ASSESSMENT AND RECOMMENDATIONS

The recovery has been based narrowly on exports and inventory correction; with prospects for domestic demand weak, downside risks are important

1. The Japanese economy remains in a serious deflationary situation even while experiencing a cyclical recovery phase in mid 2002 underpinned by inventory correction and a sharp pick-up in exports. But the recovery is too narrowly based to represent a break with the pattern of generally low growth experienced through the 1990s. The still high capital/output ratio is likely to limit any pick-up in investment to a short term adjustment, while continuing weakness in the labour market is expected to restrain consumption growth to around one per cent per annum. More recently, a combination of factors -- particularly low share prices in Japan and elsewhere, a marked appreciation of the yen and a moderating export expansion -- has dampened growth prospects going into 2003. All in all, the economy may grow by only around ½ to 1 per cent per annum to the end of 2004 with deflation continuing. But the balance of risks is now on the downside given signs of slower growth in the world economy and the possibility of a further deterioration in financial conditions, which might lead to a worsening of deflation. Thus Japan continues to be faced with the daunting challenge of radically and quickly improving the functioning of its economic system and halting deflation.

Policy options have been narrowed by ineffective actions through the 1990s; to be effective, they must now cover a wide range of areas

2. In the current and prospective situation, policy options are to a great extent constrained by the past. The budget deficit has reached levels where further increases could well stimulate households to save more, and short term policy interest rates are effectively zero. Despite a bank recapitalisation in 1999, the banking system remains in a fragile state and public confidence in the banks appears to be low. Since the collapse of the bubble, structural reform packages promising a “rebirth” and a number of “emergency” programmes involving fiscal measures have come and gone -- usually in response to short term concerns -- without apparently doing much to correct the misallocation of resources. As a result, medium term growth prospects remain poor, even as the country enters a marked phase of population ageing which will make the fiscal situation more difficult. Against this background, policy will need to move on a broad front, since no one measure will likely be sufficient to return the economy to sustained growth. Macroeconomic policy is severely constrained with the main burden falling on monetary policy to deal with deflation. Fiscal policy, by contrast, will need to take a longer run perspective to establish household confidence that the government will meet its future commitments, while utilising the still considerable scope to improve resource allocation. Confidence is indeed a key issue, especially so in the banking system. How the banking system operates is still an important factor for both the short and medium run development of the economy. Structural policy will have a key role to underpin banking reform, to raise the effectiveness of

macroeconomic policy, and to facilitate the reallocation of resources. Structural reforms will also need to give the public a feel for where the economy is headed and how it is going to get there.

Monetary policy has moved a long way over the past year but its impact is hard to assess

3. The Bank of Japan has moved a long way over the last year into the uncharted territory of quantitative easing under zero interest rates to deal with the on-going deflation. The target for current account balances of the banking system has been raised from above 6 trillion yen to 10-15 trillion since December 2001, with actual balances remaining at the upper end of the band. Moreover, they have allowed temporary deviations to meet extreme demands for liquidity. To support its financing operations the Bank has been purchasing outright 1 trillion yen of Japanese Government Bonds (JGBs) per month, effectively underwriting about a third of the general government net borrowing requirement. These significant moves, together with the reiteration to maintain the current policy stance until deflation ends, have helped to prevent financial market disruptions and also led to a downward shift of the yield curve. On the other hand, it is hard to identify a marked impact up till now on monetary aggregates, not to mention the real economy. The stock of broad money has shown no great acceleration, continuing to grow by around 3½ per cent while bank lending (adjusted for write-offs) continues to decline at a 2½ per cent rate, a pattern in place for some years now. These developments indicate just how difficult the situation is, with a dysfunctional banking system, widespread balance sheet problems, entrenched deflation expectations and zero short-term interest rates.

With downside risks important, monetary policy needs to move further into uncharted territory, perhaps with new instruments

4. The monetary policy stance has remained unchanged since last February. However, with downside risks now greater and prospects for an end to deflation in the short term poor, the BOJ will have to move further into uncharted territory. This will be all the more important in the context of a determined approach to resolving the problems in the banking sector. The Bank should raise further the target range for current accounts of the banking system. There are several methods which might be pursued to this end. Further purchases of JGBs is an option. Extensive support for the JGB market has already succeeded in driving up prices along the yield curve, and this has certainly helped the financial system to survive by realising large capital gains. The BOJ could also expand the range of assets it will purchase although such operations would need to be cautious in some of the domestic asset markets that are relatively small and where resulting price movements might be too strong. These operations should also be carried out in ways that are seen by markets as aiming neither at bailing out any particular institutions nor at achieving any specific level of asset prices. The adoption of a time frame for deflation to end and setting a specific inflation target have been put forward by some observers. Such an approach might have a role to play as the economic situation evolves and the currently large uncertainty about the impact of monetary policy on the economy is reduced.

The government appears to have met most of its fiscal policy objectives in FY 2001 and FY 2002 and has avoided a pro-cyclical fiscal stance

5. Fiscal policy has been caught between the repeated demands of the government parties for traditional fiscal stimulus and its own reform goals to redirect expenditures to more productive uses and to limit the borrowing requirement in FY 2001 and FY 2002 (the fiscal year runs from April to March). At the end of the day, the government was reasonably successful in balancing these pressures with the supplementary budgets of FY 2001 and the budget for FY 2002. Relative to a baseline budget projection, spending in priority areas was raised by some 2 trillion yen in FY 2002 and other expenditures, including public works, were cut by 5 trillion yen. Reallocation would have been even greater had the government succeeded in fully reforming the system of earmarked taxes for road building -- a reform that needs to be pursued vigorously. While the government has met its self-imposed limit of 30 trillion yen new borrowing by the general account *ex ante*, it has been able to do so only through creative accounting. With respect to fiscal outcomes, borrowing on a national accounts basis adjusted for the business cycle and for one-off revenues rose by about ½ percentage point of GDP in CY 2001. The government thus avoided the danger pointed out in last year's *Survey* of following down the revenue projections with further expenditure cuts. OECD projections for 2002 indicate that the fiscal stance should remain neutral with a cyclically adjusted deficit of some 7 per cent of GDP.

Fiscal policy in FY 2003 is likely to be marginally tighter, but will require tough policy choices to stay on track

6. For the FY 2003 budget, the government has made a sensible decision to move to an expenditure cap for the general account based on the FY 2002 initial budget, and the borrowing requirement of the general account will rise above 30 trillion yen. The expenditure plans are set to involve savings over the budget baseline of some 1 trillion yen, but the reduction of public works will only be some 3 per cent of the level in the FY 2002 budget. To facilitate the shift of funds to priority areas, the new budget outline allows the Ministry of Finance to approve requests from ministries for a 20 per cent increase while reducing other requests to keep total spending unchanged. The success or failure of the necessary move to reallocate spending will not be known till later this year. The move to a spending cap in the context of a weak economy should put the government in a better position than in the past to resist any calls for a supplementary budget later in the year. This would allow fiscal policy to finally achieve some stability and somewhat better transparency, a point advocated in previous *Surveys*. The OECD estimates that the fiscal stance could be broadly neutral in CY 2003, although gross debt will continue to increase to above 150 per cent of GDP. The outturn, however, may depend on actions taken to address banking sector problems and their repercussions on the economy. Nevertheless, there is little room for manoeuvre even in the short term, in view of the rising debt.

The medium-term fiscal perspective remains challenging and requires ambitious goals and a clear policy framework

7. Beyond FY 2003, the central issue is whether or not Japan succeeds in placing its public finances on a credible consolidation path which would minimise the danger of a sharp increase in interest rates and increased household savings via a Ricardian effect. The OECD projects that, on a general government basis, a primary surplus of 1¾ per cent of GDP is likely to be necessary to stabilise the debt/GDP ratio at some 180 per cent by 2010. With the primary deficit currently around 6½ per

cent of GDP, significant consolidation is therefore required. In this light, the extent of fiscal consolidation envisaged in the government's *Medium-term Economic and Fiscal Perspective,* agreed in January, is far from sufficient. The *Perspective* projects the primary deficit of the central and local governments to be reduced to 2.2 per cent of GDP by FY 2006, the end of their projection period, with a view to eliminating it as soon as possible after FY 2010. However, this involves an optimistic assumption about an end to deflation, which is unlikely to be realised in the near future. The *Perspective* is a small first step towards defining a medium-term fiscal policy framework. It needs to be made both more ambitious in its objectives and more concrete, and make use of shorter run real spending targets to improve credibility. It should also spell out specific policy requirements that should guide current and future policy decisions. It needs to consider how the required revenues can be secured and spending cuts achieved against the mounting pressure for expenditure to rise, not least due to population ageing. In this respect, the heavy dependence of prefectural and local governments on the central government via public works and tax transfers, which has been a marked feature of public governance, also needs to be addressed. The government's sense that deep changes are required in order to develop regional dynamism is appropriate. Reforms in this area will take time and should be linked with fundamental tax and expenditure reform.

Fundamental tax reforms must be pursued to both improve efficiency and to broaden the base for a longer run increase in tax revenues

8. Despite the clear need to raise tax revenues in the coming years, the government has been struggling to form a strategy. In the meantime, it is being buffeted by the demands for short-term stimulus measures including tax breaks which need to be compatible with the goals of tax reform. Indeed, the government has conceded that tax breaks for FY 2003 will probably involve a reduction of more than 1 trillion yen in a revenue neutral manner over several years. As before, the objective should remain to streamline tax relief and allowances to broaden the tax base, which is at the moment very narrow both for individuals and for businesses, and to improve the incentive structure of the tax system. With respect to the latter, the changeover period associated with full consolidated tax accounting for companies should be as short as possible.

Disclosure of non-performing loans has improved, but the banks should be kept under pressure to restructure and to accelerate the disposal of bad loans

9. Although there has been important progress in bringing transparency to the problems in the banking system, it also serves to highlight just how much precious time has been lost. The more robust approach to NPLs taken by the authorities since September 2001, in line with the government's structural reform programme, has confirmed that the NPL problem has indeed been far greater than acknowledged. In addition, there are grounds for supposing that the scale of the problem is still not yet fully apparent, especially in the regional banks. The migration of deposits from smaller banks to larger ones in the run-up to the partial lifting of blanket deposit insurance in April indicates that the public lacks full confidence in the banks. It is important that policy consequences now be drawn. The government decided in October to postpone the re-introduction of partial coverage by the deposit insurance system in April 2003 by two years. The re-introduction of such a scheme is important to address the risk of moral hazard facing both banks and depositors. It is now crucial for the authorities to move ahead in several areas. First, they must raise pressure on

banks to strengthen loan classifications and adopt realistic provisioning requirements. Second, the disposal of NPL should be accelerated, which will require incentives to dispose of problem loans. Third, the authorities must force bank restructuring, which could result in closure of some of them, and to insist on reforms to their governance and operating structures, including stronger internal management of credit assessments and evaluation. These actions may require the use of additional public funds, which has been avoided up till now on political grounds. Strong conditions should be attached to the use of these funds including managerial changes and the dilution of existing shareholders. Fourth, steps must be taken to deal effectively with the companies which are responsible for NPL. This would involve restructuring "distressed borrowers" into something viable, or moving the underlying assets to those who can put them to productive use -- a process which would be facilitated by measures to develop securities markets. A key policy goal should be the return of good banks and good loans to the market as quickly as possible. Continued prudential vigilance may also be required to address problems in the insurance sector. At the time of writing measures were under consideration to meet the objective of resolving the NPL problem by FY 2004.

Profitability of the banking system must be raised, inter alia, by reforms of the public financial sector and by fees on accounts

10. Resolving the NPL problem of the banking system is only a necessary though not sufficient condition for a sound banking system: profitability needs to be restored. The margins on bank lending do not cover risks and the costs of deposit-taking activities. At the end of the day, it will be up to the banks to solve these problems or their management must be changed. However, there are problems of policy consistency that need to be addressed. The authorities have continued to pressure banks to lend to small and medium-sized enterprises (for the recapitalised and privatised banks, aggregate targets have been set) despite evidence that banks have not been able to charge interest rates commensurate with the associated risks. Moreover, some quarters have been guarded about the need to raise lending rates for a number of large borrowers in difficulties, although it is an important way for many banks to restore profitability. The presence of public financial institutions, including the post office, distorts the banking system and should be dealt with now and not at a time when the economy returns to normality. In the meantime, the postal savings should be obliged to pay deposit insurance and to introduce a fee on all deposits to reflect the costs, while the cost from universal service obligations should be compensated in an explicit and transparent manner. This would level the playing field and allow private banks to follow suit.

Japan must reverse the long running slow-down in productivity and growth to cope with ageing and the accumulation of public debt

11. Moving to a sustainably higher growth path will involve a major change in the way the economy has operated since the early 1970s. Over the past two decades, growth has been input intensive and characterised by ever larger inputs of capital, which have served to maintain labour productivity. However, this path is not sustainable since marginal returns to investment have now fallen to low levels. The key to the situation has been lower multi-factor productivity (MFP) growth, which has been evident since the early 1980s (excluding the short bubble period at the end of the 1980s when the relationship between the key macroeconomic magnitudes became highly distorted). As a result, the economy is remarkably unproductive, greater quantities of labour and capital being absorbed per

unit of output than in other leading economies. At the same time, Japan is also characterised by the presence of flagship exporting industries and companies, which often set world standards for productivity. Thus the economy is dualistic, a high productivity, dynamic, export sector existing alongside a low productivity domestic (or protected) part which is less productive than in other countries.

This will require more than picking the next export success but measures to achieve better resource allocation

12. The dualistic economy reflects poor resource allocation underpinned at first by cartels and restructuring agreements following the first oil price shock, and later by poor enforcement of competition law and uncertain and restrictive regulation. The banking system has also failed to force resources to move to more productive uses and has also contributed to the lack of effective labour mobility by helping to finance low productivity activities developed by firms to take care of their life-time employees. Political debate about economic prospects in Japan is often narrowly confined to questions about how to support the next key technology (for example, nanotechnology or biotechnology), and by extension the next expanding export sector. The problem in Japan is not in these activities but in the economy more generally and especially in the domestic sectors. However, urging greater productivity and better resource allocation at a time of unemployment is hard to sell politically. It is therefore necessary to emphasise that the process by which productivity increases is the key. Productivity gains from new ways of doing things or completely new goods and services will bring forth new demand. From this perspective, the government's sense that there are still many unused possibilities for fulfilling potential household demand is certainly appropriate. But for that potential to be tapped, fundamentals will first have to be put in order, in particular addressing barriers to exit and entry and the freer flow of resources.

Widespread measures to ease barriers to entry and growth, as well as to improve regulation, are needed

13. Regulatory barriers to entry and to the further development of enterprises need to be reduced and the process of exit substantially improved. The government has correctly given an important place in its reform plan to reducing barriers to entry through a programme of deregulation, especially in a number of service sectors. This programme needs to be pursued further even though many significant regulatory barriers, including those covering agricultural activities, would remain largely untouched. Faced with the political difficulties in making headway in such important areas of regulation, the government has proposed that "special structural reform zones" be established at the request of local authorities. They would be responsible for identifying the key regulations holding back development, which would then be eased or abolished in a specified area. The proposal is a pragmatic way forward that will create demonstration effects and should be implemented. What must be avoided, however, is for the programme to be taken over by each central government ministry, which would then open the way for interest groups to block a local area moving forward on its own. Moreover, it should be seen as a step on the way to nation-wide regulatory reform. Progress has been made in recent years to improve the process of formulating and executing regulation. Administrative procedures have been established in many areas, public comment periods for regulations have been introduced, and the

principles for no-action letters put in place. However, there is some way to go before such features will become an integrated part of the culture of governance.

Barriers to exit should also be reduced and pressure on bad debtors tightened

14. With respect to the process of exit, a number of legal instruments are now in place although debtor in possession financing is still rudimentary. The existing framework would normally be enough for the market to work but it is clear that firms only refer to bankruptcy or reorganisation when it is too late. Pressure will have to be kept up on the banks to deal effectively with their non-performing borrowers and not to engage, for example, in debt/equity swaps which do not resolve the fundamental problems of an enterprise. But the government's own policy will need to remain consistent. In the last year this has been far from the case with some struggling companies benefiting from policy ambiguity.

Competition policy should be strengthened and the environment for foreign trade and investment made more open

15. Trade and competition policy also have an important role to play in getting the fundamentals right. The enforcement of competition policy needs to be strengthened by giving the Fair Trade Commission (FTC) coercive investigative powers, which should open the way for greater resort to criminal prosecutions, as well as by further increasing their staff and raising fines to levels at least commensurate with the violation. Its powers should also be extended to include sanctions against civil servants involved in bid rigging. To underline the government's determination to turn a new page, the secretariat of the FTC should be made an independent institution. Trade policy and attitudes toward inward foreign direct investment also have an important role to play. The government's intention to seek wide ranging free trade agreements, but as a complement to multilateral negotiations, is an important move but will need to be accompanied by reforms of, *inter alia*, the agricultural sector, which might otherwise remain a barrier as has been the case in other countries. The record on inward direct investment has been poor, inhibited by such factors as high land prices. Moreover, the regulatory environment is still cited by foreign companies as a barrier. Improving the regulatory environment, including better enforcement, would benefit both domestic and foreign firms alike, increasing competition and improving resource allocation.

Regulation of network sectors needs to be further developed with attention given to enforcement and appropriate staffing of the regulatory authorities

16. In the network sectors, the regulatory framework is most advanced in the telecommunications sector. In some segments strong competition has developed and prices have come down from levels which were around the highest in the OECD area. Lower prices will help the government in its policy to promote the use of information and communications technologies. A more complex and competitive market is, however, highlighting regulatory issues that need to be addressed. The abuse of dominant market position by the incumbent remains a problem, requiring greater use of *ex ante* measures and stronger powers of investigation. Above all, more effective enforcement is required. It is also evident that the regulator (in this case the previous Ministry) needs to respond to the evolving market by hiring specialists rather than relying on rotation within the civil service. This issue will also be important in the electricity and gas sectors where deregulation is much less advanced and is one consideration -- the other being the need to clearly establish impartiality -- in moving to independent regulators. Lack of progress in the

electricity sector stems from the excessive influence by the existing integrated companies over the government's policy-forming bodies. In all the network sectors, structural measures to establish competition must remain on the agenda.

Labour supply needs to be stimulated and better allocated…

17. To improve the allocation of labour, reforms are required in the direction of developing a more active and deeper external labour market. The supply of labour by women should be encouraged by reforms of the social welfare system and improved provision of child care. Non-portable corporate pensions, seniority-based wages and strong *de facto* employment protection have prevented the development of such a market to redirect labour and to provide signals for human capital formation. There is a limit to what policy can do since some of these barriers represent private arrangements. However, employment protection legislation could be placed on a more rational basis by the Diet specifying clearly the criteria to be used by the courts in assessing the acceptability of dismissals. Current moves to increase the flexibility of fixed-term contracts and other forms of temporary work should also be continued but are not an effective substitute for easing conditions for permanent contracts.

… including moves to support the traditionally high labour force participation of old workers

18. Japan faces a severe problem with re-employment of older workers, especially for those over 60 years which is the usual age for mandatory retirement by companies. The current system is already evolving in the direction of a steep fall in wages after mandatory retirement and this development will need to be supported by further moves to establish flexible fixed-term contracts for these workers. But in the longer run private arrangements, which have encouraged a very steep age/wage profile, will have to adapt in the direction of more performance-based pay. The profile leading up to retirement should then be flatter and the disincentives to employ older workers less. The guidelines covering age discrimination give an exemption to companies if setting an age limit is necessary to avoid negatively affecting wage payments to existing workers. Consideration needs to be given to removing this exemption.

Which will also call for changes in human capital formation

19. The *OECD Growth Project* also identified human capital and technology as important for growth. Human capital has been one of the key strengths of Japan with its unique brand of company training. Government training policy has been, therefore, mainly oriented towards companies, not individuals until recently. The demand for skills is, however, changing together with the business structure, which has served to reduce enterprise training. On the other hand, the incentive for individuals to seek training that is not enterprise specific has risen. The government needs to take steps to promote the development of new institutions to cater for these demands such as by removing the outdated building regulation that calls for a great deal of free space. Financial aid will need to be redirected towards individual needs (including vulnerable groups) and to this end some form of training account or vouchers might be useful.

The government has sought to implement its reform programme despite intense opposition and should persevere with its efforts

20. In addition to action in the areas dealt with above, the government has been active in seeking to implement a much wider range of structural measures, the scope of which has often made it difficult for outside observers to keep track of progress. A great deal of legislation has been submitted, including initiatives to make urban re-development easier, and measures have been adopted not only to increase health co-payments but also to reduce fees paid to health care providers and to promote competition among them. The government has also taken concrete steps to reform government corporations, a key element of its reform programme. The decision to abolish the Public Housing Loan Corporation has already had beneficial effects on private banks. Faced with intense opposition from within the ruling parties in the context of a difficult economic situation, however, reforms of the other public financial institutions were delayed though their future should be decided by the end of the year. The new postal sector law in principle opens all activities to competition, although the entry requirements for basic postal services appear to be restrictive. The postal regulatory system remains to be developed, but it must have an independent regulator who ensures that competition is fair and not impaired by dominant players. Meanwhile, the struggle to reform road construction is continuing. These and other compromises noted above have contributed to damaging the reform credibility of the government, which could undermine the popular support for reform. Overall, however, significant progress has been made in moving towards the broad objectives set in June last year. Experience in other OECD countries which have had to embark on major structural reforms suggests that the government would need to persevere with reform efforts in a number of areas in order for Japan to restore a well-functioning and growth oriented economy.

Summary

21. Japan is faced with a formidable task of managing a transition from the system that once worked well but is now ill-adapted to a changing environment. Reforming that system is politically difficult because of well entrenched vested interests. Those opposing reform must realise that there is no alternative to revitalising the economy through structural reform efforts and that there is no more time to be wasted. The economy has entered a recovery phase but this must not prevent a stepping up of reform efforts. The incipient recovery is likely to be weak and, with risks now more on the downside, an anti-deflation package is under preparation. Concerted policy actions are necessary on all fronts in order to benefit fully from synergies between the various policy areas: advance in any single policy area alone will not ensure that Japan will emerge from its current economic problems. Monetary policy will have to take the lead in tackling deflation with additional measures to further increase liquidity. What the appropriate fiscal policy stance should be in the short run depends on whether the problems of NPLs will be addressed squarely. For the time being, however, a neutral fiscal stance is appropriate and further short term stimulus measures should be avoided. But the government also needs to better enunciate a medium-term fiscal strategy to ensure the consolidation which is going to be necessary to deal with the massive debt problem, the need for fundamental tax reform, and the challenges posed by ageing of the population. Such a task will be easier to accomplish if the economy could be placed on a higher growth path, which is the major aim of the

government's broad reform programme, the implementation of which has been uneven. To achieve this goal, Japan needs to reinvigorate competitive forces that drive innovation and better resource allocation. This requires not only a much more vigorous enforcement of competition policy but also further regulatory reform that would open up new opportunities, reduce entry barriers and promote inward foreign direct investment. Better use of capital requires improved balance sheets and profitability of financial intermediaries, which should be facilitated by a more aggressive approach to the resolution of bad debts and bad debtors, and the restructuring of the financial system, including through the reform of public financial institutions. Better use of human resources requires a development of more active and deeper external labour markets, underpinned by a more effective social safety net, as well as the development of institutions that assist the formation of human capital that is not specific to an individual firm. Reform efforts in these areas, which generally go in the right direction but have been timid, must be stepped up. Finally, the government must persevere with its efforts since it is only in this manner that Japan will be able to step up dynamism and growth.

Postscript

Two important policy announcements made at the end of October are not assessed in this *Survey* as the text had been finalised just before the announcement. These initiatives are directly relevant to the issues raised in the *Survey*. First, the Bank of Japan raised the target for current account balances held at the BOJ by 5 trillion yen -- to a range of 15 to 20 trillion yen -- with increased outright purchase of JGBs to 1.2 trillion yen per month. Second, the government adopted a comprehensive policy package for accelerating reform. The following paragraphs describe the government's policy package.

The government's package aims at promoting an early resolution of non-performing loans (NPLs) with a view to halving the ratio of NPLs to total loans at major banks by the end of FY 2004 (March 2005), while supporting the restructuring efforts of borrowers, preventing a credit crunch and strengthening the social safety net. The package is also aimed at reinvigorating the economy by front-loading tax cuts of over 1 trillion yen and accelerating regulatory reforms.

The principal pillar of the package is a programme for rehabilitation of the financial system, which is aimed at:

– *Ensuring stricter assessment of loan quality and adequate provisioning*. This is to be achieved though *inter alia* the introduction of discounted cash flow type methods to evaluate the quality of loans to large borrowers classified as "need special attention". The FSA also plans to publish the difference between the self-assessment of major banks and the results of its inspections on an aggregate basis and to conduct another round of special inspections for large borrowers by the end of March 2003.

– *Reinforcing capital adequacy*. To this end, tax changes are under consideration, including allowing tax deduction of provisions for loans classified "in danger of bankruptcy" or below and lifting the current freeze on a loss carry-back system which allows the use of losses to cancel out taxes paid in the preceding years. The necessity of establishing a new scheme, which would allow more flexible injection of public funds than under the current scheme that allows such an action only in the situation of a systemic crisis, will be examined. Setting a ceiling on deferred tax assets as a part of the banks' tier I capital will also be considered.

– *Strengthening the governance at banks* through the conversion of the preferred stocks held by the government into common stocks and administrative orders to re-capitalised banks depending on the degree of failure to achieve the goals set in their rehabilitation plans. A *Taskforce on Financial Issues* is to be newly established to monitor management at the re-capitalised banks and to check their restructuring plans.

– *Accelerating the resolution of NPLs and the rehabilitation of distressed debtors*. Measures in the programme including the tax changes mentioned above are to provide incentives to banks to sell bad loans. The government also plans to establish an *Industrial Revitalisation Corporation* to purchase loans from all banks except the "main bank" that "need special attention" but where the borrowers are judged as viable, and to support their restructuring by providing additional credit and equity. Meanwhile, the market for distressed loans is to be further developed through their securitisation.

To cope with the possible increase in deflationary pressure and the rise in unemployment due to an accelerated resolution of NPLs, measures to strengthen the social safety net are under consideration. To this end, the government plans to extend employment subsidies to firms and to expand the existing public employment programme at local government levels. To prevent the adverse effects of a possible credit crunch, the government's loan guarantees for SMEs have been extended and public financial institutions are to support SMEs and restructuring firms.

Finally, to revitalise the economy, the government intends to accelerate the implementation of some deregulation measures and to accept further proposals for the special structural reform zones. As well, a tax reform bill, including some front-loaded tax cuts, is to be submitted to the Diet in early 2003.