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Japan: Economic and Policy Developments

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JAPAN

Economic and Policy Developments

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Approved by the Asia and Pacific Department

September 28, 1999

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Japan: Selected Economic Indicators, 1992-2000

Nominal GDP: US\$3,783 billion (1998)

Population: 126.3 million (1998)

GDP per capita: US\$29,937 (1998)

Quota: SDR 8,241.5 million

	1992	1993	1994	1995	1996	1997	1998	Staff Projection	
								1999	2000
Growth (percent change)									
Real GDP	1.0	0.3	0.6	1.5	5.0	1.4	-2.8	0.2	1.0
Domestic demand	0.4	0.1	1.0	2.3	5.7	0.1	-3.5	0.4	0.7
Private consumption	2.1	1.2	1.9	2.1	2.9	1.0	-1.1	0.8	0.8
Residential investment	-6.5	2.4	8.5	-6.5	13.6	-16.3	-13.7	-5.7	4.8
Business investment	-5.6	-10.2	-5.3	5.2	11.3	7.1	-11.3	-6.0	3.7
Government consumption	2.0	2.4	2.4	3.3	1.9	1.5	0.7	1.5	1.9
Government investment	14.5	15.7	2.8	0.6	9.2	-10.4	-0.3	14.2	-8.7
Stockbuilding 1/	-0.5	-0.1	-0.2	0.2	0.4	-0.1	-0.1	-0.2	0.0
Net exports 1/	0.6	0.2	-0.3	-0.8	-0.5	1.4	0.6	-0.2	0.3
Saving-Investment (percent of GDP)									
Gross national saving	33.8	32.8	31.4	30.7	31.4	31.0	29.7	28.9	28.8
Gross domestic investment	30.8	29.7	28.7	28.6	30.0	28.7	26.5	26.0	25.7
Inflation (percent change)									
CPI	1.7	1.2	0.7	-0.1	0.1	1.7	0.6	-0.2	0.1
GDP deflator	1.7	0.6	0.2	-0.6	-1.4	0.1	0.3	0.0	-0.5
Unemployment rate (percent)									
	2.2	2.5	2.9	3.1	3.3	3.4	4.1	5.0	5.5
Government (percent of GDP) 2/									
Central government balance	-1.7	-2.7	-3.5	-4.0	-4.3	-4.0	-5.0	-5.7	-5.4
General government									
Revenue (percent change)	0.9	-2.5	0.8	0.7	2.4	1.6	-2.2	-2.7	1.7
Expenditure (percent change)	5.4	7.0	2.9	4.6	4.2	-0.8	3.1	4.2	0.9
Balance	1.5	-1.6	-2.3	-3.6	-4.2	-3.4	-5.3	-7.7	-7.5
Balance excluding social security	-2.0	-4.8	-5.1	-6.5	-6.8	-5.9	-7.5	-9.8	-9.6
Structural balance excluding social security	-2.3	-4.7	-4.7	-6.0	-7.1	-6.0	-6.5	-8.5	-8.4
Social security balance	3.4	3.2	2.8	2.8	2.6	2.5	2.3	2.1	2.2
Money and credit (average percent change)									
M2 plus CDs	0.6	1.1	2.1	3.2	3.2	3.0	4.4	...	...
M3	3.4	3.9	4.0	3.6	3.1	3.2	5.0	...	...
Domestic credit	2.9	0.8	-0.4	1.8	1.4	1.3	2.6	...	...
Bank lending	2.5	1.2	0.5	1.3	0.4	1.0	-0.9	...	...
Interest rate									
Three-month CD rate (annual average)	4.3	2.8	2.1	1.1	0.5	0.5	0.6	...	...
Official discount rate (end-period)	3.3	1.8	1.8	0.5	0.5	0.5	0.5	...	...
Balance of payments (in billions of US\$)									
Exports, f.o.b.	332.5	352.9	386.0	429.4	400.2	409.2	374.4	398.3	398.8
Imports, f.o.b.	207.8	213.3	241.5	297.2	316.7	307.8	251.6	261.4	281.5
Current account balance	112.3	132.0	130.6	111.4	65.8	94.1	121.0	143.1	138.5
Percent of GDP	3.0	3.1	2.8	2.2	1.4	2.2	3.2	3.5	3.3
Terms of trade (percent change)	7.4	8.9	7.4	-0.1	-6.9	-3.9	6.7	4.4	-6.9
Change in reserves	0.7	27.7	25.4	58.7	36.8	6.9	-7.4	...	...
Merchandise trade (percent change)									
Export volume	1.6	-1.9	1.7	3.6	0.8	11.8	-1.3	2.4	0.6
Export unit value (US\$)	6.3	8.3	7.6	8.2	-7.7	-8.5	-6.8	2.4	-0.3
Import volume	-0.7	3.8	13.7	13.1	5.0	1.7	-5.3	7.6	0.9
Import unit value (US\$)	-1.0	-0.5	0.3	8.3	-0.8	-4.7	-12.6	-1.9	7.1
Total reserves minus gold (in billions of US\$)									
	71.6	98.5	125.9	183.2	216.6	219.6	215.5	...	...
Exchange rates (annual average)									
Yen/dollar rate	126.7	111.2	102.2	94.1	108.8	121.0	130.9	...	...
Real effective exchange rate 3/	111.3	135.3	144.6	151.1	127.7	120.0	110.2	...	...

Sources: Nikkei Telecom; and staff estimates and projections as of July 12, 1999.

1/ Contribution to GDP growth.

2/ Includes provision for a FY 1998 Supplementary Budget.

3/ Based on normalized unit labor costs; 1990=100.

I. REAL SECTOR DEVELOPMENTS¹

A. Introduction

1. **The Japanese economy is currently experiencing its worst post-war economic recession.** Output contracted significantly for five consecutive quarters before growth turned positive in the first quarter of 1999. The recent declines in output have, moreover, followed on the heels of a lengthy period of slow growth—real GDP grew at an average rate of just about 1¼ percent per annum between 1991–98, in contrast to a growth rate of about 4 percent during the 1980s. Japanese economic performance during this decade has also fared unfavorably from an international perspective. Not only has output grown more slowly in Japan than in other major industrial countries, but the volatility of output in Japan rose during the 1990s, whereas it declined significantly in the other G7 countries (Figure I.1). This chapter provides a brief overview of the causes of the poor economic performance in the 1990s, and a more detailed analysis of recent developments in the real sector.

2. **The collapse of the asset price bubble in 1990–91 provided the trigger for the downturn in 1992, and compounded the economic problems thereafter through its effects on the banking system.** The asset price collapse impacted on economic activity through a variety of channels, particularly the adverse impact on private investment from an increased cost of capital and lower net worth, although as discussed below, the adverse wealth effects on private consumption appear to have been small. The asset price collapse also created problems for the banking system through two distinct channels; not only did it impair loan collateral, but it also eroded bank capital directly as hidden profits on equity holdings were sharply reduced.² The resulting fragile state of the banking system, left essentially unresolved for a number of years following the collapse of the asset price bubble, culminated in a full-fledged banking crisis during 1997–98, and forced the commitment of large-scale public funds to address the problem. The credit crunch and the financial distress that accompanied the banking crisis in this period, together with the contractionary stance of fiscal policy in 1997, contributed to the recent episode of sharply declining activity (Table I.1).

3. **The lingering negative impact from the bubble period has also been related to the need to unwind the excess capital stock inherited from the years of “overinvestment” to more normal levels.**³ As discussed further below, a brew of high growth expectations, easy access to credit, and a buoyant equity market had spurred business

¹Prepared by Ramana Ramaswamy (ext. 38591).

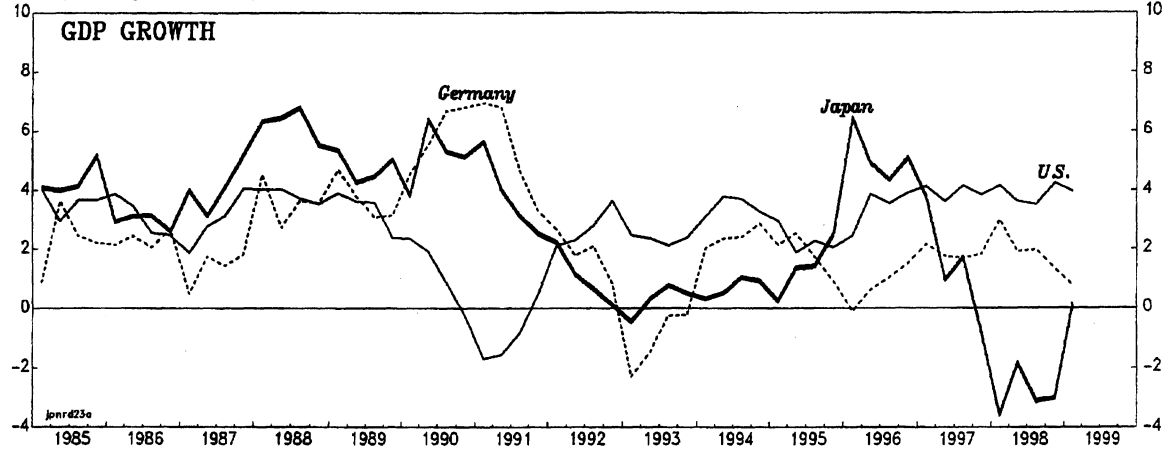
²Japanese banks have significant direct equity ownership in the corporate sector, and have counted part of the capital gains on equity ownership as bank capital.

³A detailed analysis of Japanese economic performance during the 1990s is provided in Bayoumi (1999), and Ramaswamy and Rendu (1999).

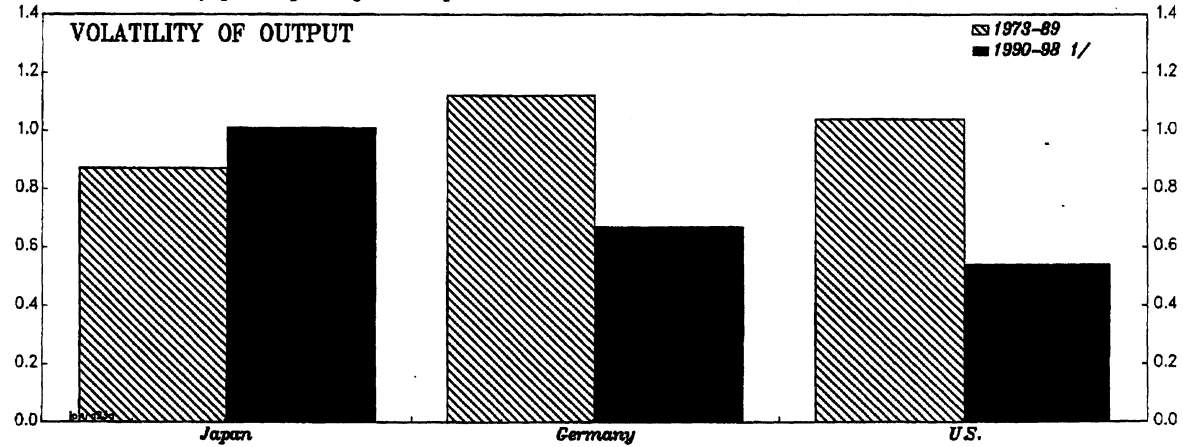
FIGURE 1.1
JAPAN

GROWTH AND VOLATILITY COMPARISONS

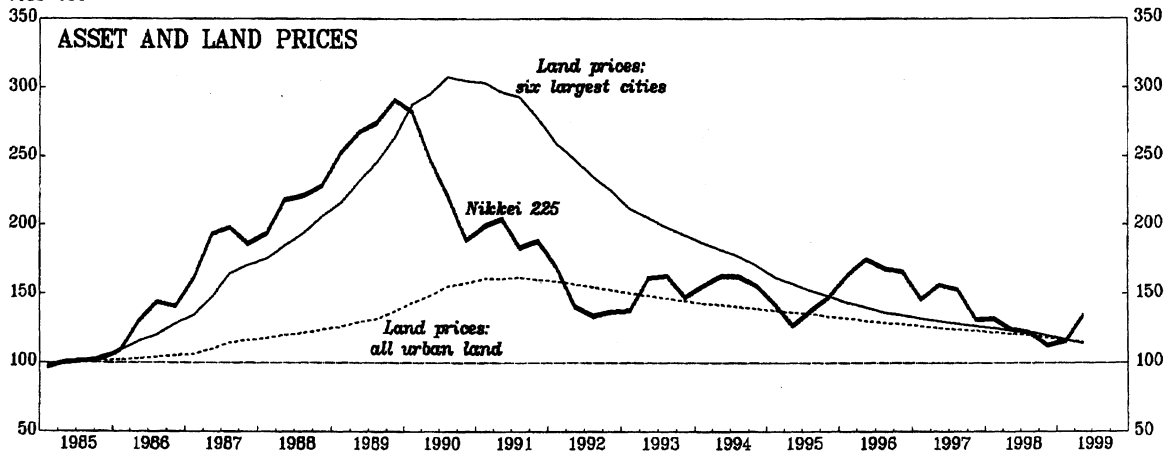
Four-quarter percent change



Standard deviation of quarterly changes in output



1980=100



Sources: IMF, World Economic Outlook database; and staff estimates.

1/ For Germany, data start in 1991Q2 to exclude reunification effects.

Table I.1. Japan: Growth of Real GDP and Demand Components, 1993-99 1/

(Percent change from the previous period)

	1994	1995	1996	1997	1998	1998				1999
						I	II	III	IV	I
Private consumption	1.9	2.1	2.9	1.0	-1.1	0.3	-0.1	-0.1	-0.2	1.2
Private gross fixed investment	-2.2	2.2	11.8	1.6	-11.8	-4.3	-3.6	-3.3	-5.8	2.3
Residential	8.5	-6.5	13.6	-16.3	-13.7	0.1	2.1	-6.1	-7.0	1.2
Business	-5.3	5.2	11.3	7.1	-11.3	-5.2	-4.8	-2.7	-5.5	2.5
Final private domestic demand	0.8	2.1	5.3	1.2	-4.1	-0.9	-1.1	-1.0	-1.6	1.5
Government consumption	2.4	3.3	1.9	1.5	0.7	0.7	0.2	0.8	-0.6	0.8
Public fixed investment	2.8	0.6	9.2	-10.4	-0.3	-2.4	-3.0	3.7	10.6	10.3
Final domestic demand 2/	1.1	2.1	5.3	0.1	-3.3	-0.9	-1.1	-0.4	-0.5	2.2
Stockbuilding 3/	-0.2	0.2	0.4	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0
Private	-0.3	0.2	0.4	-0.1	-0.1	-0.1	-0.1	-0.1	0.1	-0.1
Public	0.1	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	0.1
Total domestic demand	1.0	2.3	5.7	0.1	-3.5	-1.0	-1.2	-0.6	-0.5	2.2
Foreign balance 3/	-0.3	-0.8	-0.5	1.4	0.6	-0.3	0.4	0.3	-0.4	-0.2
Exports	4.6	5.4	6.3	11.6	-2.3	-2.8	-2.0	1.8	-3.2	-0.3
Imports	8.9	14.2	11.9	0.5	-7.5	-1.1	-5.8	-0.1	-0.8	1.8
Real GDP	0.6	1.5	5.0	1.4	-2.8	-1.2	-0.7	-0.3	-0.8	1.9
Memorandum items:										
Public expenditure 4/	2.6	2.0	5.4	-4.5	0.2	-0.8	-1.3	2.1	4.6	5.4
Nominal GDP	0.8	0.8	3.5	1.5	-2.5	-0.3	-0.9	-1.2	-0.7	2.2
GDP deflator (1990=100)	0.2	-0.6	-1.4	0.1	0.3	1.0	-0.2	-0.9	0.2	0.3
Output gap (percent of potential GDP)	-1.7	-1.9	1.1	0.4	-4.1	-2.7	-3.8	-4.5	-5.5	-4.1

Sources: Nikkei Telecom; WEFA; and staff estimates.

1/ At 1990 prices.

2/ Final private domestic demand is the sum of private consumption, residential investment, and business fixed investment. Final domestic demand is final private domestic demand plus government consumption and investment.

3/ Contribution to real GDP growth.

4/ Government consumption and public investment.

investment to unsustainable levels in the latter half of the 1980s. With these favorable conditions dissipating with the bursting of the asset price bubble, the negative impact of the increased cost of capital on business investment was compounded by the need to dispense with excess capacity.

4. **A snapshot of real sector developments in the 1990s—captured in Figure I.2—reveals the following broad trends.** The decline in private investment—both residential and non-residential—was precipitous following the collapse in asset prices. After what turned out to be a transient pick up in 1996, related in part to new opportunities created by deregulation, private investment declined sharply yet again. Public investment, which has served as the main ingredient of counter-cyclical fiscal policy in the nineties, filled in to a considerable extent the slack left by private investment. Private consumption grew more slowly in the aftermath of the collapse of asset prices; significant declines in the level of private consumption have, however, been a more recent phenomenon, occurring mainly during 1997–98. The external sector's contribution to growth (both positive as well as negative) has been under 1 percentage point during the course of the 1990s, except in 1997, when it contributed about 1½ percentage points to growth.

5. **The recession intensified in 1998, before activity picked up in the first quarter of 1999.** GDP declined by almost 3 percent in 1998—the steepest annual decline registered in the post-war period—as all the main components of private domestic demand fell sharply. However, a surge of public investment starting in the fourth quarter of 1998, together with steps to ease financial constraints, resulted in activity reviving sharply by 1.2 percent in the first quarter of 1999. There has also been a recovery in confidence in the first part of 1999, reflecting a sharp rise in equity prices and improving indicators of corporate sentiment. Nevertheless, the staff's forecast for 1999 posits only moderate growth, as the stimulus from public investment is expected to wear off later in the year, private domestic demand is projected to be weak during the rest of this year, as continued efforts at corporate restructuring continue to weigh against a recovery.

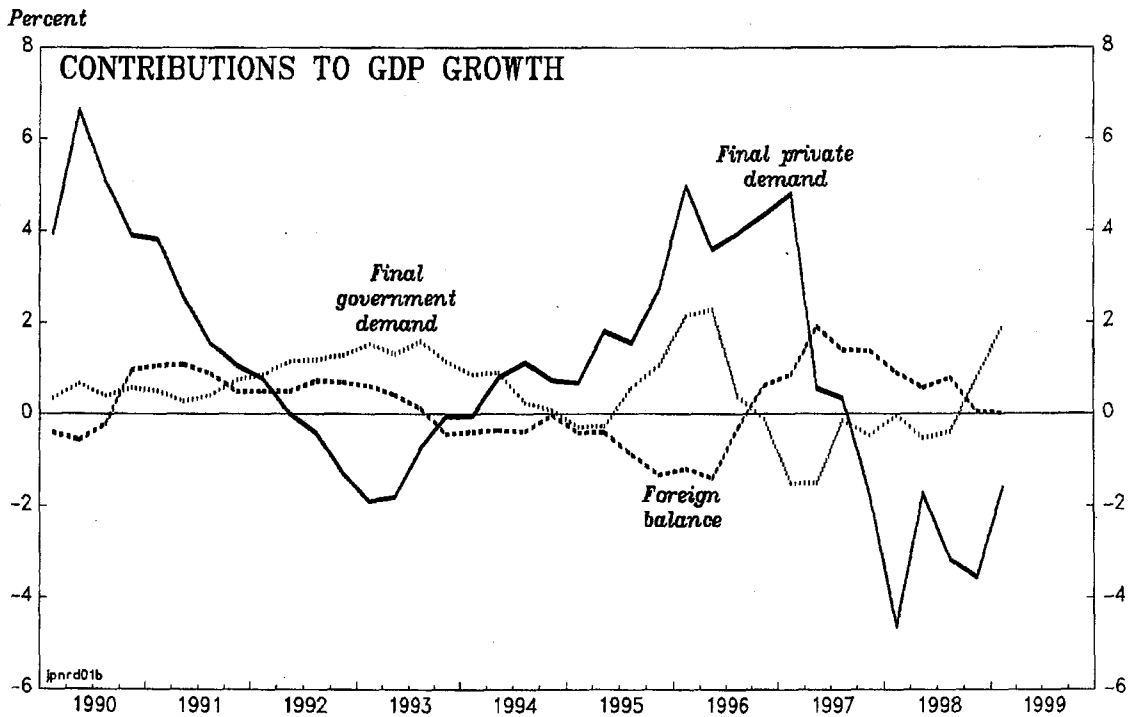
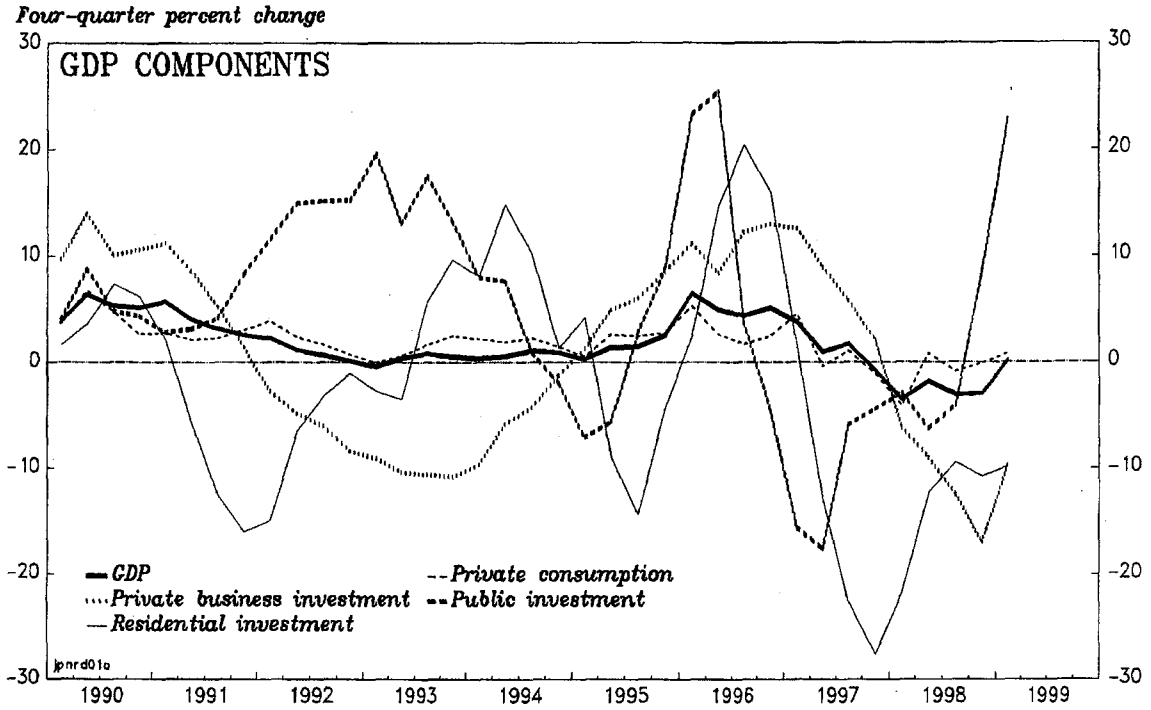
B. Components of Aggregate Demand

Private Consumption

6. **Private consumption has fallen sharply since the onset of the recession in April 1997.** Despite the increase of 1¼ percent in the first quarter of 1999, the level of private consumption expenditure is still about 3¼ percent lower than it was in the first quarter of 1997. There are two main puzzles concerning trends in private consumption in Japan. Why did private consumption not fall steeply following the asset price collapse in 1991–92? Why has private consumption declined recently?

7. **The relative stability of the private savings ratio in the aftermath of the asset price collapse in the early 1990s reflects in part the reluctance of households in Japan to**

FIGURE 1.2
JAPAN
GROSS DOMESTIC PRODUCT AT 1990 PRICES, 1990-99



Sources: Nikkei Telecom; WEFA; and staff estimates.

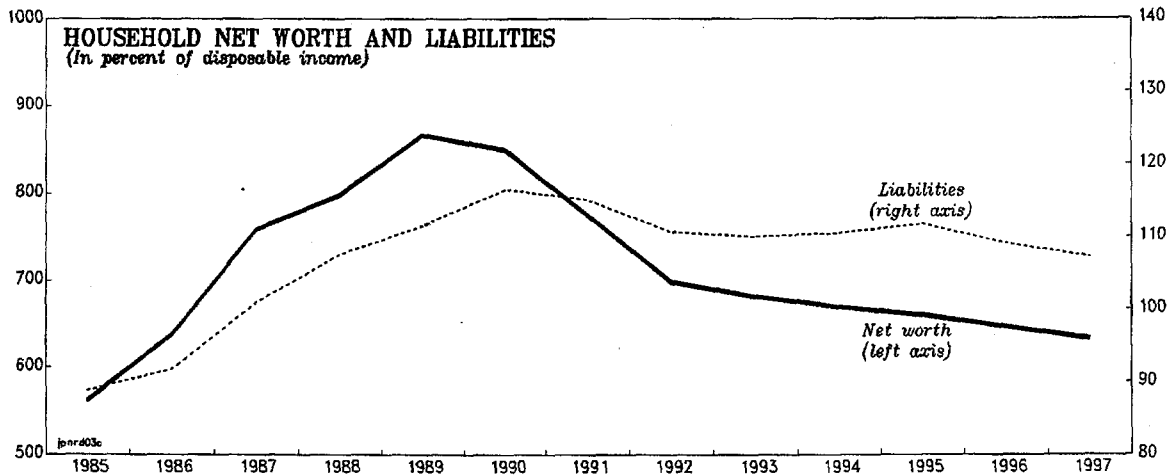
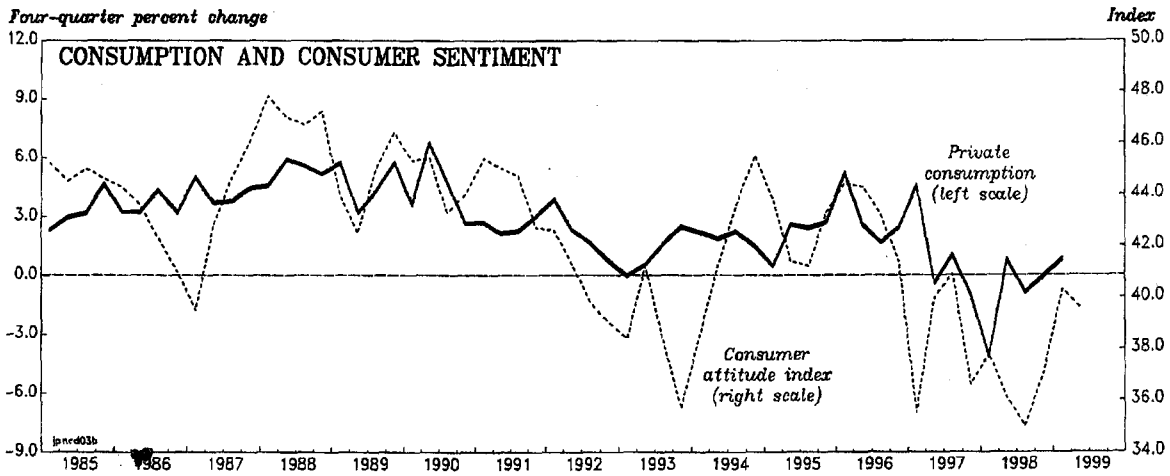
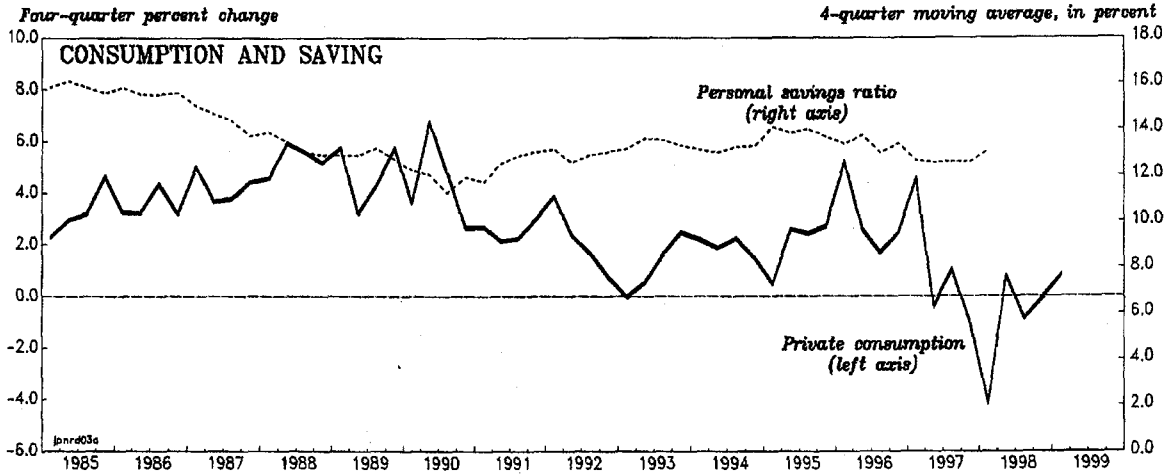
build up debt during the boom years. Figure I.3 indicates that the liabilities of the household sector did not increase substantially in relation to personal disposable income during the latter half of the 1980s, and this ratio has continued to be stable during the nineties.⁴ The ratio of net worth to disposable income did fall significantly between 1990–92. However, to the extent that declines in net worth reflected the declining price of land, the impact on private consumption is likely to have been muted, as favorable price substitution effects are likely to offset the negative wealth effects, particularly in view of the relatively low levels of home ownership in the six largest cities in Japan (about 50 percent). Household direct holdings of equity were relatively low, and the impact of declining equity prices on bank balance sheets and the true value of pension and insurance funds was probably not fully perceived because of weak accounting standards. That is, the interaction between wealth effects and personal indebtedness which proved to be an important driving force of the instability in private consumption in a number of countries that experienced a boom-bust cycle in asset prices appears to have been much less of a negative force in the case of Japan.

8. **The increase in the consumption tax was a proximate cause of the decline in private consumption in the second quarter of 1997, but the continued declines in private consumption thereafter reflected the effects of financial distress and uncertainties about job prospects.** The increase in the consumption tax in April 1997 had been pre-announced, and the 5 percent decline in private consumption in the second quarter of 1997 reflected a significant degree of intertemporal substitution. For instance, private consumption expenditure increased by 3½ and 1½ percent in the preceding and subsequent quarters respectively. The declines in private consumption in the fourth quarter of 1997, and again through most of 1998 overlaps with a period of financial instability set in motion by the failure of some major banks and securities houses. The sharp increase in unemployment and the decline in wage earnings in 1998 (discussed below) engendered a climate of uncertainty about job prospects and also contributed to the cutting back of private consumption expenditure during this period.

9. **The rebound in consumption in early 1999 may have reflected receding concerns about financial system instability following the commitment of public funds.** However, it is too early to judge whether the recent increase in private consumption marks an effective break from previous trends. The continuing uncertainties about job prospects as corporate restructuring proceeds and the recent declines in earnings suggest that private consumption is likely to remain muted for a while to come.

⁴The household debt ratio in Japan increased by about 25 percent during 1985–90. By contrast, the household debt ratio in Sweden—which had experienced an asset price boom broadly comparable to that of Japan during the latter half of the eighties—increased by about 40 percent over this period.

FIGURE 1.3
JAPAN
TRENDS IN PRIVATE CONSUMPTION



Sources: Nikkei Telecom; WEFA; and staff estimates.

Business Investment

10. **The recent decline in business investment has been more precipitous than during any other episode in Japan's post-war history.** Business investment declined for 6 consecutive quarters before being interrupted by positive growth in the first quarter of 1999. Even with the recent increase, business investment declined by almost 20 percent between the first quarter of 1997 and the first quarter of 1999 (Figure I.4).

11. **The recent weakness of business investment has continued a trend decline in the rate of business investment in the 1990s,** which in turn was driven by the effects of the unwinding of the capital stock overhang, the impact of the debt burden, and the collapse of equity prices. The share of business investment in GDP fell from a high of about 20 percent in 1990 to about 16 percent in 1998, as the expectations of high growth that had fueled the rapid build up of capacity in the latter half of the 1980s were revised down persistently during the 1990s. Many of the large firms that had earlier tapped into the buoyant equity market to finance their investments faced a drastic reduction in access to relatively cheap sources of funding when equity prices collapsed. The burden of high debt also impeded the capacity of many firms to undertake new investments, and the banking crisis in 1997-98 exacerbated these problems⁵.

12. **The recent slump in business investment also reflected the effects of tighter credit conditions on the capital expenditures of small and medium sized enterprises (SMEs).** While business investment declined across the board during 1997-98 in response to declining profitability and balance sheet fragilities, SMEs have borne the bulk of the credit crunch accompanying the banking crisis during this period. The authorities responded to the credit crunch facing small enterprises in October 1998 by allocating ¥ 20 trillion for guaranteeing the credit extended to small and medium-sized enterprises by financial institutions. The positive growth of business investment in the first quarter of 1999 seems to have reflected largely the capital expenditures undertaken by small and medium sized enterprises following their easier access to credit. Many large enterprises are, however, still in the process of dismantling excess capacity as part of the efforts to restructure the corporate sector, and recent monthly data on capital equipment orders and surveys of the capital expenditure plans of businesses indicate that investment is likely to decline in the months ahead.

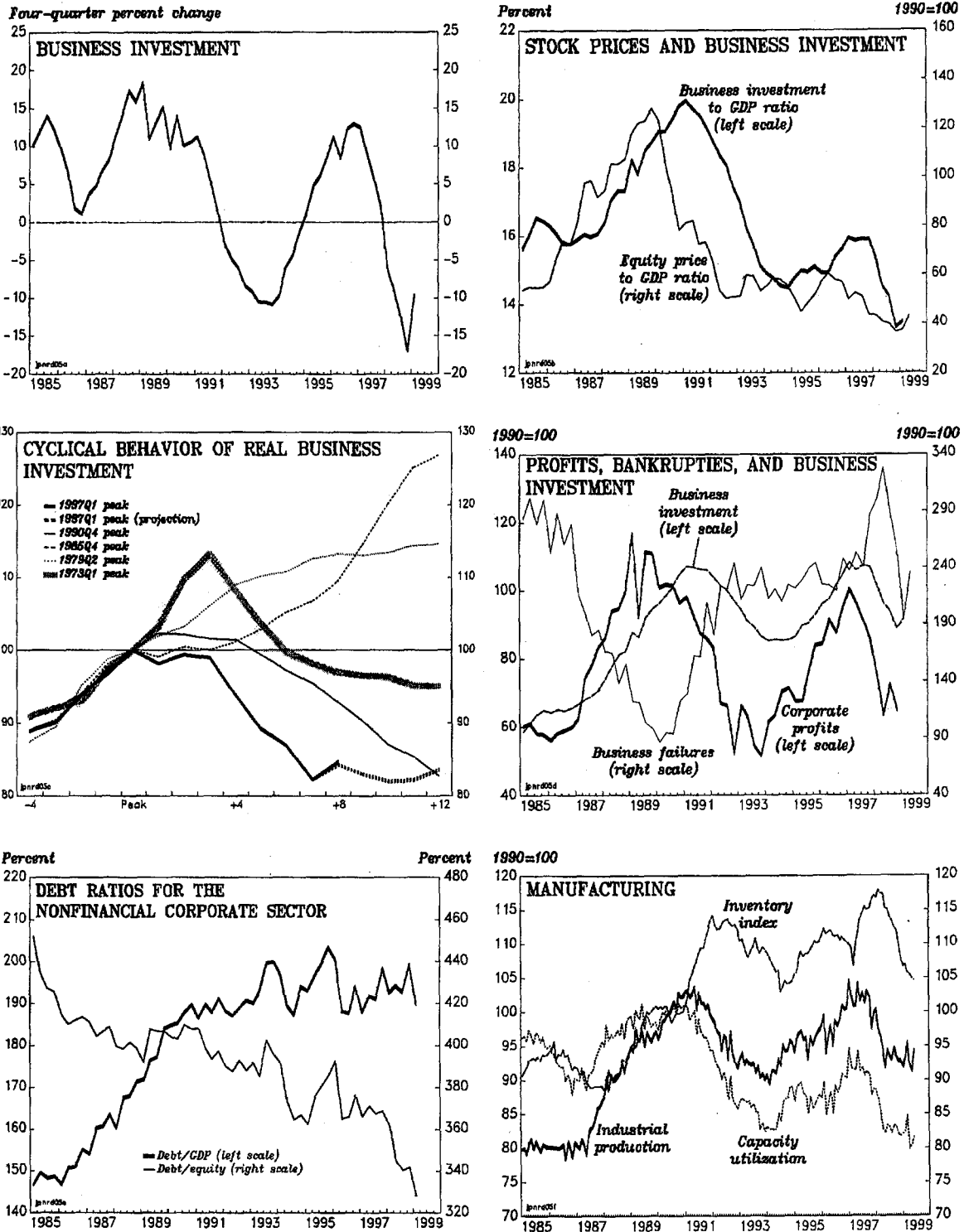
Residential Investment

13. **The decline in residential investment in recent years has been even more severe than the decline in business investment.** By the fourth quarter of 1998, residential

⁵A more detailed discussion of the trends in business investment in the 1990s is provided in the *Selected Issues Paper*.

FIGURE I.4
JAPAN

INDICATORS OF BUSINESS ACTIVITY AND INVESTMENT, 1985-99



Sources: Nikkei Telecom; WEFA; and staff estimates.

investment had fallen by about 35 percent from its peak in the fourth quarter of 1996. As in the case of private consumption, the sharp declines in residential investment during 1997–98, despite the decline in long-term yields during this period, were linked to the uncertainties engendered by the fragilities in the financial sector. Moreover, residential land prices have fallen continuously since early 1991, discouraging investment in housing (Figure I.5).

14. **The increase in residential investment by 1¼ percent in the first quarter of 1999** has been in part a response to measures in the budget for fiscal year 1999 to stimulate the housing market—tax credits for housing loans were extended from 6 to 15 years, and the ceiling on loans that could be qualified for tax credits was increased from ¥30 million to ¥50 million. There were also one-off factors driving the first quarter increase in residential investment this year, as housing starts were accelerated to take advantage of low lending rates available through March 1999—and which were expected to increase later in the year. However, housing starts declined in April–May, suggesting that this rebound may not be sustained.

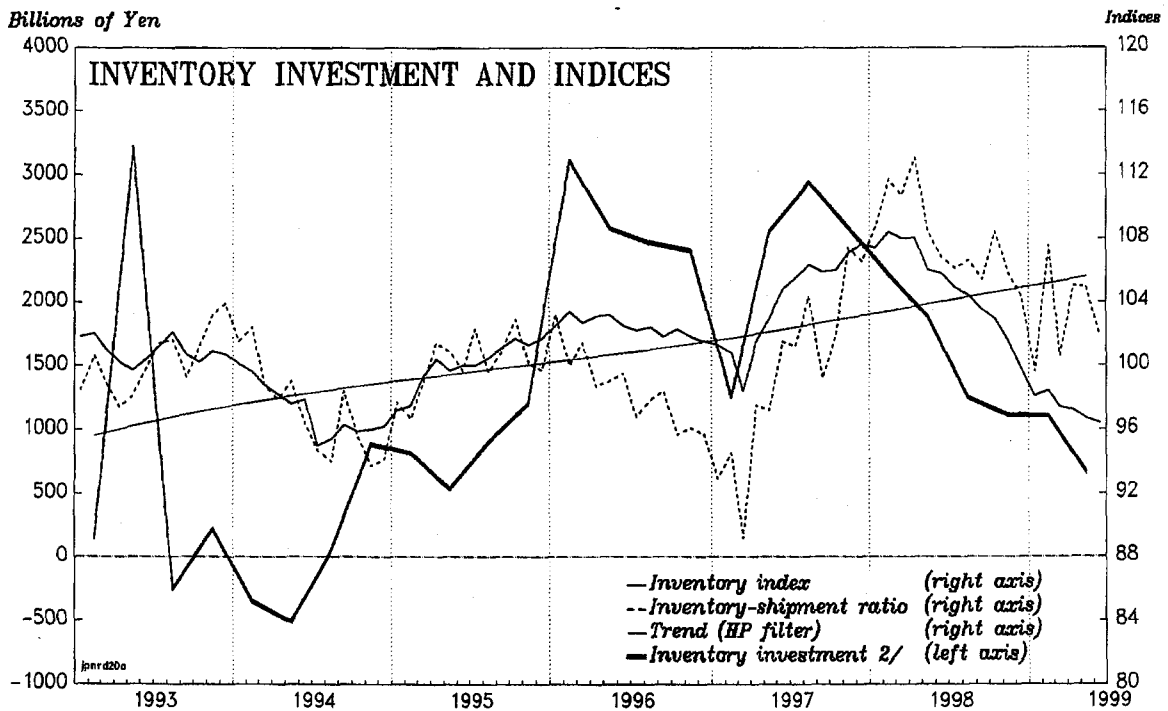
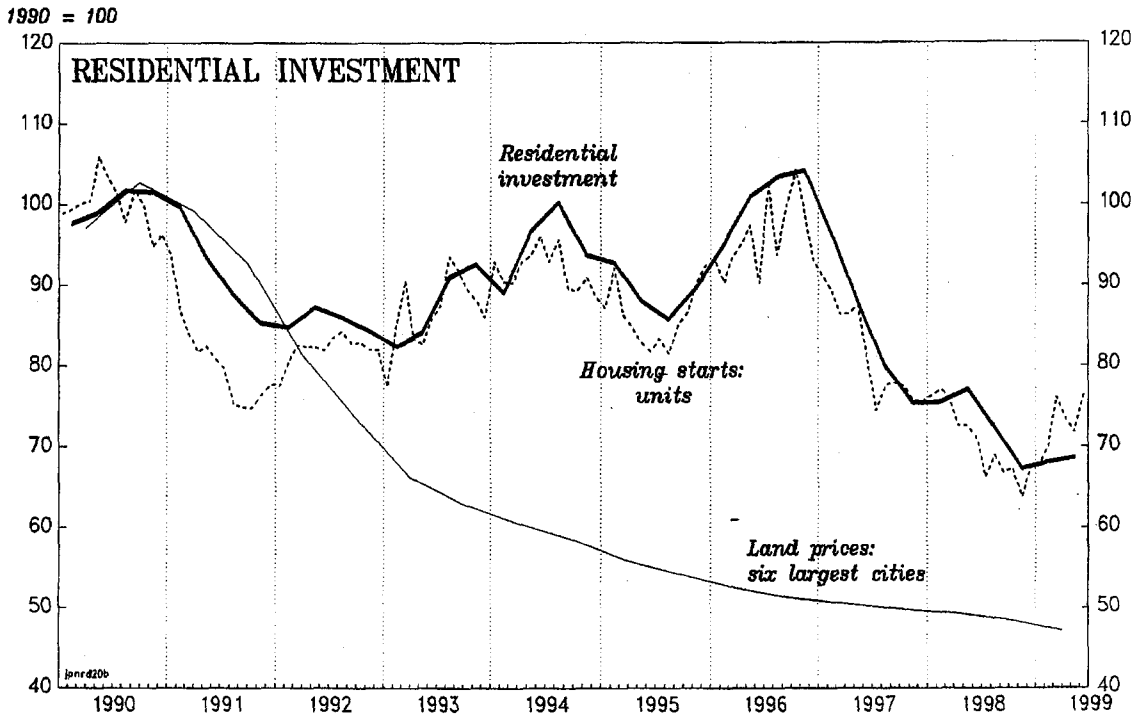
Public Investment

15. **Public investment has been an important ingredient of counter-cyclical fiscal policy in the 1990s, and has provided significant support to activity recently.** As discussed in greater detail in the Selected Issues paper, each of the stimulus packages implemented since 1992 have included increased public works spending as a major component. As the impact of the September 1995 package wore off, however, public works spending turned sharply negative from mid 1996 and continued to decline through 1997, which had the effect of compounding the adverse effects on activity arising from the full-fledged breakout of the financial crisis in late 1997. The authorities responded to the recent weakening of activity by implementing fiscal stimulus packages of ¥16 trillion in April 1998, and ¥23 trillion in November 1998. The combined public works component in these two stimulus package was about ¥16 trillion (about 3 percent of GDP), and public investment has increased sharply by around 20 percent from the third quarter of 1998 to the first quarter of 1999. However, public works spending is likely to drop in the second half of FY1999 once the bulk of the spending associated with the November 1998 fiscal package has fed through, unless additional measures are taken.

Inventories

16. **Destocking has been a source of negative impulse to the economy over the last two years.** After a rapid build up of inventories in 1996—which contributed almost ½ of a percentage point to growth in that year—destocking has proceeded essentially unabated, with inventories contributing negatively to growth for five consecutive quarters, before turning flat in the first quarter of 1999. As a result, the inventory-shipment ratio has now fallen below trend, suggesting that the down-phase of the inventory cycle may be coming close to having run its course (Figure I.5).

FIGURE I.5
JAPAN
RESIDENTIAL INVESTMENT AND INVENTORY INVESTMENT



Sources: Nikkei Telecom; and staff estimates.

The External Sector

17. **The external sector's contribution to growth has turned negative following the sharp appreciation of the yen in the second half of 1998.** Despite the crisis in Asia, the external sector contributed about 1½ percentage points to growth in 1997, given the combination of a weak exchange rate and shrinking domestic demand (Figure I.6). The external sector continued to provide support to the economy through the third quarter of 1998, as the exchange rate continued to weaken, reaching a trough of ¥145/\$ in August. Over this period, the impact of the downturn in Asia was offset to some extent by continued strength of demand elsewhere, particularly in North America.

18. As the global financial turbulence in this period resulted in an abrupt unwinding of the yen-carry-trade positions that had been building up for some time, the exchange value of the yen appreciated sharply, reaching about ¥110/\$ in early January of this year. Following the easing of monetary policy and exchange market intervention, the yen has subsequently moved into a trading range of about ¥118–122/\$ in recent months. Thus, the external sector's contribution to growth in the first quarter of 1999 was negative 0.4 percentage points, as imports registered the first increase in eight quarters and exports continued to fall.

C. Labor Market and Price Developments

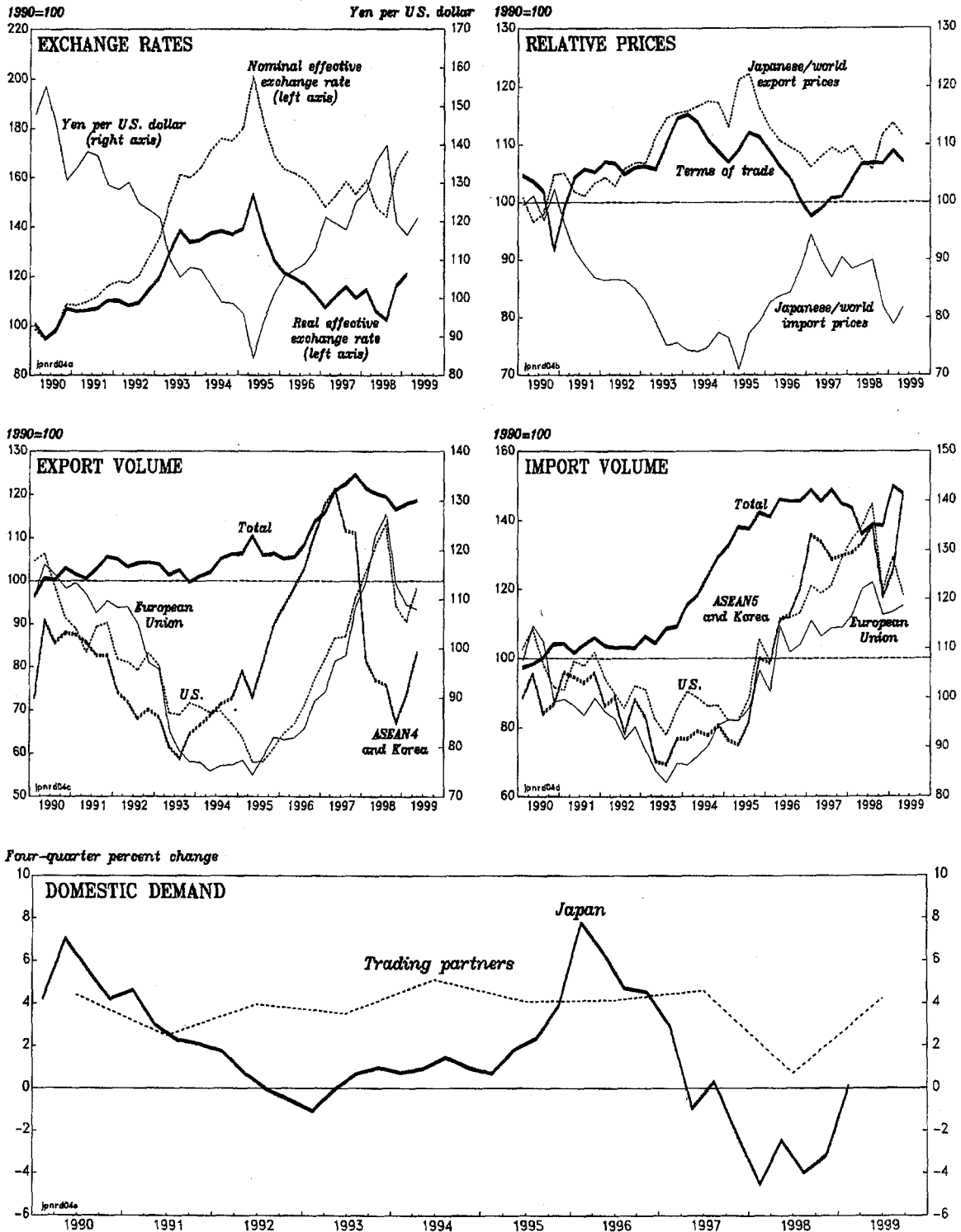
The Labor Market

19. **Despite the significant slowing of the Japanese economy in the 1990s, unemployment remained low until last year, when it rose sharply.** The average rate of unemployment between 1991–97 was less than 3 percent, just slightly higher than the average unemployment rate during the boom years of the 1980s. However, unemployment started to rise sharply from early 1998 onwards, reaching a high of 4.8 percent in April 1999. Two questions arise naturally in this context. Why did unemployment remain low until last year? Why has it risen sharply recently?

20. **The main reason for the low rates of unemployment between 1991–97 appears to be rooted in the reluctance of many firms to give up on life time-employment practices despite declining sales and profitability.** As the state of the economy worsened with the banking crisis coming to a head in 1998, the need to change existing labor market practices began to be perceived, with large firms, which have been the main practitioners of life time-employment practices, shedding labor sharply in recent months (Figure I.7).⁶ The decline in the growth of the labor force also offers a partial explanation for the low rates of unemployment through much of the 1990s; however, the magnitude of the decline in the growth of the labor force—from an average of about 1.2 percent in the 1980s to about

⁶The accompanying *Selected Issues* Paper provides a more detailed discussion of corporate restructuring.

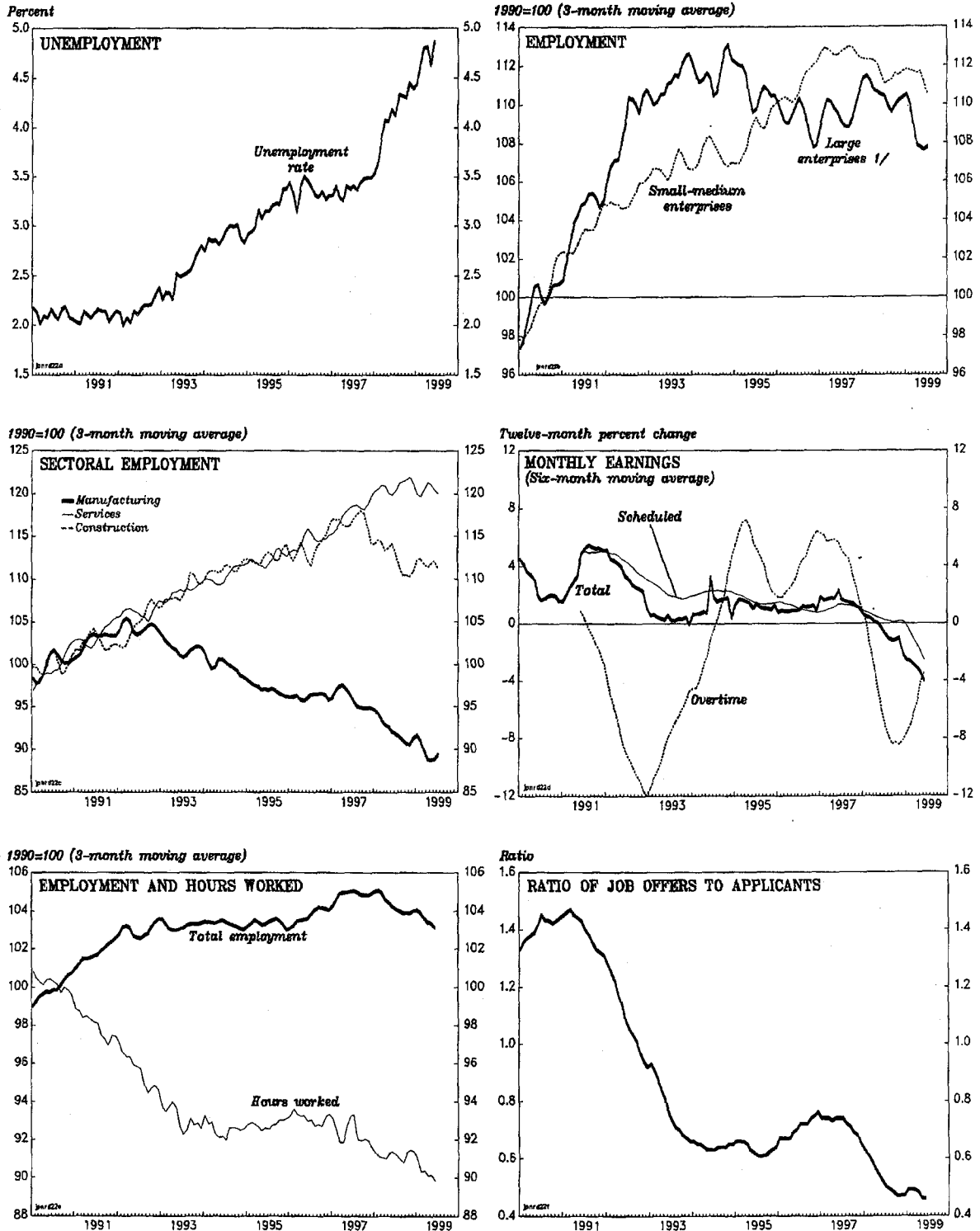
FIGURE 1.6
JAPAN
EXTERNAL SECTOR DEVELOPMENTS, 1990-99



Sources: Nikkei Telecom; WEFA; and staff estimates.

FIGURE 1.7
JAPAN

LABOR MARKET CONDITIONS, 1990-99 1/



Source: Nikkei Telecom and WEFA.

1/ Seasonally adjusted data.

0.9 percent in the 1990s—is small when viewed in relation to the magnitude of the slowdown in output growth.

21. **Employment trends suggest that the labor market is currently in a more severe state than is indicated by the recent increase in the unemployment rate.** Employment declined by about 1¼ percent in the year to the first quarter of 1999, but the rise in unemployment in this period was capped to some extent by discouraged workers moving out of the labor force. The manufacturing sector has incurred the largest job losses recently, with employment in May 1999 being about 5 percent below that in January 1998. Employment in construction also declined in this period, though not as steeply as in manufacturing. Employment in services, in contrast, has been broadly stable since early 1998; but the stability of the overall figure masks structural shifts within the service sector (Figure I.7). There has also been a sharp increase in the proportion of part time employment in recent years, reflecting perhaps the nature of the new jobs being created in the service sector.

22. **Along with the rise in unemployment, there is emerging evidence of potential mismatches in the labor market.** For instance, while the ratio of job offers to job seekers has declined sharply from 0.68 in early 1998 to a record low of 0.46 in May 1999, the ratio of job offers in new activities to job seekers has been broadly stable during this period, indicating that employers in certain types of activities may be finding it difficult to recruit suitably qualified workers.

23. **The deteriorating labor market situation has taken its toll on earnings.** Earnings grew on average by about 1¾ percent during 1991–97, and decelerated modestly to about 1¼ percent on a year-on-year basis in 1998. However, the average growth of earnings in 1998 masks the considerable deterioration that has occurred recently, as earnings declined by 2¼ percent in the year to the fourth quarter of 1998, and by 3¾ percent in the first quarter of this year. The recent declines in earnings have been accounted for mainly by steep declines in overtime pay and bonuses (Figure I.7).

24. **The authorities have recently proposed a number of measures to alleviate strains in the labor market.** These measures include support for companies that take on new employees, the provision of training to deal with mismatches in the labor market, and efforts by the public sector to take on more employees, particularly in the fields of health and vocational training. While these measures should be useful in ameliorating conditions in the labor market to some extent, accelerated restructuring will inevitably create further strains in the labor market. Dealing with these problems would require further reforms to encourage labor mobility—for example tax changes to make pensions more portable and eliminations of restrictions on temporary employment—and steps to strengthen the social safety net—including allowing benefits to be drawn over longer periods, which would help in alleviating the social costs associated with restructuring.

Prices

25. **Consumer price inflation fell sharply in the immediate aftermath of the collapse of the asset price bubble, but has remained broadly flat thereafter.** Consumer price inflation fell from about 3¼ percent in 1991 to under 1 percent in 1994, and has been on average under 1 percent during the period 1992–98. Underlying inflation, which excludes the prices of perishable food and energy from the CPI, has broadly tracked the trends in overall CPI (Figure I.8). During the year after the sales tax hike in April 1997, the 12-month changes in the CPI (and to some extent the WPI) were distorted. However, price declines intensified once this one-off effect dropped out in early 1998. The wholesale price index plummeted by 4 percent in the year to the first quarter of 1999, after having fallen by about 3½ percent in the previous quarter. However, the recent sharp declines in the WPI appear to be largely on account of falling import prices, and the domestic WPI fell by about 2 percent in the year to the first quarter of 1999, not much different from the declines that took place during 1998. Both the CPI and the underlying CPI have been essentially unchanged on a 12-month basis in April 1999.

26. **The absence of stronger deflationary pressures in Japan is a puzzle that is yet to be fully resolved.** The rigidity of nominal wages provides a partial answer, though a less convincing one for recent months, given the recent decline in overall earnings. Product market rigidities, particularly in the services sector, also provide a partial explanation for why prices have not fallen more sharply recently. It is notable that private service sector prices have continued to rise even as product prices have fallen over the past year. Sticky inflation expectations have probably been a factor, with surveys of price expectations continuing to show positive inflation expectations despite the fact that prices have been falling.

27. **It should be recognized that measurement biases in calculating the CPI imply that even consumer prices in Japan have been falling in recent years.** A number of recent studies indicate that the consumer price index may be overstating inflation in many countries.⁷ This upward bias arises because the methodology for calculating the CPI does not adequately capture shifts in the pattern of spending by consumers when relative prices change, and does not fully account for the effects of changes in quality or the introduction of new products on prices. Moreover, consumers in many countries have recently been shifting their purchases away from established retailing channels toward discount stores. Shiratsuka (1999) has estimated that the consumer price index in Japan has been overstating inflation by about 1 percent.⁸ The outlet

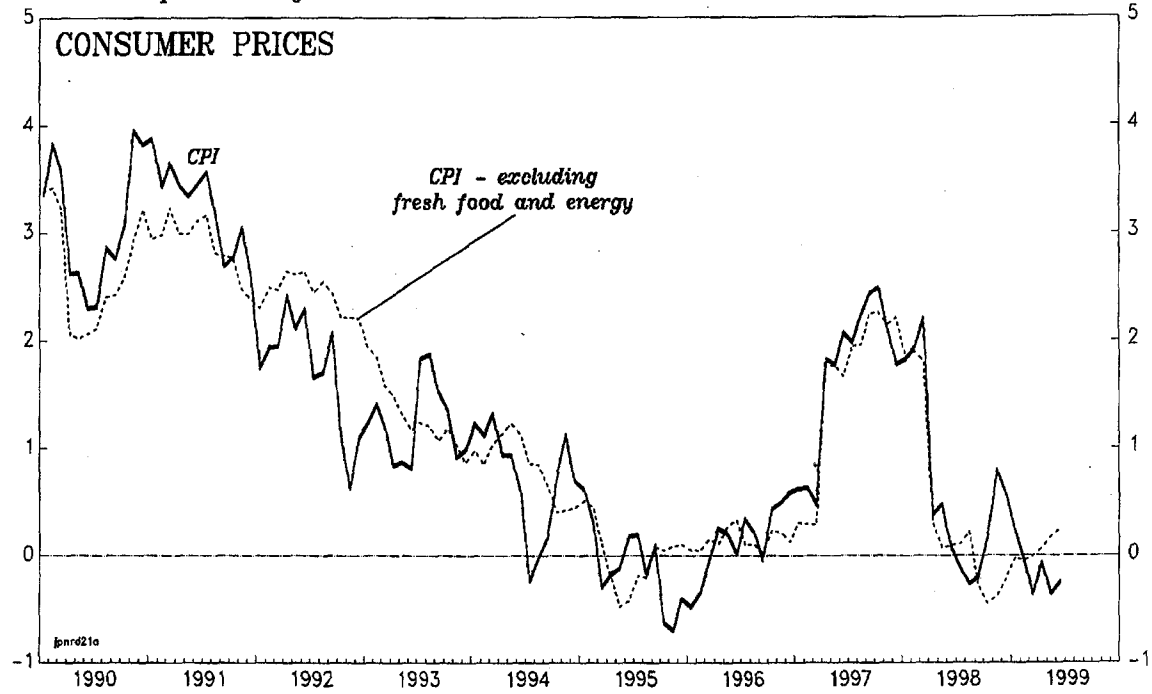
⁷See, for instance, the *World Economic Outlook*, May 1997, for a review of studies on measurement biases in the CPI.

⁸In the case of the United States, for instance, the U.S. Advisory Commission to study the consumer price index estimated that the CPI overstated inflation by 1.1 percent in 1996.

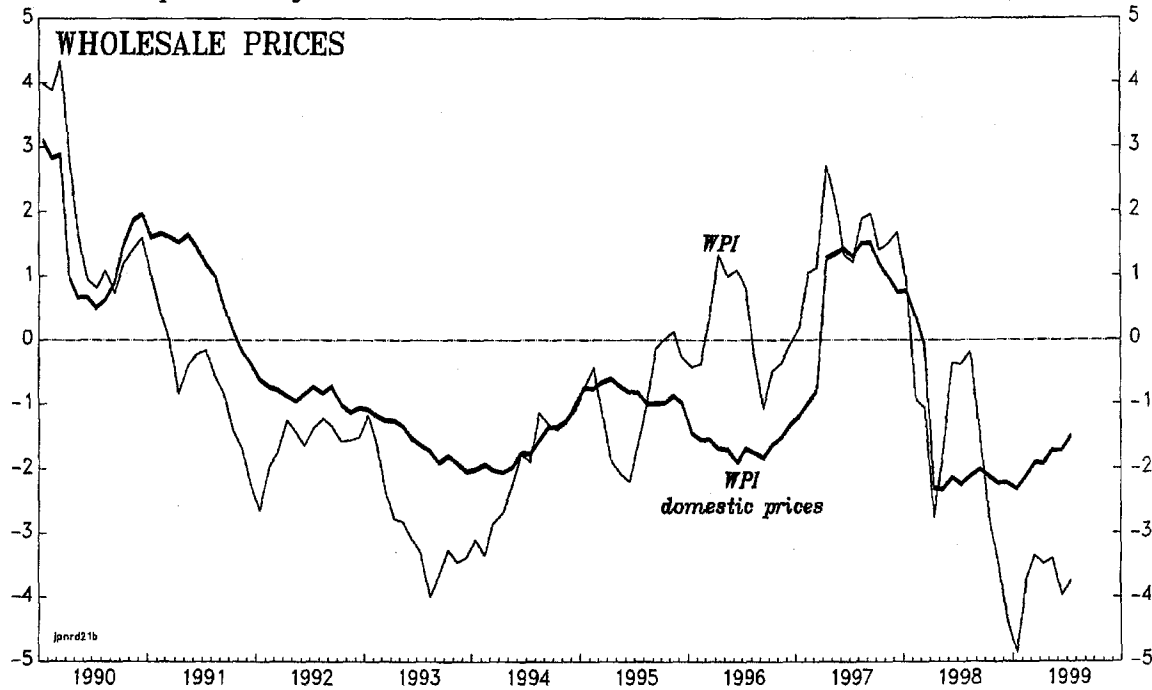
FIGURE 1.8
JAPAN

PRICE INDICATORS, 1990-99 1/

Twelve-month percent change



Twelve-month percent change



Source: Nikkei Telecom and WEFA.

1/ Seasonally adjusted data.

substitution bias, in particular, could be significant in Japan, as the methodology for calculating the CPI does not track purchases at discount stores in suburban areas; it misses special weekend-only sales; and it tracks only designated brands, missing lower prices on competing brands.

D. National Income Accounts

28. **Interpreting economic developments in Japan is rendered more difficult on account of weaknesses in the National Accounts.** There are, for instance, no “quick estimates” for the income side of the national accounts, with data being available only after a lag of about one year. Consequently, making judgements, for instance, about how private consumption will evolve during the latter half of this year is rendered more difficult than it otherwise would be, given that the data on private savings are available only up until the first quarter of 1998 (which is why the private savings ratio in Figure I.3 is truncated at that point). Moreover, the GDP data on some key components of demand, such as the breakdown of private consumption into durables and nondurables, and business investment into structures and equipment are also available only after a long lag. Data on general government activity—outside public investment—is also not available until nine months after the end of the fiscal year. The methodology used to construct quick estimates of the quarterly GDP from the underlying data is not well understood outside of the Economic Planning Agency (EPA).

29. **The EPA has recently taken a number of measures to address some of the shortcomings in the National Accounts.**⁹ Beginning in the first quarter of 1999, the EPA will, for a test period of about one year, release the “flash estimates” (calculated approximately a month after the end of the relevant quarter) together with the preliminary estimates for GDP—released usually about 70 days after the end of the relevant quarter—so that the public can be made aware of the differences in results. The flash estimates themselves will not be made available to the public at the time that they are first calculated during the test period. The EPA has also set up a committee to strengthen other aspects of the National Accounts, such as improving the statistical methodology used in computing the national accounts and enhancing the resources available to the SNA authorities, and has recently made efforts to increase public understanding of the methodology used in compiling the National Accounts.

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⁹See EPA (1999).

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II. FISCAL POLICY DEVELOPMENTS¹

1. **Fiscal policy has been expansionary for most of the past decade.** During the mid-1990s, the general government deficit expanded as public works spending and tax reductions were used to support aggregate demand in the face of an unprecedented economic slowdown. In FY1997, policy was temporarily tightened in response to an apparent recovery in economic activity. However, the withdrawal of stimulus was associated with a renewed slowdown and the policy stance was loosened again in late 1997. Two large stimulus packages in April and November 1998 have subsequently led to a substantial widening of the deficit, although such assessments continue to be hampered by limited fiscal transparency. The initial budget for FY1999 has provided further stimulus to the economy and the general government deficit excluding social security is expected to reach close to 10 percent of GDP.

2. **The expansionary policy stance has put increasing strains on public finances.** Concerns have been raised about the sustainability of fiscal policy as the net debt of the general government (excluding social security) is set to approach 90 percent of GDP by the end of FY1999. Current strains are most evident in the difficult financial situation of local governments that increasingly hampers the implementation of fiscal stimulus measures—the bulk of which (although planned at the national level) are carried out by local authorities—and has led to higher funding demands on the Fiscal Investment and Loan Program (FILP). Faced by increasing loan requests and a prospective weakening in its deposit base, the Ministry of Finance's Trust Fund Bureau (the administrator of the FILP) announced a partial withdrawal from markets for Japanese government bonds, which has contributed to an increase in long-term yields since late 1998.

3. **These issues will be discussed in greater detail in this chapter.** The following sections focus on: (i) recent stimulus policies; (ii) the financial situation of local governments; (iii) the interaction between FILP operations and government bond markets; and (iv) fiscal transparency.

A. Recent Stimulus Policies²

4. **The general government's fiscal deficit expanded sharply during the early-1990s.** As growth slowed at the beginning of the decade, cyclical factors, a sharp decline in tax elasticity, and a series of stimulus packages together shifted the general government's fiscal position (excluding social security) from balance in FY1990 to a 6½ percent of GDP deficit in FY1996. The general government's structural deficit—a measure that excludes cyclical factors—increased from 1 percent of GDP to 7 percent of GDP over the same period, and net

¹Prepared by Martin Mühleisen (ext. 38686).

²The paper by Mühleisen in the accompanying *Selected Issues* paper examines the impact of stimulus packages in more detail.

general government debt (excluding social security) grew by half to 60 percent of GDP (Figure II.1).

5. **The government's main policy tools were a series of large mid-year stimulus programs** (Table II.1). These packages sought to stimulate economic activity through a variety of measures across all layers of the public sector. Their most important elements have been public works spending and tax cuts financed by general government bond issues (so-called "real water" measures) but the packages have also included other elements, such as financial support and asset transactions:³

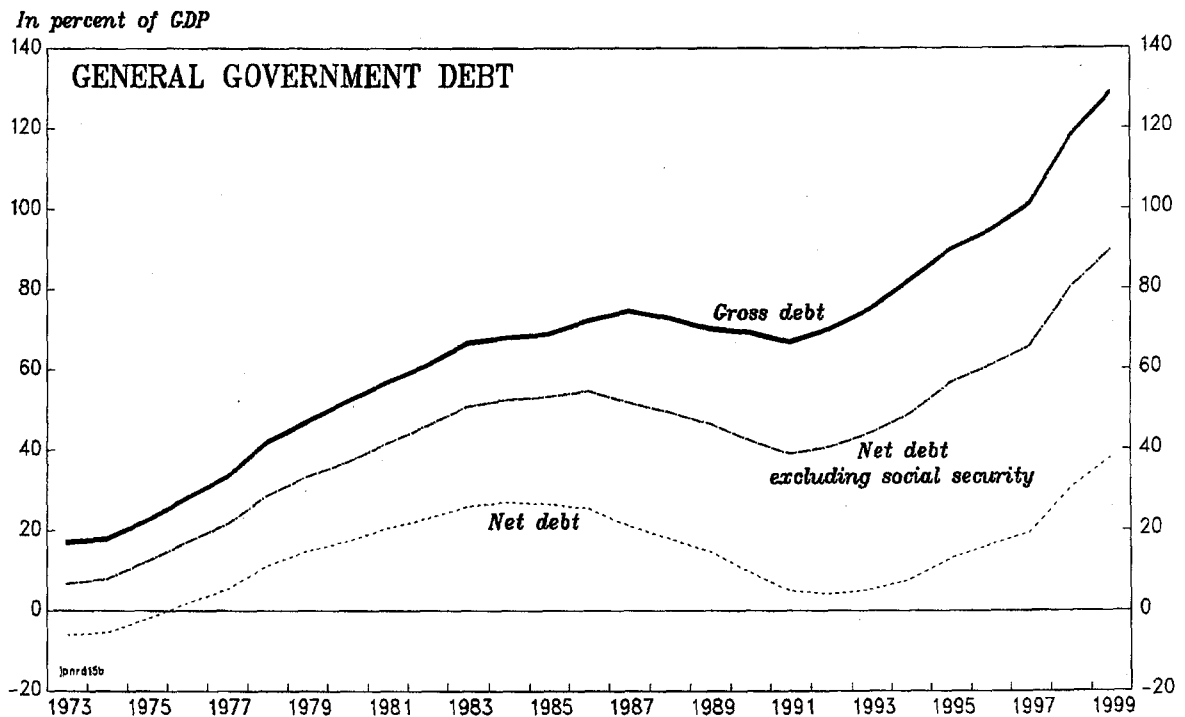
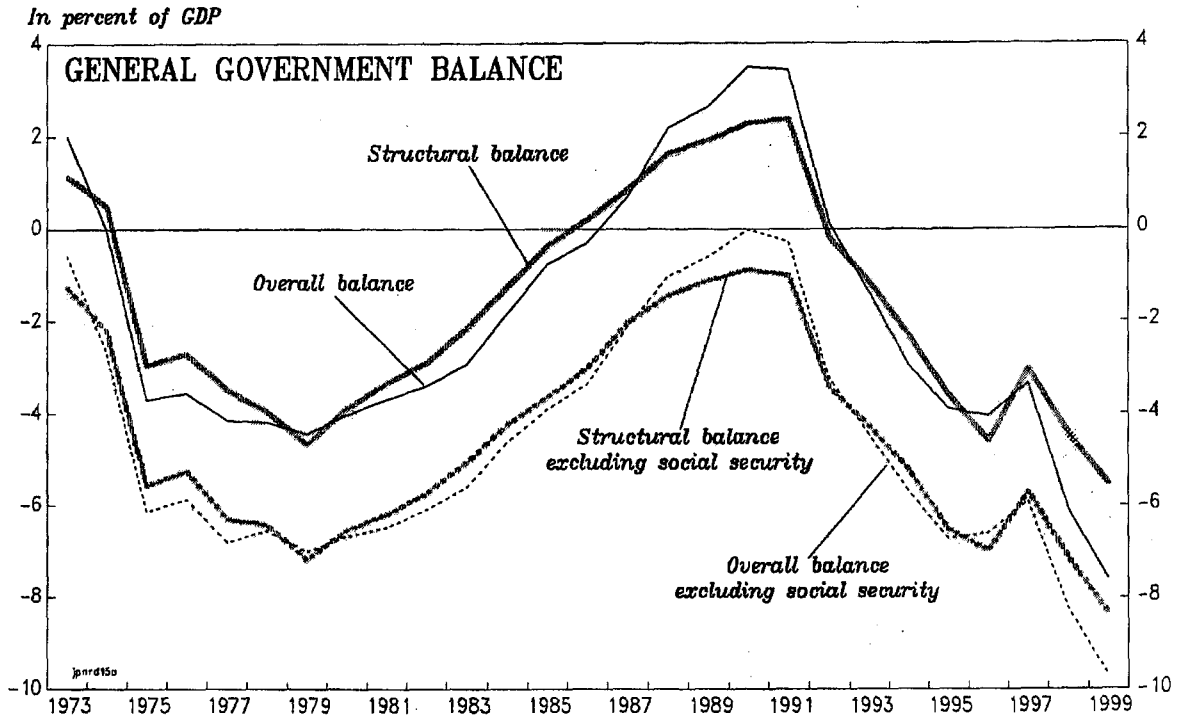
- Public works (consisting mainly of infrastructure-related construction projects) have been a central constituent of stimulus packages, given the swift impact of a rise in public orders on employment and incomes in the construction sector.⁴ Total public works projects included in the stimulus packages cumulated to about 7 percent of GDP between 1990 and 1996. Many of these measures served to maintain rather than increase investment levels, but the share of public investment in GDP still rose from 6½ percent to above 8 percent over this period.
- The rising budget deficit also reflected a drop in tax revenue, particularly in the immediate post-bubble years. The revenue losses were partly caused by a series of tax cuts since 1994, including an upward shift in income tax brackets in 1994 and several (often temporary) income tax cuts in subsequent years. The strongest revenue impact, however, originated from a sharp decline in tax elasticity between 1991 and 1994 that appears to be related to income and wealth losses in the aftermath of the bubble years.

6. **As growth picked up in 1997, concerns over the deteriorating position of public finances prompted a tightening of fiscal policies.** Public investment fell sharply as the effect of previous packages wore off, and tax revenue strengthened as a consequence of an earlier planned increase in the consumption tax rate from 3 to 5 percent in April 1997 and a phase-out of temporary income tax cuts. Moreover, the Diet passed the Fiscal Structural Reform Act (FSRA) that committed the government to lowering the general government deficit (excluding social security) to 3 percent of GDP by the end of FY2003. Prospects of a continued tight fiscal policy, however, together with the immediate dampening effect of the consumption tax increase contributed to the subsequent decline in activity.

³For example, the packages included loan commitments by government financial institutions (GFIs), especially for small and medium-sized enterprises, public loan guarantees, employment measures, and projects for other public sector agencies. These have largely been implemented through the FILP without requiring additional general government funds.

⁴Japan's construction sector accounts for 10 percent of total employment, compared to an average of 6–7 percent in other major industrial countries.

FIGURE II.1
JAPAN
GENERAL GOVERNMENT FISCAL OPERATIONS, FY1973-99 1/



Sources: Ministry of Finance; Economic Planning Agency; and staff estimates and projections.

1/ The fiscal year is from April to March.

Table II.1. Japan: Summary of Economic Stimulus Packages, 1993–98

(In trillions of yen, unless otherwise indicated)

Date Proposed	1993		1994	1995	1998	
	April	September	February	September	April	November
Total package (In percent of GDP)	13.2 (2.8)	6.2 (1.3)	15.3 (3.2)	14.2 (3.0)	16.7 (3.3)	23.9 (4.8)
Tax reductions (In percent of GDP)	0.2 (0.0)	0.0 (0.0)	5.9 (1.2)	0.0 (0.0)	4.6 1/ (0.9)	6.0 2/ (1.2)
Public investment 3/ (In percent of GDP)	7.6 (1.6)	2.0 (0.4)	4.5 (0.9)	6.5 (1.4)	7.7 (1.5)	8.1 (1.6)
Land purchases 4/ (In percent of GDP)	1.2 (0.3)	0.3 (0.1)	2.0 (0.4)	3.2 (0.7)	1.6 (0.3)	... ...
Increased lending by Housing Loan Corporation 5/ (In percent of GDP)	1.8 (0.4)	2.9 (0.6)	1.2 (0.3)	0.5 (0.1)	0.0 (0.0)	1.2 (0.2)
Increased lending by government-affiliated financial institutions (In percent of GDP)	2.4 (0.5)	1.0 (0.2)	1.5 (0.3)	2.6 6/ (0.5)	2.0 (0.4)	6.9 (1.4)
Other (In percent of GDP)	0.0 (0.0)	0.0 (0.0)	0.2 (0.0)	2.6 (0.5)	0.8 (0.2)	1.7 (0.3)

Sources: Data provided by the Japanese authorities; and staff estimates.

1/ Includes ¥0.3 trillion in welfare benefits.

2/ Later increased to ¥9.3 trillion (1.9 percent of GDP).

3/ Public investment comprises general public works (including land purchases), disaster reconstruction, buildings and equipment, and independent public works projects by local government.

4/ Excludes land acquisition for public works projects, which is included in public works spending.

5/ Includes loans by the Pension Welfare Service Public Corporation.

6/ Includes ¥1.3 trillion in lending by the Japan Corporation for small business.

The 1998 measures

7. **With the economy unexpectedly entering into recession in 1997, the government came under renewed pressure to stimulate activity through fiscal measures.** The authorities announced some ¥3½ trillion in income tax rebates and other tax cuts in December 1997 (including a 3 percentage point reduction in the corporate tax rate to 46 percent), although the initial budget for FY1998 was still mildly contractionary. However, as the economy continued to deteriorate, two massive stimulus programs with a combined “headline” figure of ¥40 trillion (8 percent of GDP, see Table II.1) were compiled in the course of 1998, aiming at returning the economy to positive growth in 1999.

8. **In April 1998, a ¥16.7 trillion stimulus package was announced immediately after the passage of the FY1998 initial budget,** including ¥12 trillion (2½ percent of GDP) in “real water” measures. The measures included:

- *Additional public works spending of ¥7.7 trillion, including ¥1.5 trillion in public works autonomously financed by local governments.*
- *Temporary income tax cuts of ¥4.3 trillion.*
- *¥4.7 trillion in additional measures, including ¥2.3 trillion in spending to support the real estate market (largely earmarked for land acquisition) and ¥2 trillion in additional lending to small and medium-sized enterprises through the FILP.*

9. **A second stimulus package was compiled in November 1998 in conjunction with preparations for the 1999 budget.** The headline figure was ¥23.9 trillion, with about ¥15 trillion (3 percent of GDP) in “real water” measures, making it the largest-ever such package. The components included:

- *Additional public works spending of ¥8.1 trillion, largely focused on urban projects such as telecommunications (all fully or partly financed by the central government).*
- *A commitment to cut income tax rates by the equivalent of ¥6 trillion in FY1999.*
- *Job creation measures worth ¥1 trillion, including subsidies for employment creation and retraining schemes, and an extension of unemployment benefits.*
- *Spending vouchers of ¥700 billion distributed to families with children and the elderly.*
- *Additional measures to ease bank lending constraints worth ¥5.9 trillion, including increased funding for government financial institutions.*
- *Support for the rest of Asia of ¥1 trillion as part of the previously announced Miyazawa initiative.*

10. **At the same time, the FSRA was suspended, pending a sustained recovery of the economy.** The strict timetable for consolidation contained in the FSRA had already been loosened in the face of economic weakness. In April 1998, the deadline for achieving medium-term consolidation targets was moved from FY2003 to FY2005, and the FSRA law was also amended to allow limits on government debt issues to be waived in times of weak economic

growth (as defined by several possible criteria, including annualized real GDP growth being lower than 1 percent for two consecutive quarters).

11. **The central government's share of the 1998 stimulus packages was incorporated in two supplementary budgets for FY1998.** Total central government spending on stimulus measures amounted to ¥13½ trillion, of which ¥1 trillion was offset by savings elsewhere. With tax revenues falling short of initial budget targets by almost ¥6 trillion (net of local allocation tax payments to local governments), the revised bond issue for FY1998 amounted to ¥34 trillion (6.8 percent of GDP), compared to an initial plan of ¥15½ trillion (Tables II.2 and II.3).

12. **Measures to restore the banking system and boost credit supply have received indirect budget support.** A separate supplementary budget, passed in October 1998, authorized bond issues and public guarantees worth ¥60 trillion (12 percent of GDP) for resolving problems in the domestic banking system (see Chapter IV). Government outlays only occur, however, at the time such guarantees are being invoked, e.g., in the case of financial losses experienced by the Deposit Insurance Corporation.⁵ The government also authorized ¥20 trillion in additional loan guarantees extended by regional credit-guarantee associations, aimed largely at alleviating credit constraints for small and medium-sized enterprises (SMEs), which has since been lauded for bringing about a strong turnaround in SME activity. The government has agreed to cover any losses arising from the guarantees, which are currently anticipated at around ¥1 trillion.

The FY1999 budget

13. **For the 1999 budget, the authorities announced tax reductions that went somewhat beyond the income tax cuts announced in the stimulus packages.** The final tax package featured ¥9 trillion in tax reductions, of which ¥7 trillion (1.4 percent of GDP) were to become effective in FY1999. The impact of the remaining ¥2 trillion (largely related to more generous tax treatment of mortgage payments) will be spread over a period of 15 years. In addition to the personal and corporate income tax cuts included in the stimulus packages, further measures were intended to promote residential and corporate investment. The authorities also announced that they would consider shifting corporate taxation to a consolidated basis:

- The personal income tax cuts consisted of a permanent reduction in the top marginal tax rate (central plus local) from 65 percent to 50 percent, and a reduction of tax liabilities of close to 20 percent across the board. These measures implied ¥4 trillion in income tax relief, effectively replacing the expiring temporary rebates of FY1998.

⁵The supplementary budgets for FY1998 contained a provision of ¥1 trillion to cover losses from earlier bank failures, and the FY1999 initial budget provided ¥2½ trillion to account for losses related to the nationalization of the LTCB and the Nippon Credit Bank.

Table II.2. Japan: Tax Receipts of the Central Government General Account, FY1994-99

	1994	1995	1996	1997			1998		1999
		Settlement		Initial	Revised	Settlement	Initial	Revised	Initial
(In billions of yen, fiscal years)									
Individual income tax	20,418	19,515	18,965	20,882	19,530	19,183	20,555	17,173	15,685
Corporate income tax	12,363	13,735	14,483	14,432	14,758	13,475	15,274	11,720	10,428
Taxes on goods and services	11,218	11,372	11,750	15,522	15,378	14,810	16,514	15,761	15,899
<i>Of which</i>									
Consumption tax	(5,632)	(5,790)	(6,057)	(9,813)	(9,669)	(9,305)	(10,818)	(10,204)	(10,376)
Liquor tax	(2,113)	(2,061)	(2,071)	(2,063)	(2,063)	(1,982)	(2,058)	(1,929)	(1,981)
Gasoline tax	(1,813)	(1,865)	(1,915)	(1,956)	(1,956)	(1,926)	(1,996)	(1,996)	(2,045)
Tobacco tax	(1,040)	(1,042)	(1,080)	(1,062)	(1,062)	(1,018)	(1,020)	(1,040)	(896)
Custom duties	908	950	1,024	1,093	956	953	947	822	785
Stamp revenue	1,752	1,941	1,969	2,019	1,816	1,681	1,824	1,562	1,521
Other	4,371	4,418	3,869	3,854	3,788	3,840	3,408	3,127	2,801
Total tax and stamp revenue	51,030	51,391	52,060	57,802	56,226	53,942	58,522	50,165	47,119
(Percentage change) 1/									
Individual income tax	-13.8	-4.4	-2.8	10.1	3.0	1.1	7.2	-10.5	-8.7
Corporate income tax	1.9	11.1	5.4	0.4	1.9	-7.0	13.4	-13.0	-11.0
Taxes on goods and service	4.1	1.4	3.3	32.1	30.9	26.0	11.5	0.6	0.9
Total tax and stamp revenue	-5.7	1.8	0.2	11.0	8.0	3.6	8.5	-7.0	-6.1

Source: Data provided by the Japanese authorities.

1/ Percentage changes calculated relative to most recent data of previous year.

Table II.3. Japan: Central Government General Account Budget, FY1994-99

(In billions of yen, fiscal years)

	1994	1995	1996	1997			1998		1999
		Settlement		Initial	Revised	Settlement	Initial	Revised	Initial
Expenditures	73,614	75,939	78,848	77,390	78,533	78,470	77,669	87,991	81,860
Social security	13,603	14,543	15,032	14,550	15,460	15,385	14,843	16,008	16,095
Public works	13,208	12,795	12,340	9,745	10,525	11,067	8,985	14,855	9,431
Defense	4,638	4,720	4,815	4,948	4,954	4,950	4,940	4,960	4,932
Official aid	985	1,034	1,061	1,091	1,094	1,083	980	1,114	988
Foodstuff control	261	269	308	269	308	306	269	268	269
Transfer to the special account for industrial investment, etc.	163	1,241	161	172	172	165	160	160	160
National debt service 1/	13,422	12,820	16,084	16,802	16,268	15,926	17,263	18,150	19,832
<i>Of which:</i>									
Interest payments	(10,706)	(10,708)	(10,725)	(11,682)	(10,918)	(10,600)	(11,589)	(11,219)	(11,368)
Transfer of local allocation tax to local government	12,069	12,302	13,945	15,481	15,481	15,481	15,870	14,305	13,523
Revenues	57,220	56,585	55,442	60,665	59,464	58,751	62,111	53,991	50,810
Taxes and stamp duties	51,030	51,931	52,060	57,802	56,226	53,941	58,522	50,165	47,119
Miscellaneous	6,190	4,654	3,382	2,863	3,238	4,810	3,589	3,826	3,691
Deficit	16,393	19,354	23,406	16,725	19,069	19,719	15,558	34,000	31,050
Financing	16,393	19,354	23,406	16,725	19,069	19,719	15,558	34,001	31,050
Bond issues	16,490	21,247	21,748	16,707	18,458	18,458	15,557	34,000	31,050
Deficit-financing bonds	4,144	4,807	11,041	7,470	8,518	8,518	7,130	16,950	21,710
Construction bonds	12,346	16,440	10,707	9,237	9,940	9,940	8,427	17,050	9,340
Others									
Carried over surplus	-97	-1,894	1,658	18	611	1,261	1	1	0
Carry in	2,629	2,725	4,619	18	611	2,961	1	1	0
Carry out	-2,725	-4,619	-2,961	0	0	1,700	0	0	0
Memorandum items:					(In percent of GDP)				
Expenditures	15.4	15.5	15.7	15.0	15.5	15.5	14.9	17.8	16.5
Revenues	11.9	11.6	11.0	11.8	11.8	12.2	12.0	10.9	10.2
Deficit	3.4	4.0	4.7	3.2	3.8	3.9	3.0	6.9	6.3
Bond financing	3.4	4.3	4.3	3.2	3.6	3.7	3.0	6.9	6.3
Deficit financing bonds	0.9	1.0	2.2	1.4	1.7	1.7	1.4	3.4	4.4
Public works	2.8	2.6	2.5	1.9	2.0	2.0	1.7	3.5	1.9

Source: Data provided by the Japanese authorities.

1/ Includes repayments of principal and running costs.

Compared to FY1998, the tax cut provided some tax relief for higher income brackets, but the effect on average households was marginal.

- The corporate tax rate (central plus local) was reduced from 46 percent to 40 percent, resulting in a net tax relief of ¥2.3 trillion, and there were additional cuts in tax rates on SMEs.
- To promote housing investment, the period for which mortgage holders qualify for tax deductions was extended from six to 15 years (for house purchases taking place in the next two years), and the existing ceiling on the deduction was trebled. However, the rate of deduction was reduced from 2 percent to 1 percent, so the net impact provided for only moderately relief.
- To enhance the attractiveness of Japanese financial markets, the repeal of the securities transactions tax was advanced from December 1999 to April 1999, withholding taxes were suspended for Finance Bills and Treasury Bills (if registered with the Bank of Japan), and nonresidents will be exempted from withholding tax on government bonds from September 1999.

14. **Public works spending is expected to increase strongly in FY1999.** Besides the tax cuts, the budget incorporated other elements of the November stimulus package, including about ¥1 trillion in additional public investment. Nevertheless, the public works allocation of ¥9½ trillion in the initial FY1999 budget is considerably smaller than in the revised budget for FY1999 (¥15 trillion). However, taking account of funds appropriated in the FY1998 supplementary budgets that are likely to be disbursed in FY1999, the authorities have indicated that public works spending is expected to rise by 10 percent in FY1999.⁶ Moreover, to ensure a high level of public investment throughout the fiscal year, the government decided in March 1999 to front-load public works spending, with the aim of minimizing the carry-over of public works projects into FY2000.⁷

15. **The budget included a substantial increase in central government transfers to the social security system.** The 8½ percent increase reflected a decision to raise government contributions to the basic pension fund (a relatively small component of the overall pension system) from the current one-third of benefits to one-half by FY2004. The government also decided to postpone an increase in contribution rates (from 17.35 to 19.5 percent of base income) to the Employee Pension Insurance—an earnings-related pension scheme for private sector workers—from 1999 to 2004, prompted by concerns over its impact on take-home

⁶This assumes that a contingency reserve of ¥500 billion for public works would be spent in the course of the year.

⁷The authorities plan to spend 95 percent of funds allocated for FY1999 within the current fiscal year, as opposed to a historic average of around 75 percent.

pay. The foregone increase in pension contributions is estimated at around ½ percent of GDP per year.

16. **As a result of the budget proposals, the staff projects that, on a national accounts basis, the general government deficit (excluding social security) is to rise from 8.3 percent of GDP in FY1998 to 9.7 percent in FY1999** (Table II.4). Official projections show that the general government deficit (excluding social security) will fall from 9.8 percent of GDP in FY1998 to 9.2 percent of GDP in FY1999.⁸ However, these numbers are based on appropriations data and do not fully adjust for the fact that much of the related public works spending will not occur until FY1999. The structural deficit (including social security) is projected to increase by about 1 percentage point of GDP.⁹

	FY1996	FY1997	Est. FY1998	Proj. FY1999
General government balance	-4.1	-3.4	-6.1	-7.6
Excluding social security	-6.6	-5.9	-8.3	-9.7
<i>Of which:</i>				
Taxes and fines	18.1	18.3	17.6	16.8
Consumption	9.6	9.9	10.1	10.2
Investment	6.2	5.7	6.2	6.2
Change in structural balance (including social security)	-1.0	1.6	-1.5	-1.0

Source: Staff estimates.

17. **The budget implies a net bond issue of ¥31 trillion in FY1999, contributing to the sizeable accumulation of public debt in recent years.** Japan has become the largest issuer of net debt among industrial countries as net bond issues have increased five-fold since 1990 (Table II.5). As a result, the amount of outstanding central government bonds has roughly

⁸The staff's lower cumulative deficit over the two years reflects an expected shortfall in local government spending, discussed further below.

⁹These projections include the June 11 package of measures to alleviate unemployment that is to be financed through a ¥520 billion (0.1 percent of GDP) supplementary budget.

Table II.5. Japan—Central Government Bond Issues, FY1990–1999

(in trillions of yen)

	Net bond issue (General Account Budget)			Gross issue	Bonds Outstanding 1/	
	Initial	Revised	Settlement	Settlement	Nominal	Percent of GDP
1990	5.6	7.3	7.3	26.8	168.5	38.4
1995	12.6	22.0	21.2	47.0	228.0	46.6
1996	21.0	22.4	21.7	49.1	247.5	49.1
1997	16.7	18.5	18.5	48.4	273.9	54.2
1998	15.6	34.0	...	76.4 2/	310.7	62.9
1999	31.1	...	...	71.1 3/	338.6 3/	70.6

Source: Bank of Japan, Economic Statistics Monthly; and staff calculations.

1/ Including subsidy, subscription, and DIC bonds, and bonds converted from JNRSC bonds.

2/ Staff estimate.

3/ Budget projection.

doubled, reaching an estimated ¥310 trillion (63 percent of GDP) by the end of FY1998. Net general government debt (excluding social security) is expected to more than double from 42 percent of GDP in 1990 to an estimated 90 percent of GDP at end-FY1999.¹⁰

B. The Financial Situation of Local Governments

18. **Local governments have supported the expansionary fiscal stance of the central government in recent years.** Reflecting the close relationship between central and local governments in Japan, local authorities have taken on a major burden in efforts to stimulate the economy (Box II.1). The central government's stimulus programs have affected local governments mainly in two ways. First, the implementation of public works occurs to a large extent at the local government level (some 80 percent of all general government public works are carried out by local authorities), and most stimulus programs have contained a substantial share of projects to be financed by local governments, either independently or jointly with the central government (Table II.6). Second, tax cuts have affected local budgets both through losses in shared taxes and reductions in local taxes.

19. **As a result, the aggregate fiscal deficit of local governments roughly doubled between FY1990 and FY1997.** On the basis of settlement data (available through FY1997), the consolidated local government deficit rose sharply from 1 percent of GDP in FY1990 to

¹⁰By end-FY1999, gross indebtedness of the general government is projected to have risen to 130 percent of GDP (compared to 70 percent of GDP in FY1990). Net debt including social security will be around 38 percent of GDP, compared to 10 percent of GDP in FY1990.

Table II.6 Japan: General Government Public Works Projects

(In billions of yen)

	1990	1991	1992	1993	1994	1995	1996	1997
Solo projects	16,496	18,432	21,491	25,651	24,505	23,488	22,953	20,845
Central government 1/	3,504	3,759	4,427	7,777	7,459	6,383	6,216	5,393
Local government	12,992	14,674	17,065	17,874	17,046	17,104	16,738	15,452
Joint projects 2/	8,502	8,802	10,244	11,493	11,184	12,547	11,915	11,061
<i>Financed by:</i>								
Central government	3,452	3,662	5,245	5,907	5,748	6,412	6,124	5,674
Local government	5,050	5,140	4,999	5,586	5,435	6,136	5,791	5,387
Financial contribution of local governments to central projects	1,091	1,039	1,260	1,340	1,088	1,462	1,254	1,236
Total public works	26,088	28,273	32,995	38,483	36,776	37,496	36,123	33,142
<i>Implemented by:</i>								
Central government	4,595	4,798	5,687	9,117	8,547	7,845	7,470	6,629
Local government	21,494	23,476	27,308	29,367	28,229	29,652	28,653	26,513
<i>Financed by:</i>								
Central government	6,956	7,421	9,671	13,684	13,208	12,795	12,340	11,067
Local government	19,133	20,853	23,324	24,799	23,569	24,701	23,782	22,075
Memorandum items								
					(In percent)			
Central government share in joint projects	40.6	41.6	51.2	51.4	51.4	51.1	51.4	51.3
Share of public works financed by central government	26.7	26.2	29.3	35.6	35.9	34.1	34.2	33.4
Share of public works implemented by local government	82.4	83.0	82.8	76.3	76.8	79.1	79.3	80.0
Total public works (percent of GDP)	5.9	6.1	7.0	8.1	7.7	7.7	7.2	6.6

Source: Ministry of Finance; Local Government White Paper, various issues; and staff calculations.

1/ Calculated as total central government expenditure on public works minus central share of joint public works.

2/ Joint projects are implemented by local governments.

Box II.1. Japan—Central—Local Government Relations¹

Financial relations between the national and local governments in Japan are marked by a substantial vertical imbalance, i.e., revenues generally exceed expenditures at the central level and fall short at the local level. The central government receives 60 percent of all total tax revenue but accounts for only 35 percent of total general government expenditure (excluding social security). By contrast, the tax revenue of local governments amounts to less than 40 percent of the funds necessary to perform their functions. To fill the financing gap at the local level, the central government transfers part of its tax revenue to local governments (mainly in the form of “local allocation taxes”, which is distributed according to formulas that seek to maintain uniform living standards across the country) but is also subject to adjustment each year to match local government needs and resources. Overall, these tax transfers amounted to 22 percent of local revenue in FY1997. Prefectures and municipalities raise the remaining funds through nontax revenue and borrowing.

Although considerably more public spending takes place at the local level than at the national level, the national government has been closely involved in most aspects of local public spending. For example, major programs in education, health, or infrastructure were in practice formulated by national ministries and financed directly or indirectly by the central government. The recently enacted Decentralization Law has provided local governments with greater planning autonomy, but local governments continue to be financially dependent on the central government.

The intense involvement of the central government makes the budgets of central and local governments much more closely linked than in other industrial countries. The vertical imbalance is resolved through grants and borrowing linking the central and local budgets in what is effectively a single budget entity. Each year, the central government produces an official estimate of the revenues and expenditures of local governments (including planned amounts of local allocation tax, transfers, and local borrowing). These estimates are combined with an array of national government policies and programs such as the FILP in order to compile income-expenditure plans for each local government, which are combined in an indicative Local Government Finance Plan. The most important feature of this process is how revenues and expenditures are balanced through the local allocation tax and local borrowing. When the program is approved by the Diet, it effectively locks in local governments in terms of their own local taxes, loan programs, employment and general administrative expenses and, most importantly, the levels of funding for almost all public programs, leaving independent public works spending as the main area where discretionary changes can be made.

In recent years, there has been an increase in local borrowing to assist in the implementation of the central government’s fiscal policy. Given the large relative size of the local public sector, the central government relies on local governments to implement parts of its fiscal policy. It is impracticable to alter the local tax system or the local allocation tax to compensate for changes arising out of cyclical fluctuations since these—and the proportion of national taxes allocated to local governments—are fixed by statutes, which can be amended only by the Diet. The size of local borrowing, on the other hand, can be changed by executive action. In view of this flexibility, the proportion of bonds and loans in local revenue tends to increase in years when the national government has adopted an expansionary fiscal policy.

However, local borrowing is increasingly subject to statutory limitations. Local authorities risk losing their remaining financial independence if their borrowing or debt levels exceed thresholds established in the Local Fiscal Restructuring Law. Two fiscal indicators in particular trigger central government intervention: (i) a local authority’s bond issues are restricted if its ratio of debt service to local tax revenues exceeds 20 percent; and (ii) a prefecture is mandated to undertake fiscal restructuring under direct national control if its fiscal deficit exceeds 5 percent of a standardized expenditure measure (20 percent in the case of municipalities). Some heavily indebted local authorities have indeed come close to these limits in recent years, and have embarked on severe austerity programs to avoid falling under the central government’s authority.

¹This box summarizes and updates material in Mihaljek (1996).

3 percent of GDP in FY1995, before declining to 2 percent of GDP in FY1997 (Table II.7):¹¹

- The deficit increase was driven by expenditure developments, the most important being a rise in current spending, driven by personnel and interest cost. There was also a sharp increase in public investment in the wake of a series of stimulus packages between 1992 and 1995. Subsequently, however, public works spending was cut back by a full percentage point of GDP within two years, and savings were also achieved in other discretionary spending items.
- Overall revenue was largely flat, but local tax revenues dropped by almost one percent of GDP in the early 1990s before recovering moderately through 1997 (partly a consequence of the consumption tax increase, the revenues of which were evenly split between central and local government). Tax transfers from the central government remained practically flat, but other revenues (including user fees and other central government grants) largely offset the swings in own tax revenue.

20. **The deficit increase has also reflected specific local factors.** Although fiscal expansion at the local level has mainly reflected stimulus policies at the national level, other developments have added to the financial burden on local governments:

- Social welfare spending at the local level has increased in response to an ageing population. Future spending is expected to accelerate with the introduction of a planned nursing insurance scheme in April 2000 that is expected to cost local governments a total of ¥1 trillion (0.2 percent of GDP) in FY2000.
- Local governments are struggling with devalued land assets and the associated rise in interest payments on purchases of real estate made in the late 1980s. Indeed, the majority of real estate developments undertaken by local governments in cooperation with the private sector during the 1980s (so-called “third-sector” companies) have turned unprofitable and are saddled with potentially large liabilities (Okue 1999a).
- A number of agricultural cooperatives are heavily indebted and burdened with non-performing assets, requiring financial assistance to avoid bankruptcy.
- In certain instances, natural disasters have added to fiscal difficulties—e.g., the Kobe city government expects to use half of its tax revenues in FY1999 to repay loans used to provide shelter for the survivors of the 1995 earthquake.

¹¹Under the official classification, bond issues and borrowing are counted among revenues, and the deficit reflects only changes in financial reserves. Based on information in the White Paper on Local Government Finance, the deficit reported here reflects the definition provided by the guidelines for *Government Finance Statistics*.

Table II.7. Japan: Local Government Operations

(in percent of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total revenue (excl. borrowing) 1/	16.2	16.4	16.1	16.2	16.1	16.2	16.1	...	...
Tax revenue	11.2	11.1	10.7	10.4	10.6	10.7	10.8	...	...
Local taxes	7.6	7.3	7.0	6.8	6.9	7.0	7.2	...	...
Transfers	3.6	3.7	3.7	3.6	3.7	3.7	3.6	...	...
Other	5.0	5.3	5.3	5.7	5.5	5.5	5.3	...	...
Total expenditure	17.3	18.2	18.7	18.7	19.3	18.6	18.2	...	...
Mandatory current spending	6.7	6.8	6.9	7.1	7.2	7.2	7.4	...	...
o/w: Personnel	5.0	5.1	5.2	5.3	5.3	5.2	5.3	...	...
o/w: Interest	0.7	0.7	0.7	0.8	0.8	0.8	0.9	...	...
Discretionary current spending	5.1	5.2	5.2	5.3	5.5	5.3	5.2	...	...
Investment	5.5	6.2	6.6	6.3	6.6	6.1	5.6	...	...
o/w: Construction	5.3	6.1	6.4	6.1	6.4	5.9	5.5	...	...
Balance	-1.1	-1.8	-2.6	-2.5	-3.2	-2.4	-2.1	...	...
Financing	1.1	1.8	2.6	2.5	3.2	2.4	2.1	...	...
Borrowing (net)	1.5	2.2	3.1	3.0	3.7	2.9	2.5	...	...
Borrowing (gross)	2.3	3.0	3.9	3.9	4.6	3.9	3.7	...	...
Bonds	1.6	2.2	2.8	3.0	3.5	3.1	2.8	...	...
Other	0.7	0.9	1.1	0.9	1.2	0.8	0.9	...	...
Amortization	-0.8	-0.8	-0.9	-0.9	-0.9	-1.0	-1.2	...	...
Other 2/	-0.4	-0.4	-0.5	-0.5	-0.5	-0.5	-0.4	...	...
Memorandum items									
Local government debt	15.1	16.7	19.2	22.2	25.5	27.6	29.6	...	...
o/w: Bonds	11.9	13.0	14.8	16.8	19.0	20.5	22.1	...	...
Debt service payments	1.5	1.5	1.6	1.7	1.8	1.9	2.0	...	...
Local Government Finance Plan									
Total revenue	14.1	14.7	14.7	14.7	14.6	14.3	14.8	15.4	15.6
Local tax	7.1	7.2	7.2	6.8	6.9	6.7	7.3	7.8	7.1
Local allocation tax	3.2	3.3	3.2	3.2	3.3	3.3	3.4	3.5	4.2
Local transferred tax	0.4	0.4	0.4	0.4	0.4	0.4	0.2	0.1	0.1
Treasury disbursement	2.3	2.5	2.6	3.0	2.6	2.6	2.6	2.6	2.7
Rents and fees	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Other	0.9	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.2
Total expenditure	15.3	15.8	16.0	16.9	16.9	16.9	17.2	17.6	17.9
Debt service	1.3	1.3	1.4	1.9	1.6	1.8	1.9	2.1	2.3
Wages and salaries	4.2	4.4	4.6	4.7	4.6	4.5	4.6	4.7	4.8
General administration	3.0	3.2	3.3	3.4	3.4	3.5	3.6	3.7	3.9
Investment	4.9	5.2	5.6	6.1	6.2	6.2	6.2	5.9	6.0
Special independent works	0.2	0.2	0.3	0.3	0.3	0.5	0.5	0.5	0.4
Other	1.7	1.5	0.8	0.6	0.7	0.5	0.6	0.7	0.5
Deficit (=Bond issue)	-1.2	-1.1	-1.3	-2.2	-2.3	-2.6	-2.4	-2.2	-2.3

Source: Ministry of Home Affairs; Ministry of Finance; and staff calculations.

1/ Using data provided by the authorities, the staff has reclassified financing items which are treated as revenues in the official statistics.

2/ Including classification errors and omissions.

21. **The financial situation of local authorities has deteriorated.** Tax losses and rising expenditure have been financed largely through increased local bond issuance, and local government indebtedness has correspondingly shot up from 15 percent of GDP in 1990 to 30 percent of GDP by the end of FY1997. This has already contributed to a rise in debt service payments to over 2 percent of GDP in 1997, up from 1½ percent of GDP in 1990.

22. **Some large municipalities and urban prefectures have found themselves in a particularly severe financial state.** Revenues of local authorities in urban areas—which depend heavily on local corporation taxes—have been most affected by the decline in economic activity. With many businesses reporting losses, the tax base for these local governments has been shrinking rapidly in recent years. Examples for local governments with financial difficulties include a number of urban prefectures (e.g., Tokyo, Osaka) which have been approaching their bond issuance and deficit limits and have now begun to contemplate drastic steps toward fiscal consolidation (see below).

Developments since 1998

23. **Financial difficulties have intensified since early 1998.** The indicative Local Government Finance Plan for FY1998 foresaw a slight reduction in the aggregate local government deficit, expected to be achieved by a substantial increase in own tax revenue (½ percent of GDP) buoyed by a growing economy, which was to offset rising spending on debt service and personnel costs (see Table II.7). However, the economy fell into recession, leading to weaker than anticipated revenue growth, which was exacerbated by temporary tax cuts contained in the April 1998 stimulus package. Preliminary estimates indicate that local tax revenue in FY1998 was roughly unchanged from the year before, falling short of initial projections by about ¥2½ trillion (½ percent of GDP), of which slightly more than half was accounted for by the tax cuts. A further revenue decline has been projected for FY1999, largely in response to tax cuts contained in the November 1998 stimulus package.

24. **The government has taken steps to alleviate the financial burden on local governments, in particular through the FILP.** While the bulk of tax allocation grants are financed by central government taxes, additional funds for local governments have been provided through loans from the Trust Fund Bureau (TFB) to the Special Account for Local Allocation Tax (Box II.2). These loans, which should in theory net out over the cycle, have averaged around ¥4 trillion in recent years. For FY1999, owing to the anticipated decline in local tax revenues, an exceptional ¥8½ trillion (1.7 percent of GDP) in TFB loans are planned. As can be seen from Box II.2, debts to the TFB have mushroomed in recent years to around ¥30 trillion (6 percent of GDP) by end-FY1999.

Box II.2. TFB Loans for Local Allocation Tax Grants

The Japanese fiscal system provides for the distribution of shared tax revenue through the Special Account for Local Allocation Tax. The amounts to be distributed are agreed upon during the budget process and become part of the initial budget (see Box II.1). To provide a stable revenue base for local governments, revenue shortfalls are bridged by short-term loans from the Ministry of Finance's Trust Fund Bureau (TFB) to the Special Account, using funds that could otherwise be invested through the FILP.¹ However, in view of the difficult financial situation of local governments, TFB loans have been part of the initial budget in recent years. The loans have a notional maturity of one month (but are rolled over), and carry an interest rate premium of 20 basis points over 10-year JGB yields. Outstanding loans are to be repaid through future surpluses in the Special Account.

TFB Loans to the Special Account for Local Allocation Tax
(in trillions of yen)

	1990	1991	1992	1993	1994	1995	1996	1997	Est. 1998	Budg. 1999
Loans (net)	-1.5	-0.8	1.5	1.6	3.7	4.2	3.7	1.8	3.5	8.4
Balance	1.5	0.7	2.2	3.8	7.5	11.7	15.4	17.1	20.7	29.1

Source: Ministry of Finance.

¹TFB financing for local governments falls into two categories: (i) loans with a maturity over 5 years have to be included in the FILP budget and can only be extended to finance specific investment projects; and (ii) special account loans with shorter maturities are not part of the FILP and can thus be used more flexibly. Both forms of loans, however, require Diet approval.

25. **Despite this support, local governments are cutting back on discretionary spending.** The integrated nature of central and local government financial planning leaves local authorities with limited room for adjustments in current expenditure (see Box II.1). Many local governments have therefore cut back on own-account investment projects, i.e., projects that are financed independently of the central government (which account for almost 60 percent of all local public works). Partly in response to these problems, the November 1998 stimulus package differed from previous packages in that it did not include increases in independent local public works (by contrast, the April 1998 package included ¥1.5 trillion of self-financed local investment). For FY1999, preliminary budget data for 25 prefectures show a decline in locally funded public works by 16 percent compared to FY1998 initial budgets, although the Local Government Finance Plan assumed that such spending would be flat (Okue

1999b).¹² A recent budget survey of 670 municipal governments also found cuts in self-financed investment projects.

26. Governments in urban areas—which receive only small shares of local allocation tax—are under particular pressure to implement adjustment measures. With local allocation tax payments intended to minimize differences in living standards, urban prefectures generally receive smaller tax transfers than their rural counterparts (the Tokyo prefecture, as an extreme case, receives no local allocation tax transfers at all). Some urban authorities have thus been forced to draw up particularly strong fiscal adjustment programs, including politically difficult measures such as the delay, reduction or suspension of pay rises and bonus payments, sharp increases in smaller local taxes and user fees, and sales of land or other assets.

C. FILP Operations and Government Bond Markets

27. The FILP has evolved into an important tool for financial management and quasi-fiscal operations. About one third of Japanese savings are held by public institutions, including the postal savings and public pension systems. Most of these funds are invested through the FILP, which is run by the Ministry of Finance's Trust Fund Bureau (TFB). Although the FILP is not formally part of the general government sector, its annual investment plan is formulated in close coordination with the budget process, and submitted to the Diet together with the regular government budget. Indeed, owing to its size, the FILP is often referred to as the "second budget".

28. The bulk of the FILP is used to finance long-term loans for public sector projects. Three-quarters of the TFB's portfolio—which currently amounts to some ¥440 trillion (90 percent of GDP)—consist of loans provided to the central government (mainly financing operations of special accounts), local governments, and government financial institutions (GFIs) and other public agencies (Table II.8). The remainder is invested in government securities, mainly long-term government bonds. A small portion of TFB funds is also invested in short-term assets, e.g., financing bills and loans provided to special accounts.

29. Demands for FILP funding have been growing. Measures announced as part of the 1998 stimulus packages have included substantial additional FILP loans, mainly to improve credit conditions in the economy and extend financial support to local governments (Table II.9):

- The revised FILP budget for FY1998 provided an additional ¥3 trillion in funding for GFIs (in particular the Japan Finance Corporation which lends to SMEs), and ¥2½ trillion in additional long-term loans to local governments.

¹²Although public works funded by the central government have increased by 5 percent, overall local public works of Prefectures are still projected to drop by 11 percent.

Table II.8. Japan: Trust Fund Bureau Operations

(In trillions of yen)

	End fiscal year							May
	1992	1993	1994	1995	1996	1997	1998	1999
Assets	302.7	326.3	346.7	373.2	392.1	418.3	436.0	437.4
Securities	92.2	89.2	83.9	96.6	96.4	107.9	111.2	...
Long-term government bonds	64.8	61.7	55.9	62.4	64.5	81.5	93.0	88.1
Short-term government bonds	2.8	0.8	0.9	4.3	1.3	3.0	1.6	1.2
Bonds of government related organizations	14.5	17.7	20.0	21.3	21.9	19.4	15.3	...
Financing bills	10.1	9.0	7.1	8.7	8.7	4.0	1.3	1.3
Loans	210.4	237.0	262.8	276.4	295.6	310.3	324.7	...
Loans to general and special accounts	42.4	49.9	58.8	68.4	76.5	83.1	92.9	93.1
Loans to local public organizations	37.0	40.5	45.4	49.0	54.3	58.5	62.0	67.5
Loans to government related organizations	131.0	146.6	158.7	159.1	164.8	168.7	169.8	...
Other	0.1	0.1	0.1	0.1	0.1	0.1	0.1	...
Liabilities	302.7	326.3	346.7	373.2	392.1	418.3	436.0	437.4
Deposits	302.4	325.9	346.2	368.1	391.5	417.2	433.3	434.5
Postal savings	168.6	181.5	195.2	211.6	223.1	238.7	251.0	252.1
Postal life insurance	7.0	8.0	7.4	8.5	5.5	6.0	5.3	5.3
Welfare insurance special account	89.9	96.6	103.0	107.4	116.8	124.0	129.1	128.8
Funds of national annuities	6.7	7.5	8.2	8.5	9.6	9.9	10.4	10.6
Other deposits	30.2	32.2	32.3	32.1	36.6	38.5	37.5	37.7
Other	0.2	0.4	0.5	5.1	0.6	1.1	2.8	2.9
Difference to end of previous year								
Assets	26.8	23.6	20.4	26.4	19.0	26.2	17.7	1.4
Securities	5.2	-3.0	-5.3	12.8	-0.2	11.5	3.3	...
Long-term government bonds	1.2	-3.1	-5.8	6.5	2.2	17.0	11.5	-4.9
Bonds of government related organizations	3.5	3.2	2.3	1.3	0.6	-2.5	-4.1	...
Financing bills	0.9	-1.1	-1.9	1.6	0.0	-4.6	-2.7	0.0
Loans	21.6	26.6	25.7	13.6	19.2	14.7	14.5	...
Loans to general and special accounts	7.5	7.6	8.8	9.6	8.1	6.6	9.8	0.2
Loans to local public organizations	1.9	3.4	4.9	3.6	5.3	4.2	3.5	5.5
Loans to government related organizations	12.2	15.6	12.0	0.5	5.7	3.9	1.1	...
Deposits	26.8	23.5	20.3	21.9	23.5	25.6	16.1	1.2
Postal savings	14.0	12.8	13.8	16.4	11.5	15.6	12.2	1.2
Welfare insurance special accounts	6.0	6.7	6.4	4.4	9.4	7.2	5.1	-0.3
Funds of national annuities	0.9	0.8	0.6	0.4	1.0	0.4	0.4	0.2
Other deposits	3.8	2.1	0.1	-0.3	4.5	1.9	-1.0	0.2

Source: Ministry of Finance.

Table II.9. Japan: Fiscal Investment and Loan Program (FILP), FY1994-99

(In billions of yen, fiscal years)

	1994	1995	1996	1997		1998		1999
		Actual		Initial	Revised	Initial	Revised	Initial
Sources of funds	50,324	45,039	50,877	56,157	57,735	57,759	71,395	52,899
Trust Fund Bureau	39,172	34,505	39,706	45,551	47,129	48,096	61,126	43,716
Postal savings	(13,760)	(16,393)	(11,522)	(11,700)	(...)	(11,400)	(...)	(11,500)
Welfare and national pensions	(6,912)	(7,730)	(7,319)	(7,300)	(...)	(6,000)	(...)	(4,310)
Repayment and other	(18,492)	(10,383)	(20,865)	(26,551)	(...)	(30,696)	(...)	(27,906)
Industrial investment special account	83	77	58	64	64	64	457	104
Postal life insurance fund	8,457	7,228	8,133	7,542	7,542	7,100	7,101	6,580
Government-guaranteed bonds and borrowing	2,612	3,229	2,981	3,000	3,000	2,500	2,711	2,500
Uses of funds	50,324	45,039	50,877	56,157	57,735	57,759	71,395	52,899
Purchase of government bonds	0	2,851	4,976	4,800	4,800	7,800	11,000	0
FILP	50,324	42,189	45,901	51,357	52,935	49,959	60,395	52,899
Portfolio investments 1/ General FILP	(8,450)	(7,950)	(8,591)	(12,030)	(12,030)	(13,300)	(17,300)	(13,550)
Central government projects (special accounts)	41,874	34,239	37,310	39,327	40,905	36,659	43,095	39,349
Government nonfinancial enterprises	(866)	(930)	(828)	(755)	(778)	(585)	(665)	(375)
Government financial agencies	(10,573)	(8,679)	(8,374)	(8,753)	(8,754)	(7,248)	(7,700)	(6,897)
Of which:	(23,048)	(14,628)	(18,878)	(20,888)	(22,442)	(20,927)	(24,155)	(24,098)
Housing Finance Corporation	(12,141)	(4,970)	(10,121)	(10,647)	(10,647)	(9,918)	(...)	(10,118)
Local governments	(6,996)	(9,629)	(8,891)	(8,600)	(8,600)	(7,600)	(10,250)	(7,740)
Other	(391)	(373)	(339)	(331)	(331)	(299)	(324)	(240)
Memorandum items:								
Increase in General FILP (In percent) 2/	-3.3	-18.2	9.0	5.4	9.6	-10.4 3/	5.4 3/	-8.7 3/
General FILP as a percent of GDP 2/	8.7	7.0	7.4	7.6	8.1	7.1	8.7	7.9

Source: Ministry of Finance.

1/ Reflects the funding of the "lend-back" system under which the postal savings system, public pension funds, and the postal life insurance fund receive funds for portfolio management on their own account.

2/ Excludes portfolio investment.

3/ Compared with revised plan of the previous year.

- Excluding government bond purchases, FILP spending in the initial FY1999 budget is planned to shrink by ¥7½ trillion compared to the revised FY1998 budget, although still exceeding the initial FY1998 budget. The high level of loans to GFIs has been maintained, implying a 15 percent increase over the previous year's initial budget. Moreover, while loans to local government were kept flat on an initial budget basis, short-term loans to the Special Account for Local Allocation Tax are to rise sharply (see Box II.2).

30. **At the same time, the TFB's deposit base is likely to decline.** In FY1998, net deposits with the TFB registered the smallest increase in many years, amounting to only ¥16 trillion compared with inflows of well over ¥20 trillion for the past decade (see Table II.8). While this may have reflected the particularly weak situation of the economy, TFB deposits are expected to shrink in absolute terms in the coming years:

- About ¥100 trillion in fixed-term postal saving (*teigaku*) deposits from the high-interest period in 1990–91 are estimated to mature by 2001. At current low interest rates, a considerable portion of these funds is likely to be invested outside the postal savings system and will thus no longer be available to the TFB.
- Current reform plans, in the context of financial market liberalization, imply that the TFB will no longer receive automatic deposits from either the postal savings system or public pension funds from FY2001, implying a fundamental change in the FILP's funding pattern.
- On the pension side, the postponement of the planned October 1999 EPI contribution increase, combined with strong anticipated growth in benefit payments, will reduce the surplus social security funds available for deposit with the TFB.

31. **Anticipating these changes, the TFB decided in late 1998 to shift its securities portfolio toward shorter-term maturities, including through a halt of long-term government bond (JGB) purchases.** Faced by strong loan demands and weakening deposit flows, the government announced in December 1998 (at the time of the budget presentation) that it would no longer acquire 10-year JGBs either through underwriting or in secondary markets. Instead, the TFB planned to step up investments in government securities with shorter maturities, thus achieving a more balanced maturity structure of its securities portfolio.¹³

32. **In a related move, the government announced its intention to modify its debt management strategy.** To accommodate the liquidity needs of the TFB and other major

¹³In the first two months of FY1999, JGB holdings by the TFB have indeed declined by ¥5 trillion, while loans to local government organizations have increased by a similar amount (see Table II.8).

market players, the government decided to issue more 1-year Treasury bills and 2–6 year bonds at the expense of long-term bonds. Since the beginning of FY1999, the government has thus issued only ¥1.4 trillion in 10-year JGBs per month (instead of a planned ¥1.8 trillion), while ¥400 billion per month has been issued at shorter maturities instead. An eventual move to consolidate maturities of medium-term bonds around the 5-year level is also being contemplated.

The reaction of the bond market

33. **The benchmark yield on 10-year Japanese Government Bonds (JGBs) was at an historic low of 0.7 percent in October 1998** (Figure II.2). JGB yields had fallen through most of the 1990s, with the mid-1998 level being a record low in Japan and a yield unprecedented anywhere in the historical record. During the first half of the decade, when inflation had declined, real JGB yields remained in line with international yields.¹⁴ However, with inflation hovering around zero since 1997, real yields also dropped to unprecedentedly low levels (see lower panel of Figure II.2). Indeed, with nominal yields so close to the floor of zero, the potential benefits from holding JGBs appeared meager compared to the downside risk of a correction in prices. The main reason for the low bond yield appears to have been large purchases of JGBs by public institutions (see below).

34. **Subsequently, news that the TFB—the largest JGB holder and a major purchaser in recent years—would withdraw from bond underwriting led to a surge in yields following the release of the FY1999 budget.**¹⁵ Bond yields had already begun to rise earlier, reaching 1¼ percent by mid-December, after the November 1998 stimulus package increased the planned JGB issue for FY1998 by 60 percent. However, a subsequent yield surge of 50 basis points in late December was mainly associated with the TFB's decision to stop underwriting in the face of an expansionary FY1999 budget.

35. **The yield increase since last November marks the end of a period of large bond purchases by public sector institutions** that, combined with investor flight-to-quality, pushed down Japanese bond yields to unprecedentedly low levels. Much of the recent increase in long-term interest rates thus represents the unwinding of two temporary factors that signals a return to more normal conditions:

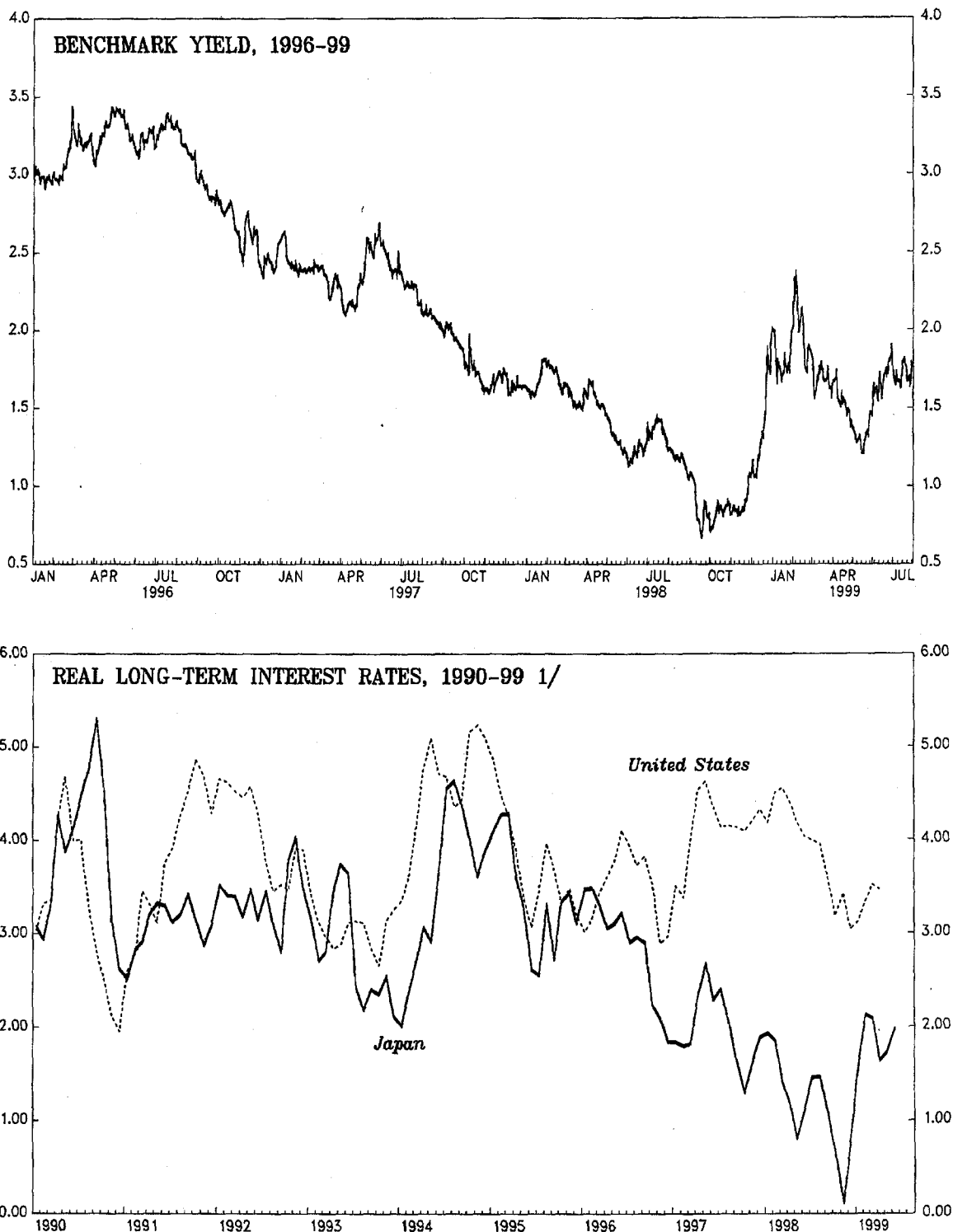
- Taking account of secondary market purchases, public institutions have accounted for more than 80 percent of the increase in outstanding bonds since 1996 (Figure II.3). While it is unclear to what extent these purchases have been made for explicit policy purposes, this level of market support has clearly been unsustainable.

¹⁴Real yields are defined as nominal yields less the annual rate of consumer price inflation.

¹⁵The TFB currently holds one fifth of all outstanding JGBs. It accounted for 60 percent of the increase in outstanding JGBs in FY1997, and 30 percent in FY1998.

FIGURE II.2
JAPAN

10-YEAR GOVERNMENT BOND YIELDS

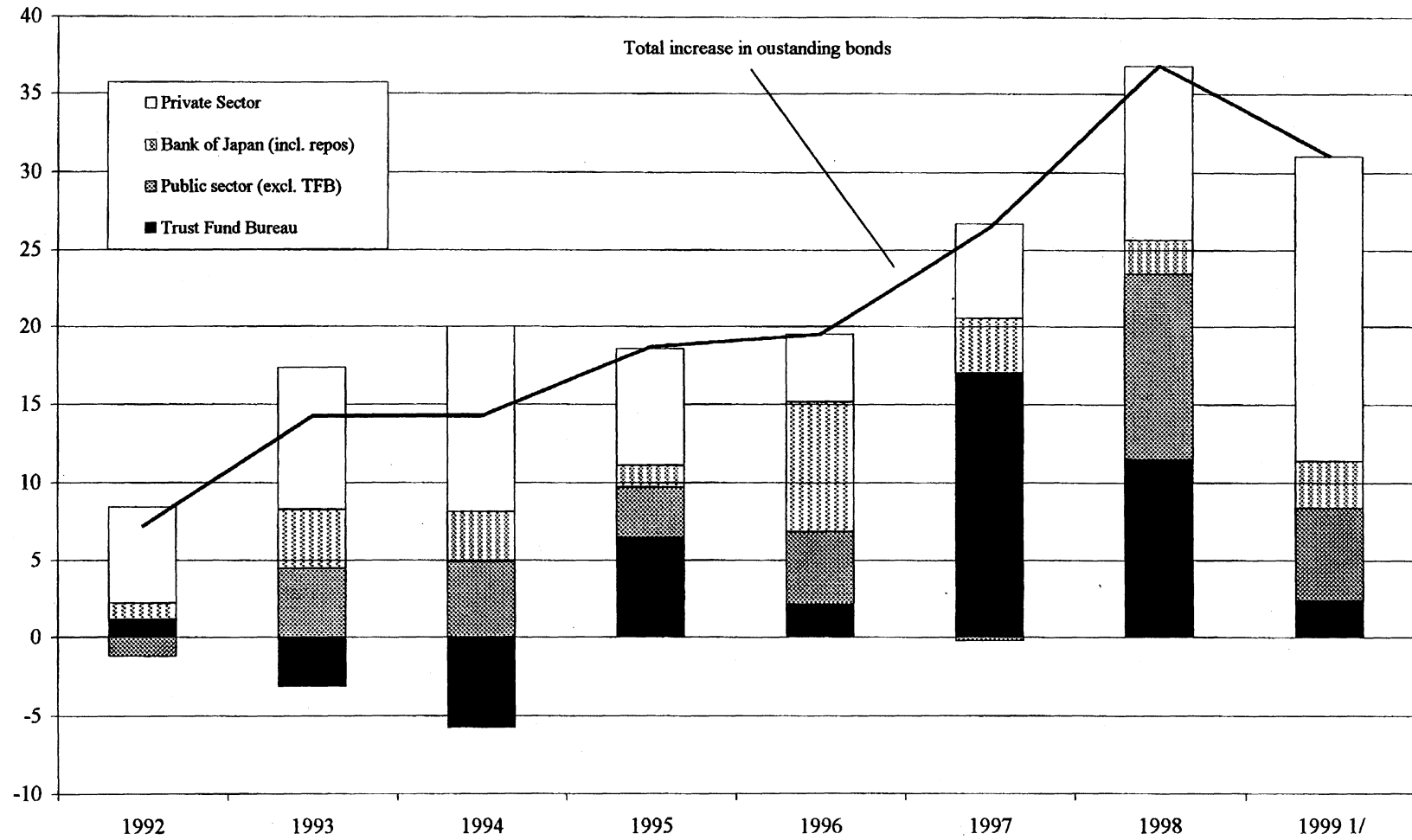


Sources: Nikkei Telecom, WEFA, and staff estimates.

1/ Japan: 10-year JGB yield; U.S.: 10-year Treasury Bond. Real rates were defined as nominal rates minus 12-month percent changes in CPI. Japan's CPI was adjusted for consumption tax increase in April 1997.

Figure II.3. Japan: Increase in Outstanding Government Bonds by Holder

(in trillions of yen)



Source: Bank of Japan, Economic Statistics Monthly.

Fiscal Year

1/ Staff projection based on data provided by the Ministry of Finance.

- With conditions in the financial sector deteriorating in 1997 and 1998, investors increasingly invested in safe government debt. There are signs that the flight into JGBs may have ebbed as measures to stabilize the banking system taken by the government in late 1998 appear to have reassured investors that the financial system is now less fragile.

36. Markets were primarily concerned about an oversupply of bonds in 1999, but concerns over future debt sustainability also played a role in the yield increase:

- The direct result of the TFB's market withdrawal was to almost double the amount of fresh government securities to be issued to the private sector in FY1999, compared to levels prevailing in the mid-1990s (Table II.10). Following the large bond issuance in FY1998, there were concerns about the capacity of the market to absorb the increase.
- These concerns were reinforced by expectations that the buildup in government debt would continue over the medium term. The government has projected an increase in outstanding bonds to ¥430–440 trillion by 2003, implying that gross issues would continue at a level of ¥60–80 trillion in coming years. Markets also feared that existing contingent liabilities could result in an even larger build-up of public debt, e.g., arising from the expansion of public loan guarantees, larger than expected costs of cleaning up the financial sector, or potential losses in public sector agencies.¹⁶
- The rise in FILP loans to local governments at the expense of investment in securities was interpreted as a reflection of the weak financial condition at this level of government, which could result in a further financial burden on the central government.

Table II.10. Japan: Primary Government Bond Issue by Purchaser
(in trillions of yen)

	Total	Private sector			Public sector		
		Total	Syndicate Underwriting 1/	Bond auction	T-Bill auction	Trust Fund Bureau	Other public sector 2/
1995	46.8	36.9	13.0	11.1	12.8	9.9	...
1996	48.9	34.2	12.0	9.1	13.1	14.6	...
1997	48.1	33.7	12.0	8.3	13.4	14.4	...
1998 (Revised)	76.2	50.5	18.5	15.0	17.0	15.3	10.5
1999 (Budget)	70.9	60.8	20.0	18.0	22.8	2.8	7.3

Source: Bank of Japan, Economic Statistics Monthly; and data provided by the authorities.
1/ Excluding 5-year discount bonds.
2/ Postal savings system and BoJ rollovers.

¹⁶A widely quoted example was the winding up of the Japan National Railway Settlement Corporation, that included the government taking on 4½ percent of GDP in additional debt in 1998.

37. **Concerns about a rise in bond supply were temporarily reinforced by an expectation that secondary market purchases by both the TFB and BoJ would also fall.** In the recent past, TFB and BoJ purchases amounted to a total of ¥600 billion per month in secondary markets, adding to a combined purchase of ¥7 trillion per year. For some time it was believed by the markets that these purchases were to be substantially reduced:

- The TFB halted secondary market purchases in January 1999, before the government decided to resume such operations in February.
- Markets interpreted a speech by BoJ Governor Hayami in December as signaling that the BoJ would severely curtail JGB purchases in secondary markets. In the speech, the Governor noted the large amount of government bond holdings by the BoJ and observed that other central banks held a greater share of private sector assets than the BoJ.¹⁷ However, the BoJ has since reaffirmed that it would continue to purchase JGBs in line with the growth in bank notes.

38. **In the first half of 1999, bond yields have continued to be volatile as markets responded to policy announcements.** After yields peaked at 2¼ percent in early February, rates declined following the monetary easing by the BoJ in February (including a commitment to expand the scope of open market operations) and the government's announcement that it would switch to issuing more medium-term bonds. These decisions, combined with sales of financing bills held by the BoJ, was interpreted by markets as an effective "twist" operation that contributed to the decline in yields to 1¼ percent by May 1999. However, rates have since increased to around 1¾ percent as the strengthening of the economy has led to speculation that the BoJ might shift towards tightening sooner than previously anticipated, combined with growing market expectations of a further stimulus package toward the end of the present fiscal year.

D. Fiscal Transparency in Japan

39. **With fiscal policy playing a crucial role in stimulating the economy, transparency issues have received considerable attention in Japan in recent years.** Market participants have repeatedly reported difficulties in analyzing fiscal developments in great detail. Uncertainty about the fiscal stance has also led to skepticism regarding the need, size and effectiveness of public stimulus programs (e.g., Posen 1998). In particular, the lack of information on the scope and timing of public works has complicated economic forecasting and contributed to volatility in both financial and product markets.¹⁸

¹⁷The speech was delivered on the same day the end of JGB underwriting by the TFB was announced.

¹⁸For example, many forecasters were surprised by the strong impact of public investment on
(continued...)

40. **Difficulties in interpreting fiscal policies are partly related to the complex arrangement of central and local government accounts.** The focal point of the fiscal accounting system is the central government's General Account, which receives almost all national tax and bond revenues. Expenditure is mostly channeled through 38 Special Accounts (under the control of individual ministries), which are partly co-financed by other borrowing, e.g., from the FILP. Similarly, the accounts of some 3,200 local administrations (prefectures and municipalities) include ordinary and special accounts, and numerous public agencies on the national and local level also have independent bookkeeping status.¹⁹ There is a substantial amount of transfers both within and between central and local government accounts (see Box II.1), but only limited information is provided on a consolidated basis.

41. **While complex, the fiscal system operates under well established principles of fiscal responsibility.** Japan's fiscal policy has generally been run on a conservative basis under close parliamentary oversight.²⁰ Although the weak economy has forced the government to adopt a more expansionary policy stance (including through the suspension of the FSRA in 1998), the budget process remains subject to strong principles of legal and financial accountability:

- **Sound legal basis.** Budget planning and execution are guided by constitutional and legal provisions that allocate clear responsibilities across the various levels of government. Funds for public expenditure have to be appropriated by the Diet, and detailed tax legislation provides the statutory basis for tax and customs liabilities.
- **Strong administrative accountability.** The budget accounting system is well established and accurate, and the government is obliged to report to the Diet on fiscal developments on a quarterly basis. Settled accounts are submitted to the independent Board of Audit for inspection about 6 months after the end of the fiscal year. There is increasing use of cost-benefit analysis for public works project appraisals, and a framework for a wider evaluation of fiscal expenditure programs is planned to come into effect in FY2001.

¹⁸(...continued)

GDP growth in the first quarter of 1999, with some expressing doubts over the way public construction indicators were incorporated in preliminary estimates for the national accounts.

¹⁹For details on institutional arrangements, see Ishi (1996) and Bayoumi (1998).

²⁰Up until 1975, a version of the "golden rule" limited borrowing in any year to the level of investment spending ("construction bonds"). Since then, with the exception of 1991-93, the government has also issued special "deficit financing" bonds to finance general expenditure. However, the government retains the medium-term goals of reducing the ratio of special bond issues to total expenditure, and keeping the tax-to-GDP ratio below 50 percent.

- **Specification of contingent liabilities.** Budget documents contain information on a number of contingent liabilities, including the amount of outstanding government loan guarantees and the maximum amount of debt guaranteed through the deposit insurance mechanism. Funds for liabilities arising from such guarantees are partially appropriated in the budget, which may also include a contingency reserve.
- **High ethical standards.** The National Public Service Law provides legislation relating to ethical standards for national public employees. Each government department and agency has established its own code of conduct.

42. **However, the accounting system is not well suited for macroeconomic analysis.** Despite their high standards of accuracy, the complex arrangement of Japanese fiscal accounts is not well suited to generating the flow of data and projections on fiscal operations needed for an adequate macroeconomic assessment of fiscal policy. It is therefore extremely difficult for outside observers to monitor recent fiscal developments, to gauge the current stance of fiscal policy, and to assess the need for corrective measures during the fiscal year. Moreover, medium-term fiscal forecasting is largely conducted in an information vacuum. The main problems are:

- **Lengthy data lags.** The government publishes monthly information on its General Account and, on a more limited basis, also for some of the Special Accounts. More information is provided with the annual budget, but not in a form that readily allows for the construction of consolidated accounts for the central or general governments. Consolidated accounts on past operations are provided on an annual basis through the National Accounts, which are published only with a lag of 12 months from the end of the fiscal year, owing mainly to difficulties in compiling aggregate accounts for local authorities.
- **Limited information on the current fiscal stance.** The budget documents provide only limited information on the consolidated fiscal position implied by the budget proposals. The frequent recourse to supplementary budgets further complicates the analysis—particularly since only limited information is provided on the timing of fiscal operations—as does the convention of comparing initial budgets with earlier initial budgets. As a result, cross-year comparisons can be highly misleading.
- **Lack of detailed medium-term fiscal projections.** The authorities publish medium-term deficit and debt scenarios under different macroeconomic assumptions. However, except for some projections relating to taxation and debt service, medium-term projections are constructed from mechanical extrapolation under different assumptions, rather than a detailed assessment of the future implication of existing commitments and policies.

- **Extensive use of quasi-fiscal operations.** The FILP continues to be used to advance fiscal objectives through operations outside the central government budget (including, for example, the provision of 1½ percent of GDP of financing to local governments or, in the past, the temporary funding of losses associated with the privatization of the Japan National Railway). Moreover, agencies funded through the FILP are not exposed to market scrutiny of their operations. While the default rate for current FILP agencies has been low, future budgetary risks from such operations are difficult to assess.

43. **While there should be further scope to enhance data provision, in the end achieving best practices in fiscal transparency would require fundamental reforms to the legal and institutional fiscal framework.** Some of the largest obstacles include: (i) the important role of Special Accounts under the control of individual ministries, which makes it difficult to track aggregate spending and revenues; (ii) the reliance on large stimulus packages (implemented through supplementary budgets) that diminish the importance of initial budgets; and (iii) the reliance of most FILP agencies on direct financing or explicit government guarantees (which appears likely to continue even after planned FILP reforms in 2001).

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III. MONETARY DEVELOPMENTS¹

1. **Monetary policy has become even more expansionary over the past year, against a backdrop of weak activity, deflationary pressures, and continuing banking system strains.** This chapter first discusses monetary policy developments over the past year, including the conduct of monetary policy at zero interest rates, then describes actions taken to support bank lending, and finally considers what options remain should it become necessary to ease policy further.

A. Monetary Policy Developments

2. **Financial markets experienced considerable volatility throughout much of the past year.** Starting in late June 1998, the widely-reported difficulties of the Long-Term Credit Bank raised market concerns about banking system weaknesses, as reflected in rising bank funding premia (Figure III.1). Turbulent global financial market conditions in August and September further increased risk premia and the demand for liquidity. To ease monetary conditions and stabilize financial markets, the Bank of Japan (BOJ) cut the overnight call rate—its operating target—from slightly below 0.50 percent to 0.25 percent on September 9, 1998.

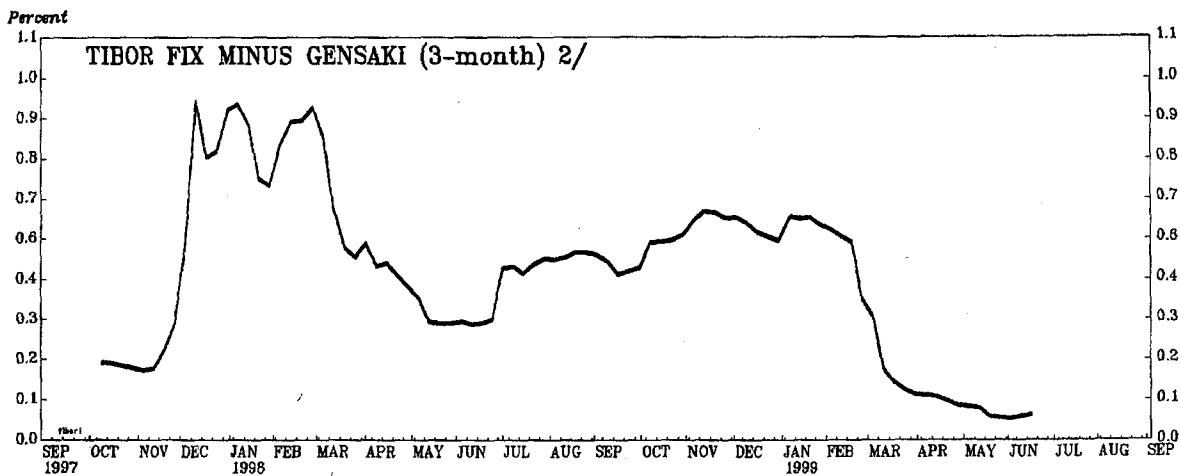
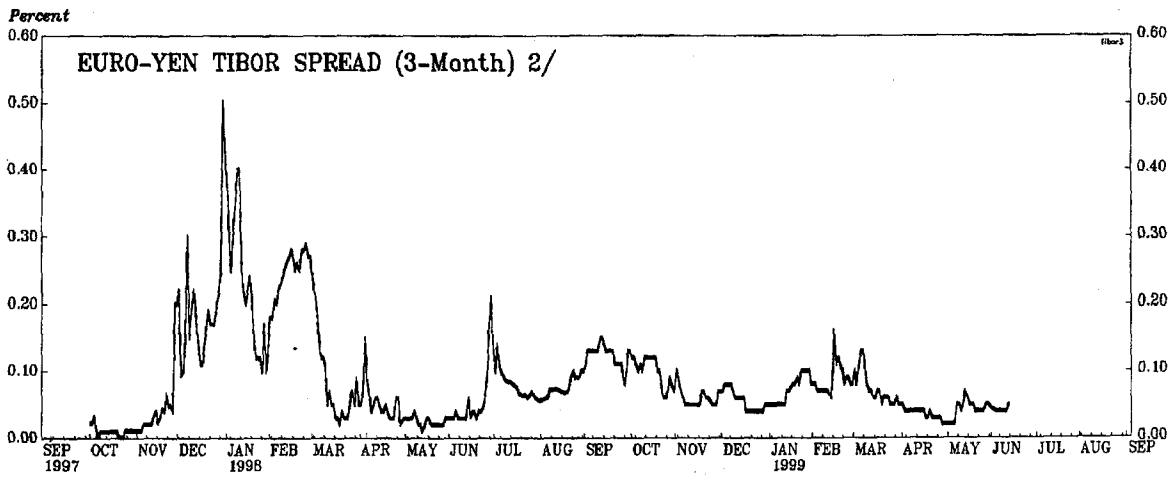
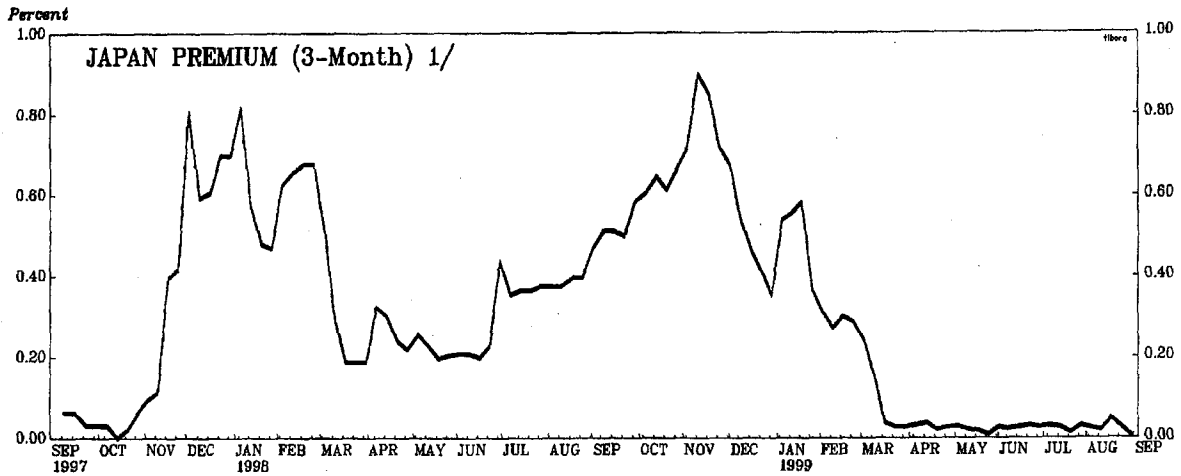
3. **Growing concerns about the financing of the government budget deficit led to a sharp increase in government bond yields in late 1998 and early 1999** (Figure III.2). The rise in yields was accelerated by major banks' desire to limit losses on their bond portfolios in the run-up to the March 1999 public capital injections. The rush to liquidate positions spread to other markets, including the currency market, which put upward pressure on the yen. The resulting appreciation of the yen tightened monetary conditions, as measured by the nominal monetary conditions index (Figure III.3).²

4. **In response, the BOJ cut the overnight call rate to "as low as possible" on February 12, 1999.** In view of concerns about the impact on the functioning of money markets, the BOJ followed a two-stage approach: first, the rate would be guided from about 0.25 percent to about 0.15 percent; then, depending on market developments, the rate would be guided lower. Following the policy change on February 12, the rate fell quickly to about 0.15 percent, then stayed around 0.10–0.15 percent until the end of February, fell again to about 0.03–0.05 percent in March, and has remained at 0.03 percent since early April. After accounting for brokerage commissions, this implies an overnight call rate of zero. Finally, in

¹Prepared by James Morsink (ext. 37875).

²The monetary conditions index is a weighted average of the short-term interest rate and the exchange rate (see Lipworth and Meredith, 1998). While it is usually based on real values of both variables, the nominal version may be calculated with a shorter lag and at a higher frequency.

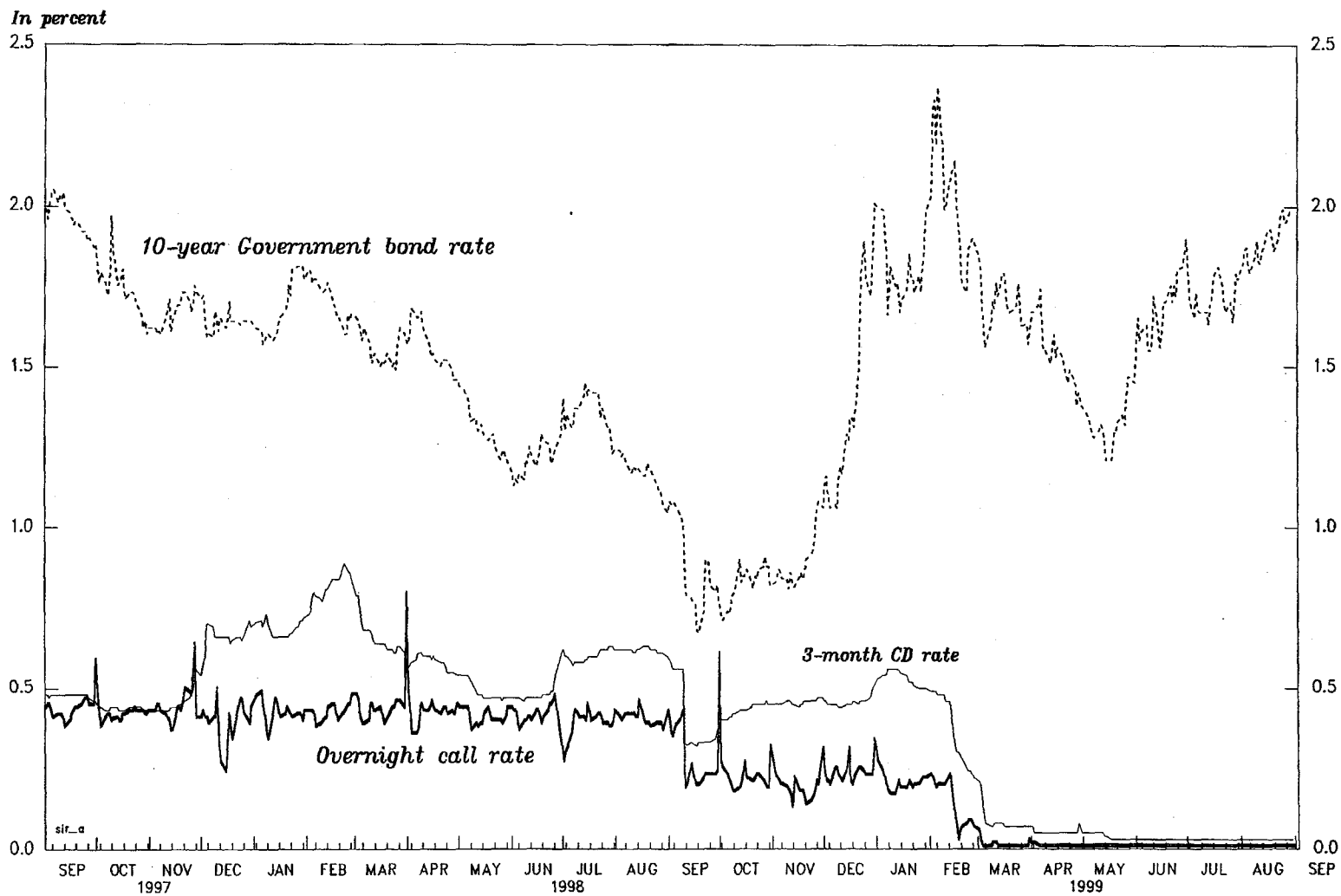
FIGURE III.1
JAPAN
BANK FUNDING PREMIA



Sources: Nikkei Telecom, WEFA, Bloomberg, and staff estimates.

1/ Average U.S. dollar LIBOR of Sumitomo Bank, Fuji Bank, and Bank of Tokyo minus the LIBOR fix.
2/ Gensaki is a repurchase agreement for government paper.

FIGURE III.2
 JAPAN
 SELECTED INTEREST RATES, 1997-99



Source: Bank of Japan, Economic Statistics Monthly; and staff calculations.

FIGURE III.3
 JAPAN
 NOMINAL MONETARY CONDITIONS INDEX, 1997-99



Source: Staff calculations.

mid-April, the Governor announced that the BOJ would “maintain the current zero interest rate policy until deflationary concerns are dispelled”.

5. **The BOJ combined the cut in the overnight call rate with the aggressive provision of liquidity to the financial system.** The policy directive for the February 1999 interest rate cut emphasized that—in order to maintain the stability of money markets—the BOJ would inject ample liquidity, even beyond the level required to hold the overnight call rate at its target. This, combined with the April commitment to keep policy loose while deflationary concerns remain, lowered the entire term structure of interest rate and helped to ease liquidity strains, as reflected in declining risk premia. Against the background of the government’s recapitalization of major banks, the monetary easing in February 1999 led to the virtual disappearance of the Japan premium and the narrowing of other bank funding premia, signaling an end to the immediate financial crisis.

6. **The recent easing of financial strains has allowed the size of the BOJ’s balance sheet to shrink** (Table III.1). During the period of financial turbulence, the BOJ provided funds to some financial institutions and absorbed funds from others, which increased the BOJ’s intermediation in the interbank market and the size of its balance sheet. Over the past year, the BOJ injected liquidity primarily through its conventional instruments, including repurchase operations in government bonds and commercial paper (CP), and outright purchases of government bonds were kept in line with the growth of currency outstanding. The BOJ also made loans to the Deposit Insurance Corporation (DIC) mainly to assist with the government’s nationalization of two major banks. While liquidity injections before February 1999 were mostly sterilized through sales of BOJ bills, since then excess reserves have risen to unprecedented levels.

7. **Excess deposits at the BOJ rose sharply, not only for banks, but also for financial institutions not subject to reserve requirements, such as money market brokers and securities dealers** (Figure III.4). The bulk of banks’ excess reserves have in fact been held by only a few institutions, primarily nationalized banks and foreign banks, reflecting concerns about the shrinking money market. However, most banks have not wanted to hold excess reserves and have deposited excess funds with money market brokers, which in turn hold them at the BOJ. Money market brokers have agreed to take on these excess deposits largely in order to maintain long-term relationships with banks. Excess funds held by money market brokers are unlikely to have a significant macroeconomic impact, as these institutions cannot expand loans and create deposits in the same manner as banks, though it is possible that the funds could be channeled into asset markets.

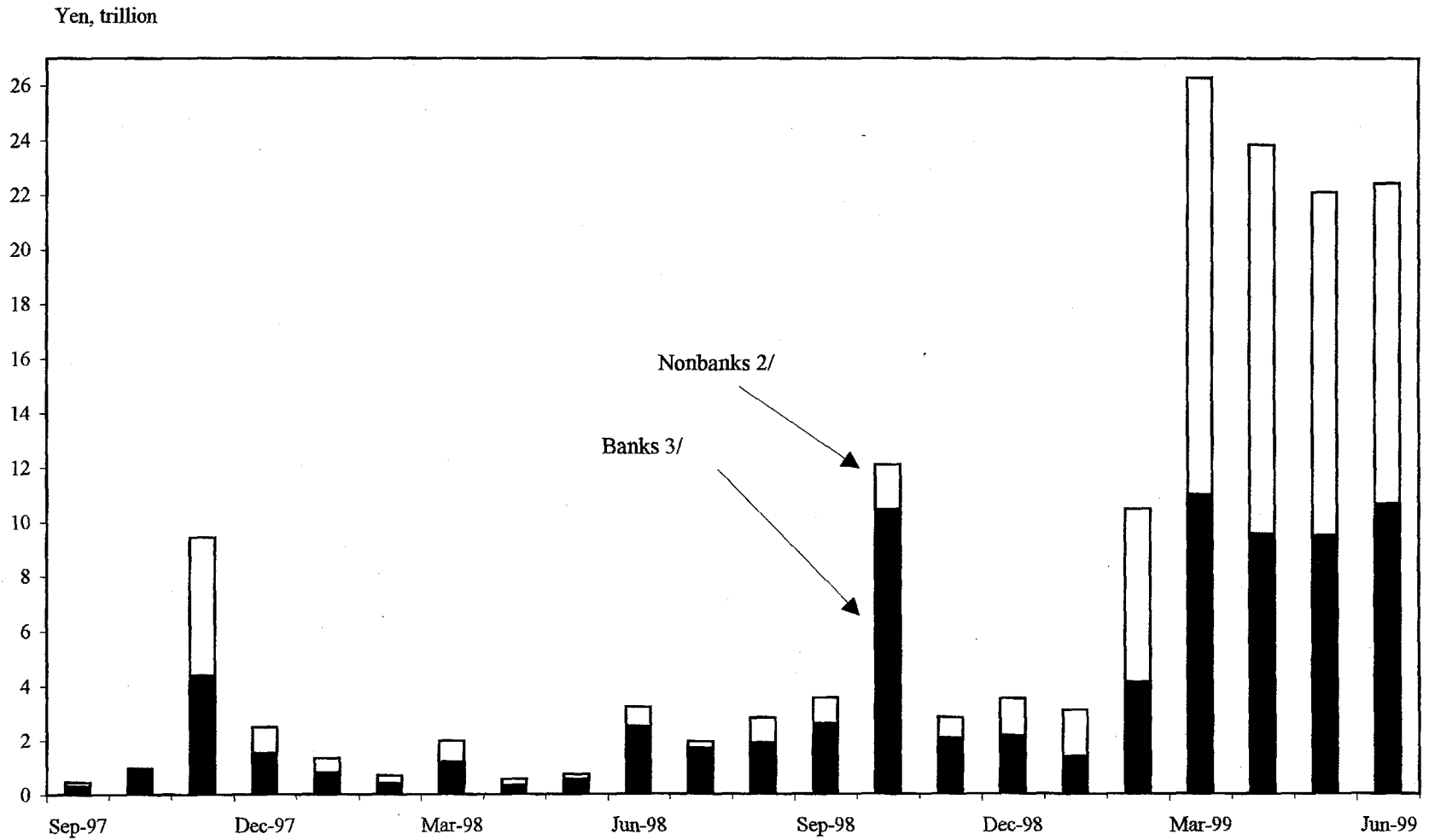
8. **The decline in interest rates to effectively zero has led to a shrinking of the call money market.** The outstanding amount in the call money market fell from about ¥35 trillion in February to about ¥20 trillion in June. Several suppliers of funds—such as life insurance companies—have shifted into bank deposits, which in turn has led banks to cut deposit rates from 0.10 percent to 0.05 percent. The BOJ remains concerned that a further decline in

Table III.1. Japan: BOJ Balance Sheet
(In trillions of yen, end period)

	1997				1998				1999	
	March	June	Sept.	Dec.	March	June	Sept.	Dec.	March	June
Assets	62.4	61.4	56.5	71.5	91.5	75.4	78.4	91.2	79.1	73.4
Loans to private institutions	1.1	1.1	0.8	4.6	5.2	3.1	3.2	1.9	1.3	1.1
Loans to Deposit Insurance Corporation	0.5	0.5	0.3	0.3	1.8	2.0	1.0	8.0	6.7	4.0
Repos in government securities	0.0	0.0	0.0	2.3	6.1	2.4	4.4	5.0	3.9	1.2
Bills purchased	5.4	1.3	4.8	9.5	10.6	3.6	10.3	13.7	5.2	3.2
Government securities	46.4	52.1	45.6	47.4	52.8	55.6	48.9	52.0	49.5	56.0
Other	9.0	6.4	5.0	7.4	14.9	8.7	10.5	10.6	12.5	7.9
Liabilities and capital accounts	62.4	61.4	56.5	71.5	91.5	75.4	78.4	91.2	79.1	73.4
Note issue	45.3	46.0	44.5	54.7	49.0	49.8	48.7	55.9	51.3	52.3
Deposits	3.7	3.6	4.0	3.5	5.8	4.1	5.7	4.4	6.2	5.1
BOJ bills sold	0.0	0.0	2.0	5.2	20.3	13.1	12.8	19.6	10.0	5.8
Repos in government securities	0.0	0.0	0.0	2.3	6.1	2.4	4.4	5.0	3.9	1.2
Other	13.5	11.7	6.0	5.8	10.2	6.1	6.7	6.3	7.7	9.1
Memo items:										
Note issue and deposits, seas. adj.	48.2	48.8	49.7	51.7	54.0	52.9	55.8	53.6	56.6	59.8
3-month change	0.1	1.3	1.9	4.0	4.3	-1.9	5.5	-4.0	5.6	6.7
12-month change	7.3	6.3	7.5	7.5	12.0	8.5	12.3	3.6	4.9	13.0

Source: Bank of Japan, staff estimates.

Figure III.4. Japan: Excess Deposits at BOJ, 1997-99 1/



Source: Bank of Japan.

1/ Cumulative amount for reserve maintenance period (16th of month to 15th of following month).

2/ Financial institutions not subject to reserve requirement.

3/ Financial institutions subject to reserve requirement.

volume could make it more difficult for financial institutions to adjust their liquidity, potentially leading to higher volatility of the call rate when banks misjudge their liquidity needs. So far, however, financial institutions have not had any difficulties in lending funds to or borrowing funds from the call market.

9. **With the overnight call rate at its floor, market participants know that the next move is up, which has focussed attention on how long the current “zero rate” policy will be maintained.**³ Specifically, in March and April 1999, some market participants became concerned that monetary policy might be tightened following the passing of liquidity pressures associated with the fiscal year end. The BOJ Monetary Policy Board therefore decided at its meeting on April 9 to make an explicit commitment to “maintain the current zero interest rate policy until deflationary concerns are dispelled,” which was communicated to markets through the Governor’s subsequent press conference and the publication of the minutes of the meeting. These actions were successful in convincing markets of the BOJ’s commitment to its current policy stance, as reflected in the continued flattening of the yield curve through May (Figure III.5). However, more encouraging recent news on the economy—including the first quarter 1999 GDP figures and June *Tankan* survey—have led to a rise in the yield curve as market participants have begun to suspect that deflationary pressures may dissipate more rapidly than previously anticipated.

10. **Notwithstanding the generally expansionary stance of monetary policy, the growth of the monetary base fluctuated considerably over the past year** (Figure III.6). During the financial market turbulence in the second half of 1998, the monetary base grew around 8–10 percent year-on-year, as it had done since the onset of the financial crisis in late 1997. However, in December 1998 and January 1999, the demand for currency—the main component of the monetary base—fell sharply, owing to increased confidence in the banking system and lower end-year bonus payments. Following the further easing of policy in February 1999, the growth rate of the monetary base has returned to its pre-crisis level of about 7 percent year-on-year. By contrast, broad money growth has been relatively stable at 4–5 percent year-on-year.⁴

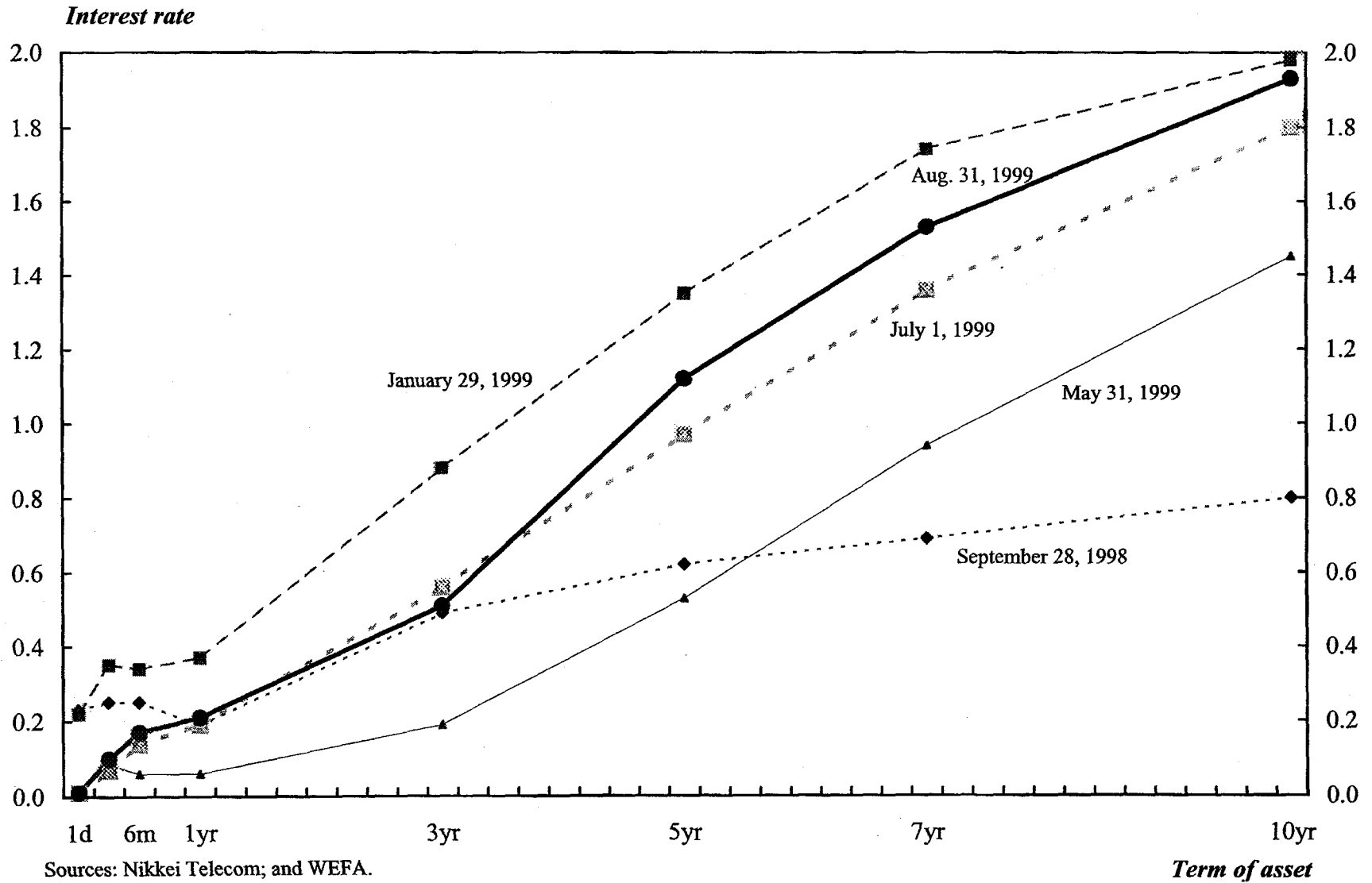
B. Measures to Support Bank Lending

11. **Notwithstanding the stabilization of the banking system, bank lending has continued to decline** (Figure III.6). While the headline figure (-5.7 percent during the year ended June 1999) exaggerates the degree of contraction, because it is not adjusted for loan securitization, loan

³Nominal interest rates cannot fall below zero because cash is an alternative store of value. When Treasury bill yields and some interbank rates fell momentarily below zero in November 1998, investors rapidly shifted into other assets and the yields quickly became positive again.

⁴The slight pickup in broad money growth in the second half of 1998 was driven in part by the buildup of precautionary deposits by corporations, which feared an intensification of the credit crunch, but growth has subsequently subsided as liquidity fears have been relieved.

Figure III.5. Japan: Yield Curves 1/



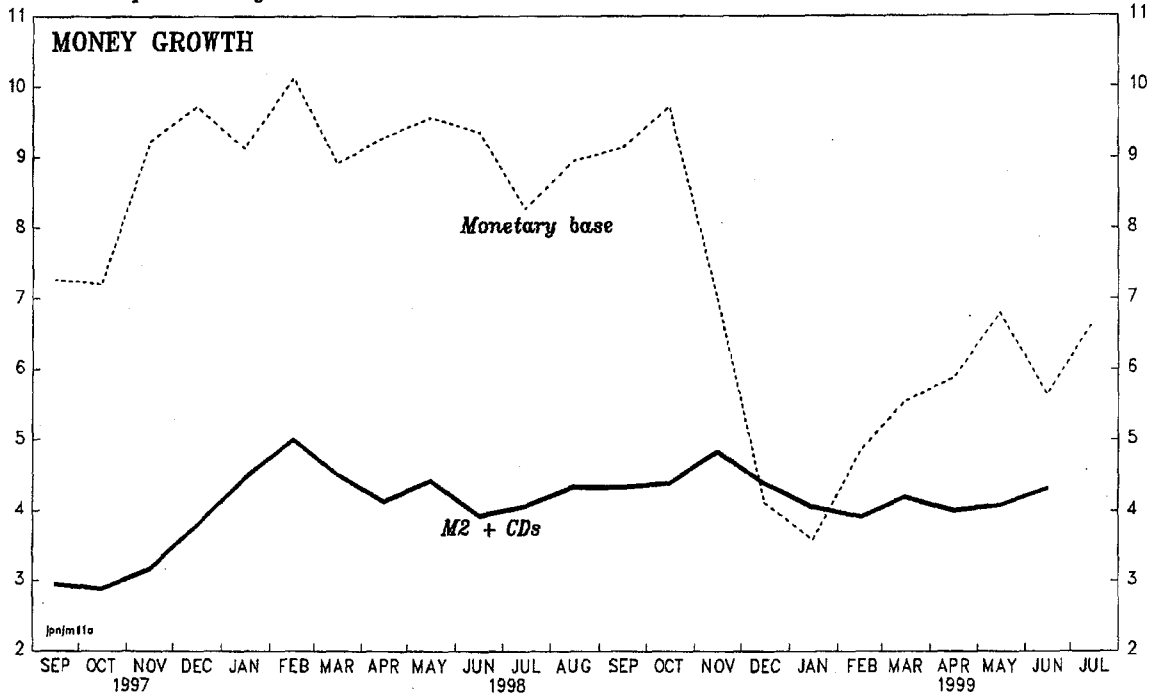
Sources: Nikkei Telecom; and WEFA.

1/ The graph shows the overnight call rate, 3-, 6-, and 12-month Euro yen rates, and government bond yields from 3 to 10 years.

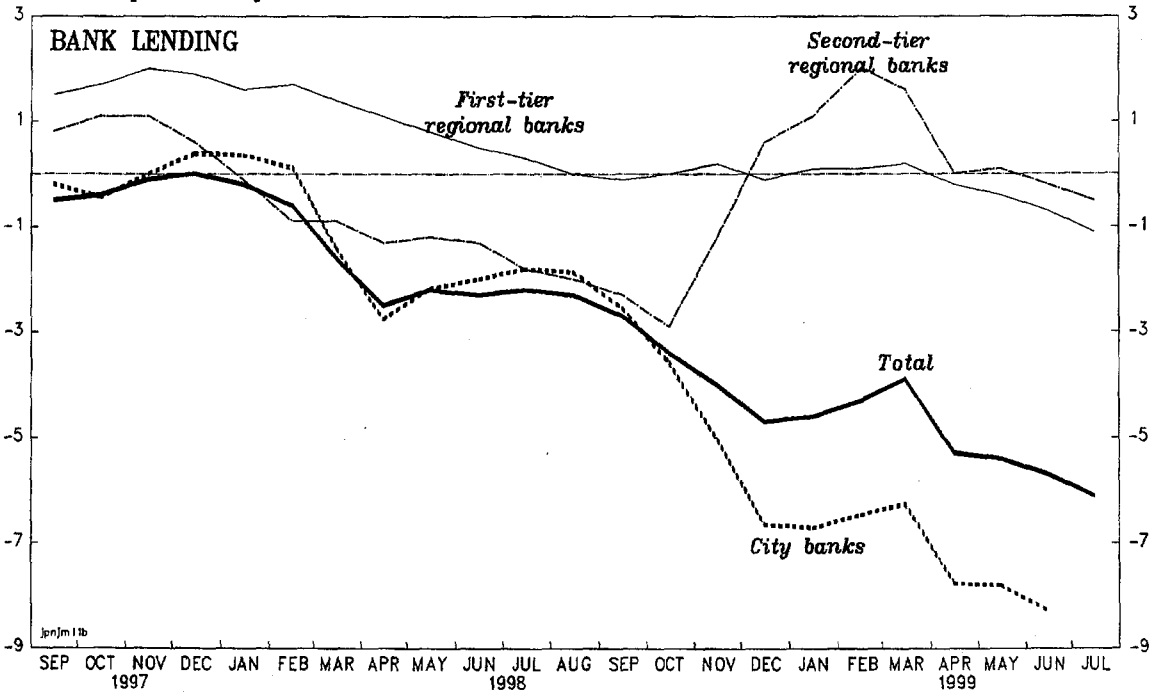
FIGURE III.6
JAPAN

MONEY AND CREDIT GROWTH, 1997-99

Twelve-month percent change



Twelve-month percent change



Sources: Bank of Japan, Economic Statistics Monthly; and staff calculations.

write-offs, and other special items, the adjusted data also show a decline (-1.2 percent) during the past year.⁵ The contraction in bank lending reflects several factors, including lower desired investment spending by firms, lenders' increased sensitivity to risk, and banks' desire to reduce risk assets to improve their capital adequacy ratios.

12. **In normal times, monetary easing by itself would stimulate aggregate demand, in part through the bank lending channel.** Monetary easing usually boosts bank lending by improving banks' liquidity and—in Japan—by increasing the value of banks' holdings of stocks, which improves banks' solvency. However, given banking sector weaknesses, this monetary transmission mechanism has been less effective than usual.⁶ Therefore, to help sound companies obtain loans, the government and the BOJ took four sets of measures over the past year: increased loan guarantees; expanded lending by government financial institutions (GFIs); use of public funds to recapitalize private banks; and the introduction of new BOJ facilities to improve the liquidity of corporate debt.

13. **First, the government sharply expanded the loan guarantee program for small and medium-sized enterprises (SMEs), which account for three-quarters of nonagricultural employment.** Loan guarantees are given by local government credit guarantee associations, which in turn reinsure 70–80 percent of the amount with the central government's Small Business Credit Insurance Corporation (SBCIC). The credit guarantee associations, of which there are 52 nationwide, have altogether about ¥1 trillion in capital, and participating firms pay guarantee fees of 0.5–1.0 percent of the loan. Effective October 1998, the overall ceiling for such guarantees was raised by ¥20 trillion (4 percent of GDP), to be used by March 2000, and the loan amount obtainable without collateral was doubled to ¥100 million.

14. **By reducing credit risk premia for SMEs, the loan guarantees were effective in unlocking bank lending.** Outstanding loan guarantees increased from ¥30 trillion as of September 1998 to ¥42 trillion in March 1999 (Figure III.7). Loan guarantees in March amounted to 13 percent of private bank lending to small businesses and 9 percent of total private bank lending. The success of the loan guarantee program can be seen in the more rapid growth of lending by regional banks, especially second-tier regional banks, which lend primarily to SMEs, compared to the growth of lending by city banks, which lend primarily to large firms (Figure III.6). The decline in the number of bankruptcies of small firms since the beginning of 1999 and the increase in investment by small firms (reflected in the strong business investment figure for the first quarter of 1999) are also attributable to the loan guarantee program.

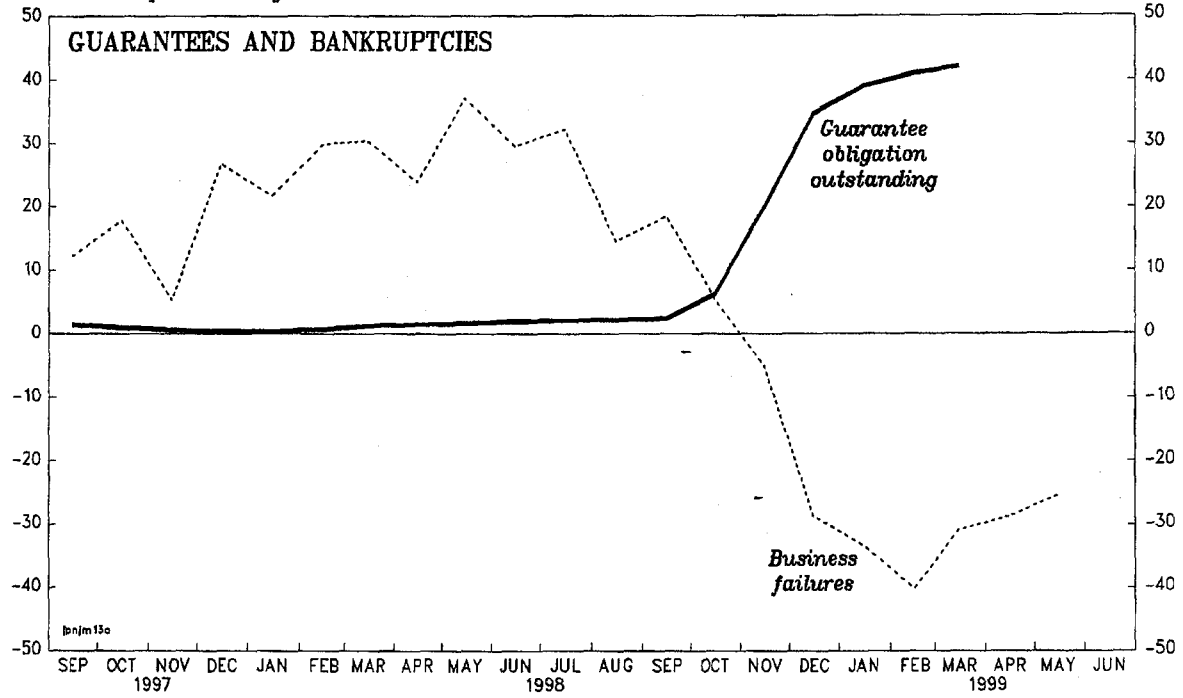
⁵The adjusted data are not included in Figure III.6 as they are only available starting in October 1998.

⁶Further analysis of the monetary transmission mechanism is provided in the 1999 *Selected Issues* paper by Morsink and Bayoumi.

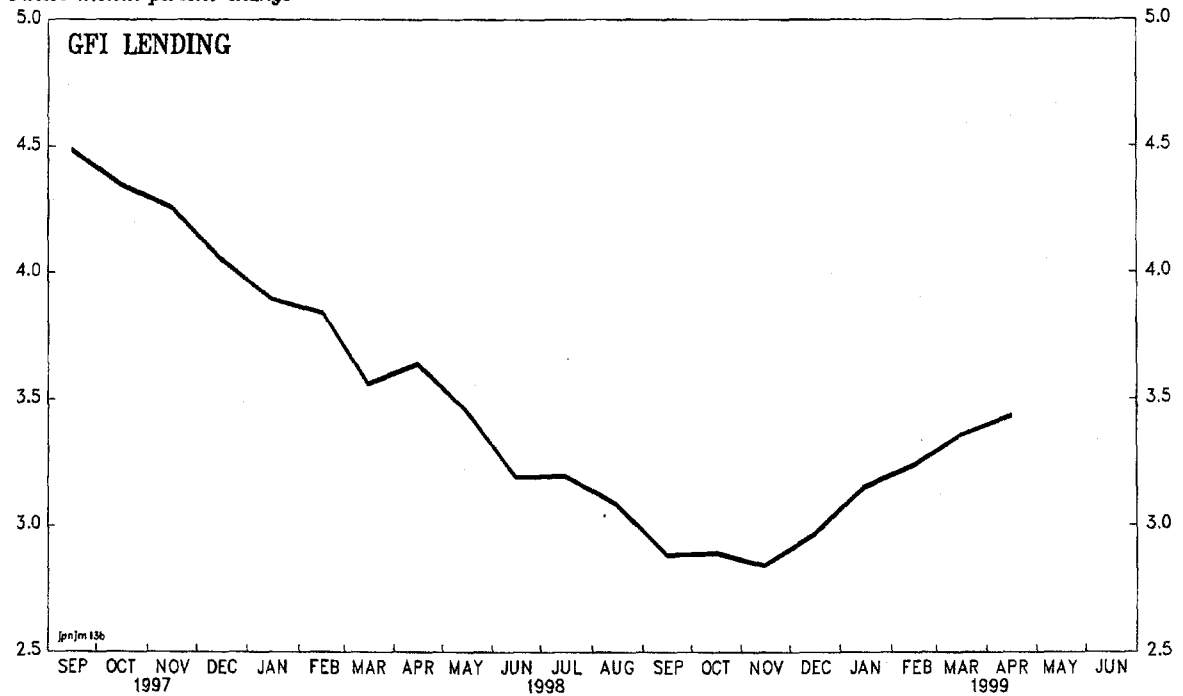
FIGURE III.7
JAPAN

CREDIT GUARANTEES AND BANKRUPTCIES, 1997-99

Twelve-month percent change



Twelve-month percent change



Sources: Nikkei Telecom; and Bank of Japan, Economic Statistics Monthly.

15. **However, this macroeconomic support comes at the cost of higher contingent liabilities for the public sector and microeconomic distortions.** The key aspect of the loan guarantees is that the government takes on the credit risk inherent in lending to SMEs, which undermines banks' incentives to make adequate assessments of credit quality and firms' incentives to make good use of borrowed funds, and increases the government's role in the allocation of credit.⁷ The government has pledged ¥1 trillion of additional funds as needed to help cover possible loan losses associated with the ¥20 trillion increase in loan guarantees.

16. **Second, the government increased lending by GFIs in late 1998 and early 1999.** To spur GFI lending, which amounts to almost one-third of lending by private banks and has been an increasingly important source of funds for the corporate sector, lending criteria were relaxed. The definition of "small firms" was broadened from SMEs (with capital less than ¥100 billion) to include larger firms (with capital up to ¥500 billion). In addition, the Japan Development Bank was allowed to lend not only for long-term capital investment, but also for working capital and to meet maturing bond obligations. To support this increased lending by GFIs, the April and November 1998 fiscal stimulus packages increased the Fiscal Investment and Loan Program's allocation of funds to GFIs in FY1998 by more than ¥3 trillion (15 percent) compared to the initial budget. As a result, the growth rate of lending by GFIs has increased in recent months (see lower panel of Figure III.7).

17. **Third, the recapitalization of most major private banks with public funds in March 1999 relieved pressures to improve capital adequacy ratios by reducing risk assets.** As a condition for receiving public money, major banks promised to expand lending by ¥6.7 trillion (2½ percent) in FY1999, with nearly half earmarked for small and medium-sized enterprises.⁸

18. **Fourth, the BOJ expanded existing CP operations and introduced new facilities to improve liquidity of corporate debt in late 1998 and early 1999.** The BOJ took three measures to support the extension of bank credit to corporations, especially towards the end of the calendar year and the fiscal year:

- The maturity ceiling for CP that could be used in the central bank's repurchase operations was increased from 3 months to one year, effective November 16.
- A new lending facility was established on November 27 that allowed banks to refinance up to 50 percent of the increase in their loan balance since September 1998. The refinance credits carried an interest rate of 0.5 percent and matured in April 1999.

⁷Some banks are reported to have initially encouraged loan officers to use the loan guarantee program to refinance bad loans, but the FSA discouraged this practice.

⁸The injection of public funds and banks' capital strength are discussed in the accompanying chapter on banking system issues.

after the end of the fiscal year. At least half of the collateral had to be in the form of private firms' debt obligations.

- A new market operation was started in April 1999 under which the central bank purchases bank bills that are collateralized solely by corporate bonds and loans on deeds. This differs from the existing discount window in that purchases are generally made on a two week schedule and prices are market-determined through an auction.

19. **The BOJ measures helped banks obtain liquidity, as they were broadly equivalent to an expansion of discount window lending, and thus supported corporate funding.** In effect, the BOJ offered to turn illiquid assets into liquid ones, which was helpful in relieving banking system strains. However, with the stabilization of the banking system in early 1999, banks have reduced their use of the facilities. The amount of commercial bills held by the BOJ rose from about ¥10 trillion in September 1998 to about ¥14 trillion in December 1998 and then fell to about ¥3 trillion in May, while the size of the overall CP market remained broadly unchanged (Figure III.8). Similarly, BOJ lending under the refinancing facility—made available to ease financing at the end of the 1998 financial year—was only about one-quarter of the eligible amount, and the new corporate-bond backed operation has been used only lightly.

20. **The BOJ measures had a limited impact on corporate financing beyond high-quality paper, because they were not principally directed at reducing corporate credit spreads.** Although these facilities allowed the BOJ to enter the corporate debt market, they were structured to limit the transfer of credit risk onto its balance sheet.⁹ Thus, the underlying credit risk stayed off the BOJ's balance sheet and in the private sector. To the extent that the BOJ's operations had a limited impact on credit spreads, they also had little effect on firms' cost of funds.

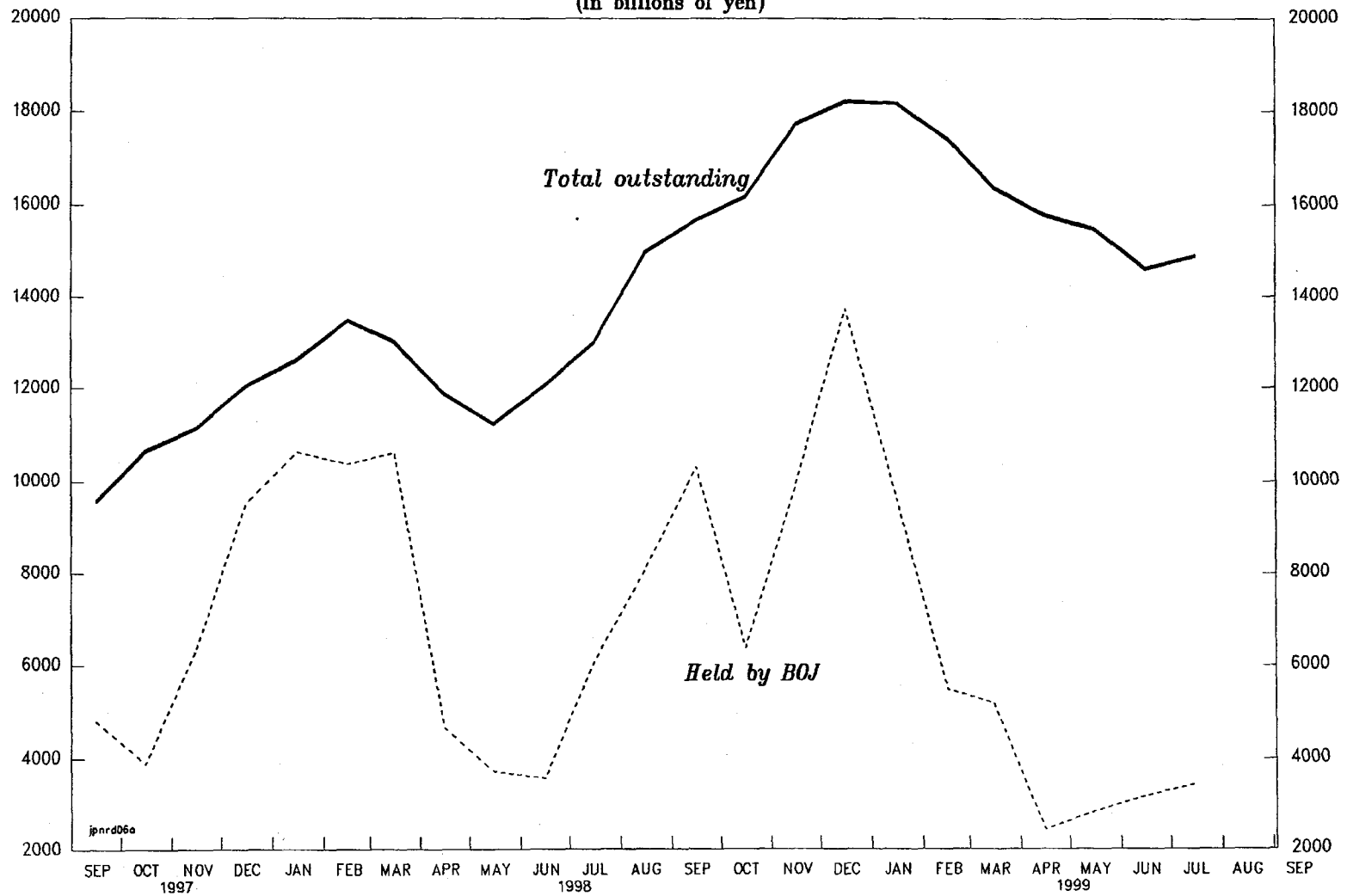
C. Remaining Options to Ease Monetary Policy

21. **The current unusual situation with interest rates close to—and now effectively at—zero has generated intense debate about whether further steps could be taken to enhance the effectiveness of monetary policy.** Proposals include the underwriting or increased purchases of government bonds, the announcement of an explicit inflation target, the adoption of a supplementary operating target, and less conventional operations, including the expansion of outright purchases of private sector securities and buying tangible assets.

22. **In the face of rising government bond yields in early 1999, there were strong political pressures for the BOJ to underwrite government bonds, thus facilitating**

⁹For example, in CP repurchase operations, the CP must be endorsed by the seller, i.e., the BOJ's counterpart, typically a bank.

FIGURE III.8
 JAPAN
 COMMERCIAL PAPER MARKET, 1997-99
 (in billions of yen)



Source: WEFA, Nomura database.

issuance and reducing upward pressure on long-term interest rates. However, BOJ officials have argued strongly that such a fundamental change in institutional structure, which at a minimum would require parliamentary approval of the activation of a special provision in the Public Finance Law, would carry a serious risk of weakening fiscal discipline.¹⁰ In turn, the prospect of larger government budget deficits and greater central bank financing could increase inflationary expectations, and thus raise long-term interest rates (see Hayami, 1999). The BOJ already has the authority to make outright purchases of government bonds on the secondary market, so-called *rinban* operations, which the BOJ conducts to match the rise in currency issue with increased holdings of government bonds. However, the BOJ argues that expanding such purchases in excess of currency issue could have the same effect on market expectations as underwriting.

23. **Clarifying the inflation objective could enhance the effectiveness of monetary policy by reducing uncertainty about future price developments and focus the public policy debate.** The BOJ has a legal mandate to achieve price stability, but this objective is not precisely defined, as it has been for some other central banks. By announcing an explicit inflation target, and publishing an inflation report and forecast, policymakers could help emphasize the essential forward-looking nature of monetary policy, with the inflation target as the intermediate goal. While the BOJ's commitment to avoiding high inflation is not in doubt, an explicit inflation target could underline the BOJ's intention to avoid deflation. For example, the period in late 1998 and early 1999, during which the BOJ did not react to a tightening of monetary conditions implied by an appreciating exchange rate, could have encouraged the perception that the BOJ may be less concerned by declining rather than rising prices. The announcement by the BOJ in April 1999 that it would "maintain the current zero interest rate policy until deflationary concerns are dispelled" can be understood as a message to the market underlining the BOJ's determination to resist deflation.

24. **With most of the necessary institutional arrangements for inflation targeting already in place, the main operational issue would be the specification of the inflation target.** Following the implementation of the new Bank of Japan Law in April 1998, the monetary policy framework in Japan already has many of the characteristics that are typical of inflation targeting frameworks, including central bank independence, the primacy of the price stability objective, instrument independence, and policy decisions made by a monetary policy committee with regular meetings and published minutes. The crucial questions in the specification of the inflation target include the selection of a price index and setting a numerical target. Experience with inflation targeting in other industrial countries supports defining the inflation target in terms of a well-known and widely-used price index, such as the consumer price index, possibly excluding a few items subject to sharp transitory price movements not linked to domestic demand pressures. Care would be needed since, when

¹⁰Japan's experience with high inflation in the immediate post-World War II period (called "vicious inflation") led to a general legal prohibition on the central bank underwriting of government bonds.

inflation is already very low, the differences between alternative measures of inflation—such as the CPI, the CPI minus food and energy, or the deflator for personal consumption—can be large compared to the inflation rate.

25. **If Japan were to adopt an inflation targeting approach, there would be several reasons to aim for a low positive inflation target.** First, it may sometimes be useful for the real interest rate to be negative, such as during recessions (Fischer, 1994 and 1996). With zero as the lower bound for nominal interest rates, the real interest rate cannot be negative if expected inflation is zero or less (Summers, 1991).¹¹ Second, in the presence of downward price inflexibility, positive inflation can reduce the output costs of adverse shocks to aggregate demand and facilitate the adjustment of relative prices. Third, the CPI in Japan—as in other countries—is biased upwards, owing primarily to the difficulties in fully capturing quality changes and the gradual shift to lower price stores. Shiratsuka (1999) estimates this bias to be about 1 percent.

26. **Nevertheless, a number of difficulties arise in considering an inflation targeting approach for Japan.** One concern is that the announcement of an explicit inflation target could reduce the BOJ's flexibility in responding to shocks. The BOJ has multiple objectives, including maintaining price stability and ensuring the stability of the financial system so as to lay the foundations for sound economic development. In view of these multiple objectives, the BOJ might need to respond to unusual developments in asset prices, the exchange rate, or the financial system. There could be a risk that defining an inflation target could constrain the central bank to respond too mechanically to the wide variety of shocks that affect the economy. Another potential problem is that the discrepancy between the CPI and WPI inflation rates has been and continues to be particularly large in Japan, compared to other major industrial countries. This wide divergence makes it more difficult to choose a single representative price index.

27. **With the overnight call rate now at its floor, the BOJ could consider adopting a supplementary operating target, so that it could signal a loosening of the policy stance, if this became necessary.** Most central banks signal a change in the policy stance by adjusting their target for short-term interest rates. However, with short-term rates at their floor in Japan, such an approach can no longer be used. An alternative suggested by a number of commentators would be for the BOJ to announce a target for another variable, such as an

¹¹Going further, given the severity of Japan's economic downturn last year, Krugman (1998) suggested adopting an inflation target of 4 percent for 15 years in order to achieve the reduction in the real interest rate necessary to close the output gap. However, a target of 4 percent is higher than those chosen by other industrial countries with inflation targeting and raises questions about the costs of inflation at this level. Also, it is not clear how a central bank in an economy that is in a liquidity trap—where increases in the monetary base have no direct effect on aggregate demand—can credibly commit to generate inflation in the short term or how it can credibly commit to maintaining this policy in the long term.

intermediate interest rate or the monetary base, while keeping the overnight call rate as its primary operating target. Using an intermediate interest rate as a supplementary target would be relatively easy to integrate with the continued use of the call rate as the primary objective. In choosing an intermediate interest rate target, it would be necessary to move quite a long way out the yield curve, since the curve presently lies below 25 basis points all the way out to one year. A monetary base target could be derived from a projected path for nominal GDP adjusted for trend velocity and the deviation of actual nominal GDP from its projected path in the recent past (for the specification of such a target for Japan, see McCallum, 1993).

28. **There are a number of issues that would need to be faced in using such an approach.** Specifically, with respect to targeting medium- or long-term interest rates, it may be difficult for the BOJ to control such rates, because this requires influencing expectations of future short-term interest rates or term premia (or both). How can the BOJ change the market's view of monetary policy several years in the future? For example, outright purchases of medium-term bonds would not necessarily change expectations of future short-term interest rates, because the increase in the monetary base associated with a bond purchase would not necessarily be sustained for any longer than that with a purchase of a Treasury bill. Also, while purchases of bonds could in principle reduce term premia if bonds and other assets are imperfect substitutes in the public's portfolio, historical evidence from Operation Twist in the U.S. in 1961 does not suggest that these effects are large (Johnson, Small, and Tryon, 1999).

29. **The implementation of a monetary base target would face important obstacles, including volatility in money base demand.** The possibility of substantial shocks to the demand for currency or bank reserves implies that the monetary stance could turn out to be easier than expected, which—notwithstanding current deflationary pressures—could fuel inflation later on. Stronger-than-expected demand for base money would be revealed immediately in upward pressure on interest rates, which would be countered by the BOJ's adherence to its primary operating target. However, weaker-than-expected demand for base money cannot put downward pressure on interest rates that are already at zero, so the monetary stance could—unknown to the BOJ—turn out to be more expansionary than planned. As a result, a supplementary base money target would either have to be revised frequently, which would reduce its usefulness as a signaling device, or—if rigidly adhered to—could increase uncertainty about future short-term interest rates and hence raise the volatility of longer-term interest rates.

30. **Other potential problems are how to control base money and whether increases in base money affect aggregate demand when interest rates are zero.** In principle, the demand for base money is indeterminate when interest rates are zero. In practice, recent experience has shown that most banks are reluctant to increase their excess reserves, preferring instead to place excess funds with money market brokers. Thus, there is no assurance that repeated injections of liquidity would in fact lead to an increase in base money. Moreover, even if an increase in base money could be engineered, it is not clear that this would have a large impact on aggregate demand. One could argue that sufficiently large

injections of excess reserves would eventually spill into asset markets, such as the foreign exchange market and the stock market, or affect price expectations. However, this is largely uncharted territory, and it is not clear that such effects would be large.¹²

31. **Finally, the BOJ could consider increasing monetary stimulus by expanding outright purchases of private sector securities and buying tangible assets.** Substantial purchases by the BOJ would likely raise prices, which could have substantial wealth effects and thus stimulate economic activity. However, affecting the prices of tangible assets and private sector securities could be problematic on political and legal grounds—how should the BOJ decide which assets to purchase? Such purchases would be equivalent to distributing wealth to some citizens and not to others, based solely on their asset holdings. Moreover, it would expose the BOJ's balance sheet to considerable credit risk. A better alternative—in an extreme deflationary situation—would probably be to affect the wealth distribution through reductions in taxes or increases in government spending or transfers, which would have the advantage of explicitly incorporating the political process, and have the BOJ finance the resulting increase in the government deficit, i.e., money financed expansionary fiscal policy. While the direct financing of the government deficit by the BOJ is generally prohibited by law (as discussed above), this restriction can be lifted temporarily in extreme circumstances.

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¹²The paper by Morsink and Bayoumi in the 1999 *Selected Issues* paper finds that increases in base money have a limited impact on economic activity after changes in the overnight call rate are taken into account.

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IV. BANKING SYSTEM ISSUES¹

1. **The Japanese authorities have over the past year tightened bank regulation and supervision and put in place a comprehensive framework for addressing banking system problems.** Regulation and supervision has improved under the Financial Supervisory Agency (FSA), established in June 1998. Legislation was enacted in October 1998 that sharply increased public funds available to deal with banking problems, toughened the conditionality for bank recapitalization with such funds, and created the mechanism for the nationalization of failed banks. Looking ahead, the principal remaining challenges for banks are to set aside adequate provisions for loan losses, address other sources of capital weakness, and restore core profitability. Progress in these areas is important given the planned reintroduction of limited deposit insurance coverage after March 2001. This chapter provides an overview of the key issues in the banking system, discusses the main policy developments, and describes remaining challenges.

A. Overview

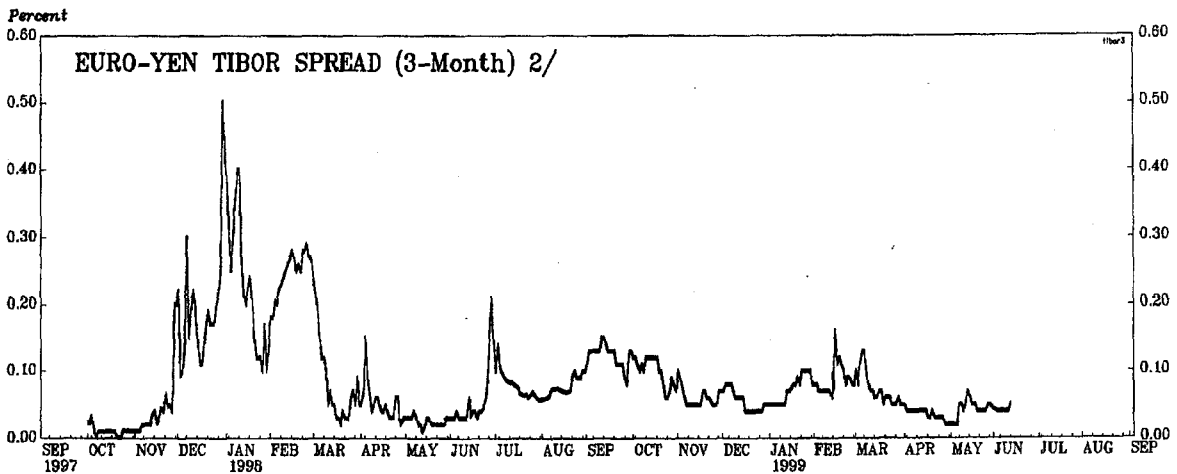
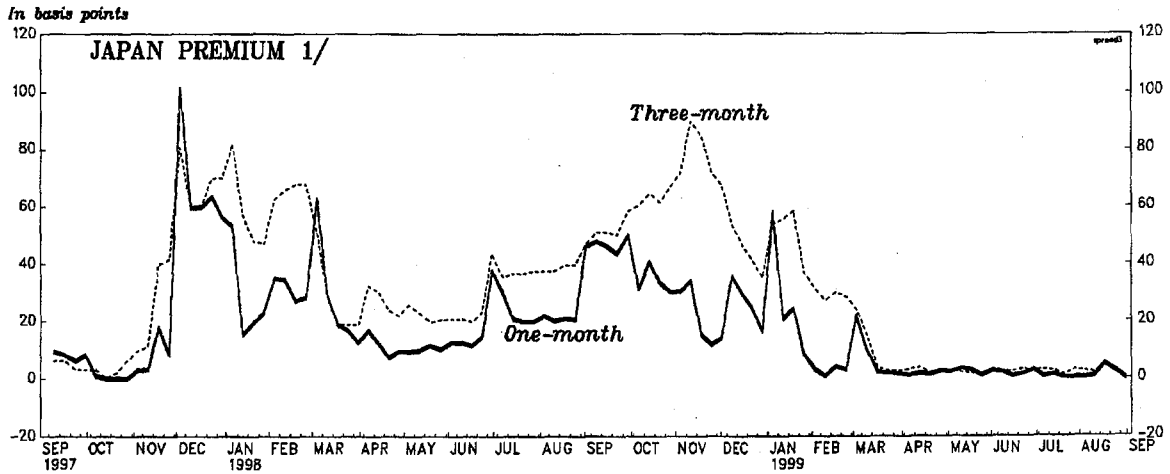
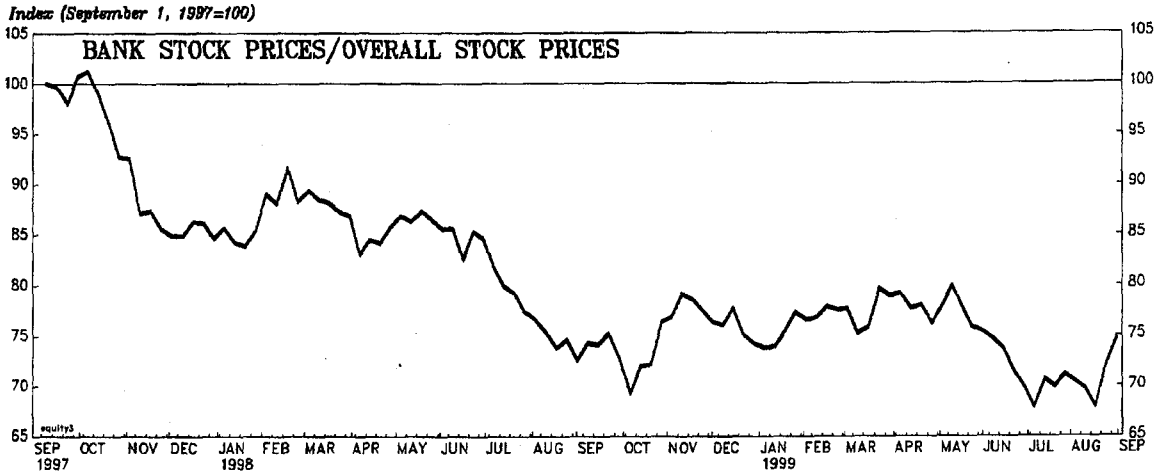
2. **During much of 1998, market perceptions of the financial soundness of most major banks deteriorated.** Bank stock prices fell, credit ratings were downgraded, and funding spreads widened (Figure IV.1). The visible difficulties of one of Japan's major banks and the apparent political deadlock over plans to inject public money into troubled banks contributed to the intensification of market tensions.

3. **In response to increasing banking system strains, legislation was enacted in October 1998 that provides a broad framework for resolving banking problems.** A start has been made in applying the new instruments: two major banks were nationalized in late 1998, most remaining major banks were recapitalized with public funds in March 1999, and the authorities have begun addressing problems in regional banks. In addition, the FSA conducted on-site inspections of all major banks in the summer and fall of 1998 and of all regional banks in the winter and spring of 1999. The expectation of public capital injections helped strengthen bank equity prices (although their relative value has fallen again recently), and the ample provision of funds by the Bank of Japan (BOJ)—especially since February 1999—led to the virtual disappearance of the Japan premium.

4. **Major banks' performance in FY1998 remained weak, although virtually all major banks reported capital ratios above 10 percent for March 1999.** Major banks made loan loss charges of ¥10 trillion, bringing cumulative loan loss charges since April 1990 to over ¥47 trillion (9½ percent of GDP). Loan loss charges were almost four times net operating profits (*gyomu-juneki*), resulting in substantial net losses (Table IV.1 and Figure IV.2). The banks' net losses would have been even larger in the absence of an accounting change that allowed them to post deferred tax credits of ¥2.5 trillion in their unconsolidated

¹Prepared by James Morsink (ext. 37875).

BANKING SYSTEM STRAINS, 1997-99



Sources: WEFA; and Bloomberg Financial Markets L.P.

1/ Average U.S. dollar LIBOR of Fuji Bank, Bank of Tokyo-Mitsubishi, and Norinchukin Bank minus the LIBOR fix.

2/ Highest rate minus lowest rate.

Table IV.1. Japan: Major Banks' Profits and Capital, FY1997-98
(Billions of yen)

	Net operating profit 1/		Loan loss charges 2/		Net income 3/		Dividends		Equity capital, March 1999			Capital adequacy ratio 4/	
	FY1997	FY1998	FY1997	FY1998	FY1997	FY1998	FY1997	FY1998	Total	Tax effect	Public funds	FY1997	FY1998
City banks													
Tokyo-Mitsubishi	342.9	559.2	1,549.1	889.2	-900.6	45.4	39.7	41.1	2,865.0	622.6	0.0	8.5	10.5
Dai-Ichi Kangyo	323.1	178.6	752.9	971.9	-146.4	-376.2	26.6	19.5	2,385.1	626.5	700.0	9.1	11.5
Sakura	293.8	172.9	1,181.0	1,023.5	-220.5	-375.3	37.3	28.5	2,211.2	677.7	800.0	9.1	12.3
Sumitomo	308.1	220.2	1,072.9	1,072.4	-621.7	-374.1	26.6	18.8	1,837.1	719.9	501.0	9.2	11.0
Fuji	320.4	192.8	951.6	712.2	-518.7	-392.9	25.2	22.7	2,309.6	732.6	800.0	9.4	11.2
Sanwa	351.9	246.5	945.1	1,003.1	-340.9	-394.4	24.6	22.2	2,096.2	592.6	600.0	9.6	11.1
Tokai	173.0	163.1	391.5	577.5	5.7	-185.7	20.6	18.2	1,603.2	371.4	600.0	10.3	12.6
Asahi	156.4	83.9	477.4	652.1	-184.0	-220.0	14.4	15.4	1,365.4	334.2	400.0	9.4	11.9
Daiwa	96.5	91.9	384.5	360.0	-52.9	-116.5	10.9	6.5	934.7	211.2	408.0	10.3	12.7
Long-term credit bank													
Industrial Bank of Japan	230.7	212.1	647.3	924.3	-342.0	-195.7	21.6	18.1	1,614.8	406.3	350.0	10.1	11.3
Trust banks													
Mitsubishi Trust	223.2	122.3	288.1	417.9	10.2	-119.6	10.4	9.8	733.4	297.3	200.0	10.4	11.7
Sumitomo Trust	131.4	166.5	333.0	357.1	-71.7	-107.1	10.0	9.3	686.2	287.7	100.0	9.9	12.3
Mitsui	121.2	56.2	238.9	373.5	7.5	-144.0	6.0	7.2	745.4	243.6	250.2	10.4	15.4
Yasuda	92.4	28.0	261.1	259.3	-159.5	-375.8	0.0	0.0	349.3	253.9	0.0	13.6	12.5
Toyo	49.1	34.4	81.0	311.7	8.5	-127.7	5.5	4.5	551.1	183.0	200.0	10.7	13.9
Chuo	58.4	27.4	88.8	93.8	12.3	-48.7	1.4	2.3	352.1	68.9	150.0	12.7	13.2
Nippon	2.2	-5.0	211.4	60.2	-100.4	-84.1	0.0	0.0	72.5	20.0	0.0	9.8	8.2
Total	3,274.7	2,551.0	9,855.6	10,059.7	-3,615.1	-3,592.4	280.8	244.1	22,712.3	6,648.4	6,059.2	9.5	11.6

Source: Fitch IBCA.

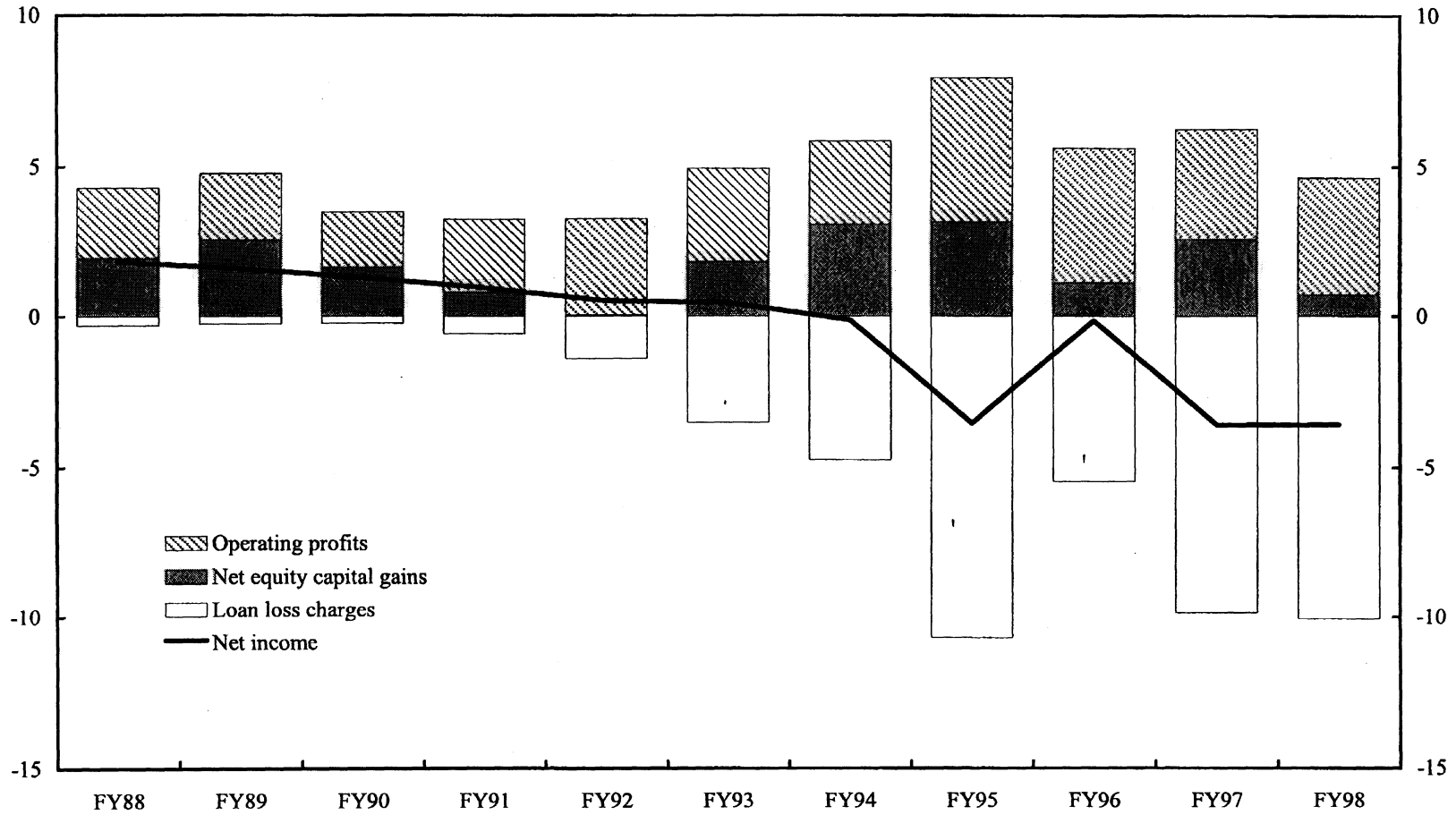
1/ Before specific loan loss charges and equity capital gains (gyomu-juneki).

2/ Total provisions and charge-offs (banking account).

3/ After special items and taxes.

4/ Consolidated basis.

FIGURE IV.2
 JAPAN
 MAJOR BANKS' PROFITS, FY88-98
 (In trillions of yen)



Source: FitchIBCA.

accounts. Public funds and deferred tax assets together accounted for more than half of Tier-1 capital as of March 1999. Despite the substantial net losses, major banks continued to pay dividends.

5. **Notwithstanding recent progress, Japan's banking problems continue to be an important source of vulnerability for macroeconomic performance.** Until these problems are dealt with, prospects for a durable recovery will continue to be blighted by a weak banking system unable to play its proper role in financial intermediation. The urgency of action is highlighted by the expiration of the current blanket coverage of deposit insurance after March 2001. Serious weaknesses remain in three key areas:

- **Bad loans** are still not fully recognized and adequately provisioned. The scale of uncovered losses remains a major source of uncertainty.
- **Capital adequacy** remains suspect, reflecting not only inadequate provisioning, but also unusually large deferred tax assets and the use of book rather than market valuation of securities holdings.
- **Core profitability** is weak, due in particular to the large scale of corporate lending, on which the interest margin is thin.

Asset quality

6. **While supervisory standards have improved, concerns remain that uncovered losses from nonperforming loans (NPLs) are substantial.** There are three main measures of problem loans in Japan:

- **The traditional disclosure standard for NPLs is set by the Federation of Bankers Associations (FBA) (Table IV.2).** This measure includes loans to borrowers in legal bankruptcy, past due loans in arrears by 3 months or more, and restructured loans. Starting in March 1999, banks are allowed to charge-off problem loans that are fully covered by specific reserves *before* legal insolvency proceedings are completed (these are known as "partial charge-offs"). This change reduced reported NPLs but also decreased reported reserves.² By this standard, major banks' NPLs in March 1999 amounted to ¥20.2 trillion—or ¥27.0 trillion if partial charge-offs are added back. Against these NPLs, major banks held loan loss reserves of ¥10.5 trillion—or ¥16.7 trillion including partial charge-offs.
- **The recently-enacted Financial Reconstruction Law** requires the disclosure of the substandard portion of Class 2 loans, i.e., watchlist loans that are in arrears by at least

²Also starting in March 1999, most banks began to include loans to bankrupt or potentially bankrupt borrowers on which interest was not yet overdue.

Table IV.2. Japan: Major Banks' Problem Loans, March 1999

(Billions of yen)

	Federation of Bankers' Associations Standard							Financial Revitalization Law Standard							
	Problem Loans			Loan Loss Reserves				Problem Loans				Reserves			
	Total	Disclosed	Partial 1/	Total	General	Specific	Partial 1/	Total	High-risk 2/	Partial 1/	Watch 3/	Total	General	Specific	Partial 1/
City banks															
Tokyo-Mitsubishi	2,759	2,078	681	1,841	462	666	714	2,875	1,787	714	374	1,694	315	666	714
Dai-Ichi Kangyo	2,990	2,205	785	1,793	330	663	800	3,054	1,886	800	368	1,686	223	663	800
Sakura	2,541	1,760	780	1,629	328	512	789	2,589	1,199	789	601	1,515	213	512	789
Sumitomo	2,302	1,960	342	1,573	469	719	386	2,399	1,694	386	320	1,423	319	719	386
Fuji	2,263	1,362	901	1,631	326	344	960	2,349	1,019	960	370	1,489	185	344	960
Sanwa	2,121	1,686	435	1,329	395	933	0	2,191	1,409	460	322	1,211	278	474	460
Tokai	1,018	732	286	718	169	164	385	1,139	642	385	111	641	92	164	385
Asahi	1,279	920	359	870	208	283	379	1,309	723	379	207	788	126	283	379
Daiwa	1,039	743	295	617	84	238	295	1,089	625	295	169	583	50	238	295
Long-term credit bank															
Industrial Bank of Japan	2,091	1,844	247	1,164	229	935	0	2,145	1,310	272	563	1,108	173	663	272
Trust banks															
Mitsubishi Trust	1,596	1,301	296	772	142	333	297	1,659	1,125	297	237	744	115	333	297
Sumitomo Trust	1,368	947	422	828	72	334	422	1,372	918	422	33	818	62	334	422
Mitsui	1,121	762	359	634	67	150	417	1,186	618	417	151	618	51	150	417
Yasuda	754	551	203	378	35	342	0	882	633	0	248	361	19	342	0
Toyo	1,070	900	170	601	52	376	174	1,072	810	174	88	588	39	376	174
Chuo	338	203	135	214	32	28	154	392	180	154	58	206	24	28	154
Nippon	312	239	73	141	18	51	73	316	200	73	42	136	12	51	73
Total	26,960	20,192	6,768	16,733	3,676	6,812	6,246	28,017	16,778	6,978	4,261	15,612	2,295	6,338	6,978

Source: Fitch IBCA.

1/ Partial charge-offs.

2/ Class 3 and 4 loans.

3/ Substandard portion of class 2 loans.

three months or for which there has been a change in terms or conditions beneficial to the debtor, in addition to doubtful loans (Class 3) and unrecoverable loans (Class 4). On this definition, which is somewhat broader than the FBA definition because it includes claims other than loans such as guarantees and foreign exchange assets, major banks' NPLs in March 1999 amounted to ¥28.0 trillion.

- **Banks' own self-assessments of asset quality** prepared to assess the adequacy of provisioning cover watchlist loans (Class 2), doubtful loans (Class 3), and unrecoverable loans (Class 4). Unlike the two other measures, this one includes all Class 2 loans. Banks are not required to publicly disclose this information, but the FSA reports aggregate amounts for groups of banks with a delay of about four months. Major banks' classified loans, *net* of collateral, guarantees, and specific loan loss provisions, amounted to ¥44.2 trillion in September 1998.

7. **The size of likely uncovered losses associated with problems loans is highly uncertain.** A conservative estimate can be derived from banks' self-assessment results (Table IV.3). Using actual provisioning rates for various categories of loans—disclosed by the Financial Reconstruction Commission (FRC)—and a BOJ study of banks' past loss experience, the classified loans for September 1998 (the latest available) would imply uncovered losses in *all banks* of ¥14 trillion. If potential losses in credit cooperatives are included (based on data for March 1998), total uncovered losses would be ¥17 trillion (about \$140 billion or 3½ percent of GDP), somewhat smaller than the ¥19 trillion estimated last year (see the 1998 *Selected Issues* paper).

8. **While banks have made substantial additional loan loss provisions since September 1998, remaining uncovered losses are likely to be considerably higher for two reasons.** First, banks may have been overly optimistic in loan classification, especially with regard to the impact of the current recession on loan quality. Second, loss rates—especially for class 2 loans—may be higher in the future than during the mid-1990s when most banks were not actively disposing of bad loans.

Capital Position

9. **Notwithstanding banks' relatively high reported capital ratios, serious concerns remain about capital adequacy.** The failure of Long-Term Credit Bank (LTCB) demonstrated that measured capital adequacy may provide little indication of a bank's true financial position: LTCB reported a capital adequacy ratio of 10.3 percent for March 1998, but was subsequently found to have negative net worth of ¥2.5 trillion (equivalent to 14.4 percent of risk assets) as of October 1998. It appears unlikely that the entire deterioration in the bank's capital strength occurred just during this seven-month period. While inadequate loan loss provisions are clearly the primary concern, there are four other important issues:

Table IV.3. Japan: Estimated Uncovered Loan Losses, September 1998

	Classified loans			Total Losses
	Class 2	Class 3	Class 4	
(Trillions of yen)				
All banks				
Classified loans 1/	66.1	6.9	0.1	...
Uncovered losses 2/	10.3	3.3	0.1	13.7
Major banks 3/				
Classified loans 1/	45.5	5.7	0.1	...
Uncovered losses 2/	7.1	2.7	0.1	9.9
Regional banks				
Classified loans 1/	20.5	1.2	0.0	...
Uncovered losses 2/	3.2	0.6	0.0	3.8
(Percent)				
Provisioning rates				
Actual 4/	2	52	100	...
Based on historical loss rates 5/	17	75	100	...

Sources: Financial Revitalization Commission; Financial Supervisory Agency; Bank of Japan Quarterly Bulletin, "Utilization of Financial Institutions' Self Assessment in Enhancing Credit Risk Management," February 1998; and staff estimates.

1/ Net of specific provisions. Gross data are not reported.

2/ Uncovered losses are the difference between appropriate and actual provisions. In turn, actual provisions are equal to gross loans minus net loans. So, uncovered losses = (appropriate rate-actual rate)* (net loans/ (1-actual rate)).

3/ Including LTCB and NCB.

4/ Based on loan loss provisions at major banks.

5/ Derived from Bank of Japan study.

- **Deferred tax assets**, which relate to anticipated future tax deductions for loan losses against loans that have already been provisioned against, amounted to about one-third of major banks' Tier-1 capital as of March 1999.³ Given that the realization of these credits depends on future taxable income, and that the prospects for bank profitability are uncertain, the regulatory ceiling on deferred tax assets of five years' taxable profit would appear to be too high. For example, in the United States, deferred tax credits are limited to 10 percent of Tier-1 capital or one year's taxable profit, whichever is smaller.
- **Unrealized losses on securities holdings:** Banks are allowed to value securities holdings at cost, rather than the lower of cost or market (LOCOM), and in practice only one major bank—Bank of Tokyo-Mitsubishi—still uses LOCOM. Although major banks in aggregate had net unrealized *gains* on listed securities of ¥2.1 trillion as of March 1999, several banks carried significant unrealized losses. Moreover, major banks' large equity holdings (whose market value is roughly 2½ times banks' own equity) imply a significant exposure of capital to market risk. Mark-to-market accounting will be required by March 2001.
- **Banks with only domestic operations are required to maintain a capital adequacy ratio of just 4 percent.** While banks with international operations, including all major banks, must have capital adequacy ratios of at least 8 percent, more than half of Japan's 121 regional banks reported capital adequacy ratios below 8 percent as of March 1999. While 20 out of 64 first-tier regional banks reported capital below 8 percent, 43 out of 57 second-tier regional banks fell short.

Profitability

10. **Japanese major banks' core profitability remains weak compared to internationally active banks in other industrial countries.** Weak profitability is not due to high costs: Japanese major banks have relatively low ratios of costs to revenues compared to major banks around the world, mostly because they employ few people and spend little on

³Banks were allowed to adopt the deferred tax accounting method for their *unconsolidated* accounts for their FY98 financial statements (this method was already used for *consolidated* accounts). The adoption of this method increased parent banks' equity capital (this year only) by the amount of deferred tax receivables that they carried. There was no effect on capital adequacy ratios, because these were already calculated on a consolidated basis.

technology (Atkinson and others, 1999). However, Japanese banks have relatively low revenues compared to their huge asset bases—their return on assets is about one-third to one-half that of large U.S. banks. The main reason for major banks' low revenues is that their primary business is corporate lending, on which interest margins are as thin in Japan as they are in other industrial countries. While large-scale, low-margin corporate lending was important in other countries in the past, over time banks elsewhere have expanded their retail lending operations and moved into more profitable lines of business, such as the production of "leveraged loans," i.e., loans that are repackaged and sold to institutional investors and other nonbank institutions (through securitization). As a result, in other countries average interest margins have widened and fee income has grown.

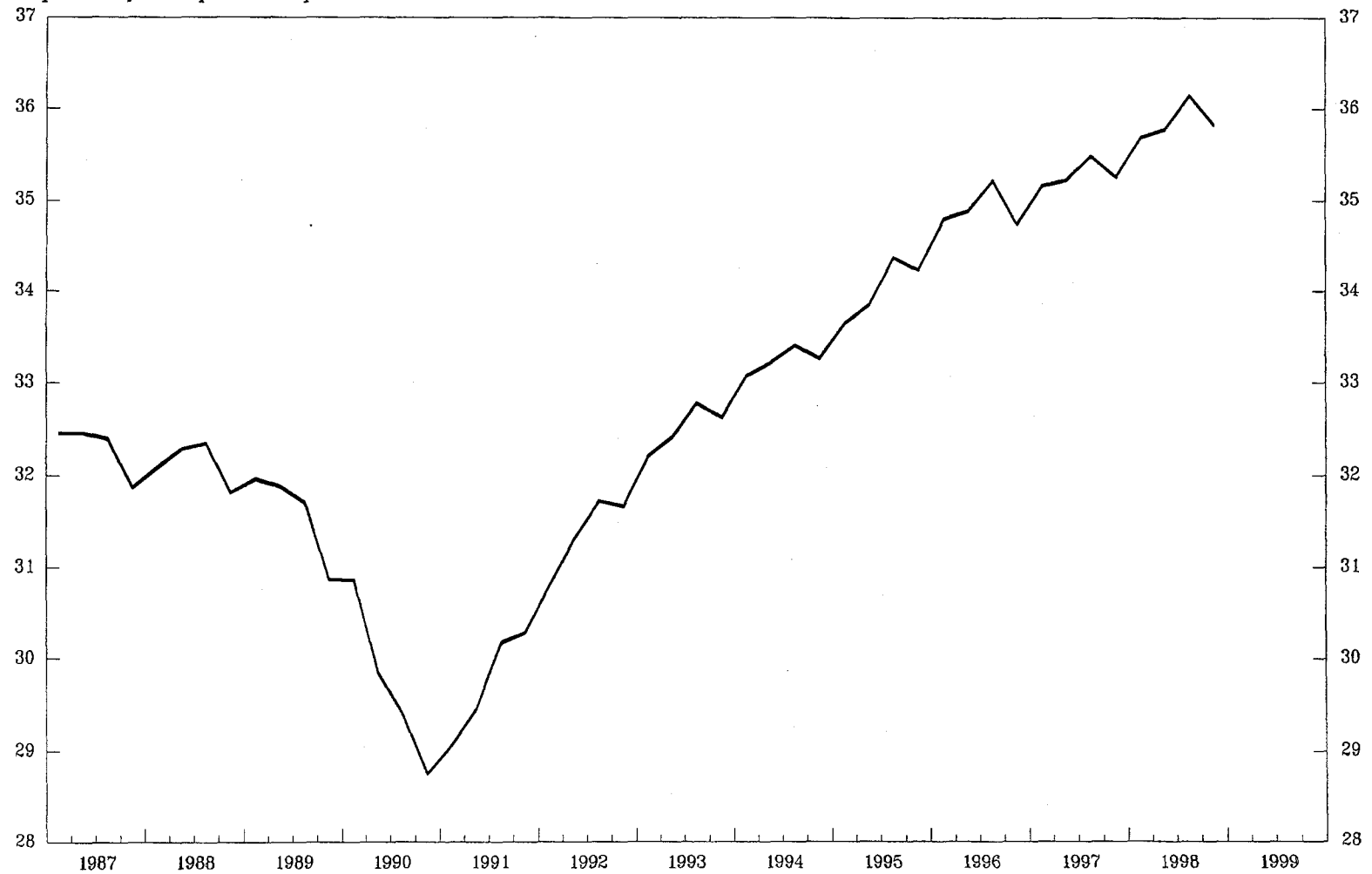
11. **Besides the need for a strategic reorientation, banks must compete in mortgage lending with the government's Housing Loan Corporation (HLC) and in deposit taking with the Postal Savings System.** Outstanding mortgages by the HLC, which offer low interest rates, exceed those by domestically licensed banks. While the Postal Savings System pays no taxes or deposit insurance premia, and is not subject to capital adequacy requirements, postal savings deposits pay attractive rates and are viewed as being backed by the full faith and credit of the government (see Lipworth, 1996). At the same time, long-term postal savings deposits are in fact very liquid, as they can be redeemed without penalty after six months, which provides an attractive hedge against an increase in interest rates. Although the interest rate on postal saving deposits is set as a fraction (usually about 90 percent) of the average 3-year deposit rate at private banks, the differential is not sufficient—especially when interest rates are low—to compensate for the nonpecuniary benefits of postal saving deposits. As a result, the share of personal deposits with the postal saving system in total personal deposits increased sharply during the 1990s, as market interest rates fell and concerns about the financial positions of some private institutions increased (Figure IV.3).

B. Main Policy Developments

12. **The authorities have made important progress in addressing banking problems during the past year.** Through its on-site inspections of all major and regional banks, the newly-established FSA has improved the recognition of the bad loan problem. At the same time, a comprehensive framework—backed by public money and administered by the FRC—was created to resolve banking problems. Together, strengthened supervision and an improved resolution framework laid the groundwork for the recapitalization of weak but solvent major banks, the nationalization of two insolvent major banks, and interventions in

FIGURE IV.3
JAPAN
POSTAL SAVING DEPOSITS, 1987-99

In percent of total personal deposits



Source: Bank of Japan.

regional banks. Banks receiving public funds announced restructuring plans that point in the right direction. These actions reduced concerns about the stability of the banking system—as reflected in the virtual disappearance of the Japan premium—and are providing a window of opportunity for further reform.

Legislative framework

13. **Legislation approved in October 1998 expanded and strengthened the framework for ensuring banking system stability.** The new resolution framework, which is set to expire in March 2001 when limited deposit insurance is scheduled to be reintroduced, has three main components:

- **The amount of public funds available to deal with banking problems was doubled to ¥60 trillion (\$500 billion or 12 percent of GDP).** Of this total amount, ¥25 trillion is targeted at the recapitalization of weak but solvent banks, ¥18 trillion at nationalization and bridge banks,⁴ and ¥17 trillion at deposit payoffs.
- **A new high-level body—the FRC—was established to oversee banking system stability and restructuring.** The FRC, headed by a cabinet-level minister, is responsible for inspection and supervision, recapitalization, and nationalization. The FSA, which assumed inspection and supervisory responsibilities from the Ministry of Finance (MOF) in June 1998, was placed under the FRC. The FSA will acquire the financial planning system function from the MOF in 2000.
- **Two existing bad loan collection and disposal agencies were consolidated into a new agency, the Resolution and Collection Corporation (RCC).** The new RCC, which emerged from the Resolution and Collection Bank (RCB) and the Housing Loan Administration Corporation (HLAC), has expanded authority to purchase bad loans not only from failed banks but also from solvent institutions.

Supervision

14. **The FSA conducted special on-site inspections of major banks in the summer and fall of 1998 and of regional banks in the winter and spring of 1999.** These inspections were more intensive than in the past and provided the authorities with roughly simultaneous evaluations of banks' asset quality. Following the inspections, the FSA sent letters to banks, detailing its evaluation of each bank's loan classification. Banks were required to respond within a month and encouraged to incorporate recommendations into subsequent loan classification exercises. The FSA's policy is not to comment publicly on any individual bank (with the exception of nationalized banks), but the FSA retains the ability to use market pressure to encourage

⁴A bridge bank is a bank under state administration that is expected to be sold back to the private sector.

compliance, for example through frequent examinations, which would become known in the financial community.

15. **The FSA found that both major banks and regional banks had understated their classified loans as of March 1998** (Table IV.4). The bulk of the FSA's reclassifications—¥3.6 trillion out of ¥5.4 trillion for major banks, and ¥1.4 trillion out of ¥2.0 trillion for first-tier regional banks—was from Class 1 to Class 2, which implied little additional provisioning. For major banks, the reclassification of ¥1.6 trillion of Class 2 to Class 3 loans applied mainly to the banks that were subsequently nationalized. Similarly, the FSA found significant inadequacies in loan provisioning mainly in the nationalized banks. These results were not surprising, given that the FSA's evaluation of the adequacy of loan classification and provisioning (LCP) was based on banks' own criteria.

16. **A new inspection manual was issued in April 1999 and becomes effective in July.** Although the purpose of the new manual is to primarily clarify—rather than strengthen—existing standards, its introduction will effectively tighten standards for those banks that had been exploiting loopholes. The new manual is not expected to have a large impact on loan loss provisioning in the aggregate.

17. **Supervisory resources are being increased, which will allow for more frequent regular on-site inspections.** The FSA's budget for FY1999 provides for a one-half increase in staff, mostly inspectors. Although about 90 percent of current FSA staff are on secondment from other ministries, most are expected to remain at the FSA. The FSA's current objective is to inspect all major banks and about half the regional banks every year, and the remainder of the regional banks (generally the stronger ones) every other year. In addition, special inspections will focus on particular issues, such as Y2K preparedness.

Nationalization of Major Banks

18. **The new bank legislation and the special inspections prepared the ground for the temporary nationalization of two major banks.** Following reports that the LTCB was having difficulties raising funds, the bank's market valuation dropped sharply in June 1998, implying serious concerns about the solvency of the bank. The authorities' initial plan—announced at the end of June—was to merge LTCB with the smaller Sumitomo Trust Bank, but this plan was eventually abandoned, in part because of Sumitomo Trust's reluctance to take over LTCB's substandard loans. The failure in September of Japan Leasing, one of LTCB's main affiliates with more than ¥1.5 trillion in debts (including ¥256 billion owed to LTCB and ¥150 billion to Sumitomo Trust), left little doubt about LTCB's own insolvency and contributed to the buildup of market pressures. After LTCB applied for nationalization on October 23, the Deposit Insurance Corporation (DIC) acquired all the outstanding shares and provided financial support, thus allowing LTCB to continue its regular operations and meet all of its obligations.

Table IV.4. Japan: Financial Supervisory Agency's Special Inspections

	Assessment of credit quality, as of March 1998 1/		
	FSA	Banks	Difference
	(Trillions of yen)		
Major banks			
Total credit	394.2	394.2	0.0
LTCB and NCB	27.5	27.5	0.0
Class 1	344.7	350.1	-5.4
LTCB and NCB	19.6	21.5	-1.9
Class 2	43.8	40.2	3.6
LTCB and NCB	5.2	5.0	0.2
Class 3	5.3	3.8	1.6
LTCB and NCB	2.4	1.0	1.4
Class 4	0.4	0.1	0.3
LTCB and NCB	0.3	0.0	0.3
Required loan-loss provisions	8.6	7.6	1.0
<i>Of which:</i> LTCB and NCB	1.6	0.8	0.8
First-tier regional banks			
Total credit	144.2	144.2	0.0
Class 1	127.0	129.0	-2.0
Class 2	15.8	14.4	1.4
Class 3	1.3	0.8	0.5
Class 4	0.1	0.0	0.1
Required loan-loss provisions	2.1	1.6	0.5

Source: Financial Supervisory Agency

1/ Classified loans are reported net of specific provisions.

19. **LTCB's capital position turned out to be much worse than originally thought.** LTCB reported a capital adequacy ratio of 10.3 percent for March 1998 and 6.3 percent for September 1998. At the time LTCB was nationalized in October, the FSA's special inspection found that the bank had negative net worth as of end-September of ¥160 billion (about 0.9 percent of risk-weighted assets), including unrealized losses on securities holdings. In March 1999, the FRC declared that LTCB's negative net worth as of October 1998 was in fact ¥2.5 trillion (14.4 percent of risk-weighted assets as of end-September). LTCB's losses were borne in part by its former shareholders, as the share price for the nationalization was set at zero.

20. **LTCB's government-appointed management is currently seeking a buyer for the bank with the assistance of a foreign investment advisor.** LTCB has started restructuring, with reductions in the number of employees and withdrawal from overseas operations, and is expected to transfer all of its bad assets to the RCC. However, LTCB's better borrowers and better employees are—inevitably—leaving. While several investment groups have expressed interest in LTCB, the original goal of finding a buyer by the end of April was not met. Although the government would prefer to sell the bank as an ongoing business, most potential investors are reportedly more interested in either creating a bank specializing in loan collection or buying a pool of assets.

21. **The authorities acted more swiftly with Nippon Credit Bank (NCB) following the FSA's special inspection.** During 1997–98, NCB had struggled through a series of attempts to restructure, including the complete withdrawal from overseas operations, cuts in the number of employees and salaries, and financial assistance from the BOJ and other commercial banks. The FSA notified NCB in November 1998 that, based on its special inspection, NCB had negative net worth as of March 1998. After NCB failed to develop an acceptable remedial action plan, and rejected the government's request that it apply voluntarily for nationalization, the authorities put NCB under state control on December 14.

Public Capital Injections into Major Banks

22. **The public capital injections in March 1999 amounted to ¥7.5 trillion, about four times the amount injected in March 1998 (Table IV.5).**⁵ In contrast to last year, the bulk of the public funds were structured as convertible preferred stock, which—in principle—will give the authorities considerable leverage over banks that fail to perform. The average yields to be paid on the public funds are low—even lower than the interest rates on last year's injections of subordinated debt—and little differentiated across banks. The injections were funded by the DIC, which raised ¥6.5 trillion from private financial institutions and borrowed the remainder from the Bank of Japan in the form of six-month loans.

⁵In addition, during FY98 banks raised about ¥2.8 trillion in Tier-1 capital from private sources, mostly related companies: about ¥1.4 trillion in common shares and about the same amount in higher yielding preferred securities.

Table IV.5. Japan: Public Capital Injections, March 1999
(In billions of yen, unless otherwise specified)

	Total	Convertible Preferred Shares		Non-convertible Preferred Shares	Subordinated Debt	Average Yield
		Amount	Grace Period 1/			
			(In months)			(In percent)
City banks						
Dai-ichi Kangyo	900	400	64	300	200	1.27
Fuji	1,000	500	66	300	200	1.05
Sakura	800	800	42	0	0	1.37
Sanwa	700	600	27	0	100	0.54
Sumitomo	501	501	37	0	0	0.71
Asahi	500	400	39	0	100	1.25
Daiwa	408	408	3	0	0	1.06
Tokai	600	600	39	0	0	0.95
Long-term credit bank						
Industrial Bank of Japan	600	350	51	0	250	1.06
Trust banks						
Mitsubishi Trust	300	200	52	0	100	1.34
Sumitomo Trust	200	100	24	0	100	1.28
Mitsui Trust	400	250	3	0	150	1.44
Chuo Trust	150	150	3	0	0	0.90
Toyo Trust	200	200	3	0	0	1.15
Regional bank						
Bank of Yokohama	200	100	28	0	100	1.50
Total	7,459	5,559	...	600	1,300	1.09

Source: Financial Revitalization Commission.

1/ Some banks issued two tranches of convertible preferred shares, with different convertibility dates. In these cases, the time to the first date is shown in this column.

23. **The banks that applied for public funds were largely the same as those that received public money under the old recapitalization scheme in March 1998**, the main exception being the Bank of Tokyo-Mitsubishi, which decided not to apply. In order to qualify for public funds, banks had to meet two criteria, like last year: positive net worth and ability to generate long-term profits. The standard for determining net worth was set slightly higher than in March 1998, as the FRC included in full unrealized losses on securities holdings and applied somewhat stricter provisioning standards for classified loans. Specifically, the FRC called for 70 percent coverage of the unsecured portion of Class 3 (doubtful) loans and 15 percent coverage of the unsecured portion of substandard Class 2 (special mention) loans. However, the base for the higher provisioning ratios was rather narrow—the unsecured portion of substandard loans was only about 10 percent of class 2 loans—so the net impact on provisioning was small compared to the magnitude of potential uncovered losses. Major banks made provisions of about ¥10 trillion in FY1998, about ¥3 trillion more than projected in November 1998.

24. **To show long-term profitability, receiving banks submitted detailed restructuring plans** (Table IV.6). These have four main components:

- **Expansion of profitable activities.** Gross income is to be raised on average by about 3 percent over four years, through increasing housing loans and loans to small enterprises, expanding ATM networks and business hours, offering private banking services to wealthy clients, and selling investment trusts (mutual funds). While these efforts are clearly in the right direction, competition in retail banking is already fierce, with regional banks having large branch networks and finance companies dominating the technology-intensive consumer loan business. Also, to the extent that many major banks try to expand into similar types of activities, they are unlikely to all succeed in their goals, because profit margins in these activities will probably fall. More generally, it will be difficult to increase interest margins in view of the weak economy, not only for economic but also for political reasons. There is also the danger that banks will expand high-margin but risky activities, such as derivatives trading.
- **Cost reduction**, which accounts for much of the projected improvement in net income. Operating expenses are projected to be reduced on average by about 8 percent over four years, mostly by cutting personnel costs. The number of bank branches is expected to decline, with a sharp reduction in overseas branches, though all but one major bank expect to remain internationally active. However, cost cutting may be less beneficial than widely assumed, as Japanese banks already have low costs compared to other international banks and need to spend more on upgrading information technology.⁶

⁶For example, Sanwa Bank as a whole reportedly spends less on information technology than the Tokyo office of Goldman Sachs.

Table IV.6. Japan: Major Banks' Restructuring Plans, FY1998 to FY2002
(Percent changes)

	Net Income 1/	Gross Income 1/	Operating Expenses 1/	Personnel Costs	Number of Employees	Number of Directors	Number of branches	
							Domestic	Overseas
City banks								
Dai-Ichi Kangyo	19.8	3.0	-7.8	-16.1	-18.2	0.0	-13.2	-20.5
Fuji	50.9	18.7	-8.0	-10.1	-8.8	-17.1	-7.7	-15.2
Sakura	35.3	8.2	-10.2	-16.4	-21.0	-58.8	-24.9	-29.6
Sanwa	13.7	6.3	-2.3	-15.4	-16.2	-62.5	-7.5	-7.5
Sumitomo	6.6	-1.6	-9.0	-5.6	-13.3	-11.6	-6.7	-23.4
Asahi	14.8	8.6	-6.9	-5.9	-7.8	-10.3	-2.1	-68.4
Daiwa	25.1	0.1	-15.3	-17.0	-17.5	-35.5	-11.8	-100.0
Tokai	20.2	2.8	-10.6	-16.9	-12.5	13.3	-10.0	-48.8
Long-term credit bank								
Industrial Bank of Japan	-11.9	-12.6	-9.9	-0.9	-6.2	-42.9	-11.1	-22.2
Trust banks								
Mitsubishi Trust	-53.3	-28.1	-0.6	-7.1	-2.8	-13.9	-9.4	-47.4
Sumitomo Trust	-14.6	-1.6	-2.9	-14.8	-11.9	-9.4	-3.6	-53.8
Mitsui and Chuo Trusts	17.0	23.8	-6.3	-1.8	-10.8	-20.0	-12.7	-70.0
Toyo Trust	39.0	10.3	-14.3	-17.2	-14.6	-40.0	-35.7	-80.0
Regional bank								
Bank of Yokohama	...	...	...	-14.9	-21.1	-36.8	...	...
Total	11.5	3.4	-7.9	-11.6	-13.8	-26.5	-11.7	-31.4

Source: *Nikkei Weekly*, Merrill Lynch.

1/ Change from FY1997 to FY2002.

- **Strategic alliances.** Trust banks have been especially active, with Yasuda Trust becoming a subsidiary of Fuji Bank, and Mitsui Trust and Chuo Trust planning to merge in April 2000. Several looser tie-ups were also announced. However, some mergers across sectors (say between a bank and a life insurance company) will add little value, because they simply formalize existing cross-selling relationships within *keiretsu* groups.
- **Balance sheet adjustments.** Banks are planning to increase package sales of distressed unsecured loans and loans secured by real estate, and some banks are planning to sell reduce their holdings of equities. However, the announced plans to sell equity holdings appear modest (¥100-200 billion per year for five years) and do not involve selling the shares of *keiretsu* members.

25. **In addition to their restructuring plans, banks applying for public funds agreed to obtain new capital from private sources** (about ¥2 trillion) and to increase lending by ¥6.7 trillion in FY1999, with nearly half (about ¥3 trillion) earmarked for small and medium-sized businesses.

26. **Major banks' restructuring plans will be monitored through quarterly hearings and semi-annual reports in conjunction with financial statements.**⁷ The FRC will take action if a restructuring plan is not being implemented or if a bank's financial condition deteriorates sharply. The FRC's first enforcement tool is an improvement order, which would be aimed at ensuring the implementation of a restructuring plan. The FRC's ultimate enforcement tool is to convert its preferred shares into ordinary shares, which it is authorized to do if a bank's capital adequacy ratio falls below 4 percent. If the government converts its holdings of preferred stock into common stock (at book values), it would gain majority stakes in three major banks and close to a majority stake in a fourth. The government could exercise its right to convert stock at these four banks as early as July 1999; conversion dates are longer—up to five years—for stronger banks. If banks' operating environment deteriorates substantially, the FRC will likely consider injecting more public funds to support strengthened restructuring plans.

Regional Banks

27. **The regulatory authorities began implementing the prompt corrective action (PCA) framework for domestic banks in April 1999** (international banks became subject to PCA in April 1998).⁸ On the basis of the FSA's special inspections, three second-tier regional

⁷Following hearings conducted at end-June, the FSA announced that major banks were implementing their restructuring plans as scheduled.

⁸For details of the PCA framework, see the 1998 Japan *Selected Issues* paper (IMF Staff

banks—Kofuku, Kokumin, and Tokyo Sowa—were declared insolvent and placed under government control. The authorities confirmed that all deposits would be fully protected and appointed receivers to manage the banks' operations while buyers are sought. Receivership can last up to one year, though a bridge bank can take over before that, and the banks are expected to sell their bad loans to the RCC. Three more banks—first-tier Hokkaido Bank and Niigata Chuo Bank, and second-tier Namihaya Bank—have been ordered to increase their capital in order to meet the newly-effective 4 percent capital adequacy ratio for banks with only domestic operations.

28. **The FRC recently announced guidelines for the injections of public funds into regional banks.** The FRC will provide public funds to support either banks that are indispensable to a regional economy or consolidation among banks, including through mergers and alliances. While the precise criteria that will be used to determine indispensability have not been announced, it is expected that a regional bank that provides 20-30 percent of the outstanding bank lending in a single prefecture could satisfy the requirement. The FRC also announced that regional banks applying for public funds will be required to raise their capital adequacy ratios to 8 percent, double the current 4 percent requirement for banks with domestic operations only.

Measures to Facilitate Debt Workouts and Bad Loan Disposal

29. **The tax code was amended in June 1998 to facilitate debt workouts.** Specifically, banks were permitted to deduct from their taxable income the losses incurred as a consequence of reaching out-of-court debt forgiveness agreements, and to allow debtors to offset the corresponding windfall gains against past and future losses. To benefit from such favorable tax treatment, the debt workout agreement must involve a comprehensive restructuring plan and be approved by all creditors. Partly as a result, major banks and life insurance companies forgave ¥1.9 trillion in debts in FY1998.

30. **The October 1998 bank legislation gave a boost to bad loan disposal by legalizing private loan collection companies.** Until then, only lawyers had been allowed to collect loans on behalf of financial institutions. Under the new law, private companies may not only collect loans on behalf of financial institutions but also buy collateralized loans from financial institutions and collect loans on their own account. Thus far, the Ministry of Justice has licensed four companies and expects to license about 30 by the end of summer.

31. **Legislation enacted in June 1998 facilitated the creation of special purpose vehicles (SPVs).** The new securitization law, which regulates securities backed by loans collateralized by real estate, enhances the SPV's ability to secure claims on specific assets by creating a centralized system for registering secured interest in (or ownership of) specified financial assets. Under the new law, the original borrowers no longer need to be notified about

⁸(...continued)
Country Report No. 98/113).

the sales of their loans. Favorable tax treatment was also granted to SPVs and related transactions.

Implementation of Big Bang Reforms

32. **The Big Bang financial reforms remain on schedule.** Following the enactment of the Financial System Reform Law in June 1998, most remaining measures were implemented during the course of FY1998. Important changes in recent months include allowing banks to sell investment trusts (mutual funds), establishing investor protection schemes for the life insurance and securities industries, the abolition of the securities transaction tax, the market pricing of short-term government financing bills, and allowing finance companies to issue bonds to raise funds for lending.⁹ Three further reforms are scheduled to occur in October 1999: commercial banks will be allowed to issue straight bonds, restrictions on the stock brokerage business of banks' securities subsidiaries will be lifted, and brokerage commissions will be fully liberalized. Cross-sectoral competition between banks and insurance companies will be allowed by March 2001.

33. **Financial deregulation has expanded opportunities for foreign financial companies.** The main developments over the past year include Merrill Lynch taking over the retail operations of failed Yamaichi Securities (previously, Japan's fourth largest securities house); the Travelers Group buying a 25 percent stake in Nikko Securities and creating a joint venture called Nikko Salomon Smith Barney; and GE Capital acquiring the equipment and auto leasing business of Japan Leasing, which failed in September 1998. Foreign securities companies now handle more than one-third of the total trading volume on the Tokyo Stock Exchange, and are playing an increasing role in the surge in mergers and acquisitions (M&A) involving Japanese companies. Reflecting substantial fee income from M&A activity and other advisory services, foreign securities companies earned record profits in FY1998—four times the level of FY1996—in contrast to many Japanese securities companies, which have continued to make losses.

Life Insurance Companies

34. **The performance of life insurance companies deteriorated further in FY1998, reflecting negative investment spreads and heavy provisions against NPLs.**¹⁰ The gap

⁹Hitherto, nonbanks were allowed to use funds raised through bonds for capital investment, but had to raise loan money through bank borrowing or equity financing. The right to issue bonds to raise loan money will be limited to nonbanks capitalized at over ¥1 billion, and they will have to meet the same standards of bad loan disclosure as banks. This change is expected to benefit large nonbanks engaged in mortgage lending, consumer lending, and leasing.

¹⁰For background, see Chapter V on Financial Sector Reforms in the 1998 *Selected Issues*
(continued...)

between investment returns and the yield promised to policyholders for the eight largest insurers grew almost 10 percent from the previous year to ¥1.3 trillion. Record loan loss provisions of ¥800 billion were made by the eight largest companies. Declining confidence in the financial soundness of life insurance companies led to a 17 percent fall in sales of life insurance policies and a continued high rate of policy cancellations.

35. **Toho Mutual Life Insurance Company—a mid-size insurer—was ordered to suspend operations in June 1999**, the second such failure in two years and the first under the new prompt corrective action (PCA) procedures for life insurance companies. Toho's negative net worth is estimated to be about ¥200 billion, well in excess of the ¥15 billion current reserves of the Policyholder Protection Fund. While the December 1998 government guarantee on the fund's financing ensures that the technical reserves (i.e., contributions plus accumulated interest) of all life insurance policies will be fully covered until March 2001, holders of savings-type insurance policies may face a cut in benefits, as occurred with policyholders at Nissan Mutual Life. The remaining 15 large and mid-sized life insurance companies all satisfied the solvency margin requirement for end-March 1999. The FSA recently started inspections of the asset quality of all life insurance companies.

C. Remaining Challenges

Planned Removal of Blanket Deposit Insurance

36. **The planned removal of blanket deposit insurance in 2001 has raised market concerns about whether banking system weaknesses will have been fully dealt with by that time.** Given the magnitude of potential uncovered losses and the uncertainty about banks' future profitability, the planned replacement of blanket with limited deposit insurance in April 2001 is already raising interest spreads on bank debentures with maturities greater than two years. While the prospect of market discipline could spur bank restructuring efforts, markets will begin anticipating liquidity problems well ahead of April 2001, so there is in fact little time for preemptive restructuring. In addition, the DIC may soon need to secure additional funds to protect depositors, as recent bank failures—especially of LTCB and NCB—are reported to have almost exhausted the original government bonds of ¥7.1 trillion granted by the government to the DIC.

37. **The Financial System Council (FSC), an advisory body to the MOF, is discussing policy options to accompany the reintroduction of limited deposit insurance after March 2001.** Items under discussion include the tools for resolving failed banks (the current tools expire in March 2001), the procedures for deposit payoffs, the possible adjustment of deposit insurance premia for the strength of a bank's balance sheet and its profitability, the possible increase in the average level of deposit insurance premia (to restore

¹⁰(...continued)
paper (IMF Staff Country Report No. 98/113).

the solvency of the DIC), and the possible extension of deposit insurance to bank debentures. In a recent interim report, the FSC proposed several policy options for resolving failed banks after March 2001, including the adoption of purchase and assumption operations, in which some or all of a failed bank's assets are purchased and some or all of its liabilities assumed by a receiving bank (this method is commonly used by the Federal Deposit Insurance Corporation in the United States). The FSC intends to present detailed proposals by the end of 1999, and the government will prepare draft legislation based on the recommendations in early 2000.

Balance Sheet Weaknesses

38. Notwithstanding the improvement in supervision, the adequacy of bad loan recognition and provisioning, as well as bank capital more broadly, remain in question. Drawing on practices in other advanced countries, the authorities could take five steps to address these concerns:

- Loan classification and provisioning standards could be made more stringent, including, for example, by setting a minimum provisioning ratio for class 2 loans.
- Capital adequacy requirements could be strengthened, especially by limiting the use of tax deferred assets and increasing the minimal capital ratio for all banks to 8 percent.
- Supervision could be further improved by increasing the FSA's resources, to allow more frequent on-site inspections of troubled banks, and enhancing its autonomy, including an independent source of funding (such as levies on supervised institutions) and the authority to set its own salaries.¹¹
- Adequate provisioning could be encouraged through the automatic tax-deductibility of specific provisions consistent with loan classification standards, subject to future recapture if actual losses turn out to be less than expected.¹²
- Disclosure standards could be strengthened by improving frequency, e.g., quarterly rather than semiannual reports, and depth, e.g., full disclosure of self assessments, including gross amounts of loans by asset class, the amounts covered by collateral or guarantees, and provisions.

¹¹Improved supervision is especially important in light of the Big Bang financial reforms that expand banks' range of activities.

¹²The recent tax change allowing banks deduct debt forgiveness did not address the deductibility of provisions. Currently, provisions are automatically deductible only under certain narrow circumstances; otherwise, tax deductibility depends on specific rulings by the tax authorities.

Encouraging Restructuring

39. **Major banks' restructuring plans by themselves appear unlikely to restore core profitability.** More aggressive action is likely to be needed in the areas of consolidation (to generate economies of scale, which are particularly important in the creation of new products and the development of new markets), securitization of corporate loan portfolios (to free up capital for more profitable lending), and the expansion of fee-based income (to increase revenues). Although the mergers announced so far are welcome, they do not substantially reduce the excess capacity in the banking system. The authorities could facilitate restructuring in three important ways:

- The injection of any further public funds could be tied to a market test, such as the requirement to raise matching funds from private markets.
- The early return of nationalized banks to the private sector could be encouraged, e.g., by allowing them to cease functioning as ongoing concerns while selling off their assets and liabilities.
- Strategies to limit the competitive advantages of the public sector in financial intermediation could be considered.

Debt Workouts and Disposal of Bad Loans

40. **While several debt workouts have been announced, more progress needs to be made.** The tax code amendment allowing banks to deduct the losses incurred from reaching out-of-court debt restructuring agreements has encouraged debt forgiveness. Measures that could accelerate the pace of debt workouts include:

- Establishing an arbitration council to mediate out-of-court debt workouts between creditors and debtors, especially in the real estate sector, in the spirit of the London approach.
- Requiring that the recipients of public funds meet specific targets for the working out or disposal of debts.
- Improving the effectiveness of corporate rehabilitation procedures, so as to give debtors more leverage in seeking out-of-court debt workouts.

41. **The pace of bad loan disposal remains slow.** Significant sales of loans and collateral are needed to introduce better value recognition and establish realistic floor prices for assets. The delay in this process is impeding restructuring in banks and nonfinancial corporations. The main obstacle to greater sales is inadequate recognition of bad loans, as disposal would force banks to realize additional losses. In addition to ensuring the full recognition of loan losses,

the authorities could encourage the RCC to hold a steady stream of auctions of bad loans that it has acquired from failed financial institutions.

Reduced Public Sector Role in Financial Intermediation

42. **The Big Bang reforms need to be complemented with steps to scale back the public sector's role in financial intermediation.** The long-term profitability of private sector financial intermediation (banks' core business) is being squeezed both by more competitive and effective capital markets and by the public sector's continuing important role in raising deposits and making loans. At present, around one third of private saving is channeled by the Postal Savings System through the Fiscal Investment and Loan Program (FILP) to fund government lending institutions, a system that lacks transparency and is likely to misallocate resources. The government has developed a blueprint for reforms which could end the automatic deposit of postal savings and pension contributions with the Trust Fund Bureau for investment through the FILP, allowing independent investment decisions by a corporatized postal savings system and requiring some FILP-funded agencies to raise funds directly on the market. Reforms in this area could go further in reducing the role of the FILP and curbing the privileged position of the Postal Savings System, especially given the diminishing importance of post offices as providers of essential financial services to outlying areas (see Kuwayama, 1999).¹³

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¹³One possibility would be to restructure the Postal Savings System as a "narrow bank," whose services are priced to fully reflect costs and risks incurred.

V. STRUCTURAL REFORM AND DEREGULATION¹

A. Background

1. **Structural reform and deregulation have been actively pursued since the Hosokawa government in 1993**, reflecting an increasing awareness of the role that structural factors can play in improving the economy's performance. The Government has implemented a series of deregulation packages, including the two three-year deregulation initiatives (1995–97 and 1998–2000), several economic stimulus packages which included elimination of remaining measures, and the “big bang” initiative to liberalize financial markets, including restrictions on foreign exchange transactions. In addition, the Administrative Reform Act was enacted in 1998, outlining a plan to improve the efficiency of the government, including the reduction in the numbers of ministries and agencies from the current 22 to 13 by 2000. Moreover, the Economic Strategic Council, which was formed in 1998 at the initiative of Prime Minister Obuchi, submitted a set of proposals for broader structural reform for the next 10 years to the Prime Minister in March 1999.

2. **Particular progress has been made in deregulation and structural reform in financial services, telecommunications, and retail sales.** In addition, there has been a slow but steady shift toward making regulatory practices more transparent and shifting from ex ante approval to ex post monitoring of compliance within general rules. Several institutions, including the Economic Planning Agency (EPA), the Ministry of International Trade and Industry (MITI), and the OECD have concluded that there have been significant benefits for consumers.²

3. **Notwithstanding these successes, a recent OECD report concluded that the deregulation process in Japan appears to have been largely ineffective**, with markets remaining distorted and uncompetitive and foreign participation continuing to be discouraged. The report concludes that too much emphasis has been placed on reducing specific regulations rather than comprehensive overall plans, implying that deregulation has been piecemeal and episodic (Box V.1). An important exception has been the recent “big bang” reforms of the financial industry, where a comprehensive reform initiative is leading to significant structural changes.

B. Recent Developments

4. **Over the past year, continuing progress has been made in deregulation and structural reform.** A number of regulations have been relaxed or abolished, in line with the second three-year deregulation plan for FY1998–2000 and the “big bang” initiative. Major

¹This chapter was prepared by Ichiro Oishi.

²Empirical estimates of these benefits are discussed in Oishi and Towe (1998) in last year's *Selected Issues* paper.

Box V.1. OECD Report on Regulatory Reforms

Recent analysis of regulatory reforms in Japan by the OECD concludes that the process has been largely ineffective. While considerable progress has been made in deregulation and structural reform, there is a concern that regulatory reform has been too episodic, slow, and incomplete to contribute significantly to strong sustainable economic growth. The OECD review reached the following main conclusions:

- **Excessive state intervention in many forms still distorts and blocks market functioning in many sectors,** while current regulations are insufficient to adequately protect competition and consumer interests.
- **“Behind the border” regulatory barriers remain a major impediment to realizing benefits from open multilateral trade and investment systems.** Japan has improved market access at the border to a level equal to or better than many OECD countries. However, internal barriers in the form of non-transparent and restrictive application of regulatory and administrative procedures remain a major deterrent to foreign traders and investors.
- **Regulatory reform should be expanded and accelerated through development of comprehensive reform plans** containing the full set of steps needed to introduce effective competition, followed by rapid implementation. To maximize the positive impact on economic performance, reforms should proceed simultaneously in key infrastructure and service sectors, and in factor markets.
- **Government-wide reforms are needed to improve the framework conditions such as administrative transparency, accountability, adaptability, and competition policy and enforcement.** A core problem is lack of adaptability in the public administration. Like some other countries, Japan suffers from a deeply conservative policy process that slows decision-making, discourages open policy debate, encourages clientelism, allows special interests to block needed change, and results in the famous “incrementalism.” New incentives, participants, and controls in regulatory reform processes are needed to re-orient old relationships with producer groups, break up information monopolies in the ministries, and reduce wide administrative discretion to regulate “in the public interest.”
- **Too much focus on the size of government, rather than its role, can divert reform efforts without addressing underlying problems.** Japan’s current administration reform program is mainly directed at streamlining the number of institutions and cutting national non-defense employees by 25 percent in ten years. However, regulatory reform should aim to establish the basis for adjustable and high-quality regulatory regimes that protect public interests in competitive markets. Radical and comprehensive deregulation is needed, but this by itself is insufficient because necessary market institutions are not yet in place. In many areas, such as prudential oversight of the financial sector, consumer protection, and environmental protection, cost-effective and market-oriented regulations are also needed.

Source: Organization for Economic Cooperation and Development (1999)

items included the abolition of minimum prices for international air fares, relaxation of geographic restrictions for truck services, and permission for private nursing care companies to operate.

5. **As part of the “big bang” initiative, foreign exchange transactions were almost entirely deregulated in April 1998.**³ The progressive liberalization of the foreign exchange regime has been a significant component of Japan’s deregulation over the last 20 years, as is documented in Table V.1. This process culminated in the general liberalization of foreign exchange transactions in April 1998 contained in the Foreign Exchange Law. More specifically, the Foreign Exchange Law included the following measures:

- **The system of authorized foreign exchange institutions has been abolished.** Any firm or individual can now buy foreign currencies and engage in currency swaps and forward transactions. Previously these transactions had only been permitted for authorized financial institutions and a limited number of other entities, such as hotels. In addition, foreign exchange lending and borrowing among residents, or between residents and nonresidents, have been completely liberalized.⁴
- **The system of designated security firms was abolished.** Investment in foreign securities by residents and domestic securities by nonresidents can be done through any securities company with no ceiling.
- **Regulations on bond issuance were liberalized.** Foreign and Euroyen bond issuance in foreign and Euroyen markets by residents were moved to ex post notification, as were foreign and yen denominated bond issuance in domestic markets by nonresidents.
- **Outward foreign direct investment by residents was liberalized.** Foreign direct investment by residents now requires only ex post notification.

6. **To further provide the internationalization of the yen, withholding taxes on government paper for nonresidents are being lifted.** Withholding taxes on appropriately registered Treasury Bills and Finance Bills were suspended from this April, while withholding taxes on appropriately registered JGBs will be eliminated for nonresidents from this September.

7. **The progressive liberalization of foreign exchange restrictions since 1980 has been associated with a gradual increase in holdings of international assets and**

³General progress on the “big bang” is reviewed in Chapter IV.

⁴Before April 1998, only lending or borrowing between residents and nonresidents of below ¥100 million had been permitted without authorization.

Table V.1: Foreign Exchange Liberalization During the 1980s and 1990s

1980	• Foreign currency deposits and borrowing by residents with Japanese authorized banks were allowed without prior approval, as were nonresidents' yen and foreign deposits and borrowing.
1981	• Pension funds and institutions investors were allowed to invest up to 10 percent of their funds in foreign securities.
1984	• Regulations restricting forward contracts and yen concession quotas were ended, as were restrictions on spot transactions by authorized banks. • Residents' Euroyen transactions were liberalized to allow purchases of foreign currency denominated certificates of deposit and commercial paper.
1986	• The upper limit on investment in foreign securities by institutional investors and pension funds was raised from 10 to 30 percent (the 5-3-3-2 rule). ¹
1987	• The Trust Fund Bureau of the Ministry of Finance was allowed to invest up to 10 percent of its funds in foreign securities.
1989	• Residents were allowed to deposit up to ¥5 million in foreign banks without prior approval.
1990	• The limit on residents' deposits in foreign banks without prior approval was raised from ¥5 million to ¥30 million.
1992	• Inward direct foreign investment by foreign residents switched from prior approval to ex post reporting.
1994	• The ceiling on inward and outward securities investments allowed without prior approval was raised from ¥30 million to ¥100 million. • Forward exchange agreements by authorized banks liberalized. • The limit on residents' deposits in foreign banks without prior approval was raised from ¥30 million to ¥100 million.
1995	• Japanese insurance companies were allowed to lend overseas without being required to syndicate at least half of the value of the loan.
1996	• The limit on residents' deposits in foreign banks without prior approval was raised from ¥30 million to ¥200 million. • The two step loan system from Japanese banks lending money overseas was ended.
1997	• The 5-3-3-2 investment rule was lifted for pension funds meeting certain criteria. ¹
1998	• Complete liberalization of the 5-3-3-2 investment rule. ¹ • Foreign exchange Law implemented.
1999	• Withholding taxes on Finance Bills and Treasury Bills were suspended in April, while withholding taxes on JGBs are to be eliminated for nonresidents in September.

Sources: Fukao (1990), Nikko Research Center (1997), and Ministry of Finance (1998).

1/ The 5-3-3-2 rule requires 50 percent or more of a funds' assets to be invested in domestic bank deposits, bonds or loans; up to 30 percent in stocks; up to 30 percent in foreign currency assets; and up to 20 percent in real estate.

liabilities. As seen in Figure V.1, portfolio investment by domestic residents rose tenfold as a ratio to GDP, from around 2 percentage points of GDP in 1980 to over 20 percentage points by 1990. There were also less dramatic increases in other investment (mainly bank loans) and outward FDI. While some of this expansion may have reflected the impact of the domestic bubble economy—the ratios dipped somewhat in the early 1990s—renewed liberalization measures appear to have spurred a fresh increase in the ratio of foreign assets to GDP after 1995. Foreign liabilities have followed a similar path, although the changes, particularly as regards the portfolio investment ratio, are smaller.

8. **However, Japanese portfolios remain relatively undiversified internationally.** An estimate by a private analyst (Fujii, 1997) indicates that the ratio of foreign assets in total household securities holdings at end-1996 (including indirect holdings through institutional investors) was 5.2 percent for Japan, compared to 9.2 percent for the United Kingdom and 9.9 percent for Italy. Given this low level of international diversification, it appears likely that the ratio of assets and liabilities to GDP will both increase over the next few years, and that Japanese rates of return will gradually converge with those in the rest of the world.

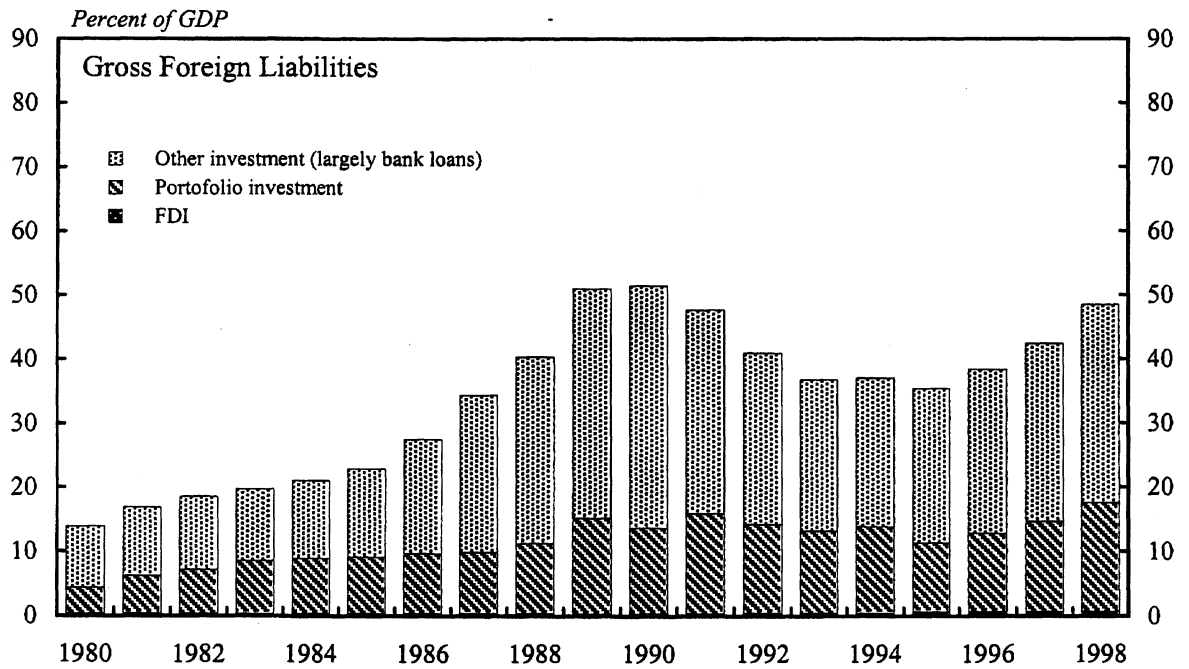
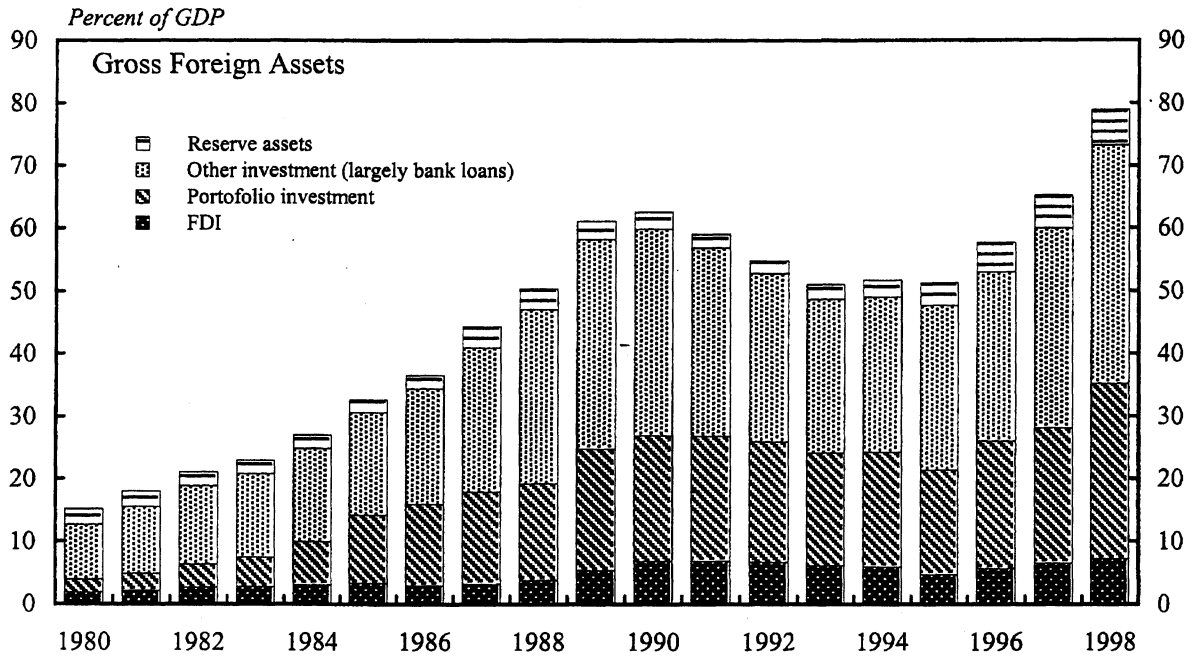
9. **The April 1998 liberalization did not cause the rapid outpouring of domestic savings into foreign assets that some had feared.** The liberalization appears to be having the kind of gradual impact on foreign assets and liabilities seen in the wake of earlier measures in the 1980s and mid-1990s, rather than an immediate and swift change in portfolio allocations. However, the liberalization does appear to have led to a wider group of purchases of foreign securities, with rapid increases in the amount of foreign assets held by the Postal Saving and Postal Life Insurance systems, certain trusts, and private pension plans (Table V.2).⁵ In addition, it remains possible that more open international capital markets could interact with other financial changes to generate significant short-term shifts in international asset allocations flows in the future. In particular, if large amounts of the high yielding long-term deposits currently in the postal saving system but coming due by the end of 2001 are switched to other assets, this could result in a significant outflow of capital abroad over the next two years.

10. **Turning to domestic measures, the Deregulation Committee, which reports directly to the Prime Minister, revised the three-year deregulation plan for FY1998–2000 at the end of March 1999.**⁶ A further 292 items were added to the original 634 items, largely aimed at switching prior approval to ex post checking of compliance with regulations and encouraging new entry into various business fields. Major additions include:

⁵The very small proportion of foreign assets directly held by households (0.4 percent) is another striking feature of Table V.2.

⁶The mandate of the Deregulation Committee (renamed the Regulatory Reform Committee in April 1999) was widened in early 1999 to include assisting in the transition from a regulatory system of prior approval to ex post checking of compliance with rules.

FIGURE V.1
JAPAN
FOREIGN ASSETS AND LIABILITIES



Source: IMF, *International Financial Statistics*.

Table V.2. Japan: Foreign Securities Holdings, March 1998–March 1999

(Percentage, unless otherwise indicated)

	Foreign Securities				Year-on-Year Percentage Change	Total Financial Assets 1/ YoY Percentage Change
	Percent of Total Financial Assets		Level (¥ millions)	March 1999		
	March 1998	December 1998					March 1999
Financial Institutions	2.7	3.0	3.0	88.77	10.8	1.6
<i>Of which:</i>						
Banks, Thrifts, etc.	1.7	1.7	1.7	19.23	-1.2	-1.4
Postal Savings	1.6	1.9	1.9	6.08	25.6	6.8
Private Life Insurance	9.7	10.1	10.3	16.12	8.8	2.4
Postal Life Insurance	5.4	6.3	6.4	7.42	23.4	3.7
Nonlife Insurers	9.2	9.7	9.0	3.49	0.5	2.8
Agricultural Mutual Insurance	8.5	8.7	7.9	2.83	-1.2	6.2
Joint and Nonjoint Trusts	8.2	11.0	10.7	11.50	29.0	-1.4
Investment Trusts	24.3	22.5	21.3	9.16	-2.4	11.2
Private Pension Funds	11.8	15.0	14.0	12.41	26.5	7.2
Social Security Fund	1.9	2.2	2.1	4.83	13.0	2.2
Nonfinancial Corporations	1.0	0.1	0.4	2.72	-62.1	-2.5
Households	0.4	0.2	0.3	3.95	-26.3	2.8

Source: Young and others (1999) using Bank of Japan, Flow of Funds data.

1/ Data are adjusted for valuation/changes.

- **Easing regulation on private job-placement services.** Under the current system, private job-placement companies can only operate in a limited number of sectors. For example, job-placement is not allowed in the manufacturing, transportation, telecommunications, and construction sectors. However, bills that have been submitted to the Diet will deregulate the industry, allowing job placement in all industries except dock work. Labor standards are also being revised to lift most existing regulations on overtime work by women.
- **Liberalization of vehicle inspections.** At present, vehicle inspections are done at government-managed sites or at a limited number of designated private facilities with centrally-determined fees. Plans are currently underway to increase competition by allowing more private-sector companies to provide these services, and to set their own charges, probably by end-FY1999.
- **Partial liberalization of electric power sales.** Under the current system, retail sales of electricity can only be purchased from 10 vertically monopolized firms. Retail sales to large scale customers (such as factories) are to be liberalized by end-FY1999.

11. **A deregulation strategy the next 10 years has been produced by the Economic Strategy Council (ESC).** The ESC was established in August 1998 at the behest of the Prime Minister. The ESC, comprising 10 business leaders and academics, released its report at the end of February 1999, which included 234 proposals, and presented a list of laws that need to be revised.

12. **The report divided its recommendations into those with the highest priority, those to be implemented as soon as possible, and those to be implemented after recovery has occurred.** However, the report did not provide any specific timetables for key proposals, including those dealing with taxes, social welfare programs, and the FILP:

- **Proposals to be taken as soon as possible** (some of which have already been acted upon) include:
 - ▶ **Promotion of securitization** and provision of tax exemptions on debt-equity swaps to foster the liquidation of real estate held as collateral in order to resolve non-performing loan problems.
 - ▶ **Assisting industrial revitalization** by changing in tax laws and the commercial code to encourage disposal of excess capacity and increase innovation in industrial organization.
 - ▶ **Strengthening of the social safety net** including the introduction of a "career development voucher," which would provide public funds to

subsidize retraining for those who wish to move industries, thereby promoting liquidity in the job market.

- **Other proposals to be considered without delay include:**
 - ▶ **Encouraging greater local government autonomy** by decentralizing the tax system and bond issuance. More transparent accounting systems are also recommended for the central government and local governments, including consolidated balance sheets and accrual accounting.
 - ▶ **Tax reforms to make the tax system more neutral and to reward effort.** The tax system should be adjusted to reduce inequalities and increase incentives.
 - ▶ **Fundamental reform of the Fiscal Investment and Loan Program.** Privatization should be considered for all FILP institutions, unless a compelling case for continued public involvement can be found. In addition, the financial accounting used in the private sector should be comprehensively applied to the FILP.
 - ▶ **Reform of the public pension and health care system.** The basic portion of public pension benefits—a minimum standard guaranteed for everyone—should be funded entirely by general tax revenues, and the salary-linked additional portion of the system should be privatized within 30 years.
- **Proposals to be delayed until economic recovery takes hold include:**
 - ▶ **Providing a clear plan for fiscal sustainability** through raising the share of indirect taxes (including a possible hike in the consumption tax rate), introducing a taxpayer number system, and cutting expenditure.

13. **In June 1999, the government announced a package of measures designed to support employment and assist corporate restructuring.** The measures relating to corporate restructuring were guided by the recommendations by the Industrial Competitiveness Council, which was established in March 1999 and consists of ministers and business leaders, mainly from *Keidanren* (business association), as well as recommendations from a MITI report published in late January and the ESC's report. The package is being funded by a supplementary budget of around ¥520 billion (0.1 percent of GDP), already approved by the lower house. The main elements of the package are:

- **Creation of 300,000 temporary (two-year) jobs at local and central governments.** An example given for such jobs would be employing businessmen with foreign language skills as teachers.

- **Support for private sector job creation.** Measures include: subsidizing the hiring of workers in growth sectors; outsourcing some local government services to the private sector; providing grants to companies that hire the unemployed; and setting up new government retraining programs aimed at the middle aged unemployed.
- **Steps to assist corporate restructuring.** Regulations are to be changed to facilitate debt for equity swaps and assist companies to spin-off new enterprises. The new “Chapter 11”-type bankruptcy legislation, which had already been announced, was also included in the package.⁷

14. **Plans for the reorganization of government are also moving forward.** The Diet has passed most of the bills needed to reorganize the national government by reducing the number of ministries and agencies from 22 to 13, and slimming down the bureaucracy. The plans build on a basic government reform law enacted last year whose provisions included integrating the Construction and Transport ministries and the National Land and Hokkaido Development agencies into one ministry, and merging the Postal and Home Affairs ministries and the Management and Coordination Agency to form another new ministry. The maximum number of national government employees is expected to be reduced by one-quarter over the 10-year period beginning in fiscal 2000.

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⁷Bankruptcy reform is discussed in Chapter VI by Levy in the accompanying *Selected Issues*.

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