

Whither the Japanese Economy?
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Introduction

When I interviewed businessmen and academics in Tokyo in early June 2003, I stated that Japan's economic situation seemed about the same as a year ago: mediocre growth; persistent mild but debilitating deflation; record high unemployment; very weak banking and life insurance institutions; and only limited government economic reforms. I asked what would be different a year hence. The strong consensus answer was: "Nothing."

What a difference a couple of months can make. Summer brought unexpectedly rapid improvements in certain major economic indicators that have quickly generated more optimistic expectations, notably output growth, the sharp rise in stock prices, and increases in employment. The government's August 12 preliminary estimate for the April-June quarter indicated GDP grew at a 2.1 percent annual rate year-on-year, two-thirds due to rises in private consumption and business investment and one-third due to an increase in net exports. The September 10 revision was astonishing: growth at a year-on-year rate of 3.0 percent, pushed up by a 14.0 percent increase in business fixed investment. The Japanese economy is now growing more rapidly than the U.S. economy, and both are growing faster than the E.U. However, an excellent quarter does not a recovery make. While Japan is enjoying a stronger than expected cyclical recovery, it is premature to say that it is finally on the path to full recovery and self-sustaining growth.

After overviews of recent economic performance and prospects, I review Japan's fundamentals and consider near-term and longer-term issues. Government economic policy is then examined, focusing particularly on aggregate-demand macroeconomic policy and on the major structural problems of the banking system. Following a brief section on Japan and the world economy, I provide a few concluding comments.

Economic Performance

Japan's poor economic performance for more than a decade has been due, at the macro level, to inadequate domestic aggregate demand and, at the micro level, to the slowness by many firms to restructure, particularly the very weak companies unable to service their bank loans.

Since 1990 Japan's GDP has cyclically fluctuated between mild recession, inadequate recovery, and sub-par growth, with the exception of 1996-97. That incipient real recovery was aborted by a mistaken government policy of premature fiscal restriction intended to reduce the budget deficit but in reality making its prolongation necessary. The deflationary trend since 1998 is one consequence of the lack of aggregate demand. A major cost to Japan has been output foregone: GDP would be at least 25 percent higher if the economy had grown at close to its potential.

After hitting its most recent trough in January 2002, Japan's economy has recovered surprisingly well to summer 2003, with six straight quarters of positive growth capped by the surge in the most recent quarter. Aside from ongoing data problems of GDP estimation, there are occasional quirks that can affect evaluation of economic performance. For example, what a

difference a quarter can make. Calendar year 2002 GDP real growth was 0.1 percent, but starting a quarter later, fiscal 2002 GDP growth was 1.6 percent.

Half the growth in fiscal 2002 was due to an increase in net exports. Domestic demand growth (0.7 percent) was driven by a rise in consumption of 1.4 percent, as business investment continued to decrease. Despite a large budget deficit, the government contribution to demand growth was slightly negative, with the continuing sharp decline in government investment (-6.5 percent) more than offsetting a modest increase in general government consumption expenditures (+2.0 percent).

Near-Term Prospects

The economy will continue to perform well in the second half of 2003, even though the July-September quarter is adversely affected by a cool summer holding down consumption. The September GDP announcement included upward revisions for the previous three quarters, so the growth rate will be an impressive 2.5-3.0 percent in 2003. However, that rate is unlikely to be sustained; a 2.0 percent projection for 2004 is reasonable. Most forecasts estimate that net exports and government demand will make a small positive or possibly a negative contribution. Business investment has turned around and will contribute substantially to demand growth, but at a lower rate than this year. The key is consumption expenditures; employment and wage incomes are finally increasing, but last year's increase in consumption was unusually high and it is unclear whether it will persist.

Given Japan's ongoing deflationary trends, open and hidden unemployment levels, and underutilized capacity, 2.0 percent growth will be insufficient to restore the economy to

sustained equilibrium growth. This fundamental reality overshadows the inevitable data revisions and differences in forecasts of specific GDP components and other performance measures. The gap between actual and achievable growth continues to be large. A pattern of cyclical recovery that does not lead to good, sustainable growth cannot be considered satisfactory economic performance.

Growth in the Longer Run

The potential growth rate is determined both by supply factors and their full utilization: the quantity and quality of labor, factories and equipment, infrastructure, technology, productivity growth, and, more broadly, social and political institutions. Over time, all change. Actual growth also depends on the economy achieving sufficient demand: spending by households, investment by businesses, government spending net of revenues, and exports minus imports of goods and services.

The most common measure of national economic performance is real GDP, which is national output adjusted for price changes. Japan continues to have a huge economy, the world's second largest using exchange-rate based comparisons. Real GDP per capita is one measure of Japan's standard of living. It is about 70 percent of the US level in purchasing power. However, neither GDP nor GDP per capita is a very precise measure of national productivity or economic efficiency, since output depends on how many people work and for how many hours.

The most relevant economic measure is the growth of real output per worker per hour. By this measure, economic growth in a full-employment equilibrium is determined by changes in the number of workers, the hours they work, and changes in their productivity. This last reflects

changes in skills, equipment per worker, and unattributed technological change (total factor productivity). In the long run, supply factors determine the growth rate, as was the case for Japan from the 1950s into the 1970s.

The current gap between Japan's actual and potential growth is due to the sustained lack of aggregate demand. It will take above-potential growth in the intermediate term - five to seven years - to absorb the currently redundant and misallocated labor force and the economy's excess physical capacity. Japan's achievable GDP growth rate for the rest of this decade is on the order of 3.5 to 4.5 percent annually.

Demography is the major long-run story. While labor will be in diminishing surplus for several years once the economy has attained potential growth rates, eventually labor will become scarce. Japan's labor force will peak at 68.7 million in 2003 and then begin to decline absolutely, the average age of the population is rising, and total population will soon begin decreasing. For some time the labor-force age group will decrease more rapidly than the population, but eventually they will both decline at the same rate, about 0.5-1.0 percent annually, assuming no substantial immigration of workers.

A conservative assumption is that, in the long run, labor productivity will increase about 2 percent per hour from continuing skill improvements, more capital per worker, and ongoing technological progress. In applying this standard growth-theory analysis, assuming the labor input (total hours worked) decreases by 1 percent annually and worker hourly productivity increases by 2 percent, then Japan's potential long-run growth rate of GDP is 1 percent, and its GDP per capita and labor output growth rates are each 2 percent. This gradual slowdown of potential growth has been a fundamental feature of Japan's ongoing transformation.

Persistent Major Features

My essays in the three previous annual reports of the Center on Japanese Economy and Business have stressed the persistence of several major features of Japan's economy. In this section, I revisit these and note significant changes.

1. As already noted, Japan's fundamental macroeconomic problem has been inadequate aggregate demand and, at least since 1998, the persistence of mild but debilitating deflation. As discussed below, even very expansive fiscal and monetary policies were insufficient to offset the domestic private demand shortfall, as shown in the huge excess of private saving over business and housing investment.
2. The most important structural problems lie, both substantively and symbolically, in the financial system. Commercial bank non-performing loans (NPLs) and capital inadequacy have been issues for years, and life insurance companies weakened by negative spreads and an opaque but weak set of government financial institutions and arrangements, including the Fiscal Investment and Loan Program (FILP), are also serious problems. The cost is a weak, inadequate mechanism for efficient allocation of finance and business investment.
3. Government economic policy making and implementation has been mediocre, despite Prime Minister Junichiro Koizumi's 2001 election pledge to bring about change. The Liberal Democratic Party (LDP) is based on a wide range of vested interests that benefit from existing policies and hence resist reform measures.

Moreover, society's values, mindsets, and beliefs support a slow, gradual

process of ameliorative reform. These include important assumptions that have turned out to be dramatically mistaken. The myth of the 1980s was that land prices would never decline. This seriously exacerbated the land and stock price bubble. The myth of the 1990s was that the economy would muddle through to eventual recovery rather than merely muddling along. The result was forbearance that has exacerbated the problems.

Many policy makers still believe that the banking system will gradually solve its NPL problem without requiring further injection of government capital. Many Ministry of Finance officials believe, and have persuaded other policy makers, that the government debt is so large that a strategy of short-run, cyclical fiscal stimulus is impossible. Bank of Japan officials seemingly believe that monetary stimulus alone cannot end deflation. These views are mistaken.

1. Dealing with potential unemployment by slowing the restructuring of weak distressed firms, large and small, and thereby saving jobs of full-time regular employees, has been the major rationale for government policy makers and business leaders. The cost of this policy has been inadequate job creation for young entrants into the labor force, too slow exit of inefficient, uncompetitive firms, and delay in needed reallocation of capital and labor. The degree of restructuring needed and that achieved varies widely by industry and by company. Manufacturing firms, subject to foreign competition, have been the least slow to adjust.
2. The Japanese economy, political system, and society are characterized by two related phenomena: high degrees of forbearance (delay, procrastination, inertia), and embedded relationships. Because they enhance and reward continuity, these qualities

are virtues when difficulties are temporary and good conditions will return.

However, when change is necessary, both are costly obstacles.

Japan is imbued with networks of strong embedded relationships between suppliers and assemblers, management and employees, banks and borrowers, bureaucrats and businessmen, bureaucrats and politicians, politicians and support groups, and among schoolmates. In a stably growing economy, such relationships build trust, reduce transactions costs, and provide incentives for investment and Research and Development (R&D). But they lock participants into each other, and over time, become reputational, even moral, commitments. When their economic rationale becomes negative, as has often been the case over the past decade, exit is very difficult. Japanese managers have found it hard to terminate supplier relationships, and virtually impossible to lay off workers outright.

3. As in the United States and the European Union, the share of trade in Japan's fundamentally domestic economy is small. However, as a major exporter and importer, and the world's largest net creditor, Japan has significant regional and global impacts. Japan's mediocre performance has meant that it has been a sputtering engine of global growth.

Reliance on foreign demand as a major source of Japanese incremental demand growth persisted even after the United States went into brief, modest recession. It continues, especially now, as Japanese hope U.S. growth will accelerate in coming months. To the extent that reliance on external demand substitutes for domestic demand stimulus and restructuring policies, this counterproductively slows Japan's needed adjustment process.

In any case, Japan cannot export its way to restore sustained growth since it would require a current account surplus of 6.0 to 10.0 percent of Japanese GDP, meaning a huge trade surplus and a very weak yen (160-200 yen/dollar). These are unacceptable to the United States and European and other Asian nations.

4. Japan is in the midst of a major, long-run transformation economically, politically, demographically, socially, generationally, and institutionally. Japan is now a mature economy in which growth inevitably is slower than in its rapid catch-up phase. The postwar economic system and its institutions are eroding and evolving into a more competitive, market-based economy. Japan is the furthest along the demographic transition from high birth and high death rates to low births and deaths, and soon from population increase to decrease. All this adds complexities to the inevitable interdependencies and feedbacks among Japan's immediate problems of mediocre growth, deflation, weak banks, slow restructuring, and unemployment. Poor management of economic policy since 1990 has increased the inevitable costs of the transformation.

Some Positive Changes

1. Previous essays have stressed that Japan's fundamental structural macroeconomic problem has been the excess of private saving over investment, a gap that gradually widened over time. Since its economy is so large because of likely foreign retaliation, Japan could not export the full amount of its massive saving surplus; Japanese have been saving too much. The sharp decline in the household saving rate

(from 9.8 percent of disposable income in 2000 to about 4.3 percent in 2002, and perhaps even lower this year) is thus welcome because it reduces the amount of the budget deficit required to generate adequate macroeconomic stimulus and hence new government bond issue. No doubt part of this decline in household saving rates is cyclical, but much must be structural - the aging of the population, a decline in asset income, and adjustment to slower future growth.

However, equally dramatic has been the rise in net corporate saving. While corporate sector saving and cash flow began to exceed corporate business investment in plant and equipment in the mid-1990s, it has substantially increased in the past several years to some 7.0 percent of GDP. Companies have been using net cash flow to reduce debt. Presumably, in the process of restoring economic growth, businesses will again become net users of household saving. These changes in saving trends and patterns take time to work their way through the economy.

2. The Japanese government has instituted significant improvements in the rules for business, including the commercial code, accounting, auditing, and governance regulation. Requiring mark-to-market of financial assets has had a substantial impact, particularly on banks. Discounted cash flow is now being used to assess company creditworthiness. Auditors are now under threat of stockholder suits and huge losses if they misrepresent the financial conditions of clients. These legal and institutional changes are important for improving corporate disclosure, transparency, and governance.
3. China has become much more important in Japanese perceptions, both as a burgeoning trading partner and as an opportunity for Japanese business investment, as

well as the target of misguided complaints that cheap imports from China have been a major cause of Japan's deflation. China's continuing rapid growth has made it a major world player and new secondary growth engine. Japan's imports from China are now as large as from the United States, and it continues to run a bilateral trade surplus with both countries.

4. Japan may finally have under way a process to reduce bank NPLs to a reasonable level, though on this I am much less confident. I consider this issue at some length below.

Areas of Concern

Deflation, and under/unemployment, are two major problems for Japan. The capital market sends mixed signals, with stock prices significantly up but bond prices down and suddenly very volatile. Expectations have improved but complacency is on the rise. Japan is entering a politically intense period with ramifications for government reform policies. These topics are discussed in this section.

Deflation

Japan's most immediate economic problem is mild but persistent deflation. Deflation is a consequence of inadequate aggregate demand and inadequate fiscal and monetary expansion policies. Until deflation is brought to an end and price stability is achieved (defined as a 1.0-to-3.0 percent annual increase in the core consumer price index), adequate bank and corporate

restructuring and sustained economic growth will be very difficult to achieve.

It is not easy to estimate deflation trends. The relevant price indices are subject to myriad factors, including seasonal, external, one-time shocks, and changes in government taxes and fees. Four measures are relevant: the core consumer price index (CPI) adjusted for seasonal changes in fresh food prices; the corporate goods price index; the corporate services price index; and, most comprehensively, the GDP price deflator. The negative trend of the first three indices has become somewhat smaller over the past year, but the GDP deflator remains more negative and has worsened. While the increase in real output in the April-June quarter is good news, the bad news is that prices decreased almost as much (a GDP deflator of -2.5 percent year-on-year, worse than the initial -2.1 percent estimate). As a result, while real GDP has been rising, GDP in current prices continued to fall until this most recent quarter. The combination of volatility of indices and special adjustments makes it difficult to judge the precise level of what have been small changes in the rate of deflation. The current core CPI is -0.4 percent, but the early August consensus forecast is that it will worsen to -0.6 percent for 2004. The evidence does not suggest Japan will escape from deflation and achieve price stability anytime soon; the government's unambitious target is to end deflation by 2005.

Labor Conditions

Japan's employment and unemployment situation is serious now and will be even more so for the intermediate run. The high, rather stable unemployment rate (5.3 percent of the total labor force) is only part of the story. An increasing number of working-age Japanese have withdrawn from or never entered the labor force; participation rates (59.5 percent in 2002) have

declined by more than two percentage points since 1992 to the lowest rate ever. Even worse, the number of those employed only part-time (less than 35 hours per week) has risen sharply, from 4.7 million to more than 12 million today, some 23 percent of the total employed.

The young have been particularly hard hit: half of the 20- to 24- year-olds not in school (about half of the total cohort) are not employed. Many have not found jobs they are willing to accept. Others have become “freeters” (choosing part-time work as an alternative lifestyle). Significant human capital is acquired through learning by doing, working in productive, challenging jobs. Poor employment opportunities for the young impose long-run costs on the economy as well as on those directly affected. At the other end, the market for senior managers is particularly thin and weak. Those forced into early retirement have difficulty finding comparable high-paying positions given their skill sets in a technologically rapidly changing economy. Japan’s economy cannot be said to be recovering until the unemployment rate begins to decline substantially.

Capital Markets

One welcome surprise has been the sudden rise in stock market prices of more than 40 percent between late April and early September, after hitting a two-decade low of 7,608 on the Nikkei 225 index. This provides a cushion for September half-year balance sheet reports of banks and industrial companies holding large amounts of equities subject to mark-to-market rules. However, the run-up has been driven overwhelmingly by sustained foreign institution net purchases for twenty consecutive weeks. It is not clear whether these investors have become

much more optimistic about Japan or have been adjusting global portfolios in light of equity price movements elsewhere.

Since the mid 1990s, Japanese government bond (JGB) prices have risen and yields have declined as the Bank of Japan's monetary easing policy of announced, increasing, and steady purchases of JGBs provided liquidity that eventually flattened the yield term structure. The JGB yield is the benchmark long-term interest rate, with profound implications for all financial activity. On June 12, 2003, 10-year JGBs yielded 0.435 percent, an all-time low. It turned out to be unsustainable; a week later, JGB prices fell sharply and over the summer prices were very volatile, with yields in a 1.0-to-1.6 percent range. What was probably an overshooting in yield declines now appears to be an overshooting in yield increases. These movements seem to reflect investor shifts from JGBs into equities rather than fundamental changes in deflation expectations. Until deflation ends and the economic recovery is sustained, it seems likely that bond yields and prices will remain within this range. In a speech on September 3, Bank of Japan Governor Toshihiko Fukui indicated the central bank will maintain its current stimulative policy framework and prevent speculative increases in yields (decreases in bond prices) that overshoot economic fundamentals.

Japanese government debt is a major long-run problem, but it is much less of a problem today than is commonly perceived. While government gross debt is 151 percent of GDP, more than half of that involves double accounting, since it is held by government institutions and the central bank. Using a unified public sector budget measure, Japanese net debt as of March 31, 2003, is 64 percent of GDP. The U.S. level is 44 percent.

Private sector holdings of government debt are very large, so changes in yields and prices generate capital gains or losses. Declines in JGB prices (increases in yield) without changes in

any other financial yields could wreak havoc on the balance sheets of banks in particular. The major bank groups held (as of March 2003) some ¥46.2 trillion (\$385 billion at 120 yen/dollar) of government debt, with an average maturity of 3.7 years; this amounted to three times their holding of equities. It is estimated that their unrealized losses from April to late August were about ¥750 billion (\$6.25 billion).

However, the prices of government bonds almost never move in isolation. The increase in stock prices during the same period generated unrealized capital gains of ¥2,300 billion (\$19.17 billion) for banks, three times their losses on government debt holdings. Interest rates will rise as deflation ends and the economy again grows well. Bank gains - on loan rate increases, loan-deposit spreads, stock price rises, and lower NPL write-offs - will more than offset losses on their holdings of JGBs and other fixed-coupon debt.

Expectations and Complacency

How the near-term future unfolds is shaped considerably by the expectations of policy makers, businessmen, and households. The extreme pessimism predominant earlier this year rapidly turned into considerable optimism. Expectations have been fueled by the rise in stock prices, the surge in corporate profits, far better than expected GDP growth for the April-June quarter, the first increases in employment and wages in two years, an improvement in small business confidence in the June Shokochukin survey, a better than expected July Tankan survey of business expectations, and other positive indicators. Is Japan now on the path to full economic recovery, or are optimists deluding themselves? Unfortunately, there is inadequate reason for optimism; it is too early to believe Japan is finally muddling through successfully. To

sustain a realistic degree of optimism requires more activist government policies to end deflation and to repair the financial system. These are not yet evident.

There are two dangers in the current positive expectations. One is that, since expectations were so pessimistic earlier, improvement may signal no more than a cyclical rebound in an ongoing mediocre economic performance. The second, more serious, danger is that heightened expectations induce greater complacency and, consequently, a slackening of reform and restructuring efforts by government and business alike. A wait-and-see approach continues to be a real danger. In mid July, the government's Council on Economic and Fiscal Policy used improvements in the economy as a justification for accelerating fiscal reform (a negative factor for aggregate demand growth). Until expectations end that deflation will persist, optimism is premature.

The Political High Season

The most immediate and important very near-term factor influencing expectations is politics. Prime Minister Koizumi was easily re-elected LDP president on September 20. His cabinet reshuffle on September 22 was less extensive than expected. While perhaps positive, the reshuffle does not signal a substantial new commitment to Koizumi's reform program.

Koizumi will very likely call for a new Lower House election in November. The recent merger of the opposition Democratic Party of Japan and the Liberal Party creates the possibility of making substantial inroads on LDP strength. Will the Democratic Party drive the election campaign into a substantive debate on important issues of economic policy and thereby force Koizumi to make concrete commitments for reform on issues he has only discussed vaguely so

far? The coming weeks will be rife with rumors, political ploys, and intense media coverage. As an economist, I will await the outcome.

Government Economic Policy

The Japanese economy is in an unprecedented situation, one which requires extraordinary measures. While the government has done a great deal, it has not done enough. Furthermore, policies have been implemented too weakly and too slowly.

Government policy thinking is influenced by a number of illusions (or delusions) propagated, and perhaps even believed, by policy makers. Discussion continues to focus excessively on potential risks and costs of possible policy measures, which are always good excuses for inertia. However, there is scant evidence that the economy will somehow return to price stability and sustainable growth on its own; the past decade demonstrates that this is a dangerous assumption, yet policy makers seem unwilling to accept that the greatest risks lie in being cautious and doing little.

In reality, the ongoing fiscal deficit and high government debt ratio do not render new, short-term fiscal stimulus impossible or even difficult; the Bank of Japan cannot go bankrupt; the banking system is fundamentally insolvent; and the restructuring of very weak, large, distressed companies will not result in massive structural unemployment.

An important role of all governments is to take on the risks and costs of programs deemed important to society at large, including correcting market failures. These include costs of adjustment when economic circumstances substantially change. The government has

particularly taken on adjustment costs in the financial sector, and that has been appropriate. Government guarantees of bank demand and settlement deposits are essential so long as the banking system is fragile. Government investment in banks through providing capital is a necessary component of reforming and making the banking system strong once again; the return on those investments will almost surely be higher than that on the many “roads and bridges going nowhere” public works projects. Of course the purpose must be to protect depositors, not necessarily managers and employees.

The government continues to face a fundamental policy dilemma. It does not want to use government funds, financed by issuing more bonds, to assist in restructuring weak bank and industrial firms, and it certainly does not want to be perceived as taking financial losses. But it also does not want to see the firms fail, with attendant job losses. In socializing risk, the government must be prepared to accept some losses. At the same time, government risk-taking activities must be well designed and transparent so as to minimize potential moral hazard and unfair income distribution effects.

Fiscal and Monetary Policies

Fiscal and monetary stimuli have been huge but remain insufficient to generate enough aggregate demand to overcome deflation and restore sustained growth. The most efficient and effective policy is to commit to use both, in concert: an expanded, easy monetary policy and further fiscal stimulus. However, no such comprehensive policy is in place. Monetary policy continues to be “wait and see,” and fiscal policy is modest retrenchment. Fiscal consolidation over the long run is essential, but the important thing now is to use fiscal as well as monetary

stimulus to stimulate growth. Once private demand adequately fuels growth, the necessary adjustment process of fiscal consolidation and a more normal monetary policy can proceed gradually. However, that is premature now.

Since his appointment as the Bank of Japan Governor in March, Mr. Fukui has improved communications and cooperation with the Ministry of Finance and other parts of the government, and the Bank recently decided to use unconventional monetary expansion measures modestly through the purchase of private-sector asset-backed securities. Quantitatively, little has been accomplished yet. In addition to pursuing unconventional measures in these unprecedented times, the Bank should commit to sufficient JGB purchases to hold yields down until deflation ends and the economy recovers. Given its basic ability to create money, economically the Bank of Japan does not have a balance sheet problem; barriers are legal constraints or self-imposed rules of thumb, which can be changed.

The real culprit has been the unwillingness to use further fiscal stimulus as a near-term measure. Fiscal consolidation is not only the long-term policy, but unfortunately it is also the current practice. The Ministry of Finance has always had a bias against fiscal stimulus, vitiating what should be its commitment to macroeconomic stability. Public works and government investment have decreased substantially since 1998; fiscal restraint has been reinforced by Prime Minister Koizumi's policy to hold the annual budget deficits to ¥30 trillion. That policy has not succeeded in restoring the economy. In the July global consensus forecast, 64 percent of expert respondents thought Japanese fiscal policy should be more stimulative; however, none believe it will be.

The adverse consequences of the burgeoning government debt-to-GDP ratio have been much exaggerated for the near term, though certainly not for the long term when it will become

one of Japan's biggest economic problems. As already noted, less than half of the government debt of 151 percent of GDP is owned by the private sector; most is owned by the government itself and the central bank. There are two perceived dangers of fiscal stimulus measures now. One is that they would (as in the past) be expenditures misused for politically attractive, economically wasteful, pork-barrel projects. This could be handled by using tax cuts or such measures as vouchers for expenditures on children, rather than public works expenditures. The other is that stimulus would induce backsliding on banking and other structural reforms by government and business alike. Good policy implementation needs to be alert to these dangers.

Banking Reform

Japan's banking mess, emphasized in detail in last year's essay, persists even though some significant reforms have been put in place during the past year. The fragile banking system continues to be Japan's most serious structural problem, substantively and symbolically. Banks have inadequate capital and huge NPLs, which means low operating profits, and lag in upgrading financial and information technologies. Banks continue to roll over loans to very weak large borrowers, delaying their restructuring. And there may be some degree of credit crunch for small corporate borrowers.

The non-performing loan problem has yet to be solved despite continuing huge write-offs. Banks reported NPLs as of March 2003 of ¥35.3 trillion (\$294 billion), 7.4 percent of total loans. This was a decrease of ¥7.9 trillion, 18.3 percent, from a year earlier and the first year since 1997 that existing NPLs were written off faster than new NPLs were booked. Banks

wrote off ¥3.5 trillion, with the remaining unreserved portion of some ¥15 trillion in loans to bankrupt and near-bankrupt firms written off; while ¥7 trillion in new NPLs were recorded. Virtually all (¥7.7 trillion) of the NPL decrease was by major banks; their reported NPLs are ¥20.7 trillion (7.2 percent of their total loans). An ongoing concern is that regional banks and local cooperatives have slightly higher NPL ratios and are not reducing them significantly.

Bank core capital continues to be seriously inadequate. Despite official protestations, it is clear that virtually all banks are undercapitalized and some are economically insolvent. It is conservatively estimated that major bank NPL loan loss reserves are short about ¥8 trillion (\$67 billion). Moreover deferred tax assets (DTAs), an inferior capital source, now comprise 44 to 61 percent of the capital of the four megabank groups; and DTAs are significant for smaller and local banks as well. (DTAs are credits for taxes already paid which can be offset against future profits for up to five years.)

Substantial capital injections for viable banks are essential to achieve necessary full recapitalization and resolution of Japan's immediate banking difficulties. A sound capital base is necessary so that banks can absorb the loan losses inherent in forcing weak borrowers to restructure or liquidate, and take on the normal lending function in which credit risk and cash flow assessments provide the basis for lending.

The government's slowness in resolving the non-performing loan problem is due to lack of political will. The institutions to handle bank NPLs are in place: the Deposit Insurance Corporation (DIC), the Resolution and Collection Corporation (RCC), and now the Industrial Revitalization Corporation of Japan (IRCJ). More than \$300 billion (¥36 trillion) in government-guaranteed funding has been committed but not yet utilized.

Some significant measures have been taken since last fall. While FSA Minister Heizo

Takenaka's October Financial Revival Program was substantially weaker than initially proposed, it did tighten standards and FSA bank inspections, and it brought the DTA issue to the fore. These measures forced six major banks in February to expensively raise ¥2.1 trillion (\$17 billion) new private capital in preferred and common stock and subordinated debt. In early August the FSA ordered five major banking groups and ten regional banks that had received public capital but had not met their earnings targets to improve their business performance or face required management resignations.

In May 2003, Resona Bank, a major part of Resona Holdings, Japan's fifth largest bank group, collapsed and was de facto (but not formally) nationalized. The way in which Resona has been handled represents, on the whole, a very positive development in Japan's seemingly never-ending banking mess. Resona Bank was particularly weak, with DTAs comprising 77 percent of its reported capital. In an unprecedented action its auditors, well aware of possible stockholder lawsuits, refused to allow more than three years of DTAs, instead of the normal five, to be counted as capital. This put Resona below the minimum 4 percent capital requirement for a domestic bank. The government immediately decided to inject ¥1.96 trillion (\$16.3 billion), increasing capital adequacy to 12 percent. This was done in the form of common and preferred shares, so the government ended up owning some 70 percent of the voting rights. Management was replaced; the new chairman and seven of the ten directors are outsiders; the FSA set up its own management oversight committee; and 142 Resona senior executives were forced to retire without benefits. Some 15 percent of Resona employees are to be let go, wages cut by 30 percent, and a number of branches closed. The new president, Eiji Hosoya, has strongly stated that cleaning up Resona's NPL problems is the first priority, and he has hired independent auditors to evaluate NPLs quickly.

Several lessons emerge from the Resona case. First, auditing firms have become major players; their decision on DTAs for banks (and many industrial companies) can create a crisis event. Not surprisingly, they are learning from the early 2002 experience of Asahi Audit Company, which had to pay a substantial fine to the FSA for its mishandling of Long-Term Credit Bank audits, and from the Arthur Andersen and Enron collapses. Under revised rules, since March auditors have been required to declare whether a client faces serious risk of going bankrupt within a year. Given their legitimate fear of lawsuits, this may be the first of many resolute decisions by auditors.

The second lesson is that the government correctly injected a huge amount of new capital. This provides Resona ample resources to write off sufficient NPLs so that these should no longer be a problem. Further, in this process the government avoided the political embarrassment of bankruptcy and the problems of handling a formal nationalization. Thirdly, the government will guarantee all deposits of a bank in crisis; there were no depositor runs on Resona or other banks. Fourthly, the debate over the injection of public funds has shifted somewhat, with the public more pragmatically accepting the necessity of government capital injections to prevent a bank crisis.

The major downside in terms of public policy was that the Resona shareholders were not penalized. Instead they even received a windfall gain from the relatively high price the government paid for its new shares. There appears to be no justification for this.

Resona was good news for the other major banks and for their shareholders; it signaled that the government would not let them fail. It is not surprising that bank share prices subsequently rose dramatically. Similarly, depositors were reassured. The subsequent improvement in banker and business expectations is palpable.

It is too early to tell whether Resona will be the model for the first step in an important new trend of using DTAs and auditors as the fulcrum for further intervention or whether it is a stand-alone event. It will depend on how severely the auditors review the six-month and year-end bank statements for this September and next March, and on how the FSA and Diet respond.

Despite these improvements, it appears the government will persist in its gradualist and forbearance policies of bank reform. In an environment of slow growth and deflation, this is virtually doomed to fail. It would take an extraordinary sustained improvement in Japan's economic condition, not likely anytime soon, for the banking system to become sound again on its own. Further injections of government capital will be required. The main issue is whether the government will develop the fortitude to initiate a comprehensive reform program or whether it will simply deal with future bank crises as they occur.

Corporate Restructuring

Relatively few Japanese firms are in severe distress or danger of bankruptcy. But most, large and small, have been forced to engage in some restructuring due to flat demand, persistent deflation and, in many cases, a high debt burden. A main management objective is to restore profitability in order to be able to take care of all stakeholders.

Most ailing firms, typically in cooperation with their bank creditors, are restructuring without going through bankruptcy or having their (non-performing) loans sold off to outside institutional investors. The process is highly varied, with the results mixed and often not generally known or understood. Although slow, restructuring is gradually improving the

efficiency, productivity, and profitability of most firms.

The greatest barriers to rapid restructuring are the strong embedded relationships pervasive in Japan's business system. These relationships make it difficult for companies to extricate themselves from now inefficient, long-term suppliers, for banks to force non-performing borrowers to sell assets and repay loans, and especially for management to lay off employees. Outsiders, especially foreigners who do not have these relationship constraints, play a useful role as direct investors (Nissan is the outstanding example) or as purchasers of NPLs from banks. Foreign financial institutions in particular have purchased packages of Japanese bank loans at huge, market-based discounts and renegotiated terms with the borrowers ("buy at 10 percent of the loan's face value, and settle at 20 percent in two to three years"), using both their own technical skills and staff and an increasing number of Japanese service providers (collectors).

Distressed firms unable to service their debt are the other side of the bank NPL problem. The government has tolerated bank forbearance, allowing the rollover of loans to distressed companies, and gradualist, incremental, case-by-case resolutions of their difficulties. One rationale, now clearly shortsighted, is to continue to utilize the corporate employment system as a social safety net rather than develop better functioning unemployment insurance and worker retraining programs.

Some 1,408 of a comprehensive sample of 2,972 non-financial listed companies have a ratio of liabilities to operating cash flow that exceeds ten. Among these, 171 are larger companies (assets of more than ¥300 billion, \$2.5 billion). They employ more than 3.6 million. Of these, 33 companies are in extraordinary distress, with an average liabilities-to-cash flow ratio of 30.9 and a debt-to-equity ratio of 29.9; and another 42 are deeply distressed, with an

average liabilities-to-cash flow ratio of 27.0 and a debt to equity ratio of 6.8. Authors of another study estimate that of the total 3,362 listed non-financial companies, 938 (27.9 percent) would not be able to cover interest costs out of operating profits if their borrowing rate was increased by just 0.5 percent, everything else being equal.

The government established the Industrial Revitalization Corporation of Japan (IRCJ) in April to accelerate the process of large-firm restructuring. It has a small but capable staff, considerable funding (¥10 trillion, \$83 billion), and a five-year mandate both to handle specific cases of restructuring and to develop appropriate criteria for deciding which firms should be rescued and precisely how. This will provide guidance to the financial markets, which is where most work-outs will occur in practice. The first IRCJ case is a Kyushu bus company group, and now several others have been announced. It is far too early to judge but, given the mediocre results of other government restructuring efforts, IRCJ will have to prove its merit. The prominent problems of very large, politically connected, distressed companies continue to be handled gingerly on a case-by-case basis.

The myriad small and medium enterprises (SMEs) in difficulty are a serious problem economically, regionally, and politically. Tokyo's surface prosperity masks real difficulties in most other cities and towns. The government has quietly but aggressively provided SMEs credit directly and indirectly. The share of government financial institutions in total loans has risen from 25 percent in 1989 to 40 percent in 2002, mostly because of loans to SMEs. The government also pressures banks to lend to SMEs and guarantees some of their loans. It is unclear how rapidly and extensively SME restructuring is proceeding, but they are even more subject to market pressures than large firms.

In addition to the problems of private sector corporate restructuring and NPLs, bad loan

difficulties within the government sector - government financial institutions, public corporations, and other agencies, and especially local governments - are substantial. Potential losses have been conservatively estimated at ¥79 trillion (\$658 billion), 16 percent of GDP. Government sector restructuring progresses very slowly.

Japan and the World Economy

Despite the small shares of foreign trade and foreign direct investment, both outward and inward, in Japan's economy, the conditions and performance of the world economy and exchange rates are disproportionately important for Japanese government policy makers, manufacturers, and financial institutions. There are several reasons: aggregate demand management, exchange rates, stock and bond prices, economic relations with both the U.S. and China, and ambivalent reliance on foreign institutions to move the corporate restructuring agenda forward.

Japanese quite naturally view U.S. economic prospects with a combination of anxiety and hope; they are not alone. The U.S. growth rate will rise over the coming 18 months, though how much and how fast is not clear, and prospects for 2005 and beyond are even less certain. Probably the trade-weighted dollar value will continue its decline, since otherwise the U.S. current account deficit of 5.1 percent of GDP will rise and the required capital inflow from the rest of the world will reach an unsustainable level.

Half of Japanese demand growth in 2002 was due to an increase in net exports, but net foreign demand is likely to become a smaller force this year and next. Japanese policy maker

reliance on increases in world demand raises two concerns. If export demand does grow well, then that will reinforce Japanese tendencies toward complacency and policy forbearance. More importantly, Japanese aggregate demand management should be based on domestic investment, consumption, and net government expenditures rather than on Japan's being a self-imposed prisoner of world economic growth, over which it has little control.

The yen/dollar exchange rate has been remarkably stable in recent months, between 115 and 122. This was despite the continuing substantial trade-weighted depreciation of the dollar, some 17 percent down from its January 2002 peak, involving a 25-percent decline against the euro and last year's 12-percent decline against the yen. The Japanese government was determined not to let the yen appreciate beyond 115. To achieve that, the monetary authorities have successfully engaged in their largest interventions ever in the foreign exchange market, purchasing some \$75 billion in the first seven months of 2003, including \$43.6 billion in May alone. As of July 2003, Japan's foreign exchange reserves totaled \$556.8 billion, by far the largest in the world, having increased \$103.7 billion in 12 months. In order to prevent their currencies from appreciating, Japan, China, and other Asian countries have been financing the U.S. current account deficit by purchasing dollars. This has placed most of the adjustment burden from dollar weakness on the E.U., Canada, and other countries whose currencies float against the dollar. In response to increasing political pressures and the G-7 meeting September 20-21, the Japanese authorities apparently decided to allow the yen to strengthen somewhat; while too early to tell, the new ceiling may be about 110 yen to the dollar. If markets push the trade-weighted dollar down further, the Japanese government will probably continue to buy dollars heavily in order to limit yen appreciation.

Japan's bilateral trade with, and business direct investment in, China have grown rapidly,

and imports from China are now about as large as from the U.S., for a long time Japan's largest postwar trading partner. The combination of China's continued rapid growth, its export orientation, a fixed exchange rate of 8.3 yuan per dollar, low export prices, current account surplus, and burgeoning foreign exchange reserves have led some Japanese to assert, incorrectly, that China is a main source of Japanese deflation. Policy makers and commentators in the United States and Europe have joined their Japanese counterparts in arguing that China should revalue the yuan.

However, it is premature for China to revalue now. In the sequencing of foreign liberalization measures, China can learn from Japan's experience in the 1960s, when it was in a similar situation. The first priority is for China to accelerate import liberalization, as well as reducing export subsidies. It should then liberalize restrictions on portfolio capital inflows and outflows. It also has to resolve its state-owned enterprise rigidities and reduce regional disparities, obstacles in implementing its WTO commitments. Substantial revaluation of the yuan probably will not, and should not, occur until these priorities are effectively met.

Concluding Thoughts

What would it take to restore the Japanese economy to achieving its potential? A great deal more than is going to occur any time soon, though happily the risk is that the economy will do better than I expect rather than worse. Even though the recent economic news is good, Japan continues to have major problems: deflation; aggregate demand insufficient to return to robust, self-sustaining economic growth; an extraordinarily weak financial system; a slow and uneven

process of corporate restructuring; unemployment and underemployment; a government debt to GDP ratio on a path to major crisis; and a weakening trade-weighted dollar. I have made a series of economic policy proposals for Japan, particularly in the section on government economic policy. Unfortunately, what Japanese policy makers should do and what I expect they will do are substantially different.

In last year's essay, I considered four economic scenarios for Japan over the next seven to ten years: gradually muddling through to eventual success; muddling along without substantial improvement; and either creative or destructive crises that substantially alter economic policies. I thought last year, and I think now, that complacency, inertia, and the temptations of forbearance and postponement of problem solving are likely to persist until some sort of crisis forces major economic policy reform. Perhaps Japan will be lucky and somehow muddle through to success. While I share this wish, realistically the chances of this happening are not good. In the long run things will get better – I remain an optimist in that respect. Nonetheless the challenge to policy makers today is not to leave matters to fate but to make the difficult decisions that will revitalize the Japanese economy as quickly as possible.

On the other hand, Japan may not be lucky. There are various potential sources of a crisis, and alternate scenarios as to how they would play out. These include loss of confidence in the government and capital flight; high (8.0-to-10.0 percent) overt unemployment; banking system collapse; reduced willingness to tolerate the rising social and generational costs of the path Japan is on today; and a crisis in the Japanese government bond market leading to sudden, sharp increases in interest rates, monetization of the debt, and inflation. Most of these are unlikely to occur. However, while the government's net debt is not yet that large, which makes possible several years of further fiscal stimulus, there is no way Japan can proceed indefinitely

with its large budget deficits and a rising net government debt to GDP ratio without generating a crisis.

While Japan's fundamentals are strong, I will not become optimistic about its near-term prospects until deflation and the deflation psychology come to an end, until employment increase and unemployment decrease prevail, until sustained private demand growth takes the lead in ensuring adequate demand growth while the government budget deficit decreases, and until the banking mess is cleaned up. The transition from the current economic situation to achieving long-term potential growth will not be easy. I hope the combination of basic strengths, private sector improved performance, and more sensible economic policy will inspire a more optimistic evaluation a year from now.