

**“Japan’s Economy Misery: What Next?”**

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## Abstract

Sustained poor economic performance and the deepening banking mess are what are making Japanese feel miserable. I feel these problems are about at their worst: there is light at the end of the tunnel. This Foote Lecture traces why Japanese growth was so poor throughout the 1990s and why the banking problems worsened. I then consider the current situation and the policies taken in the wake of the July 12 Upper house election, which are a major turning point for Japanese economic policy, and speculate on economic prospects. Foreign observers have talked about a “Japan crisis” for several years, while Japanese have simply shown pessimism and lack of confidence about the future – the country’s and their own. Restoring confidence is a requisite for sustained recovery and growth, and this requires both banking reforms and recovery of sustained economic growth. The new government is in the process of making major commitments to achieve these goals. The political imperative is so great, and the required policy actions are so obvious, that fiscal and monetary stimulus will persist and strengthen, and banking reform will proceed.

## Japan's Economic Misery: What Next?

### 1. Introduction

As you know, the Japanese economy is in a miserable state. It is mired in its deepest and longest recession since before World War II. Its banking system has been seriously weakened by a huge amount of non-performing, bad loans, and a number of banks including some very large ones are in reality insolvent. Unemployment, traditionally very low, is rising. The demand necessary to fuel recovery and growth has been lacking. A simple answer to the question posed by the lecture title "Japan's Economy Misery: What Next?" is more of the same. But, unlike most observers, I feel these problems are about at their worst. There is light at the end of the tunnel. The questions are: how soon will it appear, how brightly will it shine, and how rapidly will we approach it?

In comparative perspective, many advanced industrial countries as well developing ones in recent years have gone through recession and banking crises. What makes the Japanese case different is that it has persisted so much longer than elsewhere, really since 1992. And what makes Japan's current travails so shocking is its dramatic contrast with the Japanese economy's premier position a mere decade ago. In 1988 Japan was viewed, and correctly, as a major economic dynamo, not only huge but growing rapidly, becoming the world's largest creditor, and a dramatically expanding huge investor in foreign countries, especially the United States. Some saw the Japanese as twelve feet tall and Japanese firms, if not buying up the world at least buying up America. Its banking system was equally dynamic, at home and abroad. Nine of the world's largest ten banks were Japanese, they had top credit ratings and, based on Japanese saving surpluses and low-cost deposits and capital, Japanese banks had quickly taken over some 34 percent of international bank lending. The Japanese stock and real estate markets were booming. What heady times to be a Japanese.

Today I want to concentrate on Japan's two major, Siamese twin, immediate economic

problems: the very poor economic performance; and the worsening banking mess. These are what are making Japanese feel miserable. I realize Japan has a number of other economic problems — low service sector productivity, high wages driving out companies to lower cost production abroad, a large budget deficit — but they are longer run and structural, and their solution essentially depends upon economic growth and financial system reform. I will briefly trace first why economic growth was so poor on average throughout the 1990's, and then why the banking problems worsened. To anticipate the story, in essence the economy's mediocre performance was due primarily to serious macroeconomic policy mistakes, and the banking mess today due to dithering and delay by bankers and regulators alike, indeed in collusion. I then want to consider the current situation and the new policies being taken as a result of the July 12, 1998 Upper House election, and to speculate on future economic prospects.

Pessimism has ruled so strongly that some foreign financial pundits have suggested Japan is on the verge of economic or financial collapse. That is nonsense. Japan is a strong, cohesive, quite homogeneous society with the world's second largest economy, but with a relatively weak political and policy making system that is prone to inertia and more importantly, has made some major economic policy mistakes in recent years.

We should never forget or underestimate Japan's fundamental economic strengths. It has a highly educated, diligent, intelligent and hard-working labor force. Its saving rate, through gradually declining over the long-term — while rising slightly in the current recession — remains high. Japanese firms are at the forefront of civilian goods technology; Japan's technological level is ahead of Europe and second only to the United States. It is an affluent society with a high standard of living; more than 80 percent of Japanese think of themselves as in the middle class. There is very little real poverty. The bottom 20 percent of the Japanese live better than anywhere else except perhaps the Scandinavian countries. They have jobs, homes, access to good schools and good medical care, and they live in safe, crime and drug free environments. In a very real sense affluence has allowed Japanese policymakers the luxury of inertia during the 1990's.

Japan's economic misery today is primarily psychological, not material. Japanese continue to live a good life; restaurants are full, stores are crowded. Yet the Japanese public are, to an extent not seen for fifty years, deeply critical not only of their politicians but of their elite bureaucrats and bankers, and angry, as well as caught up in a sense of resignation if not despair, about the inability of their leaders to lead. Interestingly, while foreign observers have talked about the "Japan crisis" for several years, Japanese have not really manifested a sense of crisis. What they have shown is anxiety, pessimism, and lack of confidence about the future — the country's future and their own future job security and retirement. So, while continuing their basic consumption lifestyle, Japanese have been postponing the purchase of a new home, delaying trading in their car for a new model, and cutting back on enjoyable luxuries such as vacation trips to Canada and elsewhere abroad. But once they do go on such trips, they seem to spend with the same abandon for which they have long been noted as tourists. Nonetheless, it is the restoration of the confidence of Japanese consumers and businesses alike that is requisite for sustained economic recovery and growth.

### Miserable Economic Performance in the 1990's

Unlike previous postwar periods of economic difficulty, the economic problems of the 1990's have been home grown rather than the consequence of external shocks such as the oil crises. The fundamental problem is that Japanese macroeconomic policy makers have not known how to deal effectively with a condition of deficient domestic demand created by an ongoing surplus of domestic private saving over private investment. Fiscal policy is handcuffed by the deflationary structural bias of the Ministry of Finance; its Tax Bureau resists all efforts to reduce taxes, and its Budget Bureau resists all efforts to increase government expenditure. While the Ministry has had extraordinary influence on macroeconomic policy making, in the end it is the political party in power and its leaders that are responsible. The Liberal Democratic Party and Prime Minister Hashimoto made terrible policy mistakes in late 1996 which are the direct cause of the current recession. Before going through that, it is important to recall briefly what had transpired in the

economy in the early-mid 1990's.

During the late 1980's the Japanese economy was booming; real economic growth, led by high rates of business investment, was on the order of five percent per year. However, the stock and urban real estate markets were also booming, stimulated by real economic growth and the psychological optimism of the times and fueled by an excessively easy monetary policy that persisted for too long. As you know, the consequences were speculative mania, which ended abruptly when the stock and real estate bubbles burst in 1990 and 1991.

Inevitably the economy slowed sharply. In 1992-3 the authorities thought it was primarily due to the inevitable business cycle and that, as in the past, the economy would soon recover, needing only relatively modest stimulus. That turned out to be an incorrect assessment. Monetary policy was eased and interest rates lowered, gradually at first but dramatically in 1995 to an official discount rate of only 0.5 percent, with an attendant low interest rate structure which has helped banks and borrowers, but has severely penalized depositors and pension funds and constrained monetary policy as an instrument of macroeconomic easing. Essentially monetary policy had to be so easy only because fiscal policy has persistently been excessively tight. The government did provide fiscal stimulus through annual supplementary budgets but they were too little, too late and most important, too grudging to do little more than prevent recession. The Ministry of Finance sent ambiguous signals which undermined the confidence the packages were suppose to inspire in businessmen and consumers. The tax cuts were clearly labeled as temporary, not permanent, so people simply banked them rather than increasing consumption spending. The actual amount of fiscal stimulus was substantially less than the exaggerated amounts announced, farther reducing credibility.

So the economy limped along, growing at less than one percent a year an average, until the large supplementary budget in fall 1995 finally had a substantial impact, generating good recovery with 3.4 percent GDP growth in fiscal 1996 (the fiscal year begins April 1). However, this recovery was aborted by a tragic policy misjudgment by Prime Minister Hashimoto and his

advisers in late 1996. Beguiled by optimistic economic forecasts for 1997 and beyond, the government decided to shift its top policy priority 180 degrees from continuing to sustain economy recovery to tackling the long-run structural problem of government budget deficit reduction. While the concern was appropriate, the timing was far too early. The policy error had two major components. The first was to shift the 1997 budget to severe fiscal restraint from 1996 budget ease, reducing demand generation by as much as two percentage points of GDP. This was done by increasing the consumption tax from three to five percent, terminating the ¥2 trillion temporary personal income tax cut, and raising medical care and other user fees. The second error was to enact the Fiscal Structure Reform Law which stipulated further annual decreases in future government budget deficits and in its issuance of deficit financing government bonds.

Rather than continuing the recovery, in 1997 Japan's economy stalled and then went into decline. GDP shrank by 0.7 percent, and by year end was in recession. The Fiscal Structure Reform Law shackled Prime Minister Hashimoto's government politically; if he were to admit it was a mistake his own position was at risk. Accordingly, even as the recession was obviously worsening at the beginning of 1998, his government had first to pass a restrictive 1998 budget in order to comply with the law before it could, at long last, announce in April 1998 the huge supplementary budget of ¥16.6 trillion (about ¥12 trillion in real demand-generating expenditures and tax cuts), and to pass it in June 1998 in an extended Diet session. One could well argue that this further delay in essential fiscal stimulus, and continued worsening of the economy in the first half of the year, contributed significantly to Prime Minister Hashimoto's defeat in the July 1998 Upper House elections.

### The Worsening Banking Mess

The bursting of the stock and particularly the real estate bubble hit Japanese banks hard, particularly those lending to real estate and construction companies in urban areas, especially Tokyo and Osaka. One of the great myths of postwar Japan until 1990 was that real estate was the



best collateral for loans since land prices would not decline; after all, they never had, more than temporarily and in minor amounts, during the entire postwar period. Everyone shared in this myth: bankers, regulators, companies, and rich individuals. And they all were burned. Since the bursting of the bubble, urban residential prices by July 1, 1998 had declined from their peak by 39.8 percent, and urban commercial real estate prices by 66.5 percent according to the government's estimates (which probably are conservative). And they have not yet reached bottom, so far as we can tell.

The harsh reality is that virtually all banking institutions, including the 19 so-called Big Banks, have suffered huge actual or potential losses from borrowers not able to repay their loans and whose pledged collateral is now worth only a small fraction of the loans. The bad loan problems range from loans to companies that have gone bankrupt; non-performing loans in which interest and principal payments are unpaid and substantially past due; loans which have been restructured at highly preferential, extraordinarily low interest rates; and loans which are currently being serviced but future payments are in doubt.

It is important to understand the context in which this non-performing loan problem has been evolving. Even though by the early 1990's the Japanese financial system was well along in the process of financial deregulation and financial markets were increasingly competitive, neither the regulators — essentially the Ministry of Finance — nor the banks had adjusted sufficiently. The Minister of Finance did not introduce effective systems of prudential regulation — disclosure, transparency, rigorous oversight and inspection, adequate capital requirements, and the like — to replace the earlier system of banking safety. That system had been based on highly regulated interest rates with wide spreads so every bank was profitable; segmented loan markets; restraints on competition; and a convoy system in which all banks grew at about the same rate and stronger banks helped out weaker banks in the few cases of difficulty. It was a close, cozy, and comfortable relationship between the banks and the Ministry of Finance. And it was very safe. But it became increasingly inefficient, and depositors paid the costs. The system gradually broke down as market forces prevailed. Yet everyone persisted in believing the old system was still in effect: the

Ministry would not allow any banks to fail, and stronger banks would bail out weak ones even though the economic incentive to do so had evaporated. The inexorable rise of financial market forces has been fundamentally undermining the power of the Ministry of Finance.

Nonetheless, the instinct both of the banks and the Ministry of Finance has been to cover up these bad loan problems, and that indeed has been their behavior, but gradually they have had to make greater disclosure. Yet over time the disclosed amounts of bad loans have increased even after write-offs. Private estimates of actual bad loans have been substantially greater than the amounts announced by the banks and the Ministry of Finance. In December 1997 the Ministry of Finance shocked the world with its estimate of the bad and troubled loan problem — some ¥79 trillion, triple previous estimates, and 12 percent of total bank loans and credits, 12 percent of loans of Big Banks, 10 percent of regional banks, and 14 percent of second-tier regional banks. However, this reflected the new inclusion in the definition a category of loans currently being serviced but in potential danger of failure, the important grey area of so-called category two loans. When Bank of Japan Governor Masaru Hayami met with U.S. Treasury Secretary Rubin and Federal Reserve System Governor Greenspan, it told them the bad bank situation is substantially worse than announced, implying that virtually none of the Big Banks meet the B.I.S. capital adequacy ratio of eight percent.

In reality, the actual amount of bank bad and doubtful loans is ambiguous, for a combination of definitional, measurement, and disclosure reasons. Importantly, loans to companies that are failing in the recession may become repayable if the companies are able to achieve solvency once economic recovery takes place and growth resumes. One difficulty is that, even though the definition of bad loans has become more comprehensive and clear, and is now approaching the U.S. SEC definition, each bank estimates its own bad loan situation. The presumption is that the estimates of strong banks are closer to reality than those of weaker banks. When weak banks have in fact collapsed, subsequent audits have revealed that the actual bad loan situation was far worse than the banks had announced even a short time earlier. This is well exemplified in the current case of the Long-Term Credit Bank, where substantially more loans have recently been re-classified from good to the doubtful category, and a key issue is whether in reality the LTCB is solvent or insolvent, as is discussed below.

Both the Ministry of Finance and the banks in the early 1990's underestimated the nature and extent of the bad loan problem. One reason of course was the expectation that the economy would recover quickly and that real estate and share prices would stabilize and then once again rise. But rather than taking decisive actions, both the Ministry of Finance and the banks continued to dither; the banks began writing off some obviously bad loans, but did not reduce dividend rates, or annual staff salary increases, or reduce personnel.

1995 was a turning point. One factor was the jusen case. By 1995 the bad loan problems of the seven housing loan corporations (jusen) had made them insolvent and their situations scandalous, combining sleazy behavior by the jusen themselves, their former Ministry of Finance (*amakudari*) senior management, and their parent (founder) banks. They had to be liquidated in such a way as to prevent chaos in the financial markets and depositor runs on banks. Unfortunately, the way in which the jusen bail-out was handled left the public impression, even though only a relatively small amount of government funds were involved, that taxpayer monies were being used to bail out rich banks and farmers (since their agricultural cooperatives had been heavy lenders to the jusen). As a consequence, it became politically virtually impossible to propose using any further government funds to resolve the festering bank bad loan problems, even though that need had become increasingly obvious. It was not until the financial traumas of fall 1997 that this constraint could be overcome.

It took a long time for the Ministry of Finance to finally realize it simply could not, and more importantly, should not guarantee all banks against failure. With the jusen crisis, the Ministry of Finance realized that even depositors might no longer feel completely safe. While deposits were insured up to ¥10 million by the Deposit Insurance Corporation (DIC), the insurance fees charged banks were very low and the DIC reserves minuscule. They could be, and in fact were, soon depleted by several small banking institution failures.

To guarantee depositor system safety, in summer 1995 the Ministry of Finance announced

that all deposits would be guaranteed until March 31, 2001. However, no specific funds were earmarked to support this pledge. The Ministry of Finance (MoF) believed its announcement was sufficient to ensure credibility. It did increase deposit insurance fees substantially, up to U.S. levels. This generated new additional DIC income and reserves, but the amounts were sufficient only to handle two or three small bank failures annually, not more. Frankly, one of my fears during this period was that a financial panic might emanate from runs on a few small financial institutions — credit cooperatives and associations or very small banks - - and then quickly spread to other, larger banks.

From 1995 the banks, particularly the (then) 21 Big Banks began actively to write off their bad loans. Indeed, while modest until 1995, over time the cumulative amount of actual write-offs has been huge and impressive. The 21 Big Banks between 1992 and 1998 wrote off ¥42.02 trillion, about \$311 billion U.S. dollars at 135 yen per dollar; (68.5 percent) was written off in the last three years, ¥12.14 trillion (28.9 percent) in this last year alone. This was financed from operations profits, realized capital gains on securities holdings, and modest capital account transfers. The immensity of this write-off is apparent in comparison with the amount of capital these banks had at their March 1994 peak of ¥22.14 trillion. However, in most cases it has not been sufficient to solve their bad loan problems.

Despite the write-offs the bad loan position of banks worsened, especially after the economy slid from recovery in 1996 to recession in 1997 and deepened this year. The regulatory authorities continued to procrastinate in reforming the financial system. However, all that changed in 1997 when the traumatic failure of four major financial institutions shocked policy makers, bankers, and the public.

The first was the collapse of mid-sized Nissan Life Insurance Company. Life insurance companies had been considered to be particularly strong, certainly not subject to insolvency. That failure demonstrated that measures to protect annuity and other policy holders were inadequate, and policy holders had to take a loss, receiving only partial payment on ten-year annuity contracts.

Second was the bankruptcy of Hokkaido Takushoku Bank, the tenth largest city bank, apparent in summer 1997 and made definite in November. Bank of Japan and Deposit Insurance Corporation funds were quickly injected so there were no depositor losses and liquidity was maintained. This bankruptcy exposed the difficulties in establishing adequate alternative banking relationships for borrowers which were probably but not necessarily creditworthy and required normal refinancing of short-term loans. The third shock was the failure of Sanyo Securities in early November. This was important not because of its size, since it was one of the mid-sized securities companies, but because it was the first case of postwar default in the overnight call market, until then considered virtually riskless.

The fourth was the most of shocking of all, the Yamaichi Securities Company collapse in late November 1997. It was the straw that broke the camel's back. The revelation that Yamaichi had been hiding losses of more than \$2 billion since 1991 further undermined Ministry of Finance credibility. Either Ministry of Finance was incompetent because it did not know (which seems unlikely), or it allowed a cover-up that could be considered fraudulent. These failures discredited not only the Ministry of Finance but the entire financial system.

The Yamaichi debacle, followed shortly by the collapse of Toshoku Corporation, Japan's third largest bankruptcy up until then, made the 19 Big Banks even more cautious. They began to restrict lending in order to improve their balance sheets, especially in light of the more severe reporting requirements they faced at the end of the forthcoming fiscal year, this past March 31. A credit crunch developed in December and continued into the first quarter of 1998 and indeed until the present. Following these bankruptcies, the credit crunch generated fear among policy makers that a real financial crisis might emerge before the end of March 1998. This fear galvanized the government finally to take actions to begin to create, with government funding, the institutional infrastructure essential to resolve the problems of bank bad loans and weak bank consolidation.

The ¥30 trillion government bail-out package for the banking system enacted in February

1998 was a particularly important first step. The ¥17 trillion provided to the Deposit Insurance Corporation (DIC) made credible the government's guarantee of all bank deposits until March 2001. It means the outright failure of the many insolvent smaller financial institutions, or any of the remaining 19 Big Banks, will not result in bank runs and panics.

The remaining ¥13 trillion allocated to replenish bank capital is more problematic; much less depended on the terms and conditions under which these funds are used. The allocation, essentially by the convoy system, in March of ¥1.8 trillion in subordinated bonds or preferred stock to 18 Big Banks and three regional banks was a retrograde step, but probably tactically necessary to overcome the crisis mentality and to restore financial confidence prior to the fiscal year end. The Opposition parties have recently successfully demanded that this system be terminated, and replaced by government funding used only in a much more focused and selective way.

The Resolution and Collection Bank (RCB) was established to dispose of bad loans and associated collateral of banks that are declared bankrupt. While an important second step, it did not address the problem of providing continued credit renewals for the presumably good borrowers of a failed bank until they were able to develop new banking connections. The government's "total plan" announced in late June 1998, included measures designed to solve this by creating government-funded "bridge banks" to take over failed banks and having them provide interim finance to good borrowers while transferring bad loans to the RCB. That package of six bills included legislation to simplify procedure for banks to take over real estate collateral and securitize it. This was an important part of the Liberal Democratic Party platform for the upcoming Upper House elections on July 12.

### The Upper House Elections: A Turning Point

These past three months in Japan since July 12 have been fascinating and in some respects dramatic. They have provided headline news around the world, especially since it becomes

increasingly clear, given current trends, that much depends globally on Japan resolving its banking mess and restoring domestic confidence. And, in the usual Japanese pattern of policy making, there has been a great deal of rhetoric, obsfucation, pettiness, and privately-negotiated compromise decisions – so it has been difficult to know exactly how matters ultimately will play out, and what the consequences will be.

In my view the July 12 Upper House elections will prove to have been a major turning point in Japanese economic policy making, and perhaps even in Japanese politics. Up until only a few days before those elections the Liberal Democratic Party, which already had a majority in the Lower House, expected a victory sufficient to obtain a majority in the Upper House as well, or at least close to it. Instead, the Liberal Democratic Party suffered a devastating defeat. The public finally had an election in which to display their anger at the government's slowness and ineptitude in handling economic recovery and banking reform; and they turned out in huge numbers, some 14 percentage points more than the previous Upper House election three years earlier. The fledgling opposition Democratic Party, led by Mr. Naoto Kan – today Japan's most popular politician with the public – did extraordinarily well. Thus, the coalition of these opposition parties – the Democratic Party, the Liberal Party under Ichiro Ozawa, and the Heiwa-Kaikaku (Peace/Reform) parliamentary group – control the Upper House.

Of course Prime Minster Hashimoto had to resign: his policies and his leadership had been repudiated. A three-way contest emerged for the presidency of the Liberal Democratic Party, two rather charismatic, strong-willed contenders, and Keizo Obuchi, an affable veteran LDP politician supported by the party top leadership. Mr Obuchi is smiling, friendly, and low-keyed, not noted for his charisma, sense of vision, or oratorical capabilities. He was the least popular with the public of the three candidates. But he won. And, unlike many, I think he is the right choice. Obuchi's great skills are as a negotiator and a compromiser. With the LDP in some disarray, and the opposition parties able to block the proposed so-called "bridge bank" six bill package of banking reform, clearly what the LDP and the nation need is an effective compromiser. And his skill in managing these difficult negotiations over recent weeks demonstrates this has been the right choice.

The political message and mandate of the election is clear, to the LDP and indeed to all political parties and politicians: bring about economic recovery as soon as possible, address the bank non-performing loan problems decisively, and thereby give the public some reason to have confidence. Any who delay the reforms, whether by inaction or obstruction, would be punished at the next Lower House elections, to be held within two years.

Prime Minister Obuchi acknowledged this mandate and pledged reforms in the very first words of his inaugural policy speech to the Diet on August 7. And, despite the media and Washington mantra that Japan is moving too slowly, the fact is that the Obuchi government is moving rapidly and decisively in the context of a democracy which requires parliamentary approval of budget and tax changes, and of financial legislation.

The Obuchi government has made a 180 degree change on fiscal policy. It has said unambiguously that economic recovery is the top priority for fiscal policy, that the Fiscal Structure Reform Law should be suspended, that a second 1998 supplementary expenditure budget of ¥10 trillion will be passed this November, that the fiscal 1999 budget will be expansive, and that a permanent income tax reduction of some ¥7 trillion, most personal and some corporate, will be enacted beginning next year. These are the fiscal policy agenda items for this fall and winter.

The more immediate issue involves the resolution of the bad debt and related financial structure problems. They are immediate in three ways: banking reform is considered an essential prerequisite for economic recovery and restoration of public confidence; the “bridge bank” six bill package has been the central focus of the current special Diet session extended to October 16; and the Long-Term Credit Bank collapse in late June has become a symbol, lightning rod, and indicator of the future handling of any of the other 19 Big Banks that may come into serious trouble.

Not surprisingly, these banking issues have been highly politicized. They have provided



an opportunity for the opposition parties to criticize the LDP and Prime Minister Obuchi and, given their power in the Upper House, to propose an alternative legislative package. The ultimate opposition threat was to force a stalemate in the Diet, prevent passage of any banking reform bills, throw politics into chaos, and force a new election. They have not done this: the risk is high that the public would blame them for obstructionism, redounding to the benefit of the LDP; they were not sufficiently prepared to engage in a Lower House election soon; and they probably do not want to govern Japan, with all its problems, just now. Instead, what the opposition has been doing is to force substantive compromises in the LDP-proposed legislation which, in my view, are considerable improvements, especially in strengthening disclosure and accountability, and making tougher the terms of government bail-out funding.

While the bridge bank concept – to provide a mechanism of interim finance for the pretty good customers of clearly failed banks – is desirable and important, it came to be realized that it could probably be used mainly for regional and local banks, since their failure would not have significant repercussions in domestic, much less international, financial markets.

The key issue for the 19 Big Banks is: are they too big to fail? Would the negative psychological, not to say financial, impact be so severe, especially in these days of huge international derivative exposures, that financial panic would ensue from an outright failure? Would their numerous, large but very weak construction company, real estate company, and other corporate clients themselves be forced into bankruptcy? Where would their workers go, especially given the very limited lateral labor markets for large firm managers and white collar workers in particular? On the other hand, suppose a Big Bank has so many bad loans that after they are all written off the bank capital is seriously impaired (close to zero), or the bank is actually insolvent (negative net worth). Who is going to provide capital for its survival? Why should public funds (taxpayer monies) be used, throwing in good money after bad? What components of such a bank's business are in fact viable and worth saving?

One basic issue is to determine whether a bank actually is insolvent or not, in other words

what is the state of the grey area (category two) loans. Some borrowers are certainly basically good companies which will be able to perform adequately once economic recovery proceeds. Others are companies that in reality are bankrupt but are being carried by the bank which continually lends it additional funds to meet its interest payments. And some are loans to gangster (yakuza) related companies, where collection is difficult and even dangerous.

Part of the policy debate, epitomized in the current LTCB case, centers on what is actually meant by the failure of a bank. In the case of Big Banks, no one wants such a bank, if insolvent, to be declared legally bankrupt (formally failed) because of the strong adverse effects on domestic and international financial markets. The apparent resolution of the LTCB case is that a “virtually failed” bank will not immediately be closed. Rather, it will be nationalized as a temporary measure, and public funds will be injected. It is essential that the process be orderly. “Virtual failure” means that stakeholders will pay a substantial price. The Board of Directors will resign, giving up their pensions; and recently retired Board members will be asked to return their long-term pension payments. A significant proportion of the employees will be let go. And virtually all of the shareholder capital will be written off, to the extent necessary, against bad loans.

The negotiations underway right now are to determine how, and with what conditions, government funds will be injected into an ailing bank not yet in a state of virtual failure, dependent upon how low is its actual capital ratio (on the B.I.S. definition). It is significant that Democratic Party leader Kan on September 27, in the process of negotiations, stated that resolving the bad loan problem may require government funding of as much as ¥100 trillion (\$741 billion at 135 yen per dollar, about 20 percent of Japan’s GDP). Toyoo Gyohten, chief economic advisor to Prime Minister Obuchi, noted at a conference on Japanese banking reform at Columbia University in New York on October 2 that no one really knows how much government money will be required but that it will probably be at least several ¥10 trillions. Recognition of this fundamental reality by all politicians and by Ministry of Finance officials is essential.

The reality is that the financial markets and their institutions have taken much of the control over these issues from the Ministry of Finance. No longer possible are behind-the-scenes, opaque deals engineered by the Ministry. Deregulation has eliminated the profit niches (rents) that were utilized in the past to pay for such arrangements. So government or Bank of Japan or Deposit Insurance Corporation funds have to be used, and they are much more visible. Financial markets have brought the Japanese regulatory authorities and the government to their knees (or to their senses). Domestic and foreign investors, depositors, lenders and other creditors no longer readily believe Ministry of Finance and bank pronouncements regarding asset quality, safety and other issues of bank creditworthiness. Banks can fail, have failed, and will fail. The price of bank shares in the stock market, the differential premiums required on bank debentures, of different issuers, the “Japan premium” for foreign bank loans to Japanese banks, the ratings by foreign credit agencies – all are market-based measures which increasingly separate the stronger from the weaker Japanese financial institutions. These issues and market pressures have been well exemplified in the current Long-Term Credit Bank case.

Many banking issues remain. How rapidly and vigorously will dubious (category two) loans be evaluated? How many client companies will become bankrupt once this main source of loans ends? What will be the effect on employment? When companies that are deeply in debt and have no future prospects are closed, that should be regarded as good news, not bad news. However, the Japanese public is unlikely to feel this way, and Japanese politicians and bureaucrats will press for a fairly lenient approach, at least until the economy recovers.

With the passage of the bridge bank bills and the resolution of the LTCB problem later this month Japan will have taken major steps to resolve the banking mess. The institutional infrastructure mechanisms will be in place. As always, implementation is key. At this point how government funds will be injected and how much are required are still not completely clear. My sense is that whatever is needed will be forthcoming; they have to be. During this period of political infighting and uncertainty as to the resolution of these problems, the Japanese stock market has declined and the yen weakened. Once it became clear that the bills will pass the Diet,

both the stock market and the yen rose dramatically on October 7 in Japan (October 6 in Edmonton).

In the coming months Japan may well see several more Big Banks nationalized. Certainly, a number of smaller banks will be closed or merged based on the bridge bank legislation. With all this infrastructure in place, the basis for solution to the banking mess will be in place. There are remaining difficulties of course: each case will generate some company bankruptcies and job losses. The most important thing now will be to create a better environment for this banking consolidation process, namely economic recovery and growth.

However, the most recent economic information indicates conditions are worsening, not getting better. Almost all macroeconomic analysts of the Japanese economy, particularly those excellent economists based in Tokyo whose job is to cover the current Japanese economy for major foreign financial firms, continue to be pessimistic about Japan's economic performance. They project negative growth this year, and at best about zero growth next year. This is after they have factored in the new fiscal stimulus package already announced by Prime Minister Obuchi. Japan's Economic Planning Agency, which has become increasingly realistic in its projections under its new head, Toichi Sakaiya, admitted in late September that the projected growth rate for fiscal 1998 will be a minus 1.6-1.8 percent, and indeed today (October 6) reported to the Cabinet a minus 1.8 percent estimate. The EPA projected a flat July-September quarter, with the economy turning positive from the October-December.

Like the EPA, I am somewhat more optimistic about economic recovery, or at least less pessimistic. I believe the economy will reverse itself and begin to pick up this fall, albeit slowly. Essentially that will be the result of the June 1998 ¥16 trillion stimulus package entering the expenditure stream. But that is not the key issue. The key issue now is what will provide sufficient demand stimulus next year. Let us agree with the analysis of others that the Obuchi fiscal package currently in the works is not sufficient. If so, it is my political judgment, not economic analysis, that leads me to predict the Obuchi government will provide even more fiscal stimulus if it has to, because without recovery the Liberal Democratic Party will lose the next

Lower House election. Indeed, the government on September 29 announced it would accelerate the passage and implementation of the second supplementary budget by convening a special Diet session in November, rather than passing it early next year as part of a 15 month fiscal plan incorporating next year's budget.

What in addition to fiscal expansion can the government do to stimulate the economy and restore public confidence? The other major policy instrument is monetary policy. However, its potential interest rate effect is very limited because the Official Discount Rate is already so low. The Bank of Japan on September 9 did lower rates in the overnight call market (to 0.25 percent), its first easing action in three years and heralding further money supply growth. Some economists have proposed a dramatic further expansion of the money supply, coupled with a policy of an announced inflation rate of plus two percent, as an inducement for consumers to spend now rather than later. Unless the economy goes into a deflationary spiral, I doubt the Bank of Japan will take such a policy. It is too bold and radical even for the new, brave Policy Board and implementation could have serious adverse effects, notably a furthering weakening of the yen.

There are also a number of smaller, less visible steps the authorities can take to enhance stimulus. In part to offset the credit crunch of banks reluctant to lend, in addition to providing credit directly to top businesses through the open market by buying their commercial paper, the Bank of Japan could purchase top quality corporate bonds in its open market operations. The Ministry of International Trade and Industry has substantially eased, from October 1, the credit screening guidelines of its semi-public credit guarantee associations for the private loans to smaller businesses. And the various government financial institutions are vigorously expanding loans to small and large businesses alike.

New housing starts have crept downward. Investment in housing could be a significant source of additional demand for the economy. In September Keidanren and other business organizations proposed a variety of tax break incentives to stimulate housing purchases and thereby new housing construction. If implemented well this could have a substantial positive

demand stimulus.

### Implications for the World Economy

Since it is the world's second largest economy, Japan's economic performance has substantial implications not only for those economies suffering through the "Asian crisis" but the global economy as well. There are three major channels: Japan's imports as a source of demand stimulus for other exporting economies; the danger of increased yen weakness precipitating a devastating second round of currency devaluations; and effects not only on Japanese stock prices but on American and European stock markets as investors incorporate the Japanese factor into their evaluation of future economic prospects.

At the same time, we should not exaggerate the importance of Japan in the world economy, as some have been prone to do once again recently. The most recent IMF annual report on global financial markets, issued September 21, which states that rehabilitating Japan's economy is essential to avoid a global crisis, is certainly a nice cautionary statement but is surely an exaggeration. What is more likely to precipitate a world financial crisis: a Japanese economy continuing in the doldrums; a U.S. economy sliding into recession; the "Asian crisis"; the LTCM and hedge fund situation; something else – or all of the above?

For Asia, Japan's economic recession and slowdown in imports from 1997 were only a relatively modest contributing factor to the genesis and development of their foreign currency, domestic financial system, and now deepening economic difficulties in Thailand, Indonesia, South Korea and Malaysia. Nonetheless, the ongoing Japanese recession has made it more difficult for those countries to pursue their export-led recovery strategy. At the same time, the decrease in Japanese exports to these countries this past year has contributed to Japan's deepening recession, though only modestly.

Certainly a growing, importing, well-performing Japanese economy makes an important contribution not only to Asia but to the global economic system. Even so, given its smaller size relative to the United States and the European Community, Japan cannot be expected to be a major engine of growth. The American and European Community economies are about equal in size, and Japan's economy is about one-half the size of either, so only about one-fifth of the total market of the three economies combined. Even the Asian economies cannot expect Japan to be the dominant near-term destination of their exports even after it recovers. In this respect, the most dangerous possibility for the world economy would be that the U.S. economy, the major importer of Asian and other country goods, slides into recession in 1999.

The slowdown in global import markets, particularly in Asia, has hit commodity markets particularly hard since prices are quite elastic while supply capacities have been rising throughout the 1990's. Thus commodity exporters – from Indonesia to Russia to Canada – have had to adjust more than exporters of manufactured goods. Japan is a major importer of commodities, as are Korea and some other Asian economies. A growing Japanese economy will improve commodity prices, both directly and indirectly through the beneficial effects on other Asian economies.

The flight to safety, from Asian and other emerging economies to safer havens (particularly the United States), has included not only short-term capital flows but stock market portfolio investments. There is little evidence that Japanese banks played a major role in precipitating the Asian foreign exchange crises by withdrawing short-term loans, though like European and American banks they have withdrawn funds to a still yet unknown extent. Japanese had not invested a great deal in Asian stock markets, so their withdrawal was far outshadowed by other investors.

The real issue is the Japanese stock market itself, which has been performing very poorly in the current recession. It hit a post-bubble all time low on October 5 of 12,948.12 on the Nikkei Index, lowest since January 1986. Once it became clear the banking legislation will pass it rebounded sharply, rising by 804 points (6.2 percent) on October 7 (Tokyo time). While the performance of major stock markets is not always linked closely, in these days of recent high U.S.

stock prices, bad news from the Japanese stock market quickly adversely affects stock markets in the U.S. and Europe as well as Asia. There are those who visualize a global economic meltdown emanating from stock market crashes, but I am not one of them.

My main anxiety regarding Japan's adverse impact on the Asian economies and on the world has been the weak yen. When the yen declined to 147 to the dollar in June 1998, I and many other observers feared that if the yen decreased significantly further it would unleash a second round of currency devaluations, perhaps starting with South Korea, extending to Taiwan and Southeast Asia, and worst of all to China, which has maintained its fixed exchange rate of 8.3 renminbi to the dollar. Even though in reality China does not have that large a share of world trade, the symbolic effect of Chinese devaluation would be huge. The Japan-U.S. governmental foreign exchange intervention in June strengthened the yen to 137 temporarily, but it weakened once again. Fortunately, it has strengthened once again recently to the mid-130's, but apparently due more to Russian and hedge fund difficulties and the U.S. stock market decline rather than any improvement in Japan's fundamentals. The U.S. Federal Reserve System reduction of the federal funds rate on September 29 had already been incorporated into market expectations, but it may well signal future policy steps to weaken the U.S. dollar, thereby strengthening the yen, the Canadian dollar, and other important currencies. Apparently the foreign currency market did realize that Japanese steps to resolve its banking mess are indeed a change in fundamentals, and on October 7 (in Tokyo) the yen strengthened sharply to 128 yen. At the same time the dollar was weakening against most major currencies as well.

Japan's trade fundamentals imply the yen should be far stronger. Almost all exports are profitable at an exchange rate of 110 or less, and export producers have made large profits as the yen has fluctuated in recent months between 132 and 147. However, the financial fundamentals – the continuing very wide interest differentials between Japan and the United States – have played a major role in driving and keeping the yen weak, especially when combined with continually frustrated disappointment that Japan had yet to turn the corner on economic recovery and banking reform.



When I started preparing this lecture I saw the light at the end of the Japanese tunnel more clearly than I do now. Even so, I still feel the political imperative is so great and the required policy actions are so obvious that fiscal and monetary stimulus will persist and strengthen. And, despite all the political game-playing, posturing, and in-fighting the LDP and the opposition parties will shortly complete the passage of the “bridge bill” legislation and resolve the Long-Term Credit Bank problem. They have to; they have no choice.