COMMENT & ANALYSIS: Japan's first steps on a long journey: Contrary to what the critics say, the country's regulators and central bank are paving the way for corporate reform

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Soon after Junichiro Koizumi became Japanese prime minister, he adopted the slogan "no economic recovery without structural reform".

A year on, critics say there has been a notable lack of reform - and worry that the improving outlook for the world economy will only add to the delay.

These critics may be mistaken. There are initial indications that Japan is beginning to implement reforms and provide a macro-economic environment in which they can take hold. Analysts agree that a return to sustained growth rests on two main pillars: efforts by the Japanese government to encourage restructuring in the corporate sector; and action by the Bank of Japan to stop deflation. These initial steps must be backed up with continued action.

Is the Japanese government serious about reform? Things have not proceeded as quickly as some would like, mainly because reform involves politically difficult decisions. Most analysis of restructuring in Japan focuses on the financial side, in particular non-performing loans held by Japanese banks. However, NPLs are a symptom of the disease: non- performing assets in the corporate sector.

The key to corporate restructuring is action on the part of the banks. Here the experiences of the US (during the savings and loan crisis) and the Nordic economies (during banking crises) are valuable. The important lessons are the danger of regulatory forbearance that can make big problems worse, and the need for prompt corrective action. In each instance, once definitive actions were taken - establishing the Government Bank Insurance Fund in Norway, reorganizing the Government Guarantee Fund in Finland, creating the Bank Support Authority in Sweden, providing more flexibility to the Resolution Trust Corporation in the US - the financial and corporate sectors were revitalized.

In Japan, the legal framework for restructuring and reform is largely in place through the new Civil Rehabilitation Law bankruptcy regime; revisions to the commercial code; the enabling of the holding company structure, allowing for stock options and stock swaps; the introduction of consolidated accounting; and improved accounting standards.

Banks must use the new legal and regulatory framework to confront their problem loans. These should be identified on the basis of future cash flows and realistic assessments of the value of collateral and guarantees. The resolution of problem loans must not just involve debt forgiveness: company operations must be restructured.

Moving capital to more efficient uses carries with it recognition of losses by both the banks and the companies. Some analysts equate this with declining asset prices and economic activity. The opposite is true. Rapid restructuring is likely to lift asset prices, which buoys economic activity. Rational market participants are aware which assets need to be reallocated - for example, the property held as collateral that must be sold when companies are restructured.

The special inspections conducted by the country's Financial Services Agency from November to March, with results announced in mid-April, may be an initial small step in using a regulatory lever to force action. Most important, the inspections were market-based, involving 149 large corporate bank loan customers who had experienced significant changes in stock prices and/ or external credit ratings. Most of these borrowers came from the moribund construction, property and wholesale and retail trade sectors. Of the loans examined, almost 60 per cent were downgraded, with about 30 per cent newly classified as being "in danger of bankruptcy" or below.

The FSA has called for banks to dispose of newly emerging NPLs over a three-year time period and has now called on banks to dispose of half of these loans in the first year and 80 per cent after 2 years. The FSA is also calling for permanent, on-site inspectors at the big banks.

Third parties such as Japan's Resolution and Collection Corporation can be used to remove the NPLs from the banks' books and dispose of the non-performing assets. Here again, there are some encouraging developments. The RCC is now empowered to purchase NPLs at market prices, which is vital in encouraging banks to clean up their loan portfolios.

Equally important, any NPLs purchased by the RCC should be liquidated quickly. The agency should not seek to become a central figure in corporate work-outs, a role more appropriately assigned to the private sector. Instead, it should limit itself to rapid purchases and equally rapid sales.

Although small, relative to its NPL portfolio, the RCC has recently announced some sales of NPLs, including a Dollars 1bn (Pounds 700m) sale of claims on a big condominium-builder and an innovative Dollars 770m securitization deal. Incidentally, both these transactions involved foreign companies, an important source of capital for the restructuring process. Regardless of the purchaser, RCC sales will be fundamental to stimulating the market for distressed assets and reallocating capital to more productive uses.

Is the Bank of Japan attacking deflation, the economic cancer that eats away at an economy? In March 2001, the Bank of Japan shifted its policy from targeting a short-term interest rate to aquantitative easing strategy that targets reserves on deposit at the Bank of Japan (current account balances at the bank). Three times last year the bank raised its target. Over the past year, current account balances held at the Bank of Japan have more than tripled, from Y5,000bn (Pounds 27bn) to the current level of almost Y18,000bn. The results are apparent, with the monetary base up 36.3 per cent on the year ending in April.

Has this helped? It is difficult to draw strong conclusions, given the long and variable lags in monetary policy, particularly with the bulk of the easing coming in only the past four months. Moreover, the dysfunctional banking system has prevented the money supply from rising in line with the increase in the base.

In spite of these caveats, price declines appear to be slowing, with some increases recorded in recent months. These are positive developments. The Bank of Japan has acted. It should be encouraged to continue its policy, and do more if necessary, until consumer prices clearly respond.

Of course, nobody should declare victory yet. But it is important to recognize the first steps that the FSA, the RCC and the Bank of Japan have taken. Perhaps a journey of 1,000 miles has begun not with a single step but with several small ones.

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