.

Since 2003, quantitative easing was allocated for and actively taken. In October of last year, a stable CPI above zero percent was more clearly defined. The CPI had to continue to be above zero percent for several months, and there was no longer a worry of deflation coming back. Therefore, the hurdle became higher—these became the new conditions.

In terms of the message being sent under Governor Fukui's regime, in order to fight deflationary pressure, monetary policy would remain accommodative. A similarly strong message has been issued by the new governor. An outright purchase limit has been increased, and the target amount of the BoJ was also increased. Since 2001, quantitative easing was implemented (see Table B).

TABLE B



Looking at the interest rates, the thick line on the left of the table indicates the official discount rate, and the lower line indicates the call rate. Both are declining. Since 2001, they have fallen to a level that cannot go down further. In terms of the official discount rate, it goes below the 0.1 percent threshold. It is virtually a zero interest rate.

What are the remaining problems? Since Governor Fukui came into office, the message has become stronger and is being communicated to the market. The Japanese economy is gradually recovering. However, we have to see whether this growth is sustainable. Deflation measured in CPI is coming down to zero percent or so. However, deflation is not yet over. If deflation returns, it would lead to the emergence of new nonperforming loans.

The Japanese economy is gradually recovering. However, we have to see whether this growth is sustainable.

—Takatoshi Ito

Where the interest rate is zero, what are the policy instruments we can use? First, we can introduce a price level target policy, rather than using the inflation rate. We should try to reach a certain price level and tolerate price increases up to this target. We would like to exercise pressure on Japanese banks. In order to achieve a price level target, a nontraditional, nonconventional monetary policy can be undertaken. The BoJ must announce clearly its intention to do so.

There are some counterarguments. In our view, the most reasonable concern relates to the BoJ's balance sheet, which may be damaged. Also, the BoJ's balance sheet would create losses. To deal with this, the Ministry of Finance could announce unilaterally that losses would be compensated for by the government. This must be done only on the condition that the price level target is reached, however.

What is the price level target, then? Since 1997, the price level CPI movement has remained nearly flat, dipping a little, but growing 1 percent per year. We could move to target the price level, regardless of the inflation rate. Once that target is achieved, we can switch to the so-called "inflation target." This is our recommendation. As long as deflation continues, it will take longer to reach the price level target. When undertaking such a policy, history becomes very important. In other words, the longer the BoJ continues to make a mistake, the longer it will take for the BoJ to overcome the situation created by this mistake. This message is very important.

What would be the effect of using such a policy, by clarifying the target? We can promote confidence in the market. Inflation can go above zero percent for several months, but that is not enough. We have to wait for a sustained recovery. That is the message we can issue to the market. Then, once we achieve the price level target, what should we do? At that point, the "inflation rate target" can be adopted, because that would be easier for the market to understand in normal times. Put simply, under deflationary pressure, we can adopt a price level target policy, and then once that target is achieved, we can switch to an inflation target policy.

When we propose a price level target, people often say there are no instruments to be used, but there are, indeed, several of them. Of course, these instruments have bad side effects, so we cannot recommend their use under just any circumstances, but they can be employed if necessary. This stance would send a strong message to the market. We can create market expectations by saying that these policy instruments can be taken when absolutely necessary. For example, we can increase the purchase of long-term JGBs. We can also purchase shares and real estate.

The BoJ's quantitative easing must continue. That is very important. Several months of zero percent is too lenient a condition. Instead, we should clearly define a price level target and announce the BoJ's commitment to that target. We can say that public money can be injected to restore the capital position of the BoJ's balance sheets.

> *Moody's had downgraded Japanese public debt to a level below that of Botswana and various other developing countries.*
>
> *—David Weinstein*

DAVID WEINSTEIN

Columbia University

I am presenting my joint research with Christian Broda of the Federal Reserve Bank of New York. I want to emphasize that these are our opinions, not those of the Federal Reserve Bank. Our research grew out of some work that we were doing on fiscal sustainability. As many of you know, economics has been referred to as the "dismal science," so I am pleased to provide you with some happy news from the "dismal science" about Japan's fiscal situation.

There are many reasons why many people have thought that it was time to panic when it came to Japanese bonds. Japan's government debt to GDP ratio is more than 150 percent, close to 200 percent. We have seen some budget deficits in the order of 10 percent of GDP or close to that. There have been discussions about lower future growth due to a shrinking labor force. It is likely that the aging of the population will result in a doubling of the ratio of public pension and medical benefit recipients to the employed. Moody's made an announcement that was shocking in Japan, that it had downgraded Japanese public debt to a level below that of Botswana and various other developing countries.

I have often felt that there was something wrong with this story. In particular, a big outlier has been the performance of the Japanese bond market. If you think about a fiscal crisis that affects the bond market, you would think that there should be one of two impacts. First—that the government might default on its debt—second, that the government would be forced to print money in order to cover its obligations, what is called, in economics, "monetizing the debt." If you believe that one of these two things is going to happen, you would also think that the yield on long-term government bonds should be higher today in order to compensate bondholders for future expected losses, due either to inflation or default. Now, we come to inconvenient facts that arise if you are very worried about a fiscal crisis in Japan.

In 2003, the yield on the newly issued 20-year Japanese government bond fluctuated between 0.8 and 1.9 percent. The yield on a 10-year bond moved between 0.5 and 1.5 percent. You might think this is just the opinion of a few Japanese bond traders, but, if you look at the size of the Japanese government bond market, you realize that it is a pretty big market. The market in 2001 was ¥172 trillion, which is about 34 percent of the Japanese GDP. So, another way of thinking about the current situation is to realize that a lot of money is betting that Japan will pay off its debt through conventional fiscal policy.

Is Japanese fiscal policy sustainable? I need to begin by addressing the question of what we mean by fiscal sustainability. Essentially, what we are talking about when an economist discusses fiscal sustainability is that we define a policy as sustainable if it can continue indefinitely with a stable government debt-to-GDP ratio. In other words, the debt level may rise over a certain time period, but ultimately, will it come back to its current level.

The main finding, which struck us as a very happy one, was that Japan's fiscal situation is not nearly so bad if one makes reasonable assumptions about the future. Related to that point, we argue that most studies that predict a crisis make excessively pessimistic forecasts. Let me take you through the few ways in which our study differs from prior work.

There are five important differences. The first is that when people talk about the Japanese government's financial situation, very often they value the financial assets held by the Japanese government at zero. Secondly, there tends to be an assumption that low fertility in Japan will continue forever. Third, there is an assumption that the long-term demographic transition, the aging of the Japanese population, needs to be solved with short-term policies. We believe that some very long-term policies may be more appropriate. Fourth, one of the things that we look at is that the transfers to the old and the young should depend on the population of both groups. You will see a lot of discussion about the elderly and very little about what needs to be done for the young. Fifth, Japan should be able to avoid some explosive growth in per capita benefits. If you let the per capita benefits rise very rapidly, you may need some very high tax rates, but you can also pursue somewhat more fiscally conservative approaches.

Why is the Japanese debt level much less serious in our opinion than is commonly reported? The standard debt number that one hears in policy debates is what economists call "gross debt." In accounting terms, if you come from the business world, it would be the equivalent of your gross liabilities. However, this makes no adjustment for the asset side of the balance sheet. Just let me give you one example of a big asset listed on the Japanese balance sheet. Japan holds US$824 billion worth of foreign exchange reserves, and those assets represent a lot of money, about 8 percent of the U.S. GDP and 18 percent of the Japanese GDP. Economists like to work with a concept of net debt, which is liabilities less assets and is similar to net worth for a corporation. If you work with the net debt of the Japanese government, you realize that the net debt is less than half of the gross debt.

The second issue has to do with population projections that are used when forecasting social security payments. The basic way social pensions work in Japan is that the younger generation of Japanese pays for the older generation. As we have seen, the standard academic forecasts assume that the current Japanese fertility rate of 1.3 will continue forever. That is how the forecasts are done. We just assume that there will be no recovery in the Japanese population. If you extrapolate, the last Japanese person will likely be born in 2800. If that seems ridiculous, then you should worry an awful lot about pension forecasts that are being built on this forecast. In other words, surely, for the last Japanese person born in 2800, the pension system is going to be unsustainable. In fact, you should realize that the tax rate will eventually become infinite if there is no one left to pay taxes. Our assumption is that the Japanese are not going to disappear and that the decline in fertility is going to be temporary, because there are two important effects on fertility.

The first effect is the one commonly discussed, which is that, as women's wages rise, they tend to have fewer children, because they would rather go out and work and earn money than stay home with their children. The second effect, which economists call

Japan's fiscal situation is not nearly so bad if one makes reasonable assumptions about the future.

—David Weinstein

Another difference between our work and conventional work is that we spend a lot of time considering younger Japanese.

—David Weinstein

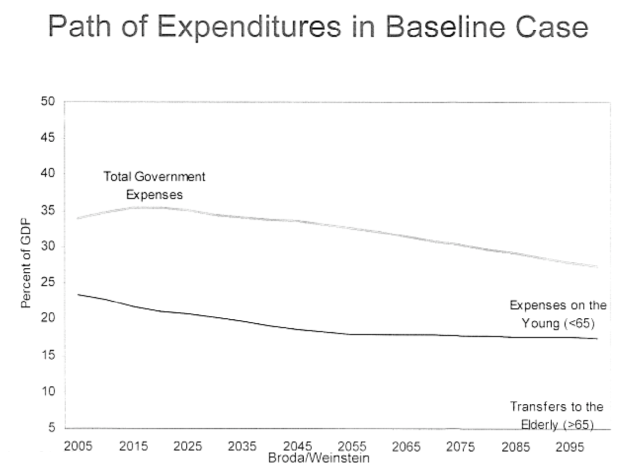
an "income effect," is that if women's wages rise enough, they can afford to have children. They can afford to pay for nannies, or maybe they will want to take some years off or pursue some strategy so that they can have children. The second effect, in our estimation, is likely to become more important in several decades, causing fertility to rise. You see this internationally. Japan is not a real outlier in terms of its fertility rate, if one controls for the income of the population. As that income is likely to rise in the next 20 or 30 years, fertility is also likely to rise.

I think it is important, also, to realize that the problems arising from long-term demographic transitions should be dealt with via long-term policies. Japan is not going to be aging forever. One can use deficit financing to spread the cost of aging over several generations. If you realize that there is going to be a really bad time, when there are a lot of old people and very few young ones, but that ultimately, the population will stabilize, then there are going to be some population gains down the road, as the ratio of elderly to the younger population begins to stabilize. You can use that to help reduce the costs for the current generation.

Another difference between our work and conventional work is that we spend a lot of time considering younger Japanese. The standard forecasts spend a lot of time thinking about how expenditures on the elderly are going to increase as the number of elderly rise, but they make little or no adjustment for the fact that if you have fewer young people in the future, then you are going to have some cost savings. With fewer young people, you will need fewer schools, lower social benefits for the young, fewer police, etc. These are cost offsets that will come into play at some point in the future and may reduce some of the costs of the aging society.

The last set of assumptions is that we assume modest economic performance and some cost containment in terms of the rise in per capita benefits. Very often, you will see in forecasts about sustainability that future economic performance is going to be even worse than that of Japan over the last ten years. It is a pretty bleak future that is being forecast, and that has implications for how much you pay in taxes. In addition, this is very often coupled with extremely generous growth in benefits, producing very high tax rates. We find that modest economic performance coupled with generous, but not too generous, growth in benefits will reduce the implied tax burden substantially.

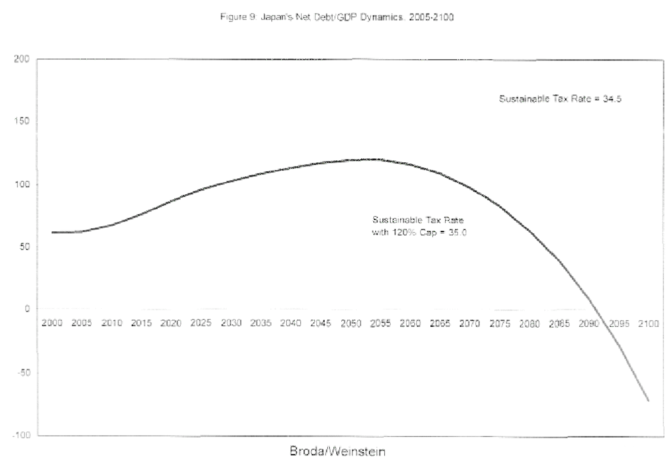
TABLE C



Let me give you a sense of what the next 100 years for Japan is going to look like (see Table C). The bottom line shows government expenditures or projected government expenditures on the elderly as a share of GDP over the next 100 years. You can see that this is going to spike about 50 years from now, as many people will be retiring. On the other hand, we project expenses on the young to decline, because the number of young people is going decline in the future, so some cost savings will occur. If you look at total government expenses, those are going to continue to rise for about 10 to 15 years, but then those expenses will taper off a bit, as the demographics start to stabilize and older people start to die off.

If you are looking at Jap-

TABLE D



anese debt levels (Table D), you are going to see in all of our scenarios, rises in the debt level over the next 50 years or so. Depending on what tax rate you use (here we are looking at a tax rate that stabilizes the debt level across the next 100 years), the debt level could rise as much as a 160 percent of GDP. This is net debt level from a current level of about 70 percent. A slightly higher tax rate might keep the debt level down to the level of Italy today, and then it would come down once the population stabilizes.

With modest benefit increases (increasing benefits roughly at the rate of real GDP per capita benefits), the long run, tax-to-GDP ratio needs to rise by two percentage points of GDP, or about 8 percent, but there is no need for an immediate tax increase. If the economy grows well in the next few years, it is conceivable that the debt might be sustainable without further tax increases. On the other hand, if this fails, I would recommend a phase into tax levels close to those of 1990 over the next 10 years. That, in our baseline scenario, would solve many of Japan's problems.

Is this feasible? I think it is, because Japan currently has among the lowest tax-to-GDP ratios of any country in the OECD; this is Japanese tax revenues relative to GDP. In particular, you can see it is even lower than in the United States, and much lower than the average for the OECD and certainly the average for Europe.

I think that Japan's demographic transition is going to be manageable. We analyze a wide range of scenarios, including the worst for the fiscal side, with very generous benefits, no recovery in fertility, and poor economic performance; and if that happens, Japan is going to need European-level taxes. They will then have European-level benefits and European-level taxes. On the other hand, if you have generous benefits, modest economic performance, and a recovery in fertility, Japan can get by with U.S.-level tax rates (i.e., a slightly higher tax rate in the future).

I do not know what Japan is going to decide, but neither of these options suggests a major crisis in the future. As a corollary, I think it is important to recognize that monetary policy is not a solution to Japan's fiscal problem. The reason for this comes from the fact that the problem that Japan is facing with an aging society is not about current liabilities. It is not that Japan has run up so much debt that it cannot pay the interest payments on it. It is about future expenditures; that Japanese society is aging, and that Japan may have or will have some big expenses in the future. Inflation today is not going to reduce future expenditures, because it is all indexed to the inflation rate. I think it is unlikely that the Bank of Japan is going to be forced to monetize Japanese debt.

I think it is important to recognize that monetary policy is not a solution to Japan's fiscal problem.

—David Weinstein

DISCUSSION

KAZUMASA IWATA

Bank of Japan

Let me make three points. First, looking at Japan's current fiscal management, it was mentioned that maybe the primary surplus (deficit) should be reduced to zero over 10 years, and that has been the policy advocated by Prime Minister Koizumi. I would like to compare the current situation with the prediction. There is a substantial net debt ratio to the nominal GDP, and that needs to be stabilized. Second, I would like to make a point about the price level target that Professor Ito mentioned. Third, I would like to share with you my personal viewpoint as to what would constitute appropriate monetary policy management.

Professor Weinstein mentioned net debt and the GDP ratio, the current level and the likely rate in 100 years, and that, if it is on the same level going forward, then that situation can be regarded as being sustainable. However, we will need a large surplus; otherwise this assumption may not be fulfilled. Nominal GDP and net debt need to be stabilized, and the basic deficit must be reduced to zero, and that has been the policy of Prime Minister Koizumi.

Compared with the current fiscal management of Prime Minister Koizumi, I see that Professor Weinstein looks forward to having tighter policy management fiscally. For example, with reference to Koizumi's cabinet, in 2013, the net debt to nominal GDP rate will become rather high. There is a primary budget deficit relative to GDP of about 5 percent, so government debt will rise, and there is a deficit coming from interest payment, servicing the debt, so that there is a secondary budget deficit. Combining these two factors, the deficit will rise, so that by 2013, the ratio between net debt and nominal GDP will be such that while it might be 60 percent at present, it would rise to 90 or even 100 percent.

The public pension system needs to be privatized.

—Kazumasa Iwata

Prime Minister Koizumi has a policy to make the primary deficit go down to zero. Even if that is realized, however, if the ratio of net debt to GDP is high, making the deficit go down to zero will not be sufficient to have a stable ratio of net debt to nominal GDP. Initially, in talking about net debt to nominal GDP, I think Professor Weinstein said that the initial number may not be relevant, but with today's cabinet, the net debt issue is something that cannot be ignored. We need to have a certain level of surplus; otherwise, we will not have a stable net-debt-to-nominal-GDP-ratio in the future. For example, if the essential GDP budget deficit is lowered by 10 percent, even if it is to be lowered by 5 percent, then maybe a stable situation will be achieved in 2015 or beyond.

Professor Weinstein's paper mentions tax revenue, but if you look at the breakdown of tax revenue, you will see that there is a tax revenue portion, as well as social security contributions. Those things are covered together. In Japan, we have a problem with the national pension system, which is faced with a crisis because the younger generations are refusing to pay the pension premium, and there are members of Parliament who also are not paying into the pension fund. The pension premium collection has not been done properly in Japan, so it has to be replaced by a tax, which means that there is a going to be a heavier tax burden.

As far as I am concerned, looking at the public pension system, I am of the view that it needs to be privatized. If it is to be privatized, then we need ¥450 trillion worth of money, meaning that there is ¥450 trillion worth of contingent liability, which is on a par with the nominal GDP. It would be a challenging task to create a good pension system, because every year the benefits to be paid would become huge.

If the level of the government's expenditure is to be kept constant and stable, then much needs to be done. There is a fiscal expenditure on one hand and a nominal GDP ratio on the other—it needs to be kept constant, and natural growth of the tax ratio has been expected, as has the automatic stabilization effect. Even in a recessionary period, this automatic stabilization mechanism has been relied on. If we look, for example, at the social security contributions, the pension system, or the medical care system, we have to say that those are the crucial points to be considered when we talk about the total picture of Japanese public finance.

There is one more point, the tax and social security burden. Combined, they are regarded as being a burden on the public. Presently, the definition of the national income is used, and its burden is 35.5 percent; 40 percent is a social security contribution, and 21.5 percent the tax portion. According to Professor Weinstein's forecast, however, with a generous payment benefit, the ratio will be 43.9 percent, but it would become 54.4 percent or so, according to the national income, which goes beyond the threshold of 50 percent.

Whether the birth rate will recover or not is a crucial point. With regard to the issue of the birth rate, there is a population of women without full-time jobs, called "freeters" in Japan. They do not have long-range plans, which means they are not likely to have children. Over the long term, looking at sustainability, we need to have a subsidy, tax incentive, or another method that would promote regaining the fertility rate.

What about the utility changes over time, together with the demographic changes, which have not been touched on by Professor Weinstein? We have an intergenerational model, where, if we use an efficient unit, the labor unit could go up rather high, according to my calculations.

What about price level targeting and the monetary policy aspect? In a long-standing, deflationary economy, the accommodating monetary policy needs to continue for a longer time than normal. I think Professor Weinstein's recommendation is appropriate, and, at the same time, when the loss is incurred on the part of the BoJ balance sheet, then the Ministry of Finance has to compensate for that, and I think that is a very good suggestion. However, if we look at price level targeting, if we are to open the Japanese deflationary issue, can it be done only relying on monetary policy, or do we need help from fiscal policy? Those are the issues that need to be considered, and there are a few camps on this. There is a potential growth rate, which could go down temporarily. Under such circumstances, monetary policy would be enough to deal with that situation, so that the problem can be addressed with the price level target. Professor Weinstein's paper is Ricardian, and Prime Minister Koizumi's thought is Ricardian, too. But I think Professor Weinstein recommends a much more Ricardian type of policy. There are multiple equilibrium points that need to be considered here. Monetary policy alone will not be enough. Rather, a stricter policy will be needed.

Governor Bernanke of the Federal Reserve Bank of New York came to Japan last May, and he asked what could be done about deflation. Maybe tax cuts, financed by money, will be the key. A Ricardian fiscal policy has not been mentioned, and on top of that, a price level target could be introduced. That was the recommendation made by Bernanke. There are some issues concerning price level targets, which can be temporary; however, there is a danger that they could diverge from the final goal, which means that credibility could be impaired in managing the policy. Actually, it is regarded as being behind the curve. The inflation expectation will go first, and the monetary policy will be delayed.

My recommendations include three principles. First, the monetary base needs to maintain positive growth into the future. Second, fiscal target policy should aim for a zero primary deficit in about ten years. Third, numerical price stability targets need to be introduced. Maybe we can call this a "numerical expression" or "reference rate"; this is the reference level in association with the CPI. Then we will successfully escape deflation. Looking at the fiscal target policy, if the inflation rate is 1–2 percent, then the Ricardian policy will be applicable. However, there is a natural interest rate and the deflation rate, which are equal, so under that circumstance, the situation will warrant a non-Ricardian type of approach.

If we are to escape deflation, then what would be the essential point? Government liabilities and the base money, their summation, comprise outside assets, and those assets need to be utilized to the fullest. Under deflation, the budget will remain unused, but it needs to be used to the fullest with reasonable assumptions about the variables; the optimum effect will be roughly 8 percent.

Professor Ito talked about unconventional policy measures and tools. Many of the unconventional tools are already being used on a de facto basis. For example, the Bank of Japan purchases JGBs totaling ¥14 trillion, about 40 percent of the budget deficit. It has purchased shares held by banks, with a prudential ceiling of ¥3 trillion. However, foreign bond purchases are constrained by the restriction that the Ministry of Finance holds the responsibility for the exchange rate.

Lastly, I would like to ask about the issue of how we can avoid overshooting the long-term rate. As I said before, for newly issued government bonds, options have to be put in so that there can be floating bonds as well.

There is a difference between Governor Hayami and Governor Fukui. Governor Fukui has shown a clear, forward-looking commitment,

Many of the unconventional tools are already being used on a de facto basis.

—Kazumasa Iwata

which is a critical difference from the past governor. I have talked about price-level targeting as well as my proposition, and there is a difference about the element of dependence historically. When it comes to policy management, in December 2003 three conditions were set, and this is the second condition, that the majority of all of the board members have to predict the CPI increase rate of more than zero, and it will never go back to deflation. This needs to be clarified further; maybe a 1 percent positive increase rate of CPI will be necessary to say that normal reversion to the CPI is zero. There is a 2 percent ceiling rate and no overshooting. I think a clear message can be sent in this fashion.

SESSION II: REFORMS OF BANKS AND GOVERNMENT FINANCIAL INSTITUTIONS

ANIL KASHYAP
University of Chicago

A normal economic recovery would be far from adequate to cure the problems of the banking system.

—Anil Kashyap

Right now, it is very common to look at the recovery of the economy and say that perhaps the financial system problems are going to go away. We think that is very unlikely. Here is a very simple calculation to suggest why just a normal economic recovery would be far from adequate to cure the problems of the banking system. As of March 2003, the period in which we last had a full set of numbers, the banking system was severely undercapitalized. Our rough estimate is that the banking system needs ¥35 trillion more capital once you made all the corrections needed to account for hidden losses, underutilized capital and underprovisioned losses, deferred tax assets, and the like. The question we start with is whether or not the recovery that has begun now in Japan is likely to be enough on its own to solve the problem. If that were the case, then we would not need big solutions for the Japanese economy.

We see that there are essentially four ways that a recovery could help the banking system. One of them, which we have already seen quite a bit of, is recovery in the stock market. Because the banks hold so much in equities, roughly ¥20 trillion, they earn capital gains every time the stock market goes up, as well. As of March 2004, for instance, the Nikkei was at 11,700, and at that point, you would have had ¥4 trillion in capital gains that would have gone toward helping the capital deficit. For every 10 percent further that the stock market recovers, you can get another ¥2 trillion.

We made a crude adjustment for the improvement in loan quality that has happened thus far, and by reducing the number of nonperforming loans and improving the quality of the loans that are and stay nonperforming, we estimate that that would also reduce the credit cost that the banks would bear and that would add another roughly ¥6 trillion.

The problem is that that still leaves you ¥25 trillion short, and if you start asking how much profitability would you have to have to overcome that deficit, the answer is, huge amounts of profitability. If profits were to grow at 40 percent per year, which is almost crazy, you could get five-year profit totals of ¥16 trillion, and that would then make usable some deferred tax credits that we think are not going to be achievable to actually become potentially usable. Add this up, and you have about what it would take to get the banking system recapitalized.

We do not think that this scenario is at all realistic, mostly because the profit forecast is far too aggressive. The 40 percent profits per year mean that by March 2008, you would have profits in the banking system that are substantially above the profits as of the peak of the asset price bubble. You would have to get profits to be a third higher than they were in March 1989 under this scenario. It also assumes, magically, that all of the bad lending decisions that the banks have been making for so long stop, so there is no more lending to unworthy companies. It also presumes somehow that lending spreads for the banks will rise, something that that data, even through April, shows no sign of happening so far. Right now the banks' lending margins are no better than they were two years ago. Finally, it ignores the fact that the banks own a lot of JGBs, and under this scenario, when interest rates rise, a lot of the gains in the stock market are cancelled by losses on the bond holdings. The major banks alone hold more than ¥100 trillion in bonds. The duration is roughly four years according to the reports that we relied on, which means that every 1 percent rise in interest rates knocks ¥4 trillion of earnings out for the banks. Our conclusion is that merely sitting on one's hands and hoping for the economy to recover will not fix the banking problem.

A large part of our analysis compares what has been done in Japan to what has been done elsewhere. Here, we rely mostly on World Bank research, where, examining 35 countries, they have studied a number of banking crises. In these 35 countries, there were three prominent policies adopted. One was to provide extensive liquidity support for banks—that has been done in Japan. Second was to guarantee the banks' creditors, like the extension of deposit insurance that began here in 1995 and has continued for nine years. The third involves the regulatory forbearance that we see in Japan, where lots of banks have been permitted to operate and then hastily closed when it becomes painfully obvious that they are not viable (interestingly, there were audits done by regulators very shortly before many of these closures where the auditors somehow thought that they were viable). In the 35 countries that have had banking crises, 80 percent of them used at least two of these three policies. What the people at the World Bank find is that unfortunately these policies do not work, in two specific senses. First, there is no evidence that the countries that adopted these polices ended up with lower costs ultimately for their taxpayers, nor is there any evidence that the speed at which the country recovered from the banking crisis was affected by using these policies. We conclude that these policies typically do not work. Much of what we do in the papers documents that these policies have been in place for a long time in Japan, and thus far, have not worked there. Based on the evidence from other countries, it is not surprising that things have not improved in Japan.

Let us now turn to an analysis of the lessons from countries that have successfully recovered. Here we focus on Finland, Sweden, and the United States, because these are really the only developed, advanced countries that have had banking crises that were systemic. Most of the countries that have had really big banking problems in the last 20 years have been underdeveloped, and it is not clear that the lessons learned there would carry over to Japan. There are two broad lessons that come out of the experience of these developed countries that we think are very important. All three of these countries used asset management companies. There is an alphabet soup of names for the different asset management companies that have been tried in Japan. Right now we have the IRCJ. The lesson is that you have to try something different from that which has been tried in Japan. In particular, those countries that used their asset management companies successfully did something very different from what has been tried in Japan; they were very aggressive about taking bad loans off the books of financial institutions, selling them, and doing so quickly. For instance, in the United States, 98 percent of the savings and loan assets that were transferred to the Resolution Trust Corporation were sold, and that was done within five years. All three countries had asset management companies; all three of them shut their asset management companies down within five years, and that was done after the asset management companies had disposed massively of the loans transferred to them.

The second phenomenon that occurred in all three countries was that the banking industry shrank dramatically. The savings and loan industry in the United States over the period around the crisis shrank by 43 percent. Finland's banking sector also shrank by a third; that is something that looks inevitable. In all of these countries, as well, a great deal of capital was injected into the banking system, and the management of the banks was replaced. We think that it is no accident that so far the Japanese financial system has stagnated and been unable to recover. Japan has been trying policies that have not worked elsewhere and avoiding the policies that have been effective in other countries.

For the banking crisis to be resolved, Japan must move away from the failed policies and toward those that have a

Japan has been trying policies that have not worked elsewhere and avoiding the policies that have been effective in other countries.

—Anil Kashyap

chance of working. We make three specific recommendations. First, the FSA special inspections that have begun over the last year should be extended and toughened up; they should be available to all types of borrowers, not just the large borrowers at the large banks—this must happen. Second (this was a theme not only in our paper, but nearly half of the papers in the solutions project), more focus on restructuring must occur. We cannot focus on labeling alone but then do nothing about it. That is evident in the successful examples of recovery elsewhere. Third, the banks that should be recapitalized need to be recapitalized sufficiently once and for all, rather than in a piecemeal fashion, as has been done thus far. These kinds of policy recommendations make no sense without a coordinated macro policy to strengthen the recovery even further, so we assume here that the macroeconomy has appropriate policies. We include a detailed case study showing that the way that Resona was handled fails all of these prescriptions, so even the recent FSA performance, in that case at least, looks inadequate. We think that it is inevitable that when the crisis ends, a number of conditions will be met: the banks will be better capitalized, they will stop making loans to nonperforming customers, and the banking system, to be viable, will be smaller and more profitable.

The FSA special inspections that have begun over the last year should be extended and toughened up.

—Anil Kashyap

We conclude that the current polices have not worked, and if you had asked us five years ago, before we knew what was going to happen, we would have said there is no basis for thinking that they would work. We do not believe that the macroeconomic improvements thus far, or even under any realistic scenario, will be sufficient. We need to see a much tougher, more proactive set of polices for a turnaround to take place in the banking sector.

TAKEO HOSHI
University of California, San Diego

Anil Kashyap has proposed a solution for the banking sector, but the problem in the Japanese financial system is not limited to the banking sector. The "Solutions" project that Hugh and David and others have been talking about and in which we have participated, has four other papers that deal with the issues in the financial system in Japan. There is one paper by Professor Mitsuhiro Fukao of Keio University on life insurance companies and another by Professor Mariko Fujii on capital markets. There is a paper by Professor Tokuo Iwaisako of Hitotsubashi on corporate restructuring and one by Professor Takero Doi of Keio University on government financial institutions. I want to go over the problems that government financial institutions in Japan face and how we should solve them. This is based on the paper in the "Solutions" project done by Professor Doi. I also wrote a paper with Professor Doi a couple of years ago, which was published last year, about FILP—the Fiscal Investment and Loan Program, *Zaito* in Japanese.

By government financial institutions (GFI), or *seifukeikinyukikan,* we mean all the government financial institutions listed in Table E. These government financial institu-

TABLE E

GFIs discussed here

- Postal Saving System （郵便貯金）
- Government Housing Loan Corporation （住宅金融公庫）
- GFIs for SMEs (Japan Finance Corp. for Small Business, National Life Finance Corp., and the Credit Guarantee Division of Japan Small and Medium Enterprise Corp., Shoko Chukin Bank) （中小企業金融公庫、国民生活金融公庫、他）
- Development Bank of Japan （日本政策投資銀行）
- Japan Bank for International Corporation （国際協力銀行）
- Agriculture, Forestry and Fisheries Finance Corp.（農林漁業）
- Okinawa Development Finance Corporation （沖縄開発）
- Japan Finance Corp. for Municipal Enterprises （公営企業）

Government Financial Institutions

tions are an important part of the FILP. As many of you know, FILP is a program that the Japanese government has to allocate investment and loans, using the funds collected through government financial institutions. FILP may have been important for economic growth in Japan before the Japanese economy matured. For example, before the Japanese government ran a budget deficit, FILP was a useful tool for the government to finance large projects without raising taxes at the same time. Even after the Japanese government started to run a budget deficit and finance it by issuing government bonds, but before the bond market was well developed, FILP was useful because it allowed the Japanese government to finance government bonds using the money collected through postal savings. As the economy matured, private financial markets developed, and many factors that made GFIs and FILP itself have disappeared. Many government financial institutions started to cause problems.

I would like to point out three important problems that many GFIs have. One is that the government financial institution may distort competition in the financial market by competing with the private financial institutions on an unfair basis. After all, the government financial institutions do not pay taxes, and they receive subsidies. From the private sector's point of view, that is not good. If you are a private bank or financial institution, you would not want to compete with a bigger financial institution that does not pay taxes and is subsidized by the government. Second, even if government financial institutions do not distort competition directly and engage in some useful activities, they may keep losing money, which eventually costs the taxpayers. Third, if the government financial institution does not lose money and engages in something useful, we can still ask whether it is really best to use GFIs.

Government financial institutions are not an insignificant phenomenon. There are two observations we can make. One, they are big—the postal savings are more than 30 percent of total deposits, and the government financial institutions collectively make more than 20 percent of total loans. Two, they grow over time. If you compare the numbers for 1990 to those for 2002, the government financial institutions, both postal savings and other government financial institutions, increased their shares. We are talking about a big part of the financial system, and it has some big problems.

My paper with Takero Doi shows an estimate of the cost to taxpayers in covering the losses that were already made by the FILP agencies—all of those government agencies and special public companies that receive money from the FILP and the government financial institutions are a big part of this FILP. Our estimates show that the cost to bail out the Fiscal Investment and Loan Program is ¥78 trillion or ¥620,000 for every person alive today in Japan.

What should be done? We propose that for each government financial institution, first we need to isolate the problem. If the problem is that the government financial institution distorts competition in the financial market, it is important to remove the distortion. In some cases, we may be able to make the government financial institution compete with private financial institutions on an equal footing by taxing it or cutting its subsidies. In some cases, we may conclude that we do not really need certain government financial institutions, because private financial markets have developed sufficiently. In that case, the government financial institutions have completed their mission, and we can close them down. If a government financial institution still has a role to play in the economy, but the problem is that the government financial institution has been losing money, then we need to determine exactly how much money the government financial institution is losing. Then, we need to evaluate whether the need the government financial institution is filling is really worth the cost.

Economists can give you the numbers, but eventually, whether a government financial institution should continue should be decided by the Japanese voters. If we decide our government institution is doing something worthwhile and not losing money, then the question we should ask is, "Is the government financial institution the best solution to

Economists can give you the numbers, but eventually, whether a government financial institution should continue should be decided by the Japanese voters.

—Takeo Hoshi

address the policy goal?" For example, the Government Housing Loan Corporation may be doing something very useful to encourage home ownership, but is giving subsidized loans the best answer? One alternative is to subsidize the homebuyer directly, which may be a less costly way to achieve the same goal.

To be fair, I should point out that the Japanese government recognizes the problems, but given what the government has been doing, we must conclude that it does not have the final solutions yet. The FILP reforms, the reform of *Zaito,* was introduced in April 2001, and we can consider that an attempt to introduce market discipline for FILP agencies, including government financial institutions. So far, however, little change can be observed. The FILP agencies are required to issue FILP agency bonds eventually, according to the plan. For now, however, only a small amount of FILP agency bonds have been issued in the market. The flow of funds between the government financial institutions and the postal savings has not changed very much.

The Koizumi government also decided on a plan for reorganization and reunification of special public corporations, or *tokushuhojin kaikaku.* Initially, study for the plan was to be completed by the end of 2002. It did not happen. Now, the study is to be completed by the end of 2004. Here, we again see takinobashi, or procrastination by the government.

The government realizes the problem of postal savings, and in September 2002, the council issued the final report on the future modalities of the three postal businesses. This final report talks about the potential models for future postal savings in Japan but does not contain final conclusions.

There are general principles we need to keep in mind when we come up with solutions for the problems of the government financial institutions. These principles are:

1. The government financial institutions should not distort competition in the financial markets.
2. The government financial institutions' activities should be worth the cost, and it is the Japanese voters who need to make that decision, for each government financial institution.
3. Having government financial institutions must be the most efficient answer for the policy goal that the government financial institutions are designed to achieve.

DISCUSSION

MAKOTO HOSOMI

Financial Services Agency

As far as we are concerned with regard to macroeconomic growth, growth itself will not be a solution to the NPL or the banking sector issue.

—Makoto Hosomi

As far as we are concerned with regard to macroeconomic growth, growth itself will not be a solution to the NPL or the banking sector issue. In October 2002, the financial revitalization program was announced; it called for the strict assessment of assets and injection of public funds to recapitalize some institutions. And, of course, corporate governance on part of the bank would be looked at as well. We are not working on the basis of the economic recovery, because economic recovery alone will not be the solution.

There was a comment made about the special inspection by FSA. There might be some misunderstanding here. There are both the standard type of inspection and the special inspection, but there is no difference in terns of the toughness of the examination given to the asset. In the case of a normal inspection, based on certain standard figures on an ex post basis, the FSA will conduct an inspection. But in the case of a special inspection, prior to the closing of the account with regard to the major borrowers of that major bank, inclusive of the financial institutions, the auditing, and the FSA, all will get together to look at the borrower's situation, whether there has been downgrading of the rating of the major borrower over the six-month period or whether there has been a significant decline of the stock prices by some of the major borrowers. Those need to be reflected duly in time in the closing of the account. That is why, before closing the account, we go into the bank and conduct a special inspection. It is a difference of timing—ex post or prior to the events. We focus on the major points for special inspections. Every year we conduct a normal inspection of the major banks, and the standard applied there is as tough as that we employ for the special inspection.

It may not be the official stance of the FSA, but let me share with you the problems faced by Japanese banks as I see them. There are the issues of corporate governance and stocks and flows of assets. What we are focusing on intensively is the quality improvement of the stock assets. How can we improve loan quality? Of course, Japanese banks have a lot of stock holdings, and the capital gain has been going up for these stocks, but I think that by holding too much stock, the banks can cause their stability to fluctuate. We have a policy that the banks' shareholding be within the tier one asset. Even if Nikkei 225 fluctuates by 10 percent, its impact on the banks' capital will be less as a result of those policies.

The second point is the nonperforming loan (NPL) issue, in association with the quality of loan issue. As you know, a financial reconstruction program was put in place. The NPL ratio of 8.4 percent needs to be halved by March 2005; two years have passed, and it has come down to 5.2 percent from the previous 8.4 percent. So the goal is to have the ratio about 4 percent. It is progressing as scheduled, but there is some unevenness from one bank to another. Some banks have already achieved going below the 4 percent figure, but there are some who are still hovering at around 8 percent.

As for loans, action has been taken to deal with the "doubtful" categorization and those below it. Within one year of the emergence of such a loan, 50 percent has to go off the balance sheet, and in three years, it must be off-balanced fully. In this area, there is no "evergreening" (a situation in which banks are rolling over loans to de facto bankrupt firms). For the "need special attention" category of substandard loan, with regard to those types of the loans, beginning in March 2003, these have been on the increase. However, unlike the "doubtful" or "substandard" categories, they have a certain room for being viable, but NPLs still need to be disposed of in this category. With regard to the normal type of business, the revitalization plan has to be written and formulated, and the FSA will take a close look at it. We have noted that there is a polarization taking place between those that are improving and those that are not. By looking at the revitalization program, we can judge which companies are doing better and which are doing worse; I think this latter category of loan has been on the decrease. The "need special attention" category of loans could also be looked at as well. We are checking on them and can judge whether or not the revitalization program has progressed smoothly.

Thanks to the economic recovery, the emergence of new NPLs has been on the decline. Since October 2002, the discount cash flow method has been employed for calculating the provisioning, and for the past year, provisioning levels have been going up. The figures I have say that collateral, real estate, and so forth is 85 percent for the "doubtful" category. For the "substandard," a little more than 60 percent provisioning has been secured. Of course, one can say anything about the appropriate levels of provisioning, but compared with three years ago, it has been on the rise.

The second stock issue is the quality of the capital. Apart from the public fund injection, let me focus on the deferred tax asset (DTA) issue. Of course, there are a lot of DTAs. I do not think it is desirable to have such a situation; last year, the Financial System Council report also said that. It is desirable to s the DTAs continue to decline. Why has the DTA issue emerged in Japan? In accordance with the Japanese system, there is a big difference between taxation and accounting. When much progress is made in NPL disposal, then the DTAs will also go up as well. However, if the NPL disposal goes down, then DTAs will go down as well.

The peak of the NPL was 8.4 percent in March 2002, but the DTA peak registered one year after, in March of last year, and has started to decline. However, DTA is an accounting notion. Whether it can be recognized as capital within the regulatory framework is another question, and it has been discussed at the Financial System Council deliberations. After the intensive disposal period of NPL is over next year, it will be considered more fully. Much effort has been made to improve asset quality, and I think we have become more ready to address seriously the issue of the quality of the capital.

Asset flow is not a matter for the administration to address, but rather one to be

> *As for loans, action has been taken to deal with the "doubtful" categorization and those below it.*
>
> *—Makoto Hosomi*

resolved by the management of the banks, but let me make a few points. First, in the case of Japan, with ¥4 trillion worth of core business operating profit being obtained by the major banks in Japan, compared with asset size, profitability is rather low. Japanese financial institutions have produced a deficit because the credit cost was higher than the net operating profit earned from the core business. Now, however, I think the structure has become ready to yield some profit. Second, there is a low margin issue—low, narrow spread. I would like to point out, however, that at least at this juncture, deflation is still continuing. There is a zero percent deposit rate. Yet, the real interest rate is very high in Japan. If the short-term rates still go up, then it is usually the case that the deposit rate, as well as the lending rate, will also go up. What will become of the spread? Will the spread be widened or kept as it is? We will have to see whether the spread improves or not in the short-term-rate-rising situation.

It has been mentioned that the business line of Japanese banks is rather backward, which may be is true to a certain extent. Japanese banks are trying to improve their fee business, and corporate banking is on the decrease, so that SME loans, consumer loans, and mortgage loans are rising instead. Government financial institutions will need to be reconsidered. Particularly with regard to housing loans, the business of the government-operated Housing Loan Corporation is being curtailed; it will be taken over by the private sector banks.

The administration can contribute to improving the profitability of the banks. For example, we can focus on the branch network function of the banks. Through the branches, we hope that more products can be handled by banks like OTC sales of insurance products and mutual fund products and so on. The notion of one-stop banking can come to the fore, and more branches can be utilized for this purpose. That would contribute to the improvement of the profitability of banks in Japan.

The current management of financial institutions has to be fully responsible for internal compliance, and the decisions that they made have to be implemented in a responsible way.

—Makoto Hosomi

The current management of financial institutions has to be fully responsible for internal compliance, and the decisions that they made have to be implemented in a responsible way. I have only talked about the major banks in Japan, but regional financial institutions were discussed in the recent IMF report. Maybe we have not been tough enough. Because of the notion of relationship-based banking, the numerical target has not been imposed on regional banks, because the regional economy and regional financial institutions need to recover in an integrated manner. Some have thought that the stance we have taken has been too soft, but looking at the NPL ratio as of March this year, we see that an improvement of 1 percent has been attained. I think regional financial institutions are addressing the issue much more properly than has been expected. Also, in some cases of the ratings given to the regional financial institutions have been upgraded.

With regard to the regional local financial institutions, we often hear of the "overbanking" of Japan. Roughly speaking, back in 1991, we had more than 1,000 deposit taking institutions, but now there are 620—a drop of 40 percent or so. What is at issue—supply and demand issue or the mere number of the financial institutions? Or is it the overall size of the financial institutions? What about the total number of financial institutions in existence in Japan? The number has been declining, as I have said. Also, in the new framework for injecting public capital, we are seeing that the consolidation of local regional financial institutions is being promoted.

The size of the financial institutions might become smaller, but Japanese banks have been curtailing their lending, while deposits have been on the rise, so asset size itself has not changed much. Japanese households are the providers of funds, but more than 50 percent of the funds are being kept in the postal savings. The financial institutions have traditionally lent the money to the businesses. Unlike other countries, credit risk transfer or securitization has not been relevant, and banks have held onto their loans to their fullest maturity. The simplest funds have been provided by the household sector to finance the lending by banks to businesses in Japan.

We hope that more money will flow from deposits and savings to investment. Instead of the financial institutions taking on fully the risk involved in companies, we hope that through the capital markets, households will also be risk-takers, to a certain extent, through investment. It would be desirable to see some money channeled into other purposes, for direct investment and so forth. It is likely and feasible that the number of financial institutions would therefore decline.

During the presentation, there was mention of the large holdings of Japanese banks of Japanese government bonds. I think the number cited was ¥100 trillion, but I think for major banks, that figure should have been ¥60 trillion. Of course, equity holding on the part of banks has been declining. If you apply a simple sensitivity test, flat equity will go down by 10 percent, and the interest rate will go up by 100 basis points; the interest rise of 100 basis points would have a bigger effect. However, the JGBs holding is quite liquid, so the portfolio can be rebalanced in accordance with changes in the interest rate, and there are many hedging tools available as well. In May 2003, the ten-year yield on the JGBs was less than 0.5 percent, but it went up to 1.5 percent around March of this year, a rise of 100 basis points. Financial institutions did not suffer serious damage, because hedging had been done in advance, for example. The FSA, on a monthly basis, checks the financial institution's portfolio and risks, and if there is a problem, early warnings are issued by the FSA. We are looking into those eventualities and situations fully.

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The Japan National Railways (JNR) was privatized earlier, and it is often compared with the future privatization of postal savings. However, these two public companies are in very different environments. JNR was in deficit over many years and labor disputes went on frequently. There was a national consensus, including 60 percent of the general public and news media, to privatize JNR. On the other hand, postal savings and postal life insurances are not in deficit. Only mail service is. Postal masters in rural areas are often believed to be helping local politicians in elections. Many people in rural areas use post offices for convenience and for safety reasons. They see few costs that government ownership of post offices creates.

However, the general public should be aware of the implicit costs of the post office system. For example, there are no taxes, there are no fees for deposit insurance, and there are hidden costs for misallocation of funds. A cost analysis would have to be done to show how costly it is for the post office to be under government control.

Certainly, it would be better to change the post office from being under government control to private ownership. However, some issues would remain. For example, how to maintain rural post offices, where costs are higher than in the urban areas? Since postal workers are government employees, how can their numbers be reduced?

If post offices start lending activities after privatization, it would further increase competition among banks and would increase bank failures in rural areas.

My proposal under the Koizumi Reform (I am a member of the Reform Committee) is that post offices can only accept ordinary deposits and stop accepting time deposits *(teigaku)*. Post offices could become sales agents for the financial products of private financial institutions. All the financial products of private financial institutions, which include stocks, bonds, and mutual funds, can be sold through post offices. The very popular teigaku deposit is similar to JGBs, so it can be a substitute.

Postal savings should work as a narrow bank, which purchases only government bonds rather than making loans. However, narrow banks have failed in the past. When the share prices start to rise, many depositors shift their deposits from narrow bank stocks, which makes it difficult for narrow banks to continue. Losses have been reported. If they cannot compete; narrow banks should close.

In the past ten years, there were 180 bank failures in Japan. One of the reasons for bank failure is due to regional distress. Regional banks, credit cooperatives, etc. are mainly lending money in their own regions or prefectures. Regional problems have occurred, such as a decline in tourists or the decline in number of factories due to their shift to China.

Another reason is the lack

If post offices start lending activities after privatization, it would further increase competition among banks and would increase bank failures in rural areas.

—Naoyuki Yoshino

of management quality of small banks. Some of the shinkin banks and credit cooperatives are still competing in terms of scale or size, rather than profits.

Banks are competing to lend money to good customers, so their profit margins decline sharply. On the other hand, banks do not want to lend money to risky borrowers. When the Japanese economy was growing and banks were protected by regulations, the number of banks was low. However, the regulations were diminished and the economy started to shrink; therefore, the overbanking issue arises.

The failure by the Ministry of Finance was not being able to make a smooth exit policy. Therefore, many weak banks remained alive. It is also related to the limited guarantee of deposits, which was not implemented due to the opposition of those politicians who wanted to keep small banks in their own region.

The solution would be to return to the limited guarantee of deposits from April 2005 as is planned and make the closure of weak banks go more smoothly.

During the high growth period, clear objectives were set by bankers. It was to increase their deposits and loans. They were competing mainly in terms of scale Recently many small banks cannot set up their objectives clearly.

One of the bad incentives is the structure of commissions and fees. Banks started to sell mutual funds at their branch offices. Each mutual fund pays different commissions to the branch. Then bankers at each branch office sell the mutual funds that they can earn high commissions from, rather than examining carefully how each mutual fund is attractive to customers. A good incentive mechanism should be set up so that customers' needs and the commissions are matched to each other.

Many banks are seeking similar objectives rather than their own direction. Japanese banks earn profits mainly from interest income rather than from loans, and income from fees and commissions are small.

Japanese banks invest their money mainly in Japan, rather than investing abroad. Japanese banks expanded their operation to overseas during the 1980s, primarily to support strong Japanese manufacturing industries. They could not start new overseas business by themselves. They looked very strong mainly because Japanese manufacturing firms, such as automobile and television, were making profits. Now they need their own strategy, such as seeking new business in Asia.

Many Japanese banks increased mortgage loans to customers since business loans declined sharply. However, mortgage loans might become risky. Land prices are still falling, and disposable income is declining in Japan.

Japanese banks might make the same mistake as they did in the late 1980s, following what their rivals are doing.

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—Naoyuki Yoshino

“Solutions for the Japanese Economy” プロジェクト

シンポジウム：停滞する日本経済への処方箋

2004年6月21日、コロンビア大学の日本経済経営研究所と、東京大学先端科学技術研究センターが共催し長引く停滞から日本経済が脱出するための方策を探り、具体的な政策提言をテーマに、東京六本木アカデミーヒルズにてシンポジウムを開催しました。 今回のシンポジウムは、同研究所と同センターが共同で取り組んでいる、15人の著名経済学者らによる政策提言を目的とした“Solutions for the Japanese Economy”プロジェクトの結果報告という位置づけになった。 シンポジウムには日米の官民学界代表者らが参加し、提言された政策に関して評価や議論が繰り広げられた。 以下はシンポジウムの抄訳です。

日本経済の専門家間では、日本の「失われた10年」は終盤に差し掛かっているという見方が始まっている。景気回復はその第三段階に入っており、今回は財政手段による景気刺激策が行われていないにも拘らず回復基調を見せている。 しかしこの状況が実際「本物の回復」なのか、公共部門や産業部門はこの状況をどう受け止めているかについて参加者による議論が交わされた。 特に、構造改革の進捗状況を考察、またそれが真の景気回復の継続に向け、諸問題を解決する方向に進んでいるのかが論点となった。 キーノートスピーチでは、起業家と教育改革の役割について、またベンチャーキャピタルへのアクセスの改善と技術面だけに止まらず、商慣行の革新に対する今後の展望についても考察した。 フィンランドなど他の先進産業経済における実例なども紹介され興味深いものとなった。

シンポジウムの前半は日本のマクロ経済政策問題に焦点を当て、金融政策および日本国家予算の長期的財政安定化政策などが議論された。 1つ目の発表では、日本が「デフレのわな」に陥っていることに問題の深刻さがあると指摘。 その解決策として、デフレ圧力下において目標価格水準を設定し、設定水準に到達した時点で今度は目標インフレ率を設定する、インフレターゲット政策に切り替えるという政策案が提示された。 続いて2つ目の発表では、国家金融資産の過小評価と人口問題に対する過度な悲観的観測により、日本の財政政策の持続性に対して行き過ぎた悲観的分析がなされていると指摘。 両発表に関して、長時間にわたって議論がかわされた。

シンポジウム後半は、金融制度改革と政府金融機関に焦点が置かれた。 後半の1つ目となる発表では、過去の金融改革の実例35件が報告され、成功例から2点が強調された。 まずは、（1）破綻した金融機関が積極的かつ迅速に資産処理をすることの重要性、（2）大幅な金融業界縮小の必要性である。 これに基づき、金融庁の査察強化、構造改革の重要性をより強調、日本の銀行に対する包括的な資本注入など、日本の構造改革をさらに促進する為のいくつかの政策が提案された。 討議者らは日本の政府金融機関が日本の金融業界の公正な競争を阻害していると指摘し、特に郵便貯金については批判的な意見が多く見られた。また、不良債権率改善や、東京近郊以外の地域に最良慣行（ベスト・プラクティス）を普及されることの困難に触れながら、融資業務のあるべき姿についても言及された。

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