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Summary

After a decade of lost opportunities, it is now urgent for Japan to move ahead with fundamentally reforming its economic structure and institutional framework while making intelligent use of the limited set of macroeconomic policy instruments now available to support economic activity. For the third time since 1990 the economy is in recession. Japan will continue to face difficulties going into 2002, as depressed economic conditions globally and subdued world markets for ICT goods in particular serve to lower exports and investment, highlighting the underlying weakness of the economy. Risks are at present weighted to the downside. In response, the government has proposed a wide-ranging and ambitious reform programme covering the disposal of bad loans held by the banking system, fiscal and structural reform and budget consolidation. Past experience of such packages evaporating suggests that the government needs to get programme implementation underway now without further delay. It is now clear that the strategy of "growth first, then reform" has not worked and, by delaying adjustment, has prevented the return of confidence and eventual sustained recovery. Putting a process in place to deal with the banking sector should be a key priority, if necessary involving budgetary resources. The process will inevitably require cutting capacity and liquidating a number of enterprises and some banks. Monetary policy has a key role to play in stabilising nominal demand and the operation of financial markets. To avoid a destabilising increase in bond prices and to improve the monetary impact, the purchase of a broader range of assets will need to be given a greater role in further monetary easing. It is likewise important to make a start on credible fiscal consolidation, that could impact favourably on confidence now, as part of longer term plans to return to a sound fiscal position and to ensure the continuation of low long-term interest rates. Measures to improve the efficiency of the expenditure system should also be pursued and a perspective for reforms of the social security system put in place. In particular, reforms of the health system could begin with an integration of insurance

This Policy Brief presents the assessment and recommendations of the 2001 OECD Economic Survey of Japan. The Economic and Development Review Committee, which is made up of the 30 Member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

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funds and a change of the remuneration system for doctors and hospitals. In carrying out structural reforms, priority should be given to those measures which open new possibilities for private demand, including deregulation of construction codes in the urban areas. In sum, immediate prospects do not look bright. But this should be seen as the product of long-term structural weakness rather than simply a reaction to the world business cycle. What is needed now is for the government to rapidly redress these weaknesses, even at the cost of temporarily negative growth. To keep such adjustment costs down, the government must ensure speedy implementation of its reform programme and resist calls for further delay. ■

How serious is the economic situation?

Japan is now clearly entering its third recession in recent times symptomatic of the failure to adequately address structural problems in the past. Although a slowdown was expected this year, the deceleration has been surprisingly rapid. Industrial production and exports declined at an annualised rate of some 15 per cent and 9 per cent, respectively, during the first half and the rapid contraction continued during the third quarter. Key to these developments has been the ICT sector, which not only contributed to the rapid growth of exports in 1999 and 2000 but also underpinned investment as capacity rapidly expanded. The sector accounted for over a half of the decline in industrial production in the first half of 2001 and, through reduced investment demand, weakness has been transmitted to the capital goods sector. Employment has also started to fall in some sectors and overtime and bonuses have been cut. Although statistics are volatile, private consumption appears to have remained stable, price deflation of around 1 per cent serving to offset weak growth of nominal income. Despite falling employment, the rate of unemployment has remained around 5 per cent since many workers without jobs have left the labour market.

Going into the second half of this year, most indicators pointed to significant weakness for some time to come even before the shock to the world economy in September. Inventories, which have increased, will need to adjust to the new circumstances and enterprises are also in the process of lowering their expectations for profits. With balance sheets in general weak, the revision is expected to lower markedly investment demand. Indeed, machinery orders fell by an annualised rate of 20 per cent in the third quarter. High levels of unused capacity in the ICT sector points to a delay before investment activity recovers even if the world economy picks up. Public works and construction activity are also set to continue to weaken as, *inter alia*, local governments respond to severe fiscal pressure. Adding to this generally negative picture, consumer confidence plunged by the end of the third quarter mainly due to concern about prospects for employment and incomes as corporate restructuring picked up. On the other hand, lower land prices are now starting to encourage both foreign investment and re-development of city centres. Against this generally negative background, GDP growth is projected to decline by ¾ per cent this year and by some 1 per cent in 2002. Exports are projected to pick up in the second half of 2002 and with the terms of trade favourable, growth should return to positive territory in 2003. Nevertheless, with head winds strong, GDP growth should only amount to some ¾ per cent. The output gap is expected to widen and with a number of weak enterprises remaining in operation, deflation is expected to remain significant.

In the current economic environment, risks are skewed to the downside. The key risks are arising in the financial markets, which were in any case subject to pressure before September. The reduced capacity and desire to take risk on the part of both foreign and domestic investors could lead to important changes in asset prices with a number of potential consequences. In the current conditions, portfolio shifts that increased JGB interest rates would weaken the banking system via capital losses on the banks' significant holdings of bonds. Moreover, if stock prices remain at their current low levels (around 10 000 for the Nikkei), or even decline further, a number of banks may have to report heavy capital losses when they prepare their balance sheets on the basis of mark-to-market in March which would impact negatively on confidence. Significant risks are also associated with policy implementation. A resolute clean-up of the banking sector will be associated with short term macroeconomic costs but a hesitant approach risks undermining confidence and deepening recessionary forces. Loss of confidence about budget consolidation could also prolong recession through a rise in long term bond rates with negative consequences for banks, the budget and the economy. With this constellation of risks, deflation might become more of a problem and the probability of a deflationary spiral, would be non-negligible. ■

What more should monetary policy do to stabilise the situation?

The Bank of Japan (BOJ) has stated on a number of occasions that it stands ready to take further actions to prevent deflationary dangers from developing and to this end adopted a new policy framework in March that improves its room for manoeuvre.

The intermediate target for monetary policy is no longer the overnight rate, which was in any case about zero, but rather the level of current accounts of the banking system at the BOJ. To redress an important critique of the zero interest rate period, which lasted until August 2000, the bank has adopted an inflation "guideline". The new policy will remain in force until the core CPI inflation rate is either stable at around zero or increasing year-on-year, a clearer commitment than the previous one, "until the threat of deflation subsides". Moreover, the BOJ has also stated that it stands ready to increase outright purchase of JGBs if necessary to achieve its intermediate target. The initial policy settings did not represent much of a change in comparison with the period of zero interest rates. Nevertheless, the change in policy was successful in stabilising expectations that expansionary policy will remain in place for at least several years and that more will be done if necessary. As a result, by mid-year the yield curve had shifted downwards by about 50 basis points over its entire range.

The BOJ has used the new framework to ease its policy stance on two occasions. A relaxation took place in August, when the target for current accounts at the BOJ was raised by 1 trillion yen and monthly outright bond purchases were increased to 600 billion yen. This was preceded by several months of public statements to the effect that further easing would not bring much relief. Unlike in March, the yield curve steepened. In response to potential liquidity shortages in the aftermath of September 11 and with the end of the financial reporting period for banks approaching, the BOJ raised the current account balances of the banking system to above 6 trillion yen and cut its discount rate from ¼ per cent to 0.1 per cent. Moreover, it restated its commitment to provide more liquidity to the system when needed. As a result, excess reserves reached a peak of some 12.5 trillion yen before the BOJ started to mop up the balances in October in line with its policy to meet the demand for liquidity.

Monetary policy will remain constrained in the future by the absence of a credit channel and by the difficulty in setting appropriate operational targets and associated instruments. Bank lending is continuing to decline at a rate of around 1½ per cent after adjustment is made for loan write-offs. However, with the economy weakening and a major programme of structural reforms and fiscal consolidation expected to get underway, the BOJ can and must ease monetary policy further. In order for such an easing to be fully effective, measures to solve the bad debt problems of the banking sector should be implemented promptly. These measures will eventually help to restore the credit channel but disruption might be encountered in the interim. At an operational level, easing will involve lifting the target for current accounts at the BOJ from the 6 trillion yen at present. The adequacy of the target will need to be assessed by the impact on financial flows (such as the change in money supply) and on asset prices, in particular, the exchange rate. Recent experience indicates that meeting a higher target will not be easy to achieve so that the BOJ will need to increase its outright purchases of JGBs, particularly medium-term maturities. The disadvantage of this strategy, however, is that it could further drive up bond prices, making the market vulnerable to subsequent instability, and the transmission effects to the real economy could be limited. From this perspective, it would be preferable to broaden the range of asset purchases by the BOJ to include foreign assets, although the decision to purchase foreign assets to maintain exchange rate stability is in the hands of the Ministry of Finance. The challenge for policy will be to convey the message that future purchases are related to further monetary easing rather than an exchange rate objective, even though the latter is one of the few transmission channels left for monetary policy. At the end of September the BOJ intervened in the foreign exchange market on a number of occasions to weaken upward pressure on the yen exchange rate but did not appear, for a while, to have sterilised the associated rise in yen balances. This was a move in the right direction and it will need to remain a policy instrument in the future. ■

What is the appropriate policy strategy for the government to pursue at this critical juncture?

The new government of Prime Minister Koizumi has quite correctly put a top priority on structural reforms and budgetary discipline to revitalise the Japanese economy. Weak growth and new concerns about the soundness of the banking system led the government to decide a new policy package in the middle of the year comprising three elements. *First*, bad debts of most major banks will be written-off over the next two years, and new bad debts over three years. *Second*, a start will be made on fiscal consolidation by limiting new borrowing by the central government's general account to 30 trillion yen in FY 2002, with the primary budget deficit of around 5 per cent being brought into surplus over the medium term. *Third*, budgetary efficiency is to be improved by the cabinet setting expenditure priorities, for the first time in FY 2002, and by a reallocation of public expenditures from low productivity projects, mainly in the rural areas, to high return ones, often in the urban areas. Such projects should also open the way for further private expenditure by establishing essential pre-conditions

such as infrastructure: this "crowding-in" differs quite markedly from the normal multiplier concept. In addition, the programme now includes wide-ranging structural reforms, some of which will be presented to the Diet this year for early implementation, which is welcome. As part of the wider review of policy, the government has accepted a Financial Sector Assessment Programme by the IMF.

The important break of the government with the 1990's in eschewing further fiscal stimulus packages and in proceeding with structural reform even with low growth has meant that a consensus has proved difficult to find. One line of criticism finding expression in the Diet is that the problem in Japan is essentially a matter of deficient demand to be resolved by an aggressive monetary policy and by an inflation target. To this end there have been some proposals to limit the independence of the BOJ. While such a narrowly-based view is not widespread, there is a clear consensus that monetary policy will need to support the programme. Others fear the ability of the economy to absorb any shock and are opposed to fiscal consolidation at this time; indeed, there have been calls to implement a large stimulus package this fiscal year. For these critics, the proposed government programme looks to be dangerously pro-cyclical. Finally, opinions differ widely about how fast non-performing loans of the banking sector need to be resolved. Some argue for a rapid resolution even with finance from the budget while others, fearing a deflationary shock, wish to extend the programme over time with a focus on restructuring and debt forgiveness. It is crucial that this debate does not lead to either policy inaction or to partial and ineffective reforms.

While there are difficult trade-offs involved, the best way forward is judged to be a focus on stabilising the fiscal situation and on dealing decisively with the banking sector. With respect to fiscal policy, the public debt/GDP ratio is around 130 per cent and there is already latent pressure for bond yields to rise, which would be extremely damaging for the banking sector, the budget and the economy. Another point to be considered is the effect on household confidence of further fiscal stimulus. There is some evidence that the rate of household saving stopped falling in the 1990s in response to the changed fiscal situation. Thus it might be misleading in the current context to judge fiscal policy solely on the simple dichotomy of pro- or counter-cyclicality. Specific elements of an appropriate fiscal strategy are presented below. ■

Why is there an urgent need to deal with the banking sector?

Although the current slowdown has not been triggered by a credit crunch arising from a banking system in distress as in 1997/98, resolving the bad loan problem is essential in order to strengthen balance sheets and to restore the credit mechanism which will promote a reallocation of resources. By not dealing adequately with non-performing loans, the banking sector is serving to support low productivity sectors and enterprises, thereby holding the economy in a low growth, deflationary, trap as firms which are effectively bankrupt cut prices to remain in business. The banking sector also remains fragile because of low profitability and a market perception of weak balance sheets due to the uncertain exposure to bad loans. Indeed, banks have already had their credit rating downgraded. Without firmer policy action, a repeat of the Japan premium cannot be ruled out. The conclusion that emerges is that dealing with bad loans must be a key priority for the government programme, but will need to be set in the context of effectively dealing with bad debtors.

The government's plan to accelerate the disposal of loans currently classified as bad by major banks would appear to be adequate when evaluated against the amount of non-performing loans that have been reported to the Financial Services Agency on the basis of delinquency criteria similar to that used by the SEC. Official calculations show that the ratio of NPLs to total loans of major banks will come down to the level in other OECD countries after three years of intensive disposal. However, if a stricter application of loan classifications were to be adopted (as recently officially endorsed), a surge in reported bad loans could be expected, as shown by the case of one large bank, the only institution to date to have shifted to this practice. More generally, there is widespread scepticism about the relevance of backward-looking provisioning by the banks in a deflationary environment. To regain market confidence it is urgent for the authorities to oversee adequate loan classifications that take account of the ability to service debt at interest rates that fully reflect credit risk. To this end, the decision by the FSA to conduct special inspections of large bank loans where market signals point to difficulties, with a view to checking adequate provisioning, is a welcome move toward tighter supervision that will need to be extended to the whole sector. Clarity with respect to asset quality will serve to highlight the lack of bank capital to deal with bad loans and insufficient profits for them to form reserves. Alleviating the problems of the banking sector is, therefore, likely to require banks to raise new capital. However, if systemic risks were to occur in the process, a capital injection with public funds should be considered. In that event, the present scenario that banks should repay the capital injected in the past might have to be rethought to include the possibility of the government eventually selling its part of the equity shares directly on the market. ■

What needs to be done to strengthen banks and deal with bad debts?

To help resolve the problems of the banking sector, the authorities will also need to enforce a reduction in banking capacity and costs by using the restructuring agreements they have with the recapitalised banks. However, it should also take an overall view, including the role of the state-owned financial institutions – such as the postal savings system and the housing loan corporation – that distort competition and lower profitability in the sector. The postal savings system, for example, benefits from a free state guarantee on its deposits and does not pay either taxes or a rate of return on its capital, although it has to provide universal services. The distortion will become more apparent next year when blanket deposit insurance is due to be lifted. These institutions require fundamental reforms. Reform of the post office is being considered separately. For the other public corporations, it is encouraging that options which include closure or privatisation are being explored by the government.

The government has made efforts to improve the legal and institutional infrastructure for facilitating the resolution of bad loans. The new civil rehabilitation law has made court-based resolution much more accessible, and its use has indeed increased significantly since its enactment. The government has also encouraged banks and the federation of industry (*Keidanren*) to agree a code of conduct for private work-outs along the lines of London rules. Such guidelines should facilitate agreements while introducing financial discipline and transparency, which was often missing in the past deals involving debt forgiveness. The civil rehabilitation law remains the principal channel to deal with reorganisation and there is an attempt to limit support for restructuring programmes extending over an unreasonably long time period. The guidelines should be supported by the government. But what has been missing in the Japanese scene so far is an active intermediary for disposal of bad loans. In this regard it is important to reinforce the role of the Resolution and Collection Corporation (RCC). The recent decision to enhance its capacity for resolution by granting it a trust bank licence and a restructuring function is a step in the right direction. But without a clearly defined objective and accountability of its management it is difficult to see a big change in the performance of the RCC. Using the RCC to promote indirect recapitalisation by purchasing NPLs at an artificially high price should be avoided since it would give the wrong incentives to banks and would compromise effective governance of the RCC. Decisions about how to finance an expanded role for the RCC also need to be taken. ■

How ambitious should be the medium term fiscal goal and the FY 2002 budget?

The government's medium-term fiscal programme, which is currently under discussion, may not be sufficiently ambitious to stabilise the build-up of debt. Although, the target primary surplus might be specified in terms of the general account of the central government for operational purposes, the target will need to be related to the development of the primary balance of the general government, which will require more timely information than is presently the case. On a general government basis, just to bring the primary deficit into balance might require consolidation of some 8 per cent of GDP, but this would still be insufficient to stabilise the ratio of gross debt to GDP. For example, to stabilise the ratio at 150 per cent (from 130 per cent at present) would, under some realistic assumptions, require a primary surplus of about 4 per cent and a consolidation of over 10 per cent of GDP. And this could increase still further if the government is forced to accept new liabilities generated by the public corporations and from the clean-up of bank bad loans. Clearly a start needs to be made soon and, drawing on the successful experience from other OECD countries, the programme should place emphasis on reducing expenditures. Excessive public works expenditures could take the brunt of the cuts but subsidies to public corporations should also be reduced. However, at some stage in the future tax revenues will also need to be raised, mainly by widening the tax base through reducing exemptions. A key issue in the design of the medium-term plan will be how to include sufficient flexibility to deal with cyclical factors while at the same time keeping the consolidation programme on course so as to maintain credibility.

Before the details of the medium-term consolidation plan are settled, decisions will have to be made about a supplementary budget this year and about how to implement the government's commitment to cap new borrowing by the central government to 30 trillion yen next year. The two are closely related, not only financially but also in terms of stabilising expectations in the bond market. Without a supplementary budget, fiscal policy is set to tighten significantly in the last quarter and into next year as public works contract. But since the economy is projected to remain sluggish and to register negative growth for several quarters, such fiscal policy could be criticised as being pro-cyclical. In last year's *Survey* a key recommendation was to set the budget not on the basis of the previous year's ini-

tial budget but on the total final budget for the year, which would lead to a smoother path for fiscal policy. This was not done in FY 2001 so that on this basis a small supplementary budget is warranted. However, to minimise any negative effects on the bond market, the budget will have to avoid the usual top-up of public works and to focus on expenditures related to the government's overall reform programme. These could include an extension of training schemes and unemployment benefits which would also serve to strengthen automatic stabilisers. As for the size of the budget, it would be appropriate to relate it to the original budget estimate of tax revenues this year with only a partial adjustment for the current cyclical weakness of revenues. If *ex ante* borrowing cap of 30 trillion yen is to apply to this year as well, the supplementary budget could be in the vicinity of 1½ trillion yen.

In setting the borrowing cap for FY 2002 at 30 trillion yen it is important to limit further tightening when tax revenue estimates are revised downwards in line with the weakening economy. Rather, the target should be viewed relative to the initial budget estimates. With tax revenues from postal savings deposits weaker in FY 2002, even this target will require significant expenditure cuts. Preliminary calculations by the OECD suggest that if the 30 trillion yen *ex ante* target for the central government is to be met, fiscal policy on a general government basis will tighten by some ½ per cent of GDP. This would bring the structural deficit down to around 5¾ per cent of GDP. The actual outturn for the central government could be a deficit of around 33 trillion yen, and consolidation would be around a quarter of a point lower than otherwise. Such fiscal consolidation may seem small but, in the context of economic weakness, would send an important signal about future plans to restore a sound fiscal position. ■

How can efficiency be improved in the public sector and in the provision of health services?

Fiscal consolidation will require, in the first instance, expenditure cuts making it important to identify areas of waste and inefficiency. At the broadest level it is necessary for the government to articulate objectives and to set overall budget priorities starting with the budget for 2002. To be fully effective it will also be important to reduce significantly the earmarking of some revenues for special purposes, especially road building. Moreover, the governance and policy objectives of public corporations should be reviewed since the change in their financing *via* the reform of the Fiscal Investment and Loan Programme is unlikely to be sufficient. The government has now announced a thorough review of these institutions and this process should seek to establish real reforms rather than simple transformation to government agencies. The tendering system must also be reformed to end bid-rigging and to cut the prices paid by the public sector. This will require a reassessment of the policy and the means used to support local SMEs.

Reforms to the pension and health systems to cope with population ageing have been a policy concern for quite some time with the latest pension reform bill coming as recently as March 2000. However, as stressed in last year's *Survey*, further reform needs to remain on the policy agenda to address the public's unease about the sustainability of the system, which might have led to higher household savings. The new government echoed these views in its Policy Outline but up till now has not suggested any specific plans for reform of the basic pension system. With respect to health care, especially for the elderly, the government has stated its intention to limit budget expenditures in FY 2002 and some concrete proposals have been made. But these do not seem sufficient to resolve the structural problems in this area. In order to reduce uncertainty about the current social security system, general guidelines for future policy will need to be developed in combination with the medium-term budget strategy.

As in many other countries the health sector has to contend with continually rising costs and only moderate to slow growth of contributions. Consumer satisfaction is relatively low, consultation times are very short, hospital stays are long and the use of medicines extremely high for what is basically a healthy population. Underpinning these issues is the method of remuneration of suppliers, both inpatient and outpatient. Moreover, the highly fragmented health insurance system leads to little pressure on suppliers, and premiums differ widely between insurance funds raising issues of horizontal equity. Reform has been held up in the Diet but now needs to be reinvigorated. Changes in payment practices and in patients rights to information should take priority. The government intends to encourage mergers between local governments and this would have a favourable side-effect by merging health funds. Over the longer term these funds will have to take on more responsibilities with respect to controlling suppliers and be made accountable to their members for performance. ■

Which structural reforms need to be given priority?

Beyond the reforms underway in relation to banking and budget policies, the government intends to implement a wide-ranging package of structural reforms. However, given the risk of further deflationary pressures and con-

straints on administrative and political resources, prioritisation is needed with structural reform focusing at first on those areas which might lead to new private demand and activity at minimum cost: a win-win strategy. Those areas which stand out in this respect are redundant building laws and land regulations, and taxes that restrict redevelopment of accommodation in the urban areas. Although the government has set up a task force to encourage urban development, it is still too oriented to the old approach of reliance on public works. Regulatory reforms are required as well as efforts to create an efficient real estate market, which will give households greater chances to reallocate their enormous holdings of low return financial assets and to improve their mobility. Other areas which are promis ing include further opening of nursing and nursery care services to private companies, and removing the obstacles to the development of household services where the government projects the possibility for rapid growth. ■

How can competition be fostered and corporate governance improved?

The government's policy package assigns an important role to promoting competition in the economy including the utilities sector. In this regard it will be necessary to reinforce the Fair Trade Commission (FTC) both through more staff and by a more aggressive approach to enforcement. Moving the FTC to the Cabinet Office might help to raise its profile as well as underline the government's commitment to competition. In the utilities sector, the relevant ministry and the FTC have issued guidelines jointly to encourage competition. The competition framework is most advanced in the telecommunications branch and the past year has seen significant progress including the incorporation of the principle of asymmetrical regulations (aimed at controlling the behaviour of a dominant firm) on the statute book and the introduction of firewalls to separate some functions of the Ministry. On the other hand, excessive emphasis in comparison with the OECD area has been placed on firewalls between activities within a group of enterprises in restricting the abuse of market power by the dominant player, and on voluntary actions in promoting competition. Structural remedies will need to be given more serious consideration in the telecommunications sector. Such an approach is even more critical in the electric power sector where the ten dominant integrated companies are already involved in actions to inhibit entry. Divestiture of generating capacity might be needed to promote competition. Experience in other countries points to the need to increase interconnection and transmission capacity and to separate transmission from generation.

Although the traditional structure of corporate governance is evolving slowly, the need for further improvement has become more evident in both industry and in finance. The government needs to move forward in this area by supporting a revised commercial code allowing companies to choose between adopting either a board of directors with an audit committee composed largely of independent directors or strengthening the traditional *kansayaku* system (statutory "auditors") by giving its members increased independence. It would then be up to the markets to determine how the system evolves. However, to make this market selection process more effective, financial institutions such as pension funds should be encouraged to be more active in using their shareholder rights to improve returns on their investments. Moves to limit the open-ended liability of directors to shareholder law suits, which not only makes recruitment difficult but probably also leads to excessive risk aversion on the part of boards, should be conditional on the revised code being implemented. Law suits are one of the few options available at present for investors to bring pressure to bear on corporate performance. ■

What can be done to improve the labour market?

Product and financial market reforms will eventually drive the shift of resources and raise productivity but experience in other OECD countries points to improved outcomes if such measures are supported by labour market policy. To be effective policy measures will, however, need to be accompanied by rigorous *ex ante* and *ex-post* analysis that is not the case at present. There are several priorities. With the numbers involved in traditional on-the-job training declining, more attention needs to be given to training/retraining programmes and to the encouragement of additional part-time college courses. Unemployment benefits could also be extended for these in re-training. Flexibility could also be increased by deregulating fixed-term contracts and in widening the list of jobs which can be filled by temporary employment agencies. Existing job creation programmes and job subsidies should also be reviewed to see whether they have significantly improved the future employment prospects of participants in relation to the costs involved. ■

For further information

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