Japan’s Economic Mess

Edward J. Lincoln
The Brookings Institution

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Abstract

Japan has experienced very slow economic growth, a large bad problem, and an outbreak of economic scandals in the 1990s. This paper analyzes what has gone wrong with Japan, both in terms of macroeconomic performance and financial sector problems. The macroeconomic malaise is the direct result of the excesses of the bubble--especially the collapse of stock market and real estate prices in the 1990s. But the government exacerbated and prolonged the problem by raising taxes substantially in 1997 just as the economy was beginning to show signs of recovery. The financial sector bad debt problems are also an obvious outcome of the collapse in asset prices, but were also an inherent danger in Japan's bank centered financial center. The paper argues that the financial system, which may have been useful or at least workable, in earlier postwar years, had atrophied, leaving bankers less attentive to evaluation of borrowers. In addition, the system may have always involved a certain amount of corruption which worsened in the 1980s and 1990s. This situation cries out for vigorous and thorough reform, principally through failure of insolvent institutions and imposition of extensive deregulation. However, much of government policy remains very disappointing. The Ministry of Finance continues to permit financial institutions to hide their problems, does not favor more bankruptcies, and is not pressing deregulation with any vigor. The "big bang" financial reforms are a useful move on the surface, but the reality once the entire process is completed will be far less helpful than commonly supposed. Overall, the present problems and the government's response to them remains quite disappointing.

The economic problems facing Japan in the 1990s present a tremendous challenge to economists. The economy has experienced relative stagnation since the collapse of the "bubble" in the early 1990s, and what appeared to be a predictable recovery in 1996 has been snuffed out. Meanwhile almost every week brings a new story of corruption related to the financial sector. These developments seem all the more startling given the record of success in the preceding four decades, and the rising sense of confidence among Japanese in the late 1980s concerning the validity of their economic model.

How should we interpret what is happening now? Is Japan on the cusp of major structural reform or do recent events reflect an inability to escape vested interests and ideological commitment to the structures of the past? Or does Japan not need to change? Do we need to reinterpret our understanding of how Japan functioned in the past in light of recent economic problems and revelations about the seamy underside of business and government relationships? And what do the answers to these questions imply for the future of the economy--will Japan continue to drift along below its potential?

These are all large questions with which economists have only begun to grapple. This paper sketches out some personal thoughts on aspects of both macroeconomic performance and financial problems. The approach is necessarily shallow and sweeping, but the intent is to provoke discussion rather than to provide definitive answers to the questions raised above. I have been optimistic about Japan in the past, but this paper is rather pessimistic. Although the focus is on the economic situation, we should all keep in mind that these issues have important political implications as well. Domestically, stagnation and unending scandal is souring the mood of the public, although this may perversely shift political dominance back to the LDP. Internationally, an introverted Japan absorbed in its domestic economic problems will not play a very positive role on global issues ranging from Middle East crises to vitalization of the U.S.-Japan security relationship.

The System of the Past

Whether or not one agrees with Professor Noguchi's argument of Japan operating under a wartime economic system originating in 1940,[1] it is fair to say that the postwar organization of the economy differed in important respects from the prewar economy and deviated very substantially from neoclassical models. The hand of government was heavy, inspired by an explicit goal of guiding the economy through industrialization, coupled with a strong mistrust of markets. Conservative fiscal policies, heavy control over financial markets, corporate governance emphasizing managerial control, encouragement of company-based unions and lifetime employment, heavily protectionist trade and investment policies, encouragement of cartels and other forms of cooperative industrial behavior, and fostering the creation of vertical and hierarchical *keiretsu* relationships were all core pieces of this system. While they did not emerge from any overarching theoretical concept, in retrospect the various pieces of this structure may have been mutually reinforcing--a point to which I will return later.

For the financial sector, the hand of government was particularly heavy for reasons that reflected the desire to guide the economy. The function of the financial system is to provide the connection between those in society who save and those engaged in real investment (that is, those building factories and other real assets), mediating among differing combinations of risk and return. This connection can occur in the form of intermediation through banks and insurance

[1]Yukio Noguchi, *1940-Nen Taisei* (Toyo Keizai, 1995).

companies or directly through bond and stock markets. As taught in American money and banking courses, there are powerful reasons to assume that a well-functioning financial system will consist of a combination of all these means.

One of the many differences among these forms of financial structure is the very basic notion of open markets. Banking (and insurance investments in Japan, which were largely long term loans) are in the form of private, negotiated, confidential relationships between creditor and borrower. In a competitive banking market, interest rates will reflect the supply and demand for funds, but the point here is that the contact between borrower and lender is a one-on-one confidential negotiation. Bond and stock markets, in contrast, are open markets with daily trading among many participants based on substantial public disclosure of corporate information that guides both the conditions for initial issuance of bonds or shares and their subsequent price fluctuation. While this distinction has blurred somewhat in the United States with the securitization of loans, it is key to understanding what the Japanese government did in the postwar period.

Open financial markets can be a problem for a government desiring to guide the economy. Private institutions make decisions on creditworthiness in deciding to underwrite bond or stock issues, and myriads of individual actors determine the price of those instruments in the market. Banking and insurance, on the other hand, are much easier for government to influence. The Japanese government, therefore, deliberately chose to emasculate the stock and bond markets to favor intermediation through banks and insurance companies.

Bonds were easily controlled by requiring very stiff eligibility requirements and discretionary authority for approval by the Ministry of Finance. This effectively permitted MOF to allow only a handful of favored corporations (NTT principal among them) to issue bonds, at least until the late 1970s.

The stock market was trivialized by eliminating its role as a market for corporate control. The evolution of rules and custom (such as mutual long-term holding of shares and issuance of new shares to existing share holders at part value) which separated stock ownership from corporate control reduced the stock market to purely speculative game.

Banking and insurance were then controlled through the regulatory game.[2] Through total control of interest rates for both deposits and loans, design and pricing of insurance products, and entry into both industries, the Ministry of Finance was in a position to virtually guarantee profits. In exchange, it behooved banks and insurance companies to pay attention to formal and informal signals from the government about the allocation of credit. This stylistic picture is undoubtedly overdrawn; banks certainly made their own decisions on many loans and did not always slavishly follow advice or signals. Banks could also cheat on loan rate limits through use of compensating deposit requirements for borrowers, but note that government tolerance of this only increased the profits of the banks by widening the spread between low deposit rates and loan rates. And certainly MOF had regulatory goals other than guiding the economy, including an overwhelming desire to prevent a repetition of the bank failures of the 1920s. Nevertheless, this model of using a highly regulated and profitable banking and insurance sector as a vehicle for influencing the allocation of credit seems largely valid.

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[2]For an elegant presentation of one economic model of the game played between regulators and the regulated, see Klaus Wallner, "Implicit Contracts Between Regulator and Firms: The Case of Japanese Casualty Insurance," paper presented to the Japan Economic Seminar, February 21, 1998.

Besides being compatible with the desire of the government to influence or guide the direction of industrial development, control of the financial system was compatible with broader aspects of Japanese society (or desirable social values as conceived by a paternalistic government). Japanese society has been one in which information does not flow freely except within group settings characterized by close personal relationships. Therefore, heavy reliance on banking with its confidential information relationships rather than open bond and stock markets was consistent with the nature of information flows within society and reinforced those tendencies. The evolution of the "main" bank system to provide the corporate oversight that equity holders could or did not provide brought long-term personalized relationships between lender and borrower akin to the long-term vertical *keiretsu* relationships favored by government and the private sector. In this model, even bankers with access to the internal financial accounts of borrowers did not trust the numbers and developed elaborate personal contacts lubricated by years of wining and dining plus the dispatch of retiring bank employees to hold positions among borrowers. All Japanese social groups depend on ceaseless attention to the nuances of personal relationships in order to function satisfactorily, so bankers acting in similar fashion is not surprising.

This heavily controlled Japanese financial system appears to have performed its function of connecting savers to investors rather well in the 1950s and 1960s. Households put their savings in bank deposits and insurance policies, and the banks and insurance firms then lent funds to industry. The economy grew quickly (suggesting that the financial system did not misdirect funds unduly to unproductive uses), bad loans appeared to be minimal, and financial institutions were profitable. One can understand the nostalgia in Japan and the continuing belief among many that the basic system should not change. One can also understand the attractiveness of this system to other countries--such as South Korea--attempting to replicate Japan's success.

Whether this system was actually a necessary structure for Japan's economic success, though, remains controversial. Conceivably Japan could have prospered with a different financial structure involving greater reliance on freely operating financial markets. That question is difficult to answer, but became relevant in the 1990s with the debate over appropriate development strategies for other nations. Certainly the World Bank relegated industrial policy and directed credit to a relatively minor role in explaining Asian success in its study of the early 1990s.[3]

This structure also carried risks--a high-growth, bank-centered economic system implied dangerously high debt-equity ratios in the corporate sector as a whole and especially in the banking sector. Not many years ago, economists focused on explaining why the "over loan, over borrowing" features of the banking sector were not dangerous. But in retrospect, Japan could easily have experienced the kind of acute problem facing Korea today at any point in the 1950s and 1960s. But a combination of international capital controls, a willingness to use monetary policy quickly to defend the currency, and the absence of other countries simultaneously following the same development strategy kept Japan from serious problems. When Japan survived the external oil price shocks of the 1970s rather well, confidence in the robustness of the existing system only increased.[4]

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[3]World Bank, *The East Asian Miracle: Growth and Public Policy* (Oxford University Press, 1993).

[4]See, for example, Yoshio Suzuki, "Why the Performance of the Japanese Economy Is So Much Better," *Journal of Japanese Studies*, Summer 1981; or Michèle Schmiegelow and Henrik Schmiegelow, *Strategic Pragmatism: Japanese Lessons in the Use of Economic Theory* (Praeger, 1989).

Creating a Collosal Problem

Just as confidence in the validity and strength of the overall economic system was increasing, however, the seeds of the problems of the 1990s were sown. The oil shock of 1973 hit just as the economy was moving out of the era of 10 percent potential growth; economic success dictated a lower growth rate in the future and the oil shock merely accentuated the transition. Lower growth implied important new pressures within the economy: a chronic imbalance between desired savings and desired investment levels and rising pressures within the financial system from segments of the industry dissatisfied with the consequences of changed financial flows.

The shift in macroeconomic balances accompanying the slowdown in growth imposed new demands on the economy. If society desired to save more than it desired to invest, then other balances had to compensate. For the rest of the 1970s the government provided the offset by running a large fiscal deficit, reaching a peak of 5.5 percent of GDP in 1979. The issuance of large amounts of government bonds to finance this deficit became led directly to the gradual breakdown in tight control of interest rates when banks balked at the low, controlled interest rates at which the government tried to float increasing amounts of debt. Once bond rates were decontrolled, the ripples eventually led to decontrol of other interest rates as well.[5]

Financial institutions also faced shifting demands for funds in the market that led them to be discontented with their very narrow niches. Loan demand from traditional manufacturing clients did not grow as quickly in the slower economic growth environment of the 1980s.

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[5]This reluctant decontrol of interest rates is described in Edward J. Lincoln, *Japan Facing Economic Maturity*, Brookings, 1988, pp. 130-210.

Searching for new, growing markets for loans, banks moved in two important directions: real estate and overseas. In both cases, the Ministry of Finance accommodated the pressures with regulatory changes. For real estate, MOF encouraged the large commercial banks to create the *jusen* as non-bank subsidiaries to engage in real estate lending in the late 1970s. Internationally, MOF presided over changes in foreign exchange control which culminated in the revision of the Foreign Exchange Control Law in 1980.

Table 1
Annual Growth in Bank Lending by Selected Sectors
Percent

Years	Total	Manufacturing	Real Estate	Overseas
1976-80	9	5	7	11
1981-1985	11	6	18	25
1986-1990	11	0	20	5

The outcome is displayed in Table one. During the 15 year period from 1976 through 1990, total bank lending expanded at a relatively even pace over the three 5-year segments, but the sectoral pattern underwent dramatic change. Lending to manufacturing was growing at a rather modest 5-6 percent rate from the mid 1970s to mid 1980s, but was flat in the second half of the 1980s. International lending grew very rapidly in the first half of the 1980s, and, surprisingly grew substantially more slowly in the second half (perhaps because more overseas lending was handled completely offshore). Real estate, on the other, continued to accelerate. From 7 percent annual growth in the second half of the 1970s, it was up at an 18 percent annual pace in the first half of the 1980s and then 20 percent in the second half of the decade.

Rapid entry to both real estate and international lending were pregnant with moral hazzard. In each case banks were dealing with unfamiliar loan clients. To evaluate these clients, banks relied on their existing routines: weak financial analysis and strong personal relationships. While this approach may work in evaluating what is happening in an existing long-term relationship with a major manufacturing firm, it is fraught with danger in entering unfamiliar markets. Combined with this weakness in analytical capability was the continued belief in an implicit guarantee by the Ministry of Finance. No financial institutions had failed in the postwar period, new entry to the industry had been blocked (except for minimal entry by foreign financial institutions), profits remained high, and deposits continued to pour in from the public. This combination of factors was almost guaranteed to lead to problems.

These structural changes dovetailed with macroeconomic developments. The story of the bubble in the second half of the 1980s is well known and does not need much detail here. Faced within an economic slow down that could have led to recession in the wake of the enormous appreciation of the yen from the spring of 1985 to 1987, the government responded with monetary ease. This was a deliberate choice; the government could have used an expansionary fiscal policy but MOF opposed any departure from the long-term goal of eliminating the large fiscal deficit that had emerged in the 1970s. Monetary ease did have the intended impact of propping up the economy--annual real economic growth from 1987 through 1991 averaged 5 percent. Arguably this growth exceeded Japan’s long-term potential growth, and it certainly resulted in very tight labor markets. Normally this would have lead to higher inflation, but yen appreciation had put manufacturers under strong price pressure (either because they needed to absorb a large part of yen appreciation in order to maintain market share abroad or because they faced new pressures from imports at home). So rather than general price inflation, Japan got asset inflation.

By 1989 even MOF acknowledged that the bubbles in real estate and stock prices were unsustainable and responded by tightening monetary policy. At the time, MOF officials seemed to be very confident that they could simply let the excess air out of the two markets, which would only hurt "evil" speculators. Instead, all of the gains since 1985 were eliminated with the predictable outcome of large amounts of bad debt. Although the stock market stabilized after 1993 (with the Nikkei average subsequently gyrating between 14,000 and 20,000), land prices continued to fall at least through 1997.[6]

Identifying the magnitude of these bad debts is complicated in Japan because of the very lax requirements on reporting non-performing loans. As of September, 1997, the Ministry of Finance announced that the banking sector held ¥28 trillion ($225 billion at then current exchange rates) in non-performing loans, but admitted late in 1997 that by a broader definition, "problem" loans totaled some ¥79 trillion ($630 billion), a number that began to approximate what private sector analysts have believed for some time.[7] This larger amount comes to about 15 percent of all bank lending in Japan and as a ratio to GDP comes to 16 percent.

Note that all these figures are only for commercial banks--insurance companies and securities houses also harbor large financial losses. Japanese insurance companies rushed into the U.S. Treasury bond market in the 1983-1985 period when the yen was trading in the ¥220-260 range, and then rode the exchange rate down. Securities firms invested on their own account in

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[6]"Big City Residential and Commercial Real Estate Prices Fall Some More, *Japan Digest*, February 3, 1998, p. 3.

[7]"MOF Admits Banks Hold ¥76.7 Trillion in Bad Loans," *Asahi E-News*, January 14, 1998; and "September Problem Loans Rise to 28 trillion Yen: MOF Study," *Nikkei Net*, December 23, 1998.

the stock market and lent money to other speculators through non-bank subsidiaries. Estimates of the total hidden losses among all financial sector firms vary, though I have seen one high estimate of $1.5 trillion.

More bad news may be on the way. Japanese banks have been major lenders to other Asian countries--representing roughly one third of international loans to Korea, Thailand, and Indonesia. Officially, Japanese lending to Asian countries totaled some $125 billion in the summer of 1997.[8] An unknown portion of these loans is non-performing, but if Japanese banks behaved with the same lack of prudence as they did in other markets, the prognosis is not good. While the size of lending suggests that any bad loan amount would look quite small relative to the existing domestic bad loan problem, these additional problems come at the margin. That is, banks are already weakened and not in a good position to absorb additional losses.

Overall, one can explain the emergence of the bad debt mess in the 1990s as the unfortunate combination of a banking system with weak analytical skills, structural shifts in the demand for funds after the mid 1970s, and the monetary ease of the second half of the 1980s. This explanation, though, puts the most charitable face on what was happening to Japan in the 1980s. In the scandals that have emerged in the 1990s have come truly shocking revelations of indiscretion and malfeasance (at least shocking in frequency of exposure; much of the revealed behavior seems quite unsurprising).

Favored investors at securities firms were given guarantees of high positive rates of return on their equity portfolios (and an embarrassed government continues to refuse to release the list

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[8]According to Bank of International Settlements data for June 1997.

of names on Nomura Securities "VIP" list since it includes politicians and career bureaucrats).[9] Huge loans went to small businesses for speculation in real estate and the stock market--including the infamous bankruptcy of small restaurant owner Mrs. Onoue in Osaka, who defaulted on debts worth $3 billion (with the supposedly staid Industrial Bank of Japan as her largest lender).[10] Large banks eagerly introduced crooked clients to subsidiary banks or credit co-ops in order to keep questionable loans off their own books while hopefully benefitting from the illicit business, relationships revealed when some of these credit co-ops went bankrupt.[11] Financial institutions (and other corporations) continued to pay off *sokaiya* racketeers who threatened to reveal negative information at annual shareholder meetings. Ministry of Finance officials told banks when their "surprise" inspections would occur in exchange for lavish entertainment and other favors.[12] Those examinations were often perfunctory at best, enabling firms to hide their

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[9]See "The Weekly Post Special 3: TEP Obtain Confidential Document from Nomura Security Fraud Case," *The Weekly Post* (web page), July 14, 1997; or "Investigation Must Reveal VIP Accounts," *The Weekly Post* (web page), September 22, 1997. Because of the scandalous nature of this issue and the names of prominent bureaucrats and politicians that are presumably on the VIP lists, reporting has been left mainly to the sensationalist weekly magazines.

[10]"Osaka Tea House Mistress Onoue Gets 12-Years For Her Extravagant Fraud," *Japan Digest,* March 5, 1998, pp. 1-2.

[11]This was also true of the *jusen*; "HLAC Plans to Sue Four Banks That Got *Jusen* to Make Risky Loans," *Japan Digest*, January 26, 1998, p. 1, notes that "the banks typically 'introduced' to the *jusen* borrowers that the banks themselves couldn't touch, and in at least one case did so with clearly fraudulent intent."

[12]"Prosecutors charge 2 MOF Officials With Accepting Bribes," *Nikkei Net,* January 27, 1998. The amount, ¥5 million (roughly $40,000) in meals and golf outings over an unspecified amount of time does not seem particularly high.

imprudent, unethical, or illegal activities, as happened in the Daiwa Bank scandal in New York.[13] Allegations have been made concerning Ministry of Finance explicit approval of (or even administrative guidance recommending) illegal schemes to hide financial problems at Yamaichi Securities.[14] And even Bank of Japan officials have now been implicated in providing advance information on Bank market operations to the private sector.[15] These scandals have gone far beyond being isolated incidents and paint a picture of widespread routine corruption and incestuous relations among financial firms, their clients, government officials, and politicians.

Responses

Restoring the economy to a healthy growth is critical to any effort to overcome the financial problems of the 1990s. In a growing economy, new loans cause the share of old non-performing loans to shrink, reducing the relative cost to financial institutions as they write off these loans and dispose of the underlying assets. But the government's record is not encouraging.

From 1992 through 1995 Japan grew on average annual rate of only 0.6 percent on an inflation-adjusted basis, and over the longer 1992-1997 period the annual rate was 1.3 percent. Perhaps this could be considered a good performance; asset deflation was so severe that the economy was lucky to escape with several years of sluggish growth rather than an outright recession. In no two consecutive quarters nor any whole calendar year has the economy

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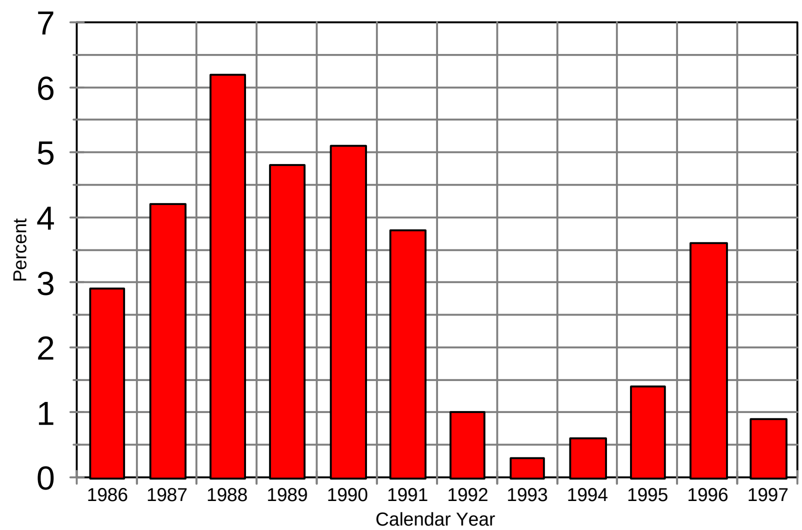
[13]"Banks Took MoF Inspectors to Dutch Red Light District, Vegas Casinos," *Japan Digest,* January 30, 1998.

[14]"Prosecutors Raid Finance Ministry Securities and Banking Bureaus," *Japan Digest,*March 9, 1998.

[15]"BOJ Exec Allegedly Gave Bankers Advance Word on Money Market Operations," *Japan Digest,* March 9, 1998.

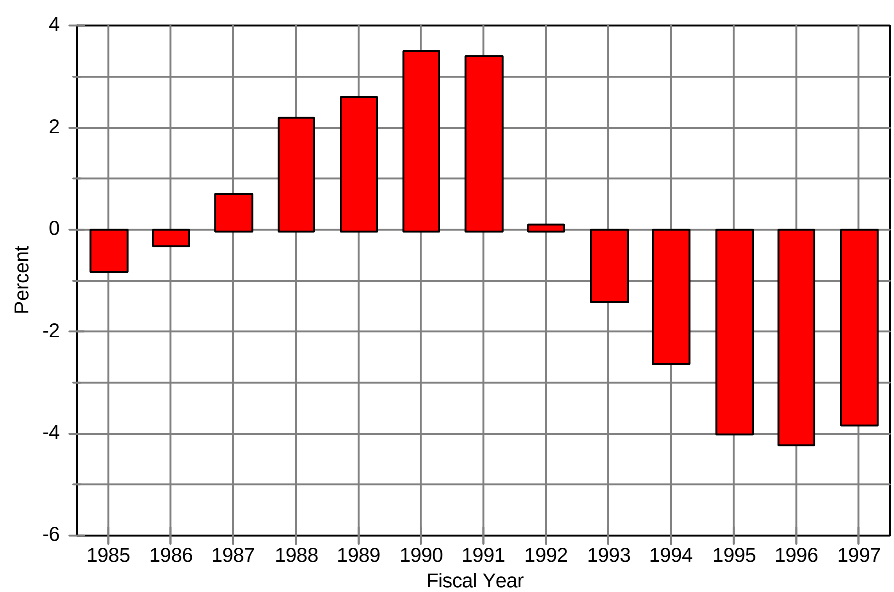
contracted (though this may happen now with back-to-back declines in the fourth quarter of 1997 and the first quarter of 1998). Therefore, what happened to Japan in the 1990s is properly labeled relative stagnation or sluggishness rather than a recession. That is, performance is sub-par when compared to either the 1980s or to potential growth rates (which was arguably around 2 to 2.5 percent in the mid 1990s).

Figure 1
Japan's GDP Growth



In response to stagnation, the government dropped interest rates to historic lows (with the discount rate at only 0.5 percent since September 1995), but low interest rates were insufficient to stimulate economic activity. Since the private sector had overinvested in plant and equipment in the late 1980s and early 1990s (on the erroneous assumption that high rates of 4 to 5 percent economic growth would continue in the 1990s), the private sector was saddled with excess capacity and little desire to invest even at low interest rates. What Japan needed was fiscal stimulus to increase domestic demand and raise capacity utilization. Prodded strongly by domestic and international voices to use an expansionary fiscal policy, the government announced a temporary income tax cut in 1994 and increased spending (principally public works spending). The Ministry of Finance was extremely reluctant to agree to this policy (with its resistance

Figure 2
Government Balance as a Share of GDP



Source: Economic Planning Agency, *Annual Report on National Accounts*, 1996 edition, p. 83; and Salomon Brothers, *Japanese Economic/Market Analysis: Japanese Macroeconomic Chartbook*, October 31, 1997.

including efforts to avoid meeting with U.S. Treasury and Embassy officials in the fall of 1993 and winter of 1994). At the time, the parade of economic stimulus packages from 1993 through 1995 were criticized for containing far less real stimulus (*mamizu*--real water) than advertised. Nevertheless, the final outcome was both a reduction in taxes and substantial increase in spending which widened the government deficit. As shown in figure 2, the change in the overall government balance since 1991 has been rather dramatic, although a substantial portion of this is due to the effect of economic stagnation on tax revenues rather than deliberate fiscal policy.

In 1996 the economy finally showed signs of recovery, expanding at a strong 3.6 percent rate. As shown in figure one, the economy appeared to be undergoing a weak recovery after the bottom in 1993, with 1996 finally representing the kind of strong growth one expects in the early phases of recovery with excess capacity. But from April 1, 1997, the dogmatic Ministry of Finance chose to end the income tax cut, increase the nation-wide sales tax (from 3 percent to 5 percent), and raise other government fees (including the co-payment by individuals in the national health care system). Estimates vary, but these changes in fiscal policy represented a net withdrawal of as much as 2.5 percent of GDP and may have had an additional negative psychological impact on households and businesses. Rather than continuing a path of recovery, the economy was stagnant again in calendar 1997 (0.9 percent growth) and may be flat or negative for fiscal 1997. Forecasts for fiscal 1998 are in the range of only one percent or less. In retrospect, the apparently strong performance of the economy in 1996 may have been exaggerated; by mid-year it was clear that the consumption tax would rise in 1997, leading to increased housing investment and other purchases in the second half of the year.

The conventional wisdom within the government had been that the consumption tax increase would result in an artificial jump in consumption in the first quarter of 1997, followed by a drop in the second quarter, after which the economy would return to normal. But domestic demand remained weak through the rest of the year, and the decline in housing investment and automobile sales continued to drift downward. Finally responding to criticism of its actions and the resulting economic weakness, the government devised a modest income tax cut for fiscal 1997 (payable in the form of a rebate to taxpayers only in February and March of 1998). But this action was very reactive and the size of the stimulus added to the economy (¥1.5 trillion) was small, followed by subsequent belligerent statements that the government would contemplate no further measures. This tax cut almost appears to have been deliberately devised to prove MOF's belief that tax cuts will not help the economy because households have a high marginal propensity to save; households are more likely to save the tax cut if they believe the benefit will be only a fleeting one.

Despite the belligerence, politicians and bureaucrats have been hinting to Americans that further fiscal stimulus--including a tax cut--will be forthcoming in April (after the regular budget passes the Diet). But these hints hardly undo the damage from the intermittent nature of fiscal stimulus, and the damage to the government's image from pursuing a very reactive policy (that is, by giving the appearance that it sets policy primarily on the basis of complaints from abroad and home rather from any real conviction). And the rumor mill suggests that the final package will probably rely mainly on traditional public works spending and some corporate tax incentives rather than an income tax cut.

The reluctance to use fiscal policy to stimulate the economy stems from the recognition that the government balance will deteriorate in the future as the aging population impacts the social security account (an impact that will be far larger than the one in the United States). Given that future deterioration, the government faces a long-term need to reduce its deficit on discretionary spending. But this shift will occur over the space of several decades and did not require such quick action in 1997. Furthermore, much of the concern over deficit spending is buttressed with numbers on gross government debt which may not provide an accurate picture. Net government debt is actually quite low in Japan. Therefore, the government moved too rapidly and too far to restore its fiscal balance in the spring of 1997.

Restoring economic growth should be just as important a goal as long-term reduction of the government deficit. Domestic financial problems would diminish in a growing economy, and the burden of financing the retirement of a larger percentage of the economy becomes easier if there is a larger economic pie to divide in the future. Thus the dogged determination to pursue fiscal austerity now will hurt the future of the economy by delaying recovery from financial weakness and reducing the future size of the economy.

Meanwhile, the government has dealt directly with the problems of the financial sector. Throughout the 1990s the Japanese government has endeavored to resolve these problems through traditional means. This is a model in which: the public is denied the truth in order to prevent them from worrying about stability of the system; weak or insolvent institutions are absorbed by stronger ones; government money flows to prop up the weakest links; and eventually renewed growth in the economy pushes asset prices back up before losses must be declared. When the economy was growing rapidly and failures were few, this approach worked. But the extent of the losses in the 1990s and the inability of the government to get the economy growing fast enough to push the stock and real estate markets back up undercuts the viability of the traditional model.

It would be a serious error to suppose that apparent failure of the traditional model has now led to a market-oriented approach of letting the weak collapse, forcing investors to take their losses, and selling off assets at market prices to get them back into productive use. From 1993 through 1996 about a dozen small institutions failed--the seven *jusen*, several credit cooperatives, and a small regional bank. Although these bankruptcies were played up in the Japanese press as unprecedented changes, the reality was that these institutions represented a trivially small part of the financial sector. In 1997 a small life insurance firm (Nissan Life) and a small securities firm (Sanyo Securities) failed, and then the Ministry of Finance finally allowed two larger institutions to fail--Yamaichi Securities and Hokkaido Takushoku Bank. When those events occurred, the press reported that market rules were now in play and financial institutions would have to sink or swim on their own.[16]

Such pronouncements proved to be premature. The shutdown of Yamaichi Securities took over six months, during which time most of the employees were kept on the payroll--financed with “loans” from the Bank of Japan. During the shutdown phase, the Ministry of Finance continued to seek firms to take over all or substantial portions of Yamaichi (Merrill Lynch, for example, is taking over a set of 30 Yamaichi local offices and approximately 2,000 employees).[17] Similar efforts with Hokkaido Takushoku bank proved successful--Hokuyo Bank

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[16]For example, “Sanyo Goes Under; Convoy System Ends,” *Asahi E-News,* November 4, 1998. Even in this case, some traditional elements remained; MOF forced other financial institutions, including the other major securities firms, to contribute to a rescue fund to paying back Sanyo customers.

[17]“Merrill Lynch Will Pick Up Some of Yamaichi Carcass, But Less Than Expected,” *Japan Digest,* pp. 1-2.

(a regional bank in Hokkaido) agreed in December 1997 to acquire all of Hokkaido Takushoku's operations (buildings, employees, liabilities, and assets) within the prefecture, and Chuo Bank agreed in February 1998 to acquire all of the banks' operations outside of Hokkaido.[18] This deal was sweetened with promises that the government would buy preferred shares and absorb some bad loans. This is hardly the stuff of a cruel and impartial market. Few people will be left unemployed and few, if any, assets will be auctioned off.

Furthermore, rather than signaling the beginning of a new policy, the failure of these two large institutions has been a reaffirmation of old policies. The vision of the president of Yamaichi Securities crying on television and the notion of employees out on the heartless sidewalk proved too much for bureaucrats, politicians, and the public. Early in 1998, the Ministry of Finance designed and the Diet passed a ¥30 trillion ($240 billion) financial bailout plan. Of this amount, ¥17 trillion ($135 billion) was to increase the Deposit Insurance Corporation's fund to reimburse depositors of insolvent banks, a necessary move since the fund was exhausted. But the other ¥13 trillion ($105 billion) was for purchase of new issues of preferred shares and subordinated bonds to be issued by banks--a move to improve their capital base.

Banks certainly need some recapitalization. Japanese banks have always been weakly capitalized, but no one was concerned when economic growth was high and bad loans few. Now banks have seen their capital erode as they have written off bad loans. Furthermore, those large banks engaged in international lending are suffering from the unfortunate decision in the 1980s to permit them to count a portion of their unrealized gains on stock holdings as part of the capital

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[18]"Chuo Trust Will Take Over Last Major Piece of Takugin, Its Honshu Branches," *Japan Digest,* February 18, 1998, p. 2.

base. At the time, the Ministry of Finance had pushed hard at the Bank of International Settlements conference to permit Japanese banks to do this. One of the motives for the establishment of BIS capital adequacy ratios for banks, in fact, was directed against the Japanese, who were accused of engaging in imprudent lending behavior in international markets, underpricing the market and driving down profits for other banks. Partial inclusion of stock holdings permitted the Japanese banks to meet the 8 percent capital adequacy requirement when it went into effect, but left them exposed to the vagaries of stock market fluctuations. Major Japanese banks are once again in danger of not meeting the BIS standard. Furthermore, smaller banks not engaged in international lending are presumed to have capital ratios even lower (if not negative) and MOF wants them to meet a weaker 4 percent capital adequacy ratio, though it then sent signals at the end of 1997 that enforcement would be "flexible."[19] Therefore, banks need a real increase in capital base.

Putting government money into bank ownership as a means for providing this recapitalization, however, is a terrible policy. Doing so injects moral hazard into the banking system (encouraging banks rescued by these new capital infusions to gamble on higher-risk investments to increase their earnings). It also makes the government even less willing to let weak institutions fail because government money and reputation will be at risk--permitting a bank which has received government money to fail would imply that MOF made a mistake in supporting the bank in the first place.

Most importantly, this infusion increases Ministry of Finance influence over the whole

[19]"MOF to Ease Implementation of Banking Rules Set for April, *Nikkei Net*, December 23, 1997; and "To Avoid More Bankruptcies MoF Eases New Capital Rules for Banks," *Japan Digest*, January 6, 1998, p. 2.

banking industry. Having decided to prop up weak banks, MOF was afraid the public would then know which banks were weak. To hide the truth from the public, large (presumably stronger) banks are also accepting this government fund infusion. In the initial tranche in mid-March, the 21 largest banks all issued preferred shares or subordinated bonds to the government, totaling ¥2.1 trillion ($16 billion), enough to raise the capital ratio of the 9 city banks by about one percentage point.[20] Actually, besides obscuring the distinction between strong and weak banks, this policy seems to have been motivated by a strong desire to make the largest banks look better abroad and perhaps cause the "Japan premium" in international lending markets to fall.

Rather than moving to a tough but realistic policy of letting weak institutions fail, the government now has a high-priority goal of preventing further bankruptcies. Clearly the banking sector needs recapitalization, and in extremis, why not use government money? Beyond the doubts expressed above, there is another missing element. Some banks are truly insolvent; some are weak and poorly managed; and some are well managed and have relatively strong balance sheets. One of the functions of recession or crises is to weed out the failures. In the United States, thousands of banks failed in the 1930s before the Reconstruction Finance Corporation provided capital infusions. In the 1980s, hundreds of savings and loan institutions failed before the Resolution Trust Corporation repackaged and resold their assets. In Japan none of this will happen. In theory, the committee to review applications for capital infusion will discriminate between weak and insolvent banks, with the truly insolvent left to fail (and depositors protected by the new infusion of money into the Deposit Insurance Corporation). In reality, little or none of

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[20]"Top Japanese Banks Set Out Plans for Public Funds Injection," *Nikkei Net*, March 5, 1998; "Public Funds Injections Would Lift Top Banks' Capital Ratios by 1 Point," *Nikkei Net*, March 5, 1998.

this will happen. Virtually all banks will be protected and the system as a whole will be weaker and recover more slowly because of this.

A final justification for government involvement is also somewhat suspect. In February 1998, the Japanese media began emphasizing the existence of a domestic credit crunch. Even reputable borrowers reported that their traditional lenders were refusing to roll over loans because the banks were so concerned about improving their balance sheets.[21] Some degree of bank credit crunch may actually exist, but there are reasons to be doubtful of the press reports. First, large healthy borrowers have alternative sources of funds (the bond market, foreign banks, etc.). Second, a credit crunch should not be confused by a desirable trend of banks cutting credit to risky borrowers who should never have gotten loans in the first place. Third, the deluge of stories of a credit crunch came conveniently at a time when the government had already decided to bail out the banking sector and probably felt a need to generate public sympathy for the plan. Bank lending in January 1998 was 0.2 percent below the year-earlier level, a small decline well within the trend the of previous several months and more likely the result of lack of loan demand than a credit crunch.[22]

Besides this new special fund for recapitalizing banks, the Japanese government has other means to inject money into the corporate sector without public knowledge. Part of social security funds, postal savings funds, and postal life insurance funds are routed through government subsidiary organizations which have a mandate to make portfolio investments in the private

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[21]"Mitsubishi Heavy Says It's Short ¥100 billion It Can't Borrow From Banks," *Japan Digest*, February 18, 1998, p.2.

[22]"Saloman Smith Barney, *Economic and Market Analysis, Issues and Prospects: Japan*, March 5, 1998.

sector. Roughly 13 percent of social secutity funds are routed to the *Nenkin Fukushi Jigyōdan* (Public Welfare Service Public Corporation or PWSPC), and 2.5 percent of Postal Savings and 12 percent of Postal Life Insurance funds are routed to the *Kan'i Hoken Fukushi Jigyōdan* (Postal Life Insurance Welfare Corporation or PLIWC).[23] These government-owned organizations then place the funds with financial institutions to engage in portfolio investment. These funds can be quietly invested in weak financial institutions or used to help prop up overall stock market prices without any real knowledge on the part of the media or public. What has probably been a quiet policy (though assumed to be occurring by the financial community) has now become explicit. In mid-March of 1998, the LDP agreed to use up to ¥1.3 trillion (just over $10 billion) in funds from Postal Savings during the rest of March to prop up the stock market.[24]

Meanwhile, a variety of other schemes appeared in 1998 to provide gimmicks to improve financial institution balance sheets and thereby avoid public recognition of weakness or insolvency. Firms have traditionally shown assets at purchase cost on their balance sheets, which has long injected an element of unreality to accounting results. Financial institutions will now revalue real estate holdings (mainly the land on which their offices and branches sit) to market value, bringing some reality. But they do not have to do the same with stock portfolios; many financial institutions hold portfolios of shares purchased near the peak of the stock market, and

[23]In FY1994, the PLIWC managed ¥9 trillion ($90 billion at 1994 exchange rates) of Postal Life Insurance fund (representing 12 percent of Postal Life funds), and ¥5 trillion ($49 billion) Postal Savings funds (2.4 percent of the total). Meanwhile, PWSPC data show it managing ¥21 trillion ($200 billion) of social security funds (roughly 13 percent of total social security funds). Data for PLIWC and PWSPC are from their annual financial statements.

[24]"Public Funds to be Used to Buoy Stocks," *Asahi E-News*, March 13, 1998.

they will be able to keep these listed as assets at those high purchase prices rather than marking them down to current value.[25] Meanwhile, MOF moved in early 1998 to put stringent controls on short selling in the stock market, with the obvious intent to lessen downward pressure on prices, a move in clear violation of the spirit of deregulation and decontrol of innovation in financial markets..[26]

Banks will also be able to net out positions with individual customers. Rather than showing a single client's loans on the asset side of the books and deposits on the liability side, the asset side will show only the net position (loans minus loans). This artificially reduces assets, thereby improving the bank's capital to asset ratio.[27] Even without a background in accounting, one assumes that such a practice is a gross violation of accounting principles.

Finally, the government has discussed using public funds to buy real estate to prop up prices or buy asset-backed securities representing bad debts of banks at above-market prices. Once again, the effort is to artificially alter prices. Government might be able to generate a small change in land prices by accelerating purchases of land for future public works projects, but this cannot continue in the long run. In fact, given long-term demographic trends and probable economic growth, land prices may be entering a very long period in which they will be flat or will continue to decline.

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[25]"LDP Would Have government Buy Mortgage Backed Securities at Above Market Values," *Japan Digest,* February 11, 1998, p. 2.

[26]MOF Will Tighten Controls on Short Selling to Prop Up Share Prices, *Japan Digest*, January 8, 1998.

[27]"MOF to Ease Implementation of Banking Rules Set for April," *Nikkei Net*, December 23, 1998.

One can hardly imagine a litany of worse policies to deal with financial problems in Japan. These policies will cause a prolongation of the debt problem, artificially prolong the life of weak financial institutions that are a drag on the economy, and yield a financial sector partially owned by the government. Gimmicks and government capital infusions will probably accomplish the purpose of staving off a serious financial collapse, but at the expense of longer-term weakness and delay in resolving the situation.

But there may be a logic to what has happened in Japan. Much of the policy response has been consistent with other economic and social themes. In particular, the American notion of shutting down insolvent institutions, auctioning off assets to new owners, and getting on with economic growth does involve both unemployment (at least temporarily) and wealth transfer. These are very difficult concepts within Japanese society. Job security has been such a core value in postwar Japan that accepting the unemployment consequences of failing financial institutions (which presumably practice lifetime employment) is a frightening departure from the presumed social compact. Even the employment or career path implications of merger and acquisitions have been far more difficult in Japan than the United States to implement efficiently.

Nor has the notion of expropriation of property for non-payment of debts been very well developed; the willingness of banks to sit on non-performing loans without foreclosure and sale of the underlying real estate collateral appears to be motivated by more than just the reluctance to accept losses. Except in highly publicized cases of *yakuza* involvement or flagrant illegal activities (such as those surrounding the lending behavior of a credit cooperative with close ties to former LDP member Toshio Yamaguchi) one gets the distinct impression that banks are reluctant to actually foreclose on property owners. However, this point should not be overdrawn; of the

12,000 bankruptcies in Japan in 1997, most moved forward under the dissolution (*hasan)* provisions of the law rather than any of the reorganization provisions (implying that most formal bankruptcies do involve dissolution of the firm and transfer of collateral to the creditors).[28]

Deregulation

In the midst of these policies to deal with bad debt problems, Japan is presumably engaged in sweeping deregulation of financial markets. In November 1996, Prime Minister Ryutaro Hashimoto called for a Japanese "Big Bang" deregulation of financial markets, borrowing his rhetoric from the deregulation of London financial markets in the 1980s. The agenda (See table 2) for deregulation includes a variety of proposed measures affecting virtually all aspects of finance, which on the surface imply movement toward a much more market-oriented system. The list is actually considerably longer, but many of the other items proposed are either quite minor or rather vague. Changes in regulations concerning foreign exchange transactions, removal of the holding company ban, and decontrol of brokerage commissions will all begin in 1998, with other moves hopefully occurring over the following three years.

On the surface, the list of proposed changes is quite ambitious and would seem to drive Japan in the direction of greater reliance on markets and competition. Many of the concerns raised above about the government's response to financial problems should be moot as these

[28]I am indebted to one of my students, Todd Brown, for this information on the nature of bankruptcy proceedings.

Table 2

Proposed "Big Bang" Financial Deregulation: Principal Components

Foreign Exchange. From April 1998, elimates the limitation on foreign exchange business to licenses commercial banks; eases rules on non-financial firms netting out exchange positions internally; permits firms to use foreign exchange in domestic transactions; eases limitation on individuals maintaining foreign currency accounts abroad.

Brokerage Commision.. Deregulation of stock brokerage commissions, beginning with large-lot transactions (April 1998) and eventually extended to all transactions.

Off-Exchange Trading. Eases rules concerning trading shares off-exchange.

Over the Counter Trading. Eases rules concerning the over-the-counter market with the intent of increasing the liquidity of the market.

Securities Transaction Tax. To be eliminated.

Financial Holding Compannies. To be permitted, with certain restrictions on size and market share of the total entity and the individual companies held.

Asset-Backed securities. To be legalized and encouraged.

Dervivatives. Rules to be eased including those pertaining to trading on the exchanges and over-the-counter.

Insurance. Price competition and product design competition to be allowed, along with a removal of the separation between life and non-life segments of the market. Other changes include greater flexibility in marketing (permitting telemarketing, for example).

Segmentation. Through the financial holding company format and other means, restrictions among different forms of financial business will be lessened. This includes permission for commercial banks and non-bank financial firms to issue bonds.

Accounting Standards. Will move accounting practices closer to international standards, including requirements for reporting on a consolidated basis and use of current market values.

reforms reduce the government's ability to manipulate markets. But will this really happen? While the proposed changes are a useful step forward, there are substantial reasons to be skeptical about the outcome. Consider the following:

Deregulation *versus* Bailout. The recent crop of actions related to bailout of the financial sector just discussed speaks volumes about the true attitude of the government. Neither the Ministry of Finance career bureaucracy nor the politicians are truly interested in liberating financial markets and allowing the weak to fail. No matter what the surface image of the "big bang" reforms, these attitudes and ad hoc policies based on them will remain. The Ministry of Finance has endorsed a gradual deregulation process over the past 20 years, but shows few signs of truly embracing an American-style framework for finance. Many officials and academics have a visceral belief that the "Japanese system" of capitalism is still better than the American model, refuse to believe their system of the past is outmoded despite current problems, and are dedicated to just patching it up. Consider, for example, that one of the supposed czars of (international) financial deregulation is Eisuke Sakakibara, Director General of International Finance at the Ministry of Finance, who is an outspoken believer in the superiority of the Japanese system.[29] The decision in 1997 to change accounting rules and create a 4 percent capital adequacy ratio for purely domestic banks, followed by the deluge of measures in 1998 to eviscerate the meaning of these changes is eloquent testimony to the unwillingness of the government to accept the fate of the market.

The Politics of Deregulation. Prime Minister Hashimoto and the Liberal Democratic Party (LDP have an overriding concern with restoring the numerical majority of the party in the Diet. They seem to believe that the appearance rather than the reality of change and progress is sufficient for that purpose. The general deregulation agenda has resulted in a very long list of individual regulations on which some action has taken place, without much real change in the regulatory role of the government in the economy. The same is true of administrative reform,

[29]His book, *Beyond Capitalism: The Japanese Model of Market Economics* (University Press of America, 1993), is a paean to the structures of the past.

characterized by a reshuffling of the ministries without altering the fundamental relationship of the state to the people. Even though the big bang reforms for finance appear to be stronger, one is tempted to assume that MOF and the politicians expect to limit the real impact. If the public truly favored radical change, presumably the political system would respond. Voters can always vote the rascals out and install other politicians. But this is not happening, and the LDP may actually succeed in its goal of returning to an absolute majority. When the government was planning the *jusen* bailout, there was some visible protest (including marches on MOF, which closed its gates and was protected by phlanxes of police for several weeks). But the current much larger bailout package with much larger implications for use of taxpayers' money to prop up insolvent institutions appears to be generating virtually no protest.

Exaggerated Claims. Some changes involve wildly exaggerated claims concerning their impact. This is particularly true of the foreign exchange decontrol occurring on April 1, 1998. Japan undertook major foreign exchange decontrol over the period from about 1976 to 1985, so what is left to be done? Most foreign exchange transactions are not regulated at the present in any meaningful way, so the new law and rules coming in to effect will make little difference. Restriction of foreign exchange transactions to authorized commercial banks will be dropped, so that any company--financial or non-financial--can engage in foreign exchange. But over 160 banks are currently authorized to engage in this business; it is unclear that expanding the number will really inject much more competition into the market. Proponents note that convenience stores (Seven Eleven, Family Mart, etc.) could enter the exchange business, but one wonders what difference this would really make other than convenience (since their daily volume of business is unlikely to be sufficiently large to make them a driver of more competitive commission fees). Netting out foreign exchange transactions without even going to a bank provides a modes efficiency gain for non-financial corporations, but one presumes that many of them have already been doing so (which was permissible with the approval of MOF, and obviously possible for any other firm willing to violate the rules).

Firms will also be allowed to even make domestic transactions in foreign currencies, rather than repricing imported products into yen. A trading company, for example, could sell imported oil to domestic power companies in dollars rather than yen. But all this accomplishes is a shift of exchange risk from importers to other companies, which may or may not be a useful change. Theoretically the greater freedom permits efficient packaging of exchange risk in contract negotiations. But if the trend were for strong companies (such as the large general trading companies) to use their market power to push the exchange risk on to smaller domestic firms, then the change could conceivably be detrimental.

Finally, individuals are to be allowed to hold foreign financial accounts. Here is another puzzling development, since some Japanese do exactly this already. But one should ask if opening foreign accounts is likely to be the major path for individuals to invest abroad. Americans, who have not had any legal restrictions, hold only a minuscule amount (less than 0.01 percent) of their portfolios in foreign deposits and even allowing for non-reporting for tax cheating purposes, the amount is unlikely to be high.[30] Japanese individuals already have access to yen-denominated money market and mutual funds that are invested in foreign markets, and offerings of such funds (including by foreign financial institutions operating in Japan) have

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[30]U.S. Department of Commerce, *Statistical Abstract of the United States,* 1997 edition, p. 511.

increased in the past year. Thus, the freedom individuals obtain on April 1 is unlikely to bring a major alteration in investment behavior. Note also that even this small change is being undermined; the Ministry of Finance has announced new and onerous reporting requirements for any individual moving more than the equivalent of $15,000 into or out of the country. These rules could have a chilling effect on individual behavior.

Disclosure. A deregulated financial system which moves away from the past bank-centered model requires a high level of public disclosure of accurate corporate information (and controls on favored insider access to information). As noted above, the preference for a bank-centered system--with its reduced need for public information--was entirely consistent with the generally poor public flow of information in Japan. This at least suggests that movement toward financial markets that depend on reliable public information may be difficult to achieve. The proposed changes in accounting rules (registering assets at current market value) that are part of the big bang are a step in the right direction, but even this change has been undermined by the various gimmicks the Ministry of Finance has introduced in 1998 to help financial institutions conceal their true weakness.

Personnel Practices. Attempted deregulation of the financial may be incompatible with deeply ingrained personnel practices. Japanese corporations—both financial and non-financial—have strongly favored management personnel systems in which management career employees rotate broadly through the organization rather than becoming specialists. But complex financial markets require high levels of specialized expertise that may be at odds with this practice. Even if managers need not carry out financial analysis themselves, they need to be sufficiently knowledgeable and skilled to understand what their staff people are doing (a failing that was a principal part of the Daiwa Bank scandal in New York).

Furthermore, there may be a problem with employee incentives. As a crude generalization, Japanese financial institutions appear to be excessively biased toward negative incentives. Poor performance or mistakes can knock a career manager off the path to the top management positions, whereas great success does not accelerate that progress. This can lead managers to be overly cautious (a caution that may take the form of sticking to standardized behavior, such as lending to long-term clients even if those clients are no longer really creditworthy). Or if they discover problems, the preference will be to hide those problems during tenure in a particular post (thereby passing the problems along to the next holder of the position) rather than exposing the problems and dealing with them aggressively. Traders, meanwhile, are generally not rewarded much for their actual market performance. For them the fear of showing a loss predominates (leading to the increasingly desperate behavior of the individual who eventually lost the $2 billion for Daiwa bank). Traders need a monetary incentive to encourage positive performance and they need the leeway to make short-term mistakes without punishment and fear. In markets with risk, traders will not win all the time and need to operate in a framework that tolerates some losses and establishes rules for when to cut the losses. But the Japanese incentive structure appears to insert too much fear about admitting losses. Both the tradition of career management rotation emphasizing general (human relations) skills and the avoidance of monetary rewards for superior performance are fundamental components of corporate personnel practices in Japan, suggesting that it will be difficult for the financial sector to alter its practices.

Household Savings Behavior. Financial deregulation presupposes a population willing to take advantage of the changes—individuals willing to take invest in the new financial instruments and take advantage of lower transactions costs. But the Japanese public remains distinctively risk averse in its investment decisions, keeping a high share of its savings in the form of bank accounts. In 1995, Japanese households held a very large 62 percent of their total financial assets in the form of cash and bank deposits (compared to only 23 percent in the case of American households), as shown in Table 3. The contrast with the United States is startling, but the preference for bank deposits has not changed much over time; in 1977 the share in currency

Table 3

Household Financial Portfolios

	Japan		United States
	March 1977	March 1996	1996
Currency and Demand Deposits	15.6	10.0	3.8
Time and Savings Deposits	57.9	51.8	21.5
Insurance	13.2	25.4	5.0
Stocks and Bonds	13.3	12.8	69.7

Note: Based on flow of funds accounts. U.S. data includes two items not found in the Japanese data--proprietors' equity and pension reserves. Both are excluded from this table for the sake of comparison.

Source: Bank of Japan, *Economic Statistics Annual*, 1977, pp. 24, and 1996, p. 267; and U.S. Department of Commerce, *Statistical Abstract of the United States, 1977*, p. 511.

and bank deposits was 73 percent. The modest downward drift of this share was entirely in favor of increased life insurance, and not increased holdings of stocks and bonds. There are two ways to interpret these data. Optimists view this outcome as simply the result of regulation, so that the Big Bang will result in a rapid increase of household holdings of securities. Pessimists view the situation as the result of a deeply ingrained risk aversion among households, so that the Big Bang is unlikely to alter household portfolio behavior very much.

In the absence of an eager household sector, financial deregulation could leave Japan still characterized with a high degree of intermediation, in which the holders of the new financial instruments appearing in the market are mainly the banks. This was the story of corporate bonds in the 1980s; as the corporate bond market was gradually decontrolled and allowed to expand, the primary purchasers of corporate bonds were banks, resulting in little alteration in the real flow of funds or in the way institutions handled information and made decisions. In Japan, 77 percent of corporate bonds in 1996 were held by the banking sector (47 percent by commercial banks and 30 percent by government-owned financial institutions, with households holding only 10 percent. In the United States, banks hold only 4 percent of corporate bonds, households 13 percent, and other financial institutions 68 percent (representing mainly investment banks and insurance companies, providing indirect ownership for households through pension funds, money market and mutual funds).[31]

At the very least, alteration of household investment patterns will require increased public confidence in the stability of the new financial instruments. But many of the new innovations imply a higher expected return at higher levels of risk, and it remains entirely unclear whether the public understands the trade off between risk and expected return or is willing to accept it.

The Japanese government and media have portrayed the “big bang” financial reforms as an epochal change. Certainly the proposed changes are a step in the right direction--if all the proposed reforms are implemented fully. But for all the reasons sketched above, the outcome will be far less dramatic than supposed.

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[31] These data are from flow of funds accounts for Japan and the United States, available in Bank of Japan, *Economic Statistics Annual*, 1997 edition, pp. 266-267; and Department of Commerce, *Statistical Abstract of the United States*, 1997 edition, p. 511. Japanese data are for end of fiscal year 1996; U.S. data for end of calendar 1996.

Conclusion

Neither the macroeconomic setting nor the structural problems of the financial sector are encouraging. At the present time, Japan appears to face several years in which growth will remain below potential and financial sector problems continue to fester. Even potential growth is not high (perhaps 2 percent now, and even lower in the next several decades because of demographic reasons), so below-potential growth represents a truly disappointing performance.

Afraid of the perceived uncertainties and costs of an American-style reliance on freely functioning markets, the public is not rallying around the notion of reform. People certainly vote for deregulation with their pocket books--they flock to discount stores and cheap airline tickets--but do not clearly favor policies which would drive deregulation more strongly. Politicians and businesses have too much vested in the existing system, and have few ideas of how they would function in a deregulated environment. Even in the current sluggish environment, relatively little pain exists; the level of affluence is high and unemployment has not increased much. Therefore, the public is not sufficiently disenchanted with the existing system to demand change, and certainly anxious about the possible consequences of change.

Stumbling along with a some deregulation and some stimulus to the economy provided on a largely ah hoc basis seems to be the most likely scenario. Major collapse is unlikely. Like an *o-mikoshi* procession, MOF will lurch along, adopting stimulative policies just before the point where the economy heads into serious recession. And MOF will do whatever possible to prevent major collapse in the financial sector, even if its policies actually prolong weakness in the system.

All of this is very discouraging. Once Japan had finished its century-long catch-up with the West by the mid-1970s, the time had come for major structural change in the economic system. Although piecemeal and grudging deregulation and structural change did occur over the next 20 years, there was little fundamental reform. Now the needed changes seem more evident, but the vested interests have only become stronger. A vigorous, dissatisfied, entrepreneurial younger generation could conceivably force change, but they represent the beginning of the baby-bust generation and may not have the numbers to drive reform.

This appaisal of the financial sector also holds implications for our views of other aspects of the Japanese economy. Economic analysis of the advantages and disadvantages of lifetime employment, Japanese-style long-term contracting, “J-firm” corporate governance, and other aspects of the economic system needs to be rethought. When the economy was performing well, the tendency was to seek the explanation for success in many of these distinctive features of the economy. Were they really beneficial in the past? And if so, do we need to more carefully or narrowly define those benefits? Are they still beneficial? Have we neglected or underestimated some of the costs of these structures? Have they, like finance, become ossified or atrophied over time, so that vested interests and established relationships now interfere sufficiently with economic rationality as to have a debilitating impact on the economy? Sadly, the misfortune of Japan provides a rich research agenda.