POLICY BRIEF

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Economic Survey of Japan, 2003

Summary

The current economic upturn does not diminish the urgency of continuing with fundamental reforms to lay the foundation for a robust and sustainable expansion strong enough to reverse the downward trend in Japanese living standards relative to other OECD countries and to restore price stability after nearly eight years of deflation. Given the negative implications of falling prices, the Bank of Japan should strengthen its quantitative easing policy by further expanding the range of assets it purchases. In addition, the effectiveness of monetary policy depends critically on resolving the problems in the banking and corporate sectors. The authorities should follow through on the objective of substantially reducing non-performing loans and revitalising the corporate sector, while ensuring that banks are adequately capitalised, using public money if necessary. Moreover, it is important to scale back the role of government financial institutions. Given the likely negative impact of accelerated bank and corporate-sector restructuring on activity and the need to ensure that the recovery is not ended prematurely, excessive fiscal policy tightening should be avoided, while any increase in revenue due to buoyant activity should be used to reduce the deficit. Achieving the moderate fiscal consolidation projected for 2004 is a key to building confidence in the longer-term sustainability of public finances, which also requires a credible consolidation plan for 2005 and the years beyond, including measures to limit spending and boost tax revenues.

This Policy Brief presents the assessment and recommendations of the 2003 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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Moreover, it is essential to prevent increases in spending as a share of GDP, an objective that requires reform of pension and health care programmes in the face of rapid population ageing. Given the constraints on macroeconomic policy, a successful programme to revitalise the economy will require a broad programme of structural reform, focused on strengthening competition to boost consumer welfare and improve the allocation of resources. To achieve such an outcome, competition policy should be improved by making the Fair Trade Commission stronger and more effective and by creating a framework conducive to competition in network industries that have been liberalised, such as telecommunications and energy. Expanded international trade, greater inflows of direct investment and removal of outdated regulations – accelerated through the recently created special zones – also have important roles to play in boosting competition. In sum, a broad-ranging programme of carefully designed macroeconomic policies and far-reaching structural reforms to enhance Japan's growth potential is needed. ■

Is Japan's economic recovery likely to continue?

The recent acceleration of growth has raised hopes that Japan's economic fundamentals are changing for the better following a disappointing decade, during which economic growth averaged only 1 per cent a year. Indeed, Japan has made progress in addressing some structural problems, notably the weakness of the banking sector, while restructuring in the corporate sector has advanced. However, despite these positive signs, there is still considerable uncertainty regarding Japan's economic outlook. Achieving a robust, sustained expansion will depend on overcoming serious structural problems, which still limit Japan's growth potential and weaken demand. Resolving such problems requires greater resolve in pursuing a broad-based policy that features structural reforms to improve resource allocation, revitalise business sector activity and restore the soundness of the banking sector. The latter would improve the effectiveness of monetary policy, which, while very expansionary, has proven incapable of bringing an end to the deflation that has persisted since the mid-1990s. Monetary policy must remain expansionary until the recovery is secure and deflation has definitely ended. Extensive use of fiscal stimulus has increased public debt to more than 150 per cent of GDP just as Japan enters a phase of marked population ageing. The challenge for fiscal policy is to pursue sustained fiscal consolidation over an extended period.

Gauging the strength of the recovery is not easy, but Japan's upturn appears to be continuing, with output growth likely to exceed 2½ per cent in 2003. Corporate restructuring efforts have paid off with a recovery in profits, resulting in a rebound in business investment. Macroeconomic policy has also played a supportive role; further monetary policy easing has kept long-term interest rates at low levels, while the stance of fiscal policy has been slightly expansionary since 2002. Export growth has been buoyant, supported by strong demand from China. However, the pace of growth has been insufficient thus far to reduce the unemployment rate, which is still near its record high of around 5½ per cent, while the underlying trend of moderate deflation continues. Nevertheless, increased optimism about Japan's economic prospects has attracted substantial inflows of foreign investment, which have helped to boost the stock market by one-third since April, thus strengthening the balance sheets of financial institutions. Meanwhile, there are signs of some progress in dealing with long-standing problems in the banking sector, the key to re-opening the monetary transmission mechanism. The expansion is projected to continue through 2004, though at a more moderate rate, subject to interest and exchange rate developments and the international economic environment. ■

How can monetary policy be made more effective?

The Bank of Japan has moved aggressively into the uncharted territory of quantitative easing under zero interest rates by substantially increasing the targets for the current account balances at the central bank. This approach has been successful in

Short-term outlook[1]

	2002	2003	2004	2005	2003 1st half	2003 2nd half	2004 1st half	2004 2nd half	2005 1st half	2005 2nd half
Demand and output (volumes)										
Consumption										
Private	1.3	1.1	1.1	1.1	1.1	0.4	1.3	1.2	1.1	1.0
Government	2.3	1.6	2.0	1.8	0.7	3.4	1.6	1.5	1.9	2.0
Gross fixed investment	–4.7	4.4	0.2	0.0	5.6	5.0	–1.1	–1.1	0.3	0.6
Public[2]	–4.9	–7.0	–8.3	–3.5	–10.3	4.0	–13.4	–8.4	–1.7	–1.0
Private residential	–4.8	–1.9	–1.4	–2.0	–3.1	0.4	–0.8	–2.0	–2.0	–2.0
Private non-residential	–4.7	10.3	3.5	1.5	14.0	6.2	3.3	1.8	1.4	1.5
Stockbuilding[3]	–0.4	0.2	0.1	0.1	0.0	–0.3	0.3	0.2	0.1	0.1
Total domestic demand	–0.5	2.3	1.1	1.0	2.2	1.8	1.0	0.9	1.1	1.2
Exports of goods and services	8.1	7.5	9.5	9.8	6.3	6.0	10.9	10.1	9.8	9.7
Imports of goods and services	2.0	4.5	5.2	5.1	1.1	5.7	5.0	5.0	5.2	5.2
Net exports[3]	0.7	0.5	0.7	0.8	0.6	0.2	0.8	0.8	0.8	0.8
GDP	0.2	2.7	1.8	1.8	2.8	2.0	1.8	1.6	1.8	1.9
Inflation and capacity utilisation										
GDP deflator	–1.7	–2.5	–1.3	–0.8	–3.0	–0.8	–1.6	–1.1	–0.7	–0.5
Total domestic deflator	–1.6	–2.2	–1.3	–0.7	–2.7	–1.0	–1.4	–0.9	–0.6	–0.5
Private consumption deflator	–1.5	–1.4	–0.6	–0.4	–1.5	–1.1	–0.5	–0.4	–0.4	–0.3
Unemployment rate	5.4	5.3	5.2	5.0	5.4	5.3	5.3	5.2	5.1	5.0
Output gap	–3.2	–1.9	–1.5	–1.0	–2.0	–1.8	–1.6	–1.4	–1.1	–0.9
Memorandum items:										
Net government lending										
(% of GDP)	–7.1	–7.4	–6.8	–6.9						
Gross debt	147.3	154.6	161.2	167.2						
Net debt	71.8	79.1	85.7	91.7						
Short-term interest rate	0.1	0.0	0.0	0.0						
Long-term interest rate	1.3	1.1	1.7	1.8						
Current account (% of GDP)	2.8	2.9	3.6	4.3						

1. Assuming an exchange rate of 111.2 yen to the dollar.
2. Including public corporations.
3. Contribution to GDP growth.

Source: OECD, OECD *Economic Outlook* 74 (November 2003).

maintaining stability in financial markets and preventing a deflationary spiral, as low interest rates have had a positive impact on economic activity. However, there is little evidence of a significant effect on bank lending, which continues to decline, thus limiting the positive impact on the real economy. At the same time, Japanese government bonds have been extensively used in implementing the quantitative easing approach, which appears to have distorted the allocation of financial flows. In particular, the central bank's commitment to continue large purchases of government bonds has attracted private-sector purchases in this market. The resulting run-up in prices has created the risk of latent losses for financial institutions once deflation ends and the yield curve becomes steeper.

The priority for monetary policy should continue to be stopping deflation, which has a negative impact on Japan's growth prospects. To achieve this objective, the central bank should strengthen the effectiveness of quantitative easing by broadening the range of assets that it purchases. The recent decision by the Bank of Japan to buy securities backed primarily by receivables held by, or loans to, small and medium-sized enterprises is thus welcome and will also increase the investment capacity of smaller firms. The authorities should consider expanding the range of assets further. Such an approach would enhance the credibility of the Bank of Japan's commitment to ending deflation since inflation would likely generate capital gains on those assets whose prices are positively correlated with inflation. Moreover, it could help to ease the impact of the quantitative easing policy on the government bond market. Further opportunities to limit the impact on that market have been provided by intervention in the foreign exchange market, which amounted to nearly 13.5 trillion yen in the first nine months of 2003.

Looking further ahead, monetary policy should also include a coherent exit strategy to deal with the complex adjustment that will occur when deflation ends. This will require a medium-term framework for monetary policy management, including a long-run target for the inflation rate or the price level that is high enough to limit the risk of falling back into deflation. The central bank should commit to continue monetary easing for a longer period than necessary to achieve the target, thus allowing some overshooting, until the risk of deflation becomes negligible. The recent clarification by the Bank of Japan of its commitment to continue the quantitative easing policy is welcome. ■

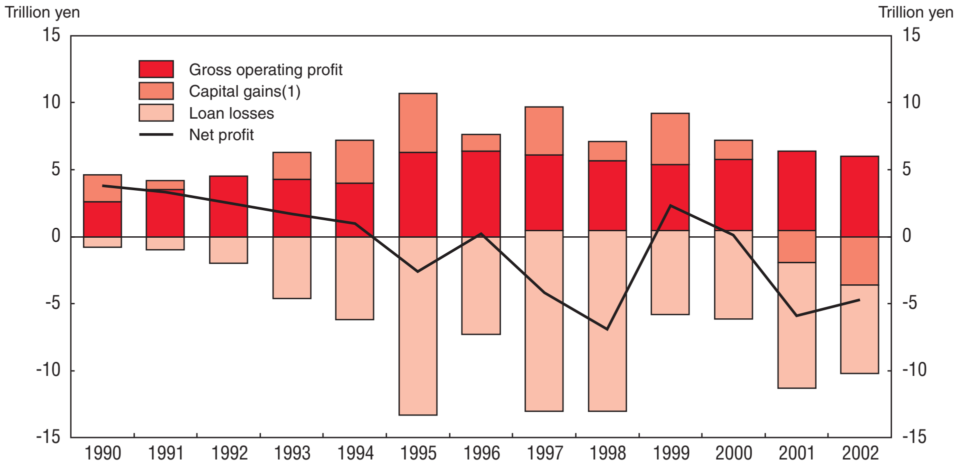
How can the banking sector be strengthened and non-performing loans reduced?

Increasing the effectiveness of monetary policy also requires addressing further the problems in the banking sector, which have essentially closed the credit transmission channel. Bank lending has been shrinking at an annual rate of around 2 per cent during the past few years, reflecting both the banks' need to protect their balance sheets and weak loan demand from the corporate sector. The weakness of capital in the banking sector is partially due to the large loan losses stemming from the high level of non-performing loans, resulting in ten consecutive years of net operating losses. The deflationary environment keeps the rate of default on loans at a high level, which, in turn, limits the effectiveness of monetary policy in ending deflation. Moreover, the declining value of collateral raises the external finance premium, thus further slowing the growth of lending. Given the close linkage between the weakness in the banking sector and deflation, these two problems must be solved simultaneously. It is essential, therefore, that further monetary policy measures by the Bank of Japan be accompanied by decisive action to restore the health of the banking sector. In this regard, initial progress in implementing the Programme for Financial Revival, a bold programme for rehabilitation of the financial sector announced in October 2002, is welcome.

One key priority in restoring the health of the financial sector is the government's goal of reducing the major banks' stock of non-performing loans by half to about 4 per cent of total lending by March 2005. The banks have made progress toward this objective, reducing the ratio to 7.2 per cent in March 2003, despite new non-performing loans. However, this will be a challenging target to achieve since the rate of new non-performing loans remains high. This increase reflects both a deterioration in loan quality during a period of sluggish economic growth and stricter self-assessment of assets by the banks, prompted by special inspections of major borrowers by the Financial Services Agency. The first round of regular inspections found a level of non-performing loans that was substantially above that reported by the banks, suggesting that the size of the problem was larger than acknowledged by the banks themselves. One positive sign is that the gap between the authorities and the banks regarding the amount of non-performing loans narrowed in the second and third regular inspections. Further strengthening the self-assessment of assets, as well as provisioning, is a key aspect of fully resolving the non-performing loan problem.

The newly created Industrial Revitalisation Corporation (IRC) and the Resolution and Collection Corporation (RCC) should be used effectively to accelerate the disposal of non-performing loans and corporate restructuring. Both institutions will purchase loans through March 2005 to supplement the role of the private sector. Achieving the IRC's desire to revitalise

Figure 1. **Profitability in the Japanese banking sector**



1. On equities and real estate.
Source: Fukao (2003).

some 100 firms requires it to offer terms sufficiently attractive to induce banks to sell their loans, mainly those classified as "requiring special attention". On the other hand, offering too high a price will make it difficult to realise its hope of recording profits, which will in any case require successfully restructuring the companies responsible for the bad loans. This is also true of the RCC, which purchases loans of poorer quality mainly to smaller firms, which are chiefly classified as "in danger of bankruptcy" or below. In short, both institutions should purchase loans at appropriate prices and impose effective restructuring programmes to avoid moral hazard problems and allow these publicly financed institutions to break even financially, thus avoiding additional burdens for taxpayers.

Even with the efforts of the IRC and the RCC, achieving the government's target of accelerating the pace of disposal of non-performing loans will nevertheless be a challenge, given the weakness of banks' capital. In addition to the declines in the quantity of capital, it is necessary to address concerns about its quality. *First*, the banks and the life insurance companies, another troubled area of the financial system, hold significant amounts of each other's capital, creating concerns about "double-gearing" and systemic risks. *Second*, deferred tax assets – future tax deductions which banks are allowed to count as capital – are of questionable quality, given the banks' long record of operating losses. This problem was recognised by an outside auditor that disallowed much of the deferred tax assets claimed by a major bank in May 2003, forcing it to seek an injection of public funds. The increased accountability of auditors is an important step that should be maintained to boost confidence in financial markets. Given that deferred tax assets account for about half of tier I capital, their quality requires careful scrutiny. The issues related to setting a ceiling on deferred tax assets in banks' capital are currently being discussed by the Financial System Council. These factors may create a need for additional capital, either from the private sector or from injections of public funds, subject to strict conditions. It is important to rigorously enforce guidelines prohibiting banks from acquiring capital from weak clients in exchange for loans.

The weakness of capital in the banking sector reflects a fundamental problem of low underlying profitability due to narrow lending margins, despite significant restructuring efforts to cut costs. This suggests a need to improve the governance of banks, including those for which the government is a major owner. In addition, the imposition of guidelines on the level of bank lending to small and medium-sized enterprises seems to run counter to the general thrust of Japan's bank rehabilitation strategy by weakening the accountability of bank management for its lending decisions. Finally, low profitability suggests excess capacity in the banking sector. It is thus essential to scale back the growing role of government financial institutions, which have used their inherent advantages to increase their market share. Moreover, injections of public funds should be made selectively, subject to strict conditions related to the implementation of restructuring programmes. In addition, properly carrying out due diligence is essential to ensure the accountability of the new management at restructured banks. ■

How can fiscal sustainability be achieved?

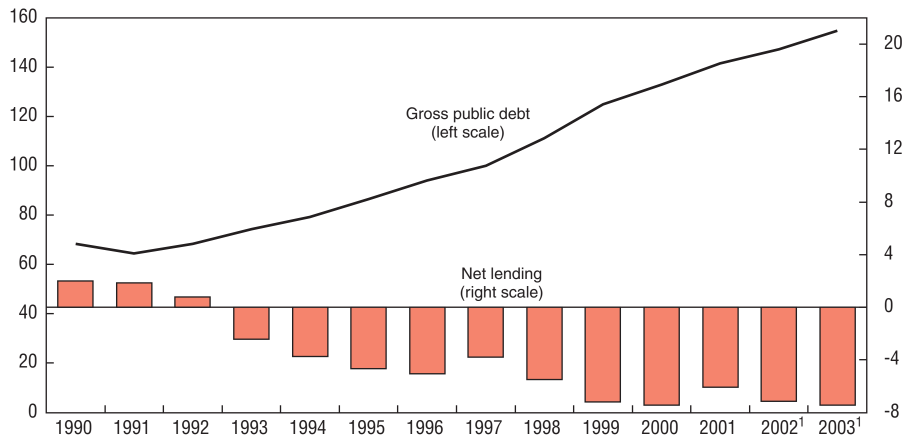
Achieving the 2005 target for reducing non-performing loans by half implies an acceleration of corporate restructuring, which would have a negative impact on output and employment in the short run. However, given the precarious state of public finances, any discretionary increases in social welfare outlays should be offset by spending cuts elsewhere and any increase in revenues due to a rise in nominal income should be used to reduce the deficit. Indeed, with a deficit estimated at nearly 8 per cent of GDP in 2003, public debt is likely to exceed 150 per cent of GDP. The impact of the sharp run-up in debt has been limited by the exceptionally low level of interest rates on government bonds, reflecting the risk aversion of investors and the persistence of deflationary expectations. Indeed, interest payments in absolute terms are lower than a decade ago despite the substantially higher level of public debt. If interest rates had remained at their level of the early 1990s, government interest payments would be higher by nearly 5 per cent of GDP. The transition to positive rates of inflation, even if there is no rise in the real interest rate, will boost interest payments on public debt over time, creating a risk of financing strains.

The fiscal situation is not sustainable at present given that the nominal interest rate exceeds the nominal growth rate. Moreover, population ageing is creating pressure for increased outlays, while there are areas, such as the financial sector, where additional public spending may be necessary to enhance growth prospects. In addition, there is a risk of significant contingent liabilities associated with government special status corporations. The government has taken steps to limit expenditures, although the impact on the budget deficit has been more than offset thus far by weak economic conditions that continue to erode tax revenues. However, assuming no supplementary budget in FY 2003, there is likely to be a ½ per cent of GDP decline in the structural budget deficit in 2004. A more significant tightening could undermine the on-going recovery and reinforce deflation, thus delaying a major decline in the budget deficit. In sum, the authorities must negotiate a narrow path that avoids actions that might push the economy back into recession, while building confidence in the longer-term sustainability of public finances. The key to building such confidence appears to be taking concrete steps early on to cut the budget deficit, as expected in 2004, and by establishing a credible consolidation programme that spells out the changes in expenditure and revenue necessary to reduce the budget deficit further in 2005 and over the medium term.

The government announced a *Reform and Perspectives – FY 2002 Revision* that targets a primary budget surplus by the early 2010s, while keeping general government expenditures at the FY 2002 level of 38 per cent of GDP. Such a surplus is necessary to stabilise public debt, though at a higher level of around 180 per cent of GDP. However, the *Perspective* does not provide specific measures to achieve this major shift in public finances, which, according to OECD calculations, amounts to an 8 percentage point change in the primary balance. The credibility of the *Perspective*

Figure 2. **Budget balance and public debt**

Per cent of GDP



1. OECD estimates for 2002 and 2003.
Source: OECD.

could be enhanced by establishing a direct link to specific spending and revenue decisions, as well as by strengthening the policy feedback mechanism to take into account deviations from targets. In particular, meeting the spending limit will be a challenge given the spending pressures, notably those related to population ageing. Indeed, meeting the spending limit in the FY 2003 budget required a significant reduction in discretionary outlays to balance increased expenditures mandated by the social security programmes. With discretionary spending falling, it will be more important than ever to increase the efficiency of public expenditure to enhance growth prospects. ■

What reforms are needed for the pension scheme and the tax system?

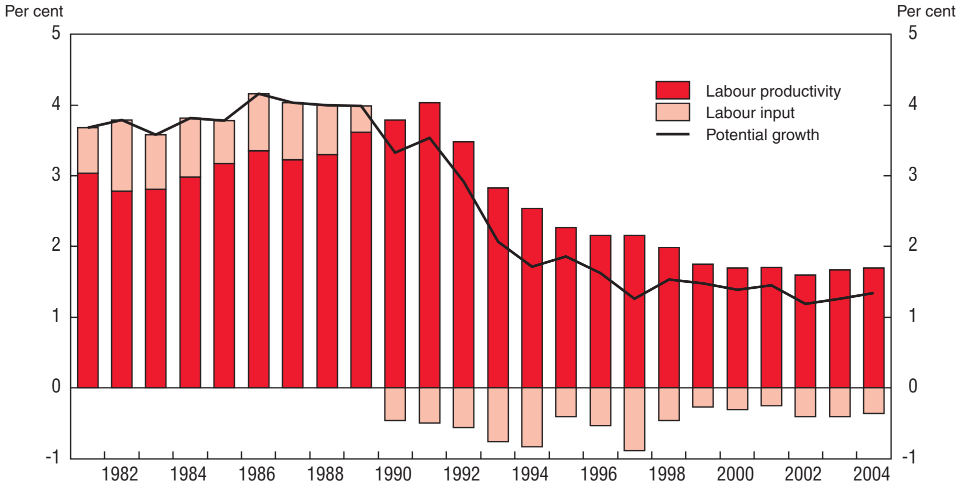
Public finances will come under greater pressure over the longer term from the ageing of the population, as the ratio of elderly to younger people continues to increase more rapidly than in other OECD countries. Public expenditure on pensions has doubled from 6 to 12 per cent of national income in the past decade and will rise to 17 per cent by 2060 if no further action is taken. The authorities have announced a plan to set a ceiling on the contribution rate and allow benefit levels to adjust to demographic and economic trends. Such an approach should be implemented to avoid significant hikes in contribution rates, with negative implications for work incentives. This should be accompanied by policies to ensure that those most at risk of poverty in old age – notably women, who tend to work part-time – have more opportunity to accumulate pension rights. This could be achieved by bringing part-time workers into the earnings-related second-tier pension system. Although activity rates of the elderly are already among the highest in the OECD area, consideration should be given to reducing the disincentives for persons over the age of 60 to continue working while drawing the second-tier pension. As a reduction in replacement rates would force pensioners to rely more on private saving, the government needs to ensure a better flow of information to savers on the real financial health of pension funds and insurance companies. In particular, regulators should ensure that the interest rate used to value future liabilities is adjusted to current realities and that fund sponsors take prompt corrective action when an actuarial deficit emerges in a pension fund.

Given the objective of freezing public expenditures as a share of GDP, balancing the budget will require a significant rise in government revenue, which at under 32 per cent of GDP is well below the OECD average. The FY 2003 budget provides some tax reductions that are intended to spur growth, followed by base-broadening measures that will make the changes revenue neutral over the medium term. However, much more will need to be done in the area of tax reform in order to achieve the fiscal consolidation targets. The general principle should be to streamline tax relief and allowances, while broadening the tax base, to limit the distortive effects of higher tax rates that would reduce Japan's potential growth rate, which at 1¼ per cent is already one of the lowest in the OECD area. Given the size of the fiscal consolidation required, an increase in the consumption tax rate will be required at some point. ■

How can competition be strengthened so as to increase Japan's potential growth rate?

While the low potential growth rate partly reflects falling labour inputs, it is primarily due to the deceleration of productivity growth. To counter this trend, the Japanese authorities have emphasised the importance of structural reform to boost productivity and have made progress in some areas. In particular, urban zoning regulations have been reformed to encourage more efficient use of land, while requirements for starting new companies have been eased to promote entrepreneurship. Policies to introduce competition to network industries have

Figure 3. **Potential growth**



Source: OECD.

been implemented, while additional resources have been granted to the Fair Trade Commission (FTC). To encourage international competition, Japan entered into its first free trade agreement, with Singapore, at the end of 2002.

However, reform must be accelerated to increase Japan's growth potential. One key is to strengthen competition, which appears weak in Japan based on a number of indicators, such as internationally high prices in a number of protected sectors. Enhancing competition would help lower those prices and promote innovation, thus boosting consumer welfare and improving resource allocation. There is considerable scope, therefore, for using pro-competition policies to raise Japan's growth prospects, in part by upgrading the FTC:

- Its independence should be increased by selecting its commissioners from a wider range of society, rather than relying on civil servants.
- Its resources should be evaluated to ensure that they match its expanding role.
- Establishing a career path within the FTC would help it to better use its resources by attracting higher quality staff.
- Sanctions for violation of the law should be increased to strengthen their deterrent effect.

Stronger sanctions – including surcharges and penalties – would also enhance the effectiveness of the leniency programme, which is under consideration. The introduction of this programme, as well as a whistleblower programme to counter widespread anti-competitive collusion that is often linked to trade associations, should be brought forward. ■

What specific reforms are needed in key sectors of the economy?

Another reason for weak competition is that the regulatory policy framework for network industries is still in its infancy compared to most other OECD countries. There are no independent sectoral regulators at present to ensure pro-active *ex ante* regulation, a necessary condition for introducing competition in markets dominated by strong incumbents. Moreover, regulatory capture appears to be widespread, which could be addressed through the creation of a single regulator covering relevant network sectors. The most liberalised network industry is the *telecommunication sector*, where the rapid expansion of broadband connections has strengthened competitive pressure. However, despite significant declines, prices remain high in some areas and important issues concerning interconnection charges remain to be settled. Liberalisation of the *electricity* and *natural gas* sectors has been hampered by market structures characterised by local monopolies. Hence, the most important measures necessary for competition are establishing physical interconnection and non-discriminatory access charges and conditions, as well as the vertical unbundling of activities. In the *postal market*, the universal service obligation for new entrants should be ended if competition in the basic letter segment is to develop.

Relaxing overly prescriptive regulations and strengthening competition are needed to reduce the cost of intermediate inputs, such as *transport*, which are among the highest in the OECD area. Costs are increased by tight regulation of charges for facilities – often used to cross-subsidise the construction of additional infrastructure. Existing infrastructure could be better exploited by allowing prices to affect demand, such as by introducing a market-based slot allocation mechanism in the airport sector. Moreover, related services, such as cargo handling and maintenance, are often provided on a non-competitive basis. In some cases, prices appear to be co-ordinated through complex interrelationships between companies that may prevent new entry, pointing to the need for a pro-active competition authority. As in other segments of the transport sector, prices should be reduced through the privatisation of facilities and the introduction of market-based charges. In addition, regulation tends to stifle competitive pressures, pointing to the need for removing the pre-notification requirement for price changes.

The retail sector is characterised by a relatively large number of small shops, providing high quality at high prices. However, to the extent that prices are pushed up by collusive practices in the distribution sector, this should be addressed by rigorous enforcement of competition policy.

Meanwhile, the large-store segment appears less developed than in other countries. Regulations that restrict the establishment of large stores and thus limit the access of consumers to low-priced goods should be relaxed. ■

What policies are needed to enhance competition and labour market flexibility?

Regulatory reform is also essential to remove barriers to the establishment of new businesses and to achieve social goals at minimum cost. While progress has been made in many areas, addressing the more challenging issue of regulations in the social welfare area requires the creation of a more powerful organisation to succeed the Council for Regulatory Reform, whose mandate expires in March 2004. Given the strong opposition that the Council, which consists of private-sector experts, faces from some ministries, its successor should have a more formal legal basis. The creation of special structural reform zones is another way to overcome the power of vested interests by using the creativity and knowledge of local authorities and the private sector in removing obstacles to growth. Such an outcome, though, depends on preventing ministries from blocking proposals that could create new business opportunities. Moreover, the success of special zones depends on the demonstration effect to spread reform from limited areas to the rest of the country. The regulatory framework for environmental protection would also be improved by increasing reliance on economic incentives, such as cutting taxes on very-low sulphur content diesel fuel, to reduce air pollution.

Enhanced international competition through increased inflows of direct investment and trade is another priority. The government is taking measures aimed at doubling the cumulative amount of foreign direct investment in Japan in five years, mainly by reducing obstacles and pro-active measures such as disseminating relevant information. Its success, however, may ultimately depend on creating more positive attitudes to foreign investors at the local level and enhancing Japan's growth potential to attract the interest of overseas firms. While some flexibility may be necessary for some sensitive products, excessive pressure to maintain high levels of protection for agriculture should not be a reason to prevent Japan's inclusion in free trade agreements, which would allow it to tap into the economic dynamism of Asia. In addition to increasing the welfare of Japanese consumers, improvement of agricultural market access would in general help developing countries expand their exports to Japan. Within that sector, further opening of the rice market, which has already been partially opened to imports, might help the rural sectors in certain Asian developing countries, even if the primary benefits might accrue to higher-income countries. Any aspects of multifunctionality in agriculture, such as protecting the environment, should be dealt with by adopting well-targeted policy measures that minimize trade distortions. In the manufacturing sector, the development of trade and investment links with developing countries would be further promoted through lower tariffs on textiles and clothing. Increased trade, combined with effective foreign aid, would help poorer countries move onto faster growth paths. Although Japan was the largest aid donor in the 1990s in absolute terms, the aid programme has been cut in recent years. Greater transparency in decision-making and enhanced accountability for results might help the public accept a higher aid budget.

Increased labour market flexibility is essential to cope with strengthened competition and accelerated restructuring in the financial and corporate sectors. The ability of policymakers to alter private-sector practices, such as the seniority-based wage system, which appears to constrain flexibility, is limited. Nevertheless, the government can take the lead in encouraging performance-based pay in public corporations. Policies to encourage the development of a more active and deeper external labour market by further relaxing restrictions on fixed-term contracts, temporary workers and private job-placement firms, would also be beneficial. Moreover, the high level of protection for regular workers should be reduced. Emphasising training to develop skills that are transferable between firms appears to have larger benefits than employment subsidies, which typically entail large dead-weight costs. A larger external labour market could, in turn, facilitate greater use of performance-based wages, which should help boost the productivity of workers. Less reliance on seniority-based wages would also help encourage the continued employment of older workers beyond the age of 60. Finally, the labour force participation of prime-age women would be boosted by family friendly policies. ■

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