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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

October 13, 2000

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Japan: Selected Economic Indicators, 1993-2001

Nominal GDP: US$4,347 billion (1999)
Population: 126.6 million (1999)
GDP per capita: US$34,334 (1999)
Quota: SDR 8,241.5 million

	1993	1994	1995	1996	1997	1998	1999	Staff Projection 2000	Staff Projection 2001
Growth (percent change)									
Real GDP	0.3	0.6	1.5	5.0	1.6	-2.5	0.2	1.4	1.8
Domestic demand	0.1	1.0	2.3	5.7	0.2	-3.1	0.5	1.0	2.2
Private consumption	1.2	1.9	2.1	2.9	0.5	-0.5	1.2	0.6	1.2
Residential investment	2.4	8.5	-6.5	13.6	-16.2	-14.4	1.4	3.7	5.6
Business investment	-10.2	-5.3	5.2	11.3	9.0	-7.6	-5.9	6.2	8.5
Government consumption	2.4	2.4	3.3	1.9	1.5	1.5	1.3	1.3	1.8
Government investment	15.7	2.8	0.6	9.2	-10.4	-3.0	7.8	-9.8	-9.2
Stockbuilding 1/	-0.1	-0.2	0.2	0.4	0.1	-0.6	0.1	0.1	0.3
Net exports 1/	0.2	-0.3	-0.8	-0.5	1.4	0.5	-0.3	0.5	-0.3
Exports of goods and services	1.3	4.6	5.4	6.3	11.6	-2.5	1.9	9.3	3.2
Imports of goods and services	-0.3	8.9	14.2	11.9	0.5	-7.6	5.3	6.8	6.1
Saving-Investment (percent of GDP)									
Gross national saving	32.7	31.5	30.7	31.5	31.4	29.9	28.6	29.0	29.1
Gross domestic investment	29.7	28.7	28.6	30.0	29.1	26.7	26.1	26.2	26.6
Inflation (percent change)									
CPI	1.2	0.7	-0.1	0.1	1.7	0.6	-0.3	-0.2	0.5
GDP deflator	0.6	0.2	-0.6	-1.4	0.3	0.3	-0.9	-1.1	0.4
Unemployment rate (percent)	2.5	2.9	3.1	3.3	3.4	4.1	4.7	5.0	5.3
Government (percent of GDP)									
General government									
Revenue (percent change)	-2.5	0.8	0.7	2.4	1.6	-2.1	-3.5	1.6	2.2
Expenditure (percent change)	7.0	2.9	4.6	4.2	-0.9	1.6	4.4	3.4	-2.7
Balance	-1.6	-2.3	-3.6	-4.2	-3.3	-4.7	-7.4	-8.2	-6.3
Balance excluding social security	-4.8	-5.1	-6.5	-6.8	-5.9	-6.8	-9.2	-9.5	-7.3
Structural balance 2/	-1.5	-1.8	-3.1	-4.7	-3.7	-3.4	-5.4	-5.3	-4.9
Money and credit (percent change, end-period)									
M2 plus CDs	1.4	2.9	3.2	2.9	3.8	3.9	2.6	1.9 4/	...
Broad liquidity	2.9	3.7	4.1	3.5	3.3	3.1	2.4	2.9 4/	...
Domestic credit	0.8	-0.4	1.8	1.4	1.3	2.6	2.9	4.4 5/	...
Bank lending	0.5	-0.2	2.1	-0.4	0.0	-4.7	-5.9	-4.6 4/	...
Interest rate									
Three-month CD rate (annual average)	2.8	2.1	1.1	0.5	0.5	0.6	0.1	0.04 4/	...
Official discount rate (end-period)	1.8	1.8	0.5	0.5	0.5	0.5	0.5	0.5 4/	...
Balance of payments (in billions of US$)									
Exports, f.o.b.	352.9	386.0	429.4	400.2	409.2	374.4	403.9	451.5	475.8
Imports, f.o.b.	213.3	241.5	297.2	316.7	307.8	251.6	280.5	332.7	358.3
Current account balance	132.0	130.6	111.4	65.8	94.1	121.0	106.8	116.9	109.7
Percent of GDP	3.1	2.8	2.2	1.4	2.2	3.2	2.5	2.5	2.3
Terms of trade (percent change)	10.4	7.1	0.5	-6.9	-3.9	6.7	4.7	-12.0	-0.8
Change in reserves	27.7	25.4	58.7	36.8	6.9	-7.4	77.3	...	...
Total reserves minus gold (in billions of US$)	98.5	125.9	183.2	216.6	219.6	215.5	286.9	337.9 4/	...
Exchange rates (annual average)									
Yen/dollar rate	111.2	102.2	94.1	108.8	121.0	130.9	113.9	107.4 6/	...
Real effective exchange rate 3/	134.9	143.5	149.5	126.7	117.7	107.3	119.8	129.5 4/	...

Sources: Nikkei Telecom; and staff estimates and projections as of July 12, 2000.

1/ Contribution to GDP growth.
2/ Including social security, excluding bank support.
3/ Based on normalized unit labor costs; 1990=100.
4/ June 2000.
5/ April 2000.
6/ July 12, 2000.

I. Real Sector Developments[1]

A. Japan in the 1990s: Stagnation and Volatility

1. **The Japanese economy is slowly emerging from its worst post-war economic crisis.** After growing at about 4 percent per annum in the 1980s, economic growth slowed to about 1½ percent in the 1990s, a performance that also compares unfavorably from an international perspective (Figure I.1). Moreover, Japan has had five technical recessions (defined as two or more quarters of consecutive output declines) in this period—in 1992, 1993/94, 1995/96, 1997/98, and most recently, in the second half of 1999. While GDP increased sharply by 2.4 percent in the first quarter of 2000 (about 10 percent on an annualized basis), the recovery remains uneven and fragile. This chapter provides a brief overview of the causes of the poor economic performance in the 1990s, and a more detailed analysis of recent real sector developments.

2. **The trigger for the economic problems in the 1990s was the asset price collapse in 1990–91, although the persistence of weak performance was due to the impact of the asset price collapse on the banking system and on business investment.** The bubble in Japanese stock prices burst in 1990. By mid-1992, equity prices had fallen by about 60 percent, and are currently still less than 50 percent of peak values. Land prices began their downward spiral a year after stock prices plunged; while the fall in land prices was initially less precipitous than in equity prices, the decline continued inexorably throughout the 1990s, and land prices are currently less than 40 percent of peak levels. The asset price collapse created problems for the banking system by impairing loan collateral, and also by eroding bank capital (until recently, Japanese banks counted part of their "hidden" capital gains on equity ownership as bank capital). Business investment slumped steeply in Japan in the 1990s as the large corporate sector found equity financing of investment expensive, and small and medium sized enterprises that had a greater dependence on bank lending faced a credit crunch due to the fragile state of the banking system. Moreover, the excess capital that many firms had accumulated from years of overinvestment in the 1980s drastically curtailed incentives to augment capital stocks. The slump in business investment—which fell from about 20 percent of GDP in 1990 to about 16 percent in 1999—has been one of the major contributors to the stagnation of the Japanese economy in the 1990s.[2]

3. **While considerable attention has been directed toward understanding the causes of slow growth in Japan in the 1990s, an important development that has received less attention is the massive increase in the volatility of Japanese output during this period.** Volatility, as measured by the coefficient of variation of quarterly GDP, rose almost sixfold

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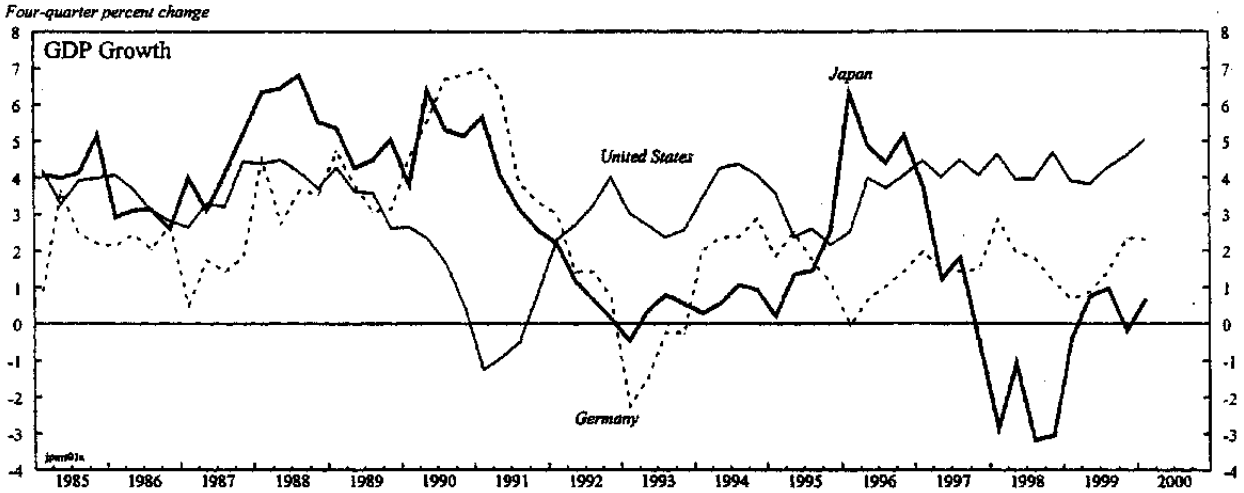
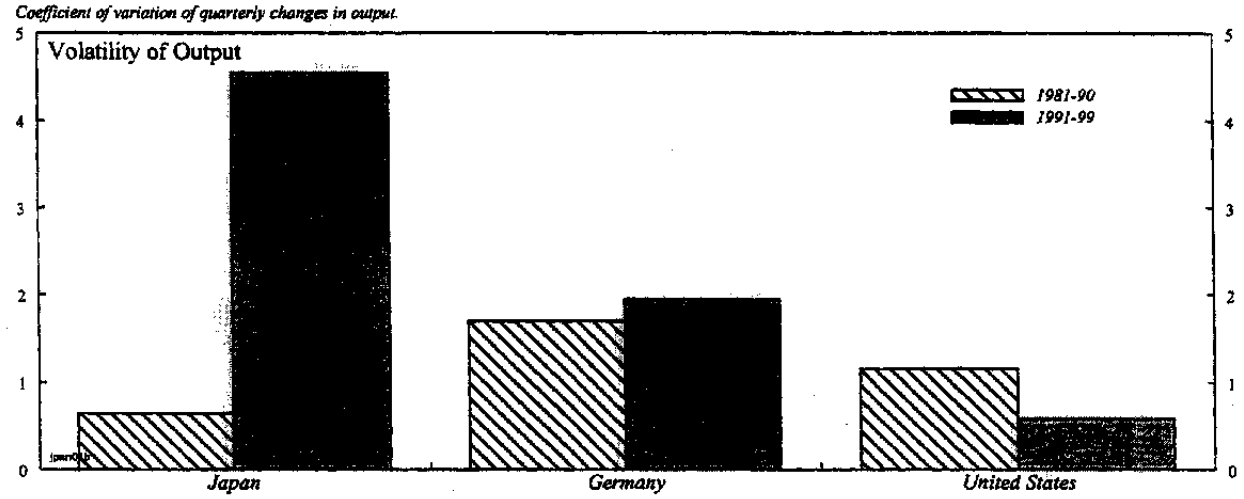
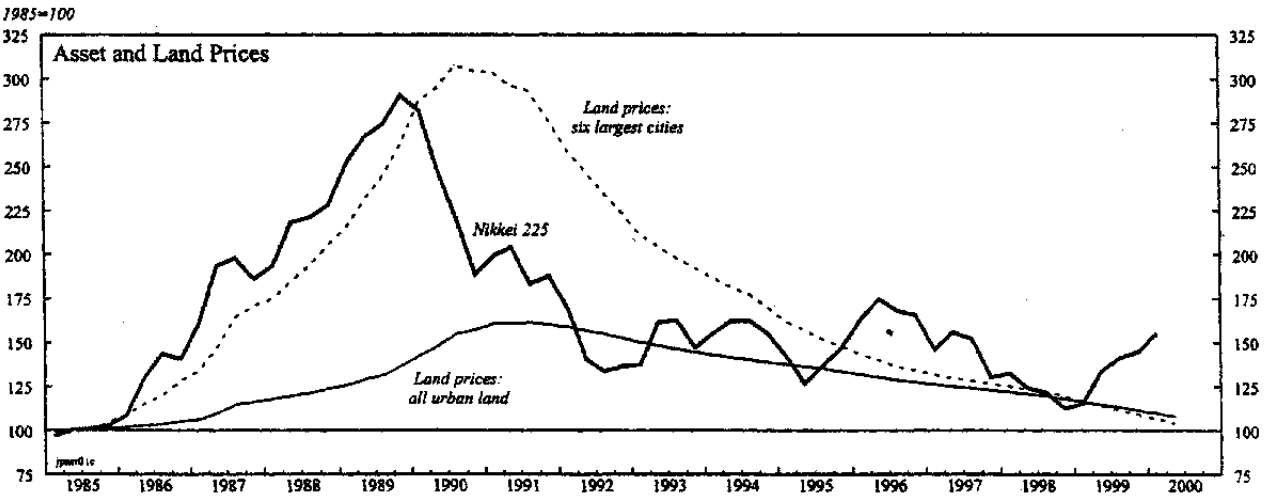
[1] Prepared by Ramana Ramaswamy (ext. 38591).

[2] For a detailed discussion of the causes of the slow growth in Japan in the 1990s, see Bayoumi and Collyns (2000).

Figure I.1. Japan: Growth and Volatility Comparisons







Sources: IMF, CEI Database; Nikkei Telecom; and staff calculations.

in Japan, from 0.65 in the 1980s to 3.75 in the 1990s. To put this development in perspective, volatility of output rose only marginally in Germany in the 1990s despite the economic disruptions caused by reunification, while volatility actually fell significantly in the United States (see Figure I.1). Why has volatility of output increased so dramatically in Japan in the 1990s, whereas it has fallen in most other G7 countries during this period? The answer is a complex one, combining aspects of the way policies were formulated and implemented in Japan, the effects of the financial panics induced by the banking crisis during 1997–98, and technical factors relating to the measurement of the national accounts statistics.

4. **Activist macro policies may have, paradoxically, played a role in accentuating output volatility in Japan**. Recent research indicates that the systematic implementation of stabilization policies in the large industrial countries in the post-war period had the effect of reducing output volatility (in relation to the pre-war period) by muting the effects of the various demand and supply shocks to which economies are periodically subject.[3] As in the case of other countries, stabilization policies in Japan also proved successful in reducing output volatility in the post-war period. The structural break that appears to have occurred in the 1990s appears related in part to the inconsistent manner in which macro policies were pursued in the 1990s—particularly with fiscal policy alternating between expansionary and contractionary phases—leading to exacerbated output volatility. The volatility of public investment—an important ingredient of activist fiscal policy in the 1990s—contributed directly to increasing the volatility of output. Moreover, the use of temporary tax cuts, that were periodically reversed only to be reintroduced later, may have contributed to increased output volatility, not only through its direct effects on demand, but also indirectly, by making the economic environment a more uncertain one. The preannounced hike in the consumption tax in April 1997 contributed importantly to volatility by generating intertemporal substitution of consumption.

5. **The failure to resolve banking problems in a timely manner also appears to have contributed to increased output volatility in the 1990s**. It has been argued that the strengthening of prudential regulations in the banking systems of industrial countries in the post-war period dramatically reduced the incidence of financial panics and contributed to the reduction in output volatility.[4] While banking problems have periodically cropped up in many industrial countries during this period, very few of them have had to grapple with a banking crisis of the magnitude that Japan faced in the 1990s, with the possible exception of the Nordic countries during 1991–93. While the Nordic countries were relatively quick to resolve their banking problems, Japan allowed them to fester. The failures of some prominent banks and brokerages during 1997–98 had the effect of undercutting confidence and accentuating the volatility of private consumption. Precautionary savings rose sharply in response to the financial turmoil that accompanied the bank failures. As the authorities gradually, but systematically, adopted measures to resolve the banking problems, the

[3] See Romer (1999) for a systematic discussion of these issues.

[4] Romer (1999).

precautionary savings began to be unwound during the first half of 1999 (contributing in part to the surge in private consumption during this period—discussed in more detail below). Given that private consumption constitutes about ⅔ of GDP, these factors also contributed to the high volatility of output during this period.

6. **Swings in the exchange value of the yen and external demand shocks (associated in part with the Asian crisis) also contributed to output volatility.** A sustained appreciation in the first half of the 1990s pushed the yen to a high of ¥80/$ in April 1995. It then depreciated steeply to reach a low of about ¥147/$ in August 1998, only to strengthen again through 1999 to its current value of ¥107/$. These large swings in the exchange value of the yen—which appear to have reflected internal market dynamics as much as cyclical developments in the economy—have made the external sector's contribution to growth highly volatile. For instance, the external sector's contribution to growth moved from a negative ¼ percentage point in 1994 to about 1½ percentage points in 1997 as the yen weakened. With the onset of the Asian crisis, and the strengthening of the yen in late 1998, the external sector's contribution moved back to a negative contribution of about a ¼ percentage point in 1999.

7. **Measurement problems connected with compiling and calculating Japanese national accounts have contributed both to the high volatility of GDP in the 1990s and have also given misleading signals about the true state of the economy.** The data problems appear to have been particularly pronounced for private consumption and public investment. Measurement problems connected with private consumption have had a bearing on output volatility in the 1990s in a variety of ways. First, seasonal adjustment procedures have not taken adequate account of structural shifts in the pattern of private consumption in recent years—particularly the shift that has occurred between the last quarter and the first quarter of the following year. This is related in large part to changes in the pattern of bonus payments—a part of the traditional December bonuses has tended in recent years to spill over into the January of the subsequent year. As a result, in recent years private consumption as defined in the national accounts has fallen sharply in the last quarter of the year and risen sharply in the first quarter of the subsequent year. The failure of seasonal adjustment procedures to take account of leap year effects has also contributed to this volatility, for example in the first quarter of 2000.

8. **Sampling problems connected with computing private consumption on a national accounts basis also appear to have contributed to volatility and made it difficult to assess the true strength of the economy.** The Household Survey, which is used as the main input for computing private consumption, excludes single-person households, while the proxy measure used to capture the consumption of single-person households tends to underweight them. Since this segment of the household sector has increased its spending rapidly in recent years, the national accounts are likely to have understated recent trends in private consumption; this may go some way toward explaining the recent discrepancies between the stronger supply-side data and the weaker demand-side data—the quarterly national accounts are calculated almost exclusively from the expenditure side.

9. **Measurement problems have also affected public investment.** The EPA uses annual information from the budget, taking into account any revisions due to supplementary budgets. To gauge the quarterly path, the annual figure is allocated based on statistics on public construction works in progress. This procedure may contribute to volatility in the quarterly series, however, because the estimate from the budget may provide a misleading picture for public investment in the year as a whole (for example, if local authorities are financially constrained and implement fewer projects than envisaged in the budget). This has certainly been a feature of the track of public investment in recent years, when the actual level of public construction has at times been lower than initially programmed (reflecting the weak financial position of local governments), making the task of forecasting public investment a difficult one.[5]

10. **High output volatility makes forecasting an even more difficult task in Japan than it is in other countries.** A recent study of the private sector forecasting performance in the 1990s found that the forecasting record has been quite dismal for literally all countries—both industrial and developing.[6] Only two of the 60 recessions that occurred across both industrial and developing countries during this period were predicted a year in advance. Two-thirds remained still undetected in the April of the year in which the recession occurred. The forecasts for Japan have been even more off the mark than those for other industrial countries. Among the G3, for instance, the forecast errors for Japan in the 1990s have been almost twice as large as those for Germany and the United States (Figure I.2). Moreover, there has been a much greater variation among forecasters in the Consensus Forecast in their predictions of Japanese output growth than is typically the case with output forecasts in other industrial countries. The standard deviation of the year ahead GDP predictions made by the various forecasters in April of each year was about 50 percent higher for Japan than for either the United States or Germany. The standard deviation of the same year's output projections made in April was, however, even higher (relatively) in Japan—being about twice as large as in the United States and Germany (see Figure I.2).

11. **The greater dispersion among forecasters of the Japanese economy may also be due to the poorer quality of the information on the basis of which the forecasts have to be made as well as greater underlying volatility.** The fact that the variability of the same year's predictions by Japanese forecasters is much larger (relative to the other G3) than is the year ahead forecast is testimony to the difficulties connected with procuring timely and reliable data—for instance, the quarterly national accounts in Japan are released about a full month after they come out in the United States. Given the delays as well as the ambiguities involved in interpreting Japanese data, forecasters tend to be split as to whether data movements reflect genuine turning points or are transient in nature.

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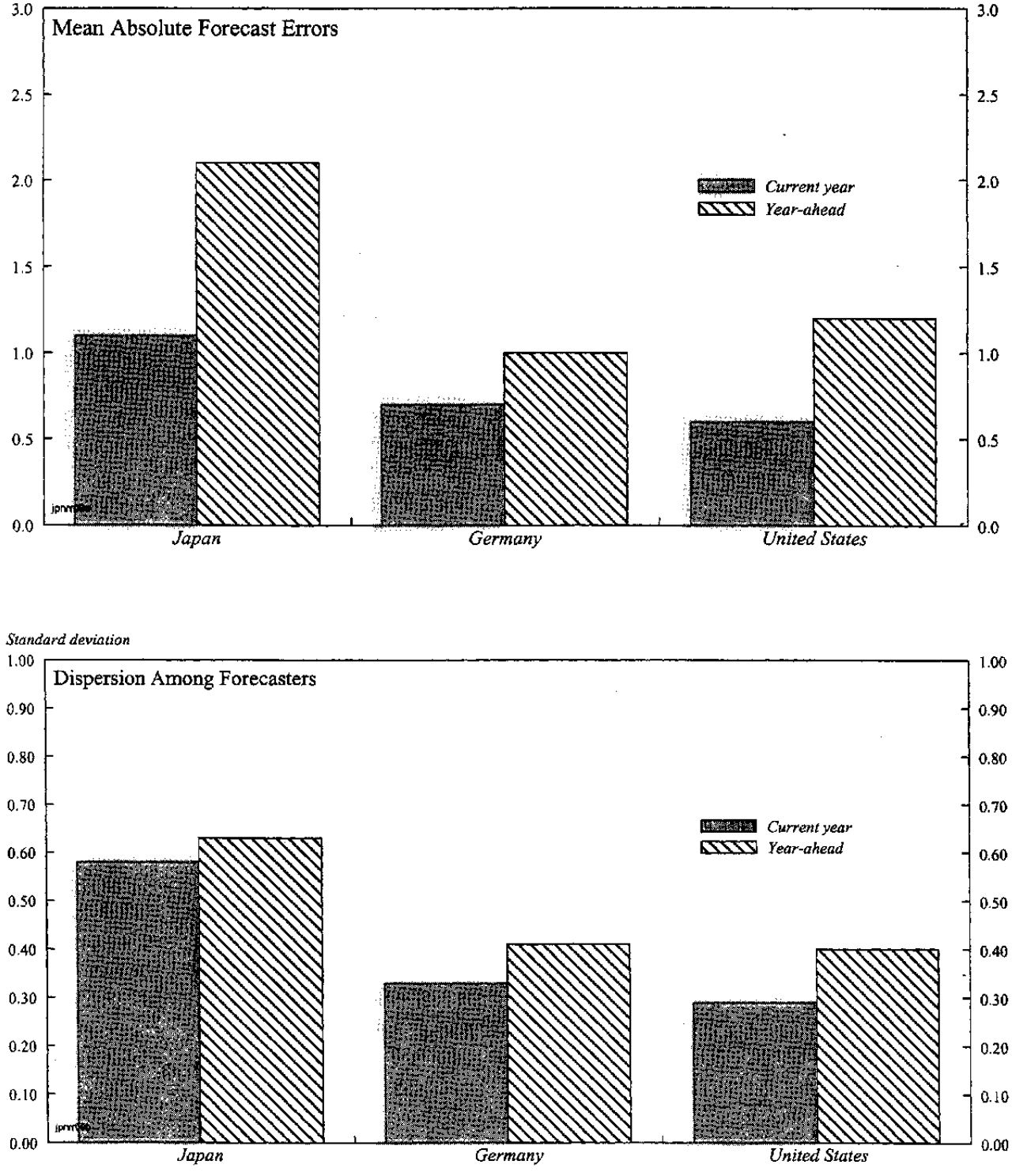
[5] See OECD (2000).

[6] See Loungani (2000).

Figure I.2. Japan: Forecast Errors and Variability of Forecasters, 1991-99



Sources: Consensus Economics Inc., Asia Pacific Consensus Forecasts; and staff calculations.

12. **The authorities have recently taken a number of steps to address some of the shortcomings with Japanese data.** The Economic Planning Agency (EPA) is reviewing the seasonal adjustment procedures used for computing the quarterly national accounts. There are also plans to improve the reliability of private consumption data by expanding the coverage of single person households in surveys that are used as inputs for compiling private consumption on a national accounts basis. Beginning in the first quarter of 1999, the EPA began releasing "flash estimates" (calculated approximately a month after the end of the relevant quarter) along with the preliminary estimates of GDP—released usually about 70 days after the end of the relevant quarter—as a prelude to the advance release of the "flash estimates" in the future. This exercise, intended as a transitional step toward improving the timeliness of Japanese data, indicated the presence of a large discrepancy between the flash estimates and the preliminary estimates, particularly in the case of gross capital formation. In order to avoid confusion in the markets, the EPA is exploring ways of improving the "flash estimates" before they are released in advance on a regular basis to the public. To improve transparency and help the public have a better understanding of Japanese data, the EPA has made available a document explaining the methodology used for compiling the national accounts.

B. Corporate Restructuring and the Supply Side

13. **The framework for corporate restructuring has been strengthened recently, and this is beginning to be reflected in actual corporate restructuring, although the process is still in its early phases.** A whole array of laws and practices governing the operation of businesses has recently been modified to improve efficiency and transparency, including: the introduction of laws to provide tax and other incentives for companies to shed excess capital and labor (Industrial Revitalization Law); changes in laws and practices to facilitate rehabilitation of highly indebted or nearly bankrupt firms, mergers and acquisitions, and spin-offs (Commercial Code changes); and changes in accounting practices that require firms to present financial accounts on a consolidated basis and to mark-to-market their assets. There have also been deregulation initiatives to improve the access of smaller firms to markets that have in the past been implicitly or explicitly protected, and also to enlarge their access to financing—the recent openings of the Mothers Stock Exchange in Tokyo and Nasdaq Japan in Osaka are examples of such attempts to tap organized financing for new ventures in high-tech industries. These initiatives to promote greater transparency and competitiveness have started to gradually transform the way that businesses are run and, together with cyclical factors, are beginning to have effects in improving the profitability of firms.

14. **Financial services and information technology products have grown relatively rapidly during the past year, and there has been a modest pick-up in profitability.** After lagging behind manufacturing for a number of years, the service sector has grown relatively rapidly in recent years. Deregulation initiatives in transport and communications, and the "Big Bang's" effects in opening up of the financial sector to foreign firms and mergers and

acquisitions have led to a rapid growth of these sectors during the past two years (Figure I.3). In particular, information technology products' contribution to industrial growth in recent months has been significant—about one-third—although the robust performance of this sector cannot be attributed to the effects of corporate restructuring alone, since this phenomenon is part of a more general global trend (Figure I.4). Nevertheless, the deregulation initiatives have played an important role in providing the foundations for a rapid growth of the information technology sector in Japan.

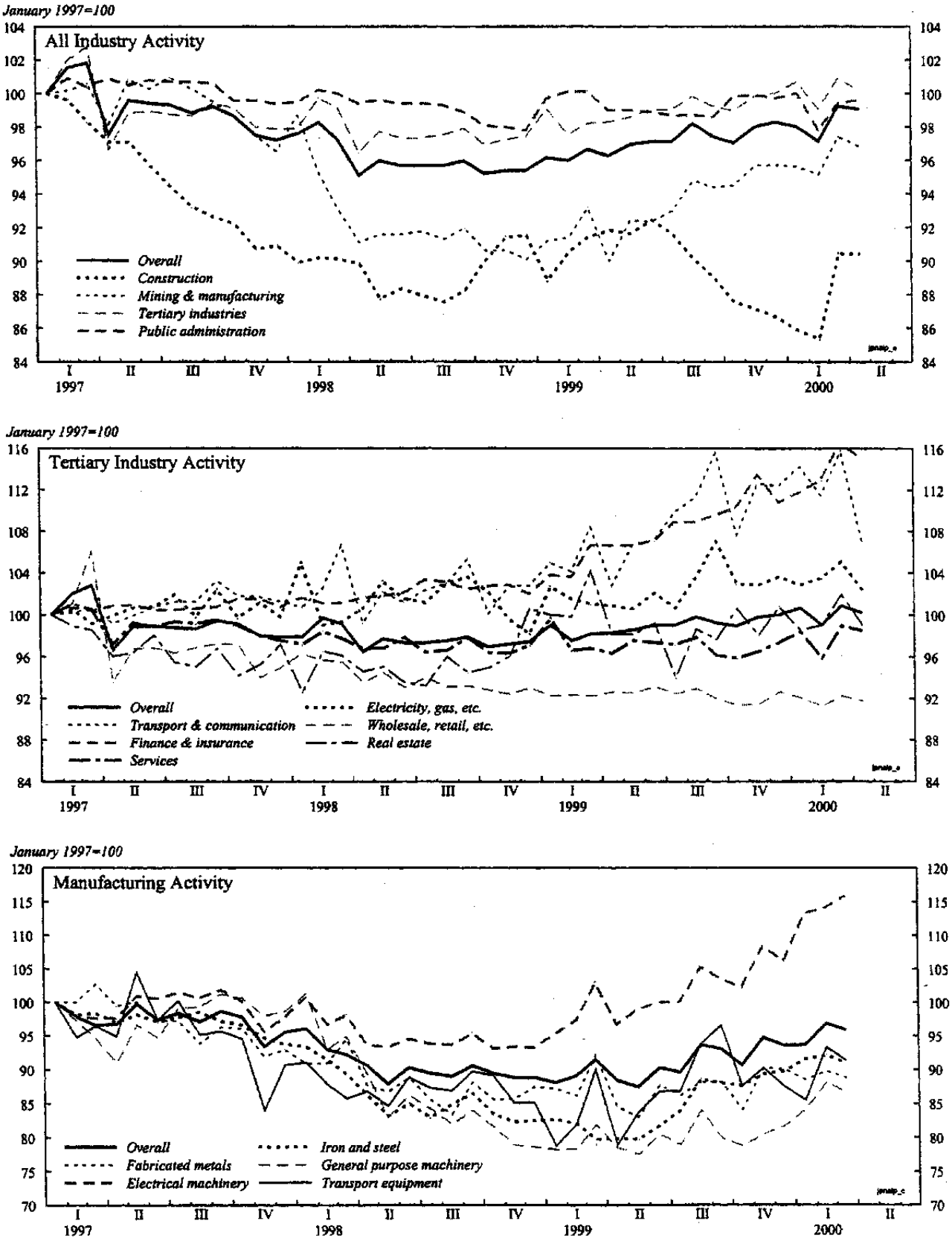
15. **Corporate restructuring in Japan, nevertheless, has still some way to go.** Debt levels and labor costs are still high by historical standards, and the return on assets, despite having increased in recent months, is still well below the levels achieved in the past (Figure I.5). Indeed, corporate data suggest that the recent profit gains have been mainly related to the more efficient use of inputs—squeezing suppliers—rather than from the reduction of labor costs. To accelerate the process of corporate restructuring, the recent reforms need to be complemented by tax and other incentives to facilitate mergers and spin-offs and encourage labor mobility.

The Labor Market

16. **Despite the marked slowing of the Japanese economy in the 1990s, unemployment rose gradually during the first half of the decade, but picked up sharply in recent years.** The rapid increase in unemployment in recent years, to almost 5 percent recently, has been driven in large part by the decisions of large firms—which had traditionally been the main practitioners of life time employment—to shed labor, as economic conditions worsened considerably. Employment fell sharply in the first half of 1999, particularly in large enterprises, and a sharper increase in unemployment during this period was avoided only on account of discouraged workers leaving the labor force (Figure I.6). The employment situation, however, improved in the second half of 1999, as employment in services rose. Employment has fallen again this year—in part due to the particularly sharp decline in manufacturing employment, which fell by almost 2½ percent in the first five months of this year, as corporate restructuring moved ahead.

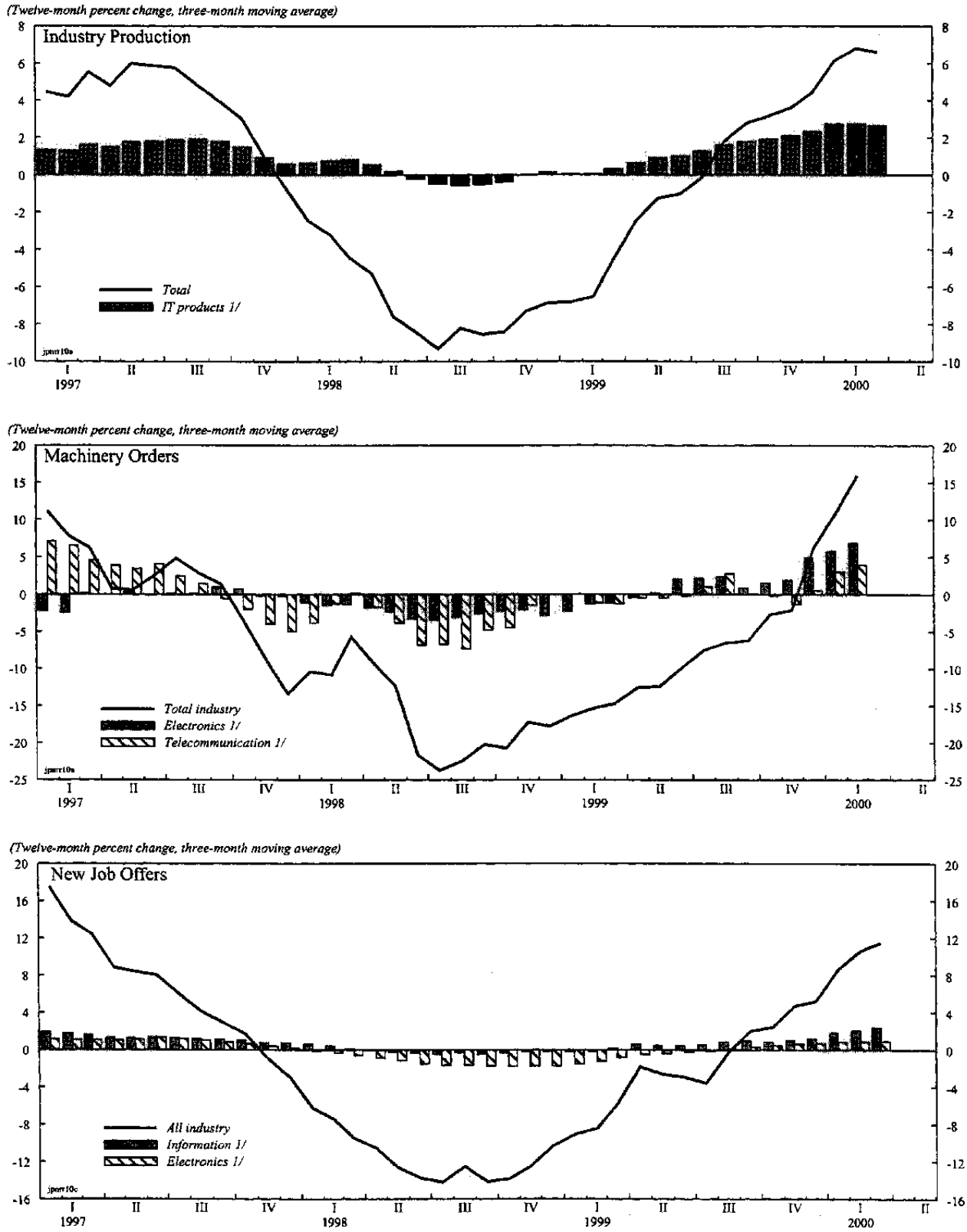
17. **With restructuring getting underway, there is evidence emerging of growing mismatches in the labor market.** Despite the severe state in the labor market, the ratio of job offers to job seekers has risen from a low of 0.46 in May 1999 to 0.56 in April 2000. The increase in the ratio of new job offers to job seekers has been sharper—from 0.79 in May 1999 to 1.02 in April 2000—indicating that employers in certain types of activities are finding it difficult to recruit suitably qualified workers. In this regard, rising youth unemployment as well as diminished employment prospects for elderly workers have contributed to the increase in structural unemployment. Older workers tend in general not to match the job requirements of the newer industries; while mismatches between skills and job requirements have also driven the increase in youth unemployment, there also appears to be

Figure I.3. Japan: All Industry Activity Index



Source: CEIC database.

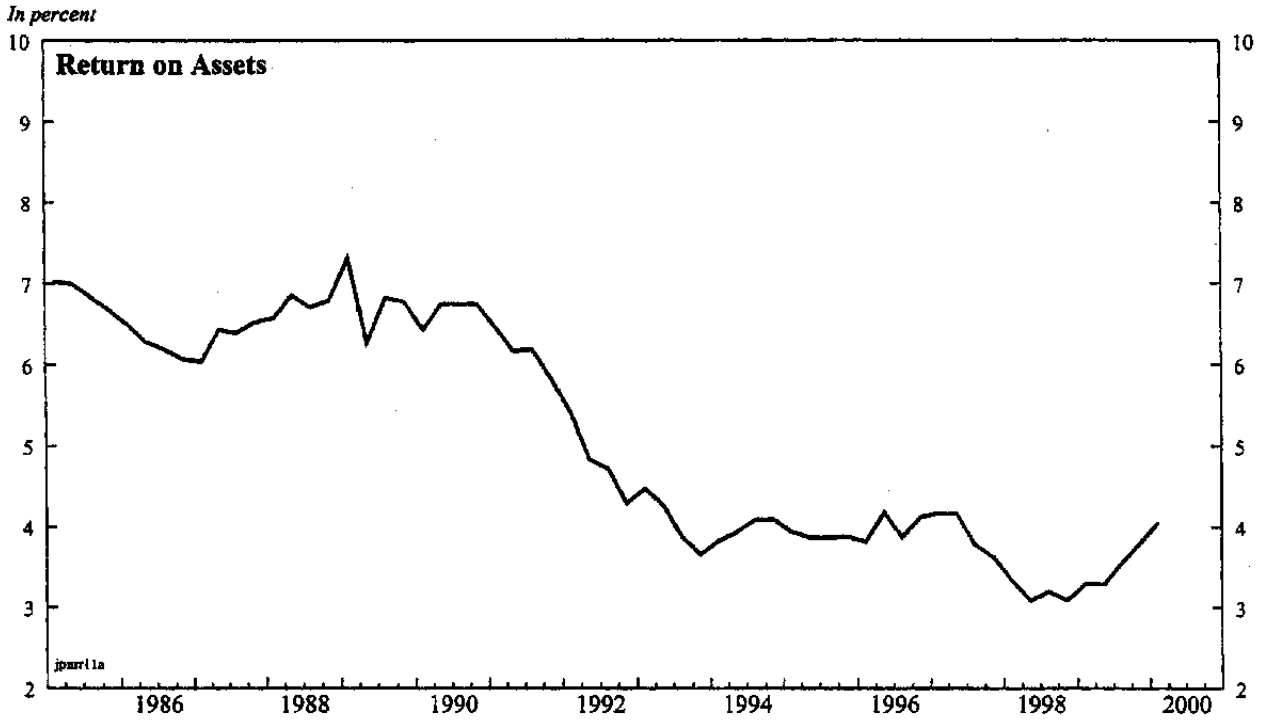
Figure I.4. Japan: Industrial Production and Information Technology

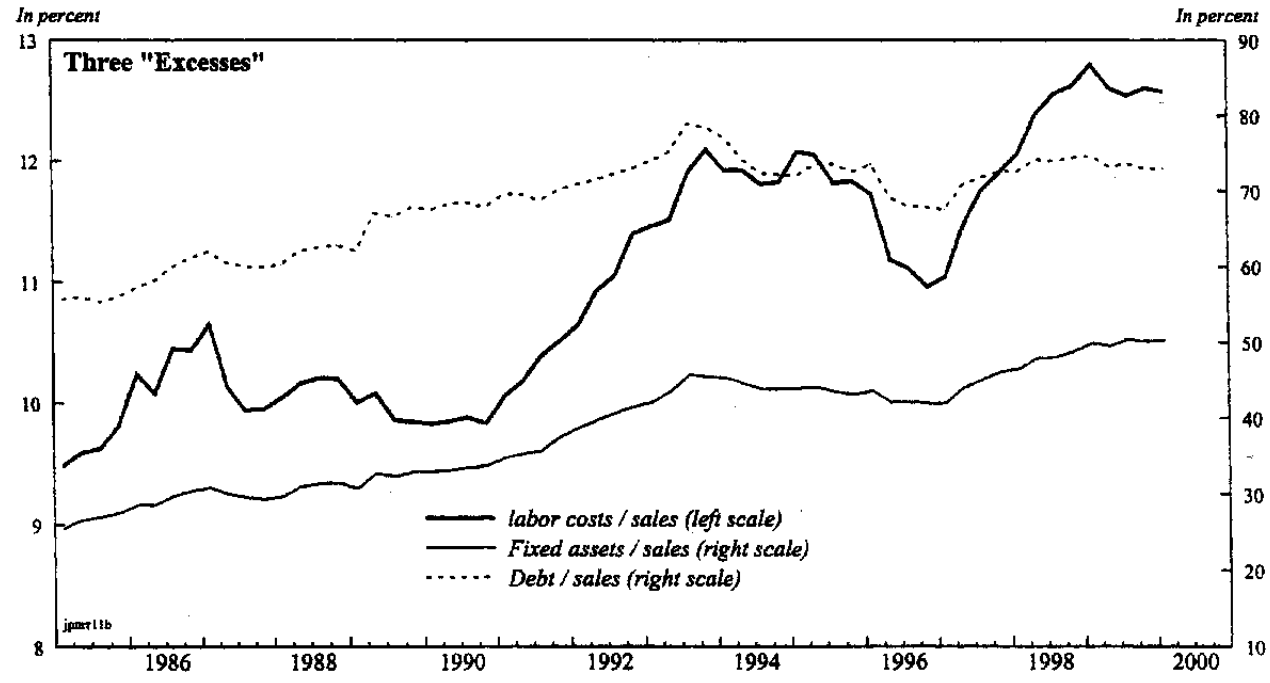


Source: Ministry of International Trade and Industry.

1/ Contribution to growth of industrial production.

Figure I.5. Japan: Corporate Survey, 1985-2000 1/

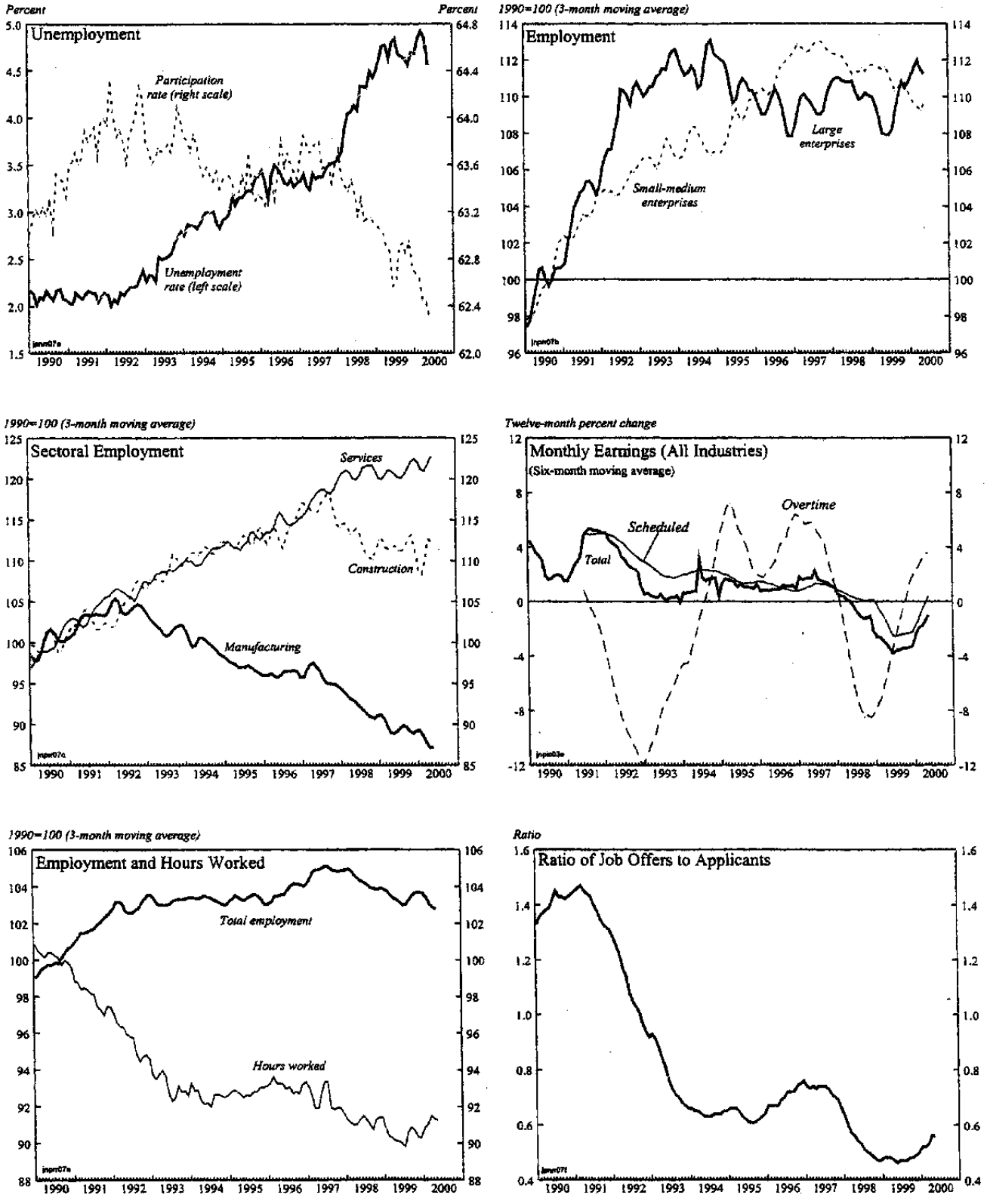




Source: Ministry of Finance; and staff calculations.

1/ Seasonally adjusted data.

Figure I.6. Japan: Labor Market Conditions, 1990-2000



Sources: Nikkei Telecom; and WEFA.

some evidence recently of an increase in voluntary unemployment in the case of young people.[7]

18. **The deteriorating labor market situation has taken its toll on earnings, although earnings appear to be stabilizing in recent months.** Earnings grew on average by about 1¾ percent during 1991–97. The deteriorating labor market situation during 1998–99 had an adverse impact on earnings, which fell by about 1 percent in 1998, and by 3¼ percent in 1999. The steep decline in earnings in 1999 was accounted in large part by a decline in overtime pay, as well as in bonuses, which are tied to past corporate profits. Earnings have been falling less steeply in recent months, as an increase in overtime pay has partly compensated for the decline in scheduled earnings (see Figure I.6).

Prices

19. **Prices, as measured by the consumer price index, show continuing deflationary pressures.** Consumer price inflation fell sharply in the immediate aftermath of the collapse of the asset price bubble, but remained essentially flat up until mid-1999, once the effects of the sales tax hike in 1997 are excluded. Underlying inflation, which excludes the prices of perishable food and energy from the CPI, has broadly tracked the trends in the overall CPI (Figure I.7). Both the CPI and underlying CPI indicate that deflationary pressures intensified in the economy from late 1999—the underlying CPI's decline by about ½ percent on a 12-month basis in April 2000 was its largest fall in over a decade. The decline in the GDP deflator by about 1¾ percent in the first quarter of 2000 is also its largest fall in over a decade. It should be recognized that measurement biases in calculating the CPI (estimated to be overstating inflation by about 1 percent) imply that deflationary pressures may be somewhat stronger than indicated by the CPI.

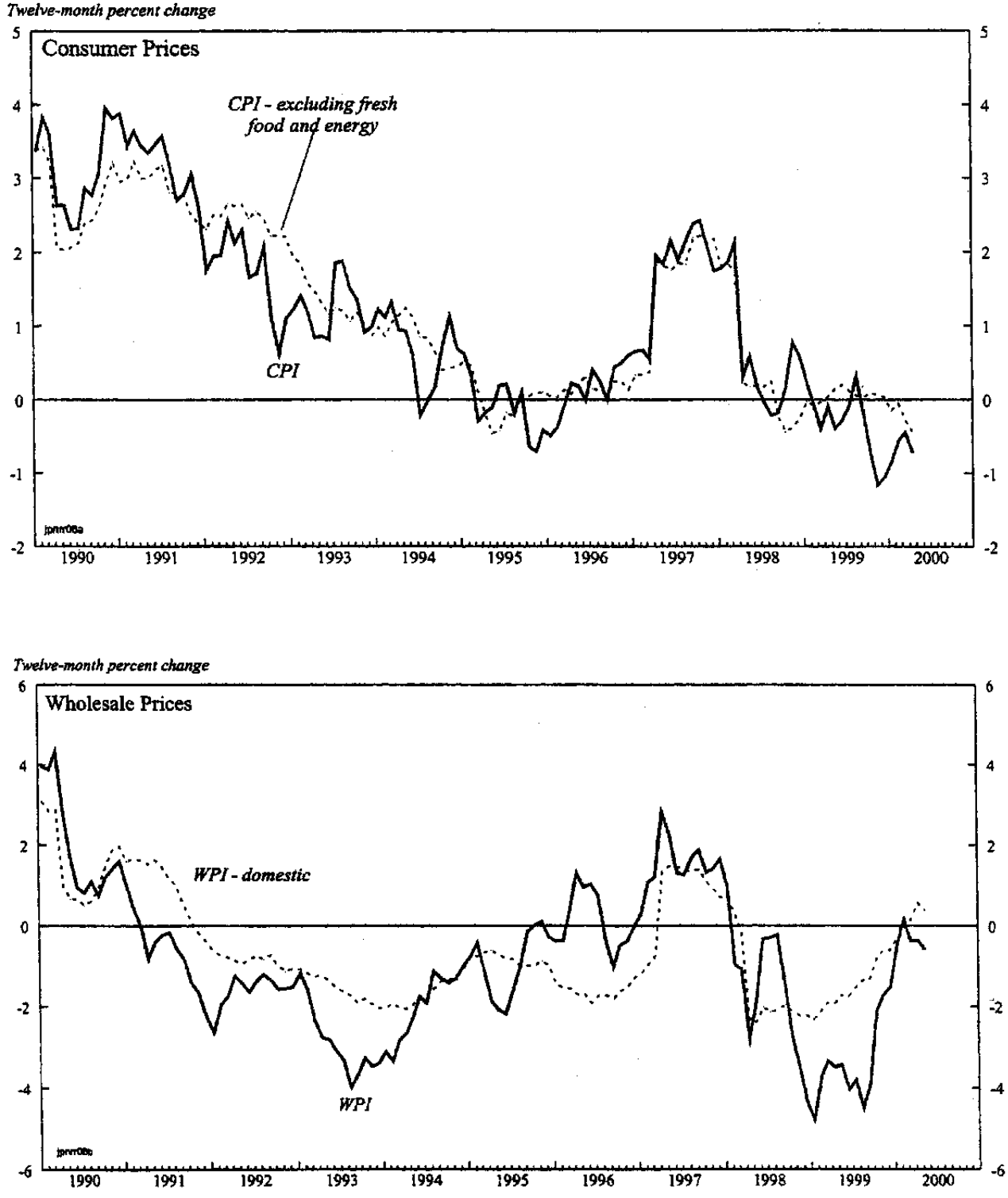
20. **The WPI, in contrast, indicates that deflationary pressures have subsided in recent months.** After declining by over 4 percent in mid-1999, the WPI has declined by only about ¼ percent on a 12-month basis in April 2000. The change in the domestic WPI also indicates a similar story—in fact it moved into positive territory in March 2000, the first time in over a decade that this has happened (once the effects of the sales tax increase in 1997 are excluded). The slower pace of decline in the WPI in recent months reflects essentially the pick-up in commodity prices, particularly oil prices, which have a larger weight in this index than in the CPI.

C. Demand Side Developments

21. **A snapshot of real sector developments in the 1990s—captured in Figure I.8—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 pickup in 1996, related in part to new opportunities created by deregulation,

[7] See Tachibankani, Fujiki and Nakada (2000).

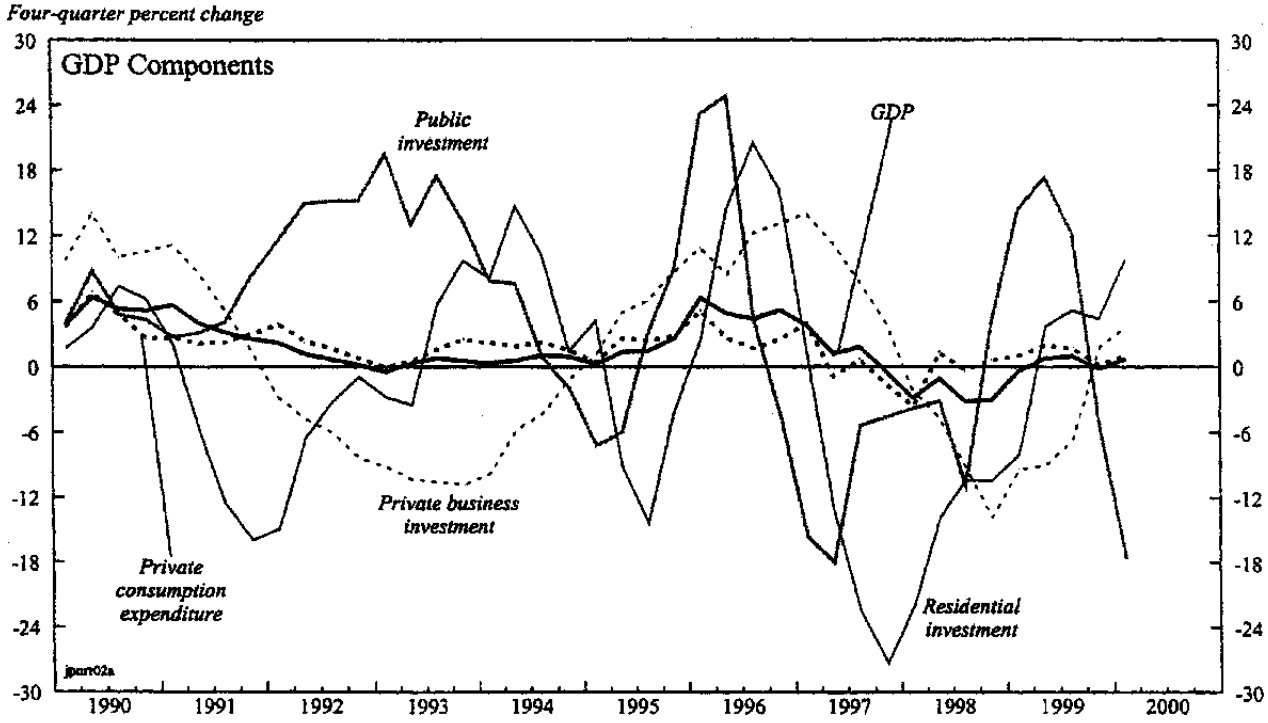
Figure I.7. Japan: Price Indicators, 1990-2000 1/

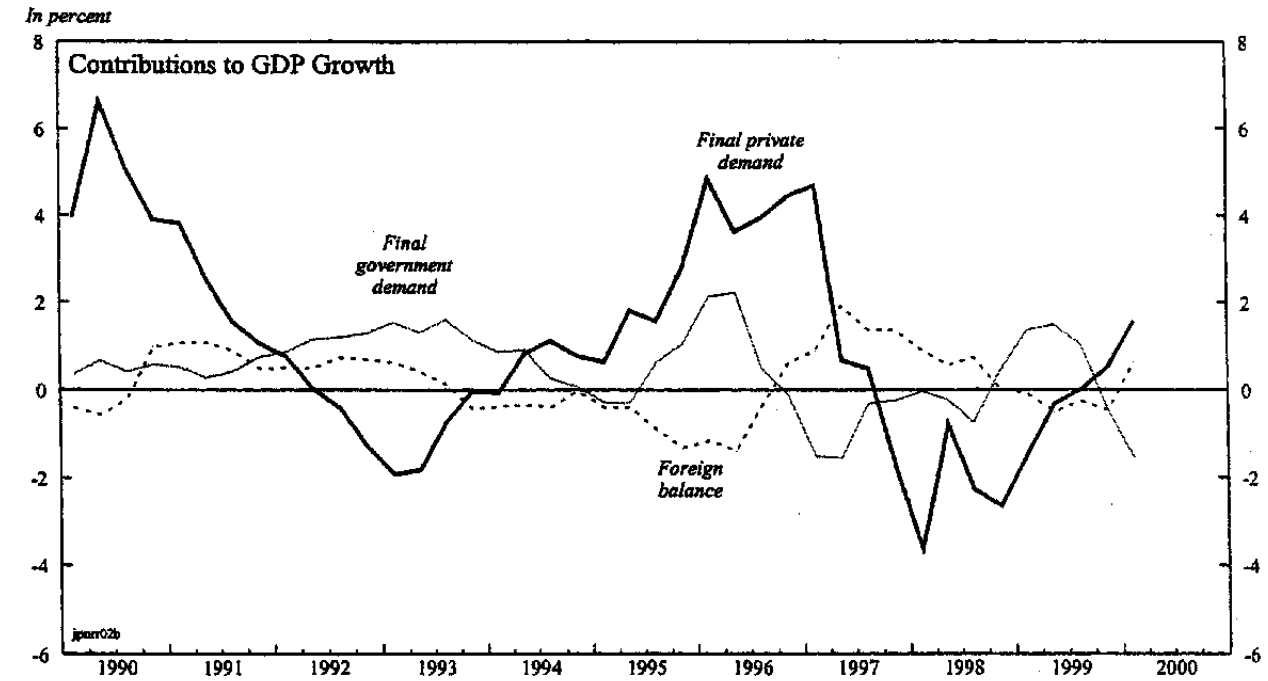


Sources: Nikkei Telecom; and WEFA.

1/ Seasonally adjusted data.

Figure I.8. Japan: Gross Domestic Product at 1990 Prices, 1990-2000





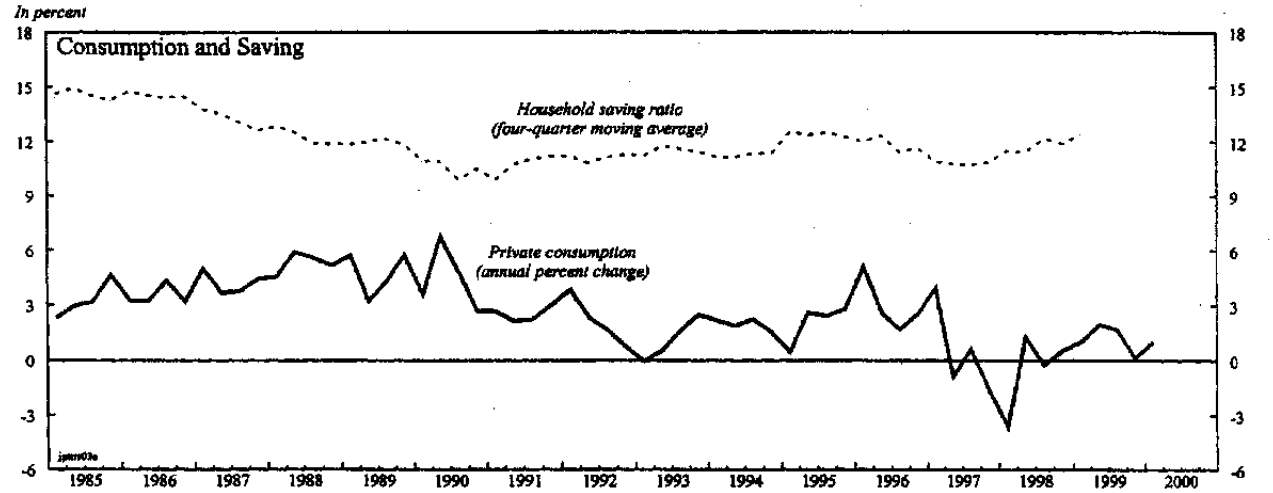
Sources: Nikkei Telecom; and WEFA.

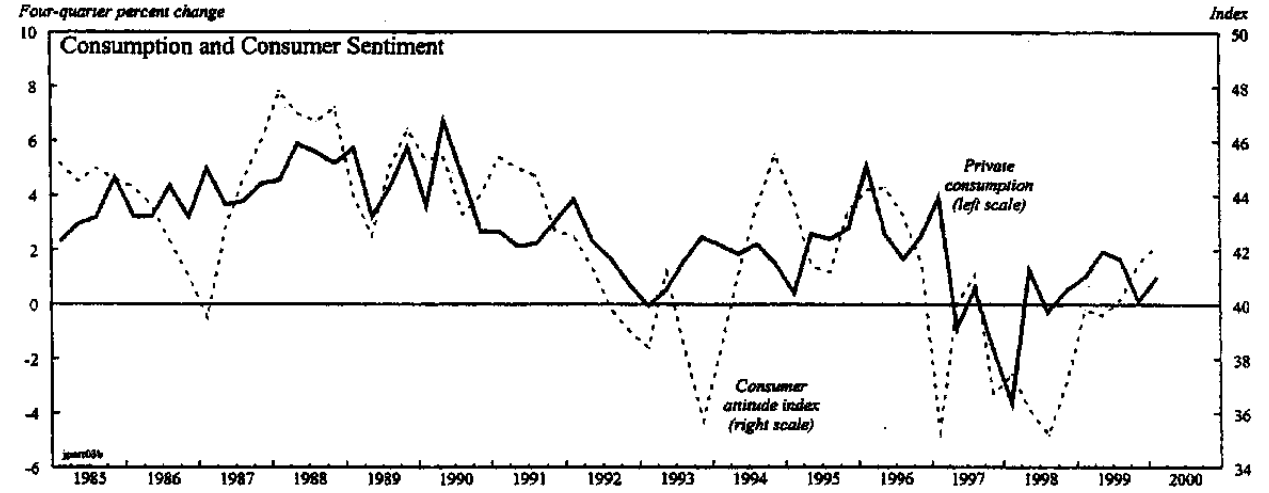
private investment declined sharply yet again. There appears, however, to have been a pick-up in business investment in the last quarter of 1999 and in the first quarter of 2000. Residential investment also fell sharply in the 1990s, and despite the pick-up in the first quarter of this year, there appears to be considerable uncertainty about whether the recent increase marks the beginnings of a more sustained revival. Public investment, which has served as the main ingredient of counter-cyclical fiscal policy in the 1990s, filled in to some extent the slack left by private investment. Private consumption did not fall sharply 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, and then again in the second half of 1999. There has, however, been a rebound of private consumption in the first quarter of this year. 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. There has been a strong rebound—driven mainly by temporary factors—in the external sector's contribution to growth in the first quarter of 2000.

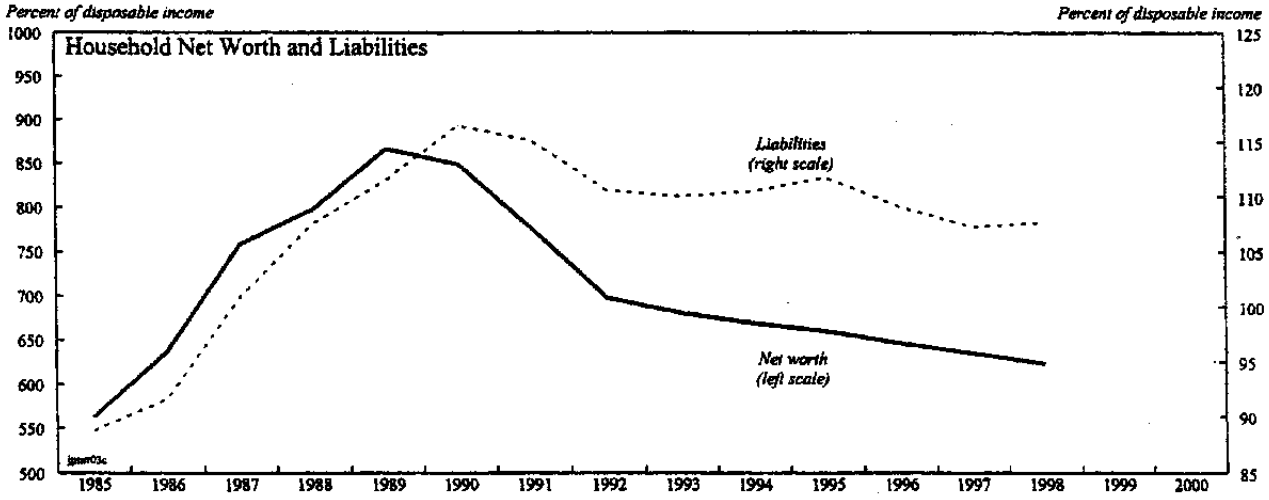
22. **The high volatility of private consumption recently has been driven by a mixture of fluctuations in confidence as well as technical factors**. The declines in private consumption during 1998 overlapped with a period of financial instability set in motion by the failure of some major banks and securities houses, and the rise in unemployment. The steps taken subsequently by the Japanese authorities to resolve the bank failures, as well as the measures undertaken to strengthen the financial system succeeded in abating panic by early-1999, and private consumption rose with the gradual restoration of confidence (Figure I.9). The strength of the pickup in private consumption during the first half of 1999 was likely overstated by technical factors, in particular, due to the spillover of the traditional December bonuses into the early part of the following year, as discussed earlier. The decline in private consumption in the fourth quarter of 1999 was driven in large part by a particularly sharp decline in bonus payments, and uncertainties about job security generated by announcements to intensify corporate restructuring. Seasonal factors, as in the previous year, and sampling biases (noted above) likely overstated the weakness of private consumption in the fourth quarter of 1999. Likewise, seasonal factors (including the leap year effect) contributed to the surge in private consumption by 1.8 percent in the first quarter of 2000.

23. **The slump in business investment, which has been the main driving force behind the slow growth in the 1990s, now appears to be coming to an end**. Business investment fell steeply in the 1990s. The slump in business investment was particularly precipitous during 1997–98—it declined by almost 20 percent from peak to trough, a contraction far more severe than in previous recessions (Figure I.10), as the banking crisis tightened the availability of credit, particularly in the case of small and medium-sized enterprises. The pickup in business investment in the first quarter of 1999 proved transient, driven mainly by credit guarantee schemes that allowed small and medium sized enterprises to catch up on replacement investments missed out in late-1998 due to the credit crunch that accompanied the financial panic. The pickup in business investment in the fourth quarter of 1999, and the first quarter of 2000, however, appears more resilient, with rising corporate profitability,

Figure I.9. Japan: Trends in Private Consumption

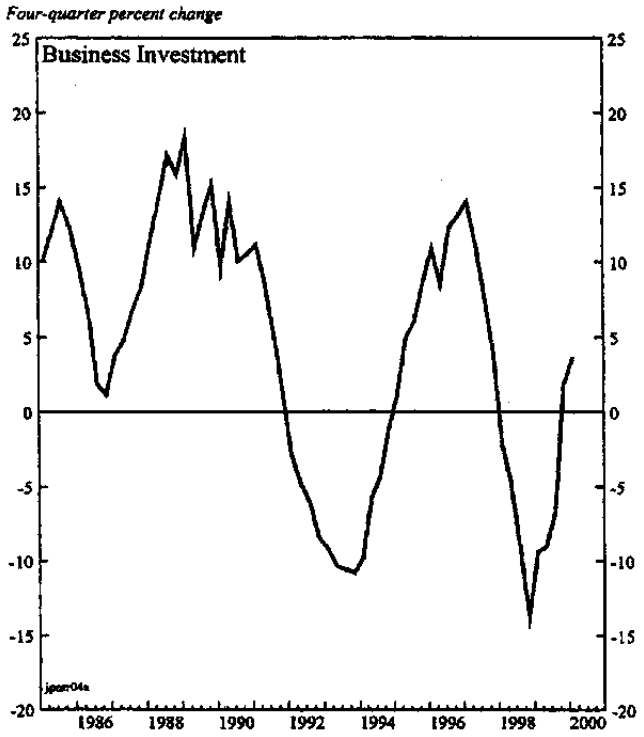


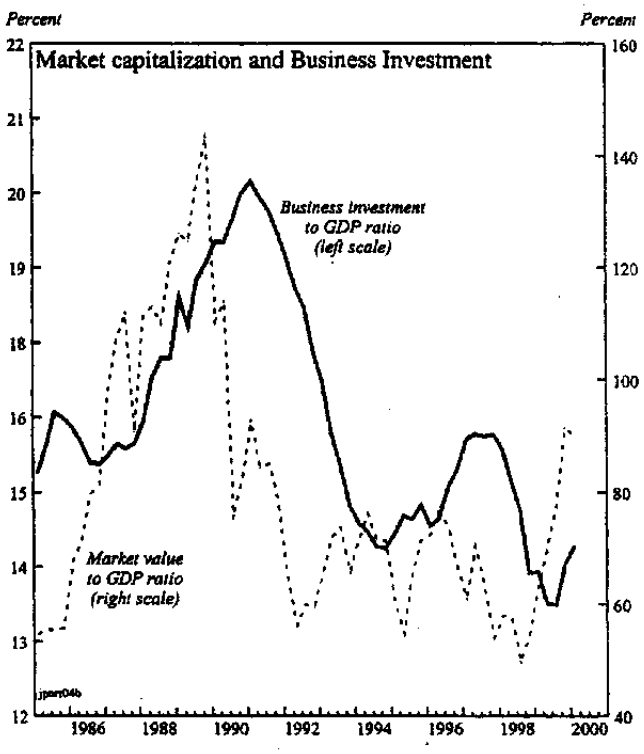


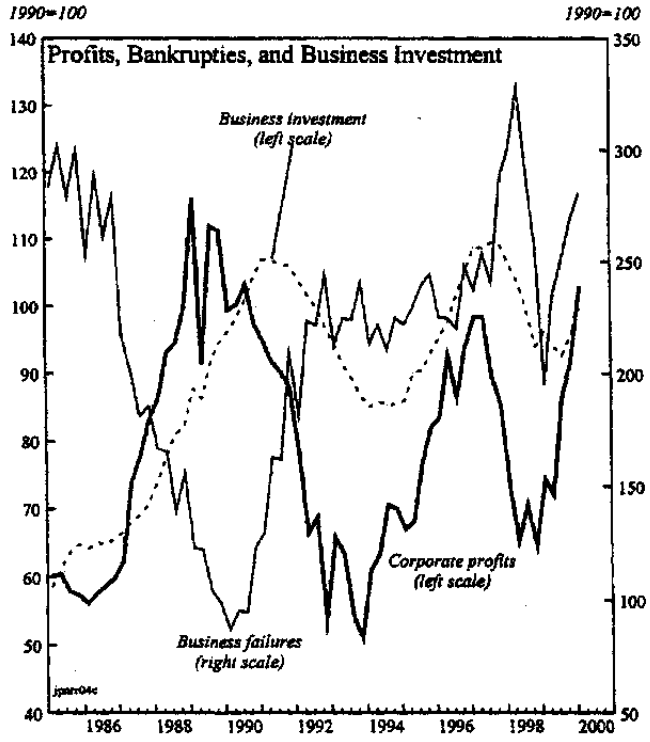


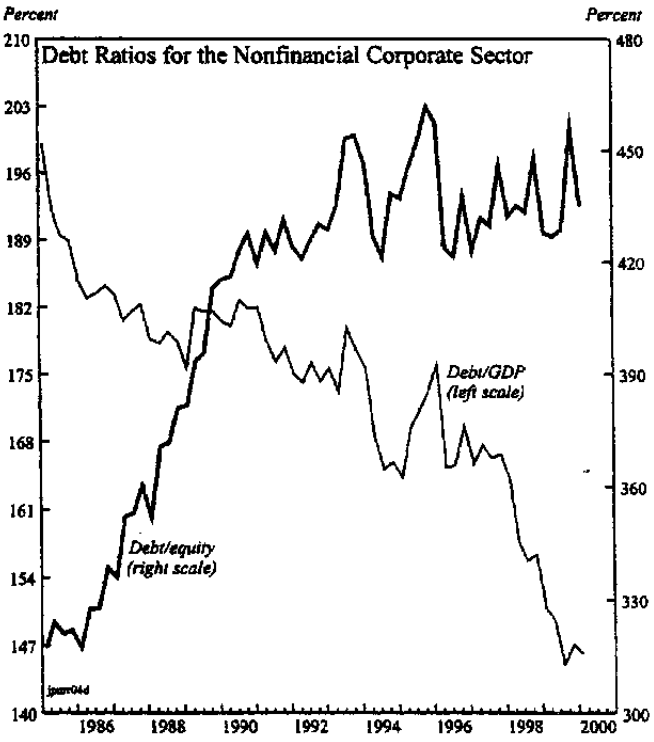
Sources: Nikkei Telecom; and WEFA.

Figure I.10. Japan: Indicators of Business Activity and Investment, 1985-2000









Sources: Nikkei Telecom; and WEFA.

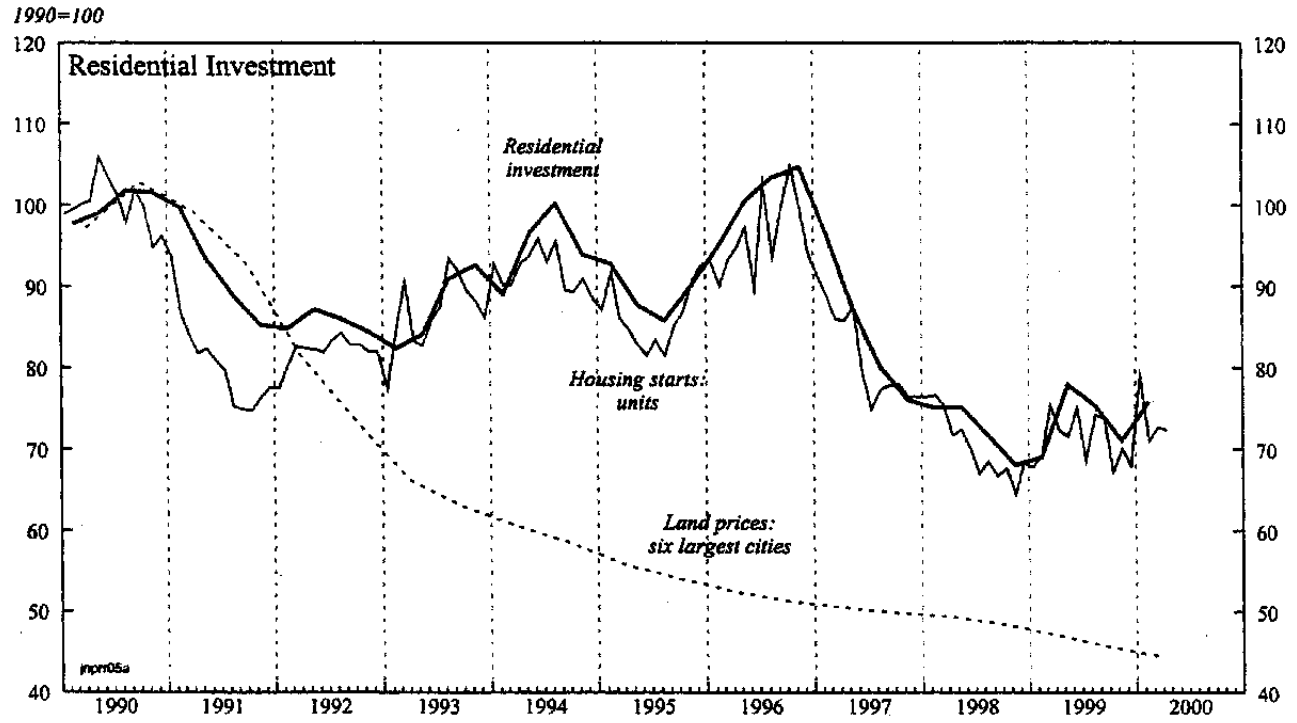
declining excess capacity, and an upturn in equity prices providing the basis for business expansion. An increase in fixed capital formation in the high-tech industries—where overcapacity is much less of an issue—has contributed importantly to the recent surge in business investment. Nevertheless, weaknesses remain, particularly in the case of small and medium sized enterprises in the more traditional sectors which are still being weighed down by excess capacity and high indebtedness—the recent Tankan Survey, for instance, captured what appears to be an ingrained pessimism among these firms.

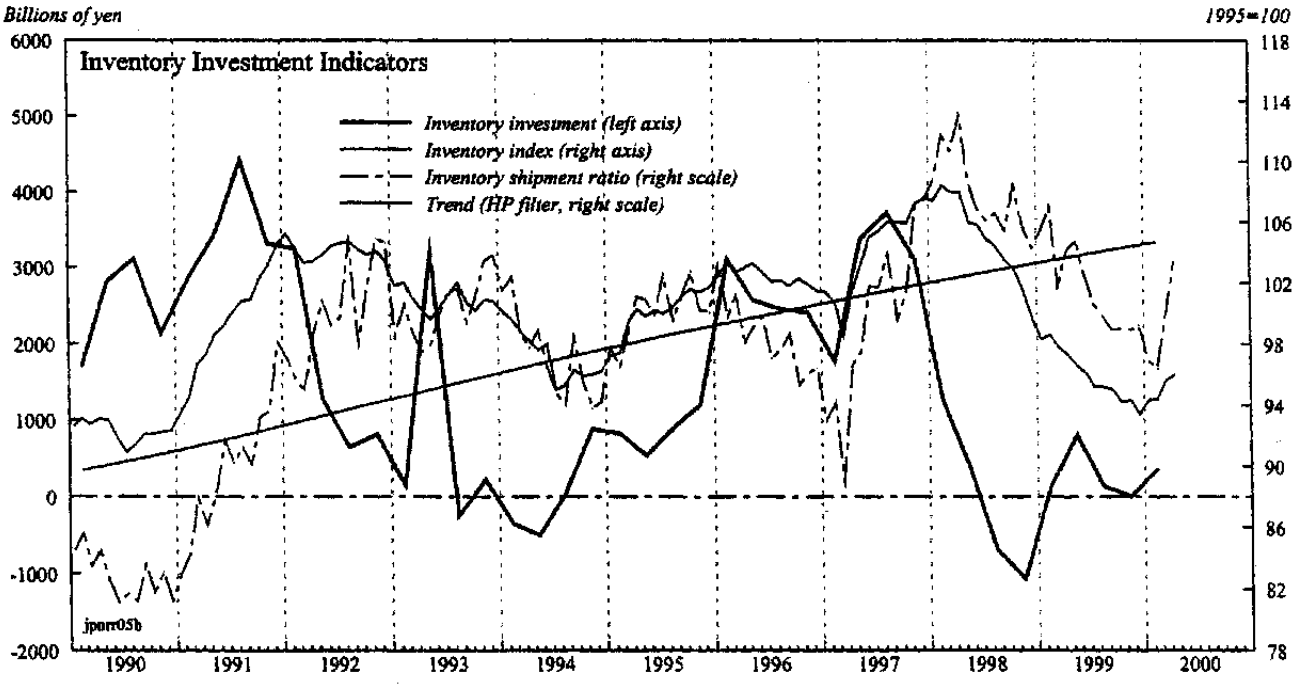
24. **Residential investment has also fallen steeply in the 1990s, as land prices have fallen continuously since 1992, discouraging investment in housing**. Residential investment fell particularly sharply during 1997–98 (Figure I.11), despite the decline in long term yields during this period, because of the uncertainties engendered by the fragilities in the financial sector. Residential investment increased sharply in the first half of 1999—by almost 15 percent—largely in response to the increase in tax credits for housing loans in the budget for fiscal year 1999 to stimulate the housing market. There were also one-off factors driving the rapid increases in residential investment in the first half of 1999—housing starts were accelerated to take advantage of low lending rates available through June 1999. As the effects of these temporary factors wore off, residential investment slumped by about 9 percent in the second half of 1999. Residential investment increased sharply by 6.6 percent in the first quarter of 2000, partly in response to the renewal of tax credits for the housing market.

25. **Public investment has been an important ingredient of counter-cyclical fiscal policy in the 1990s, and has tended to fluctuate with the various stimulus packages**. Public investment grew by about 23 percent between the third quarter of 1998 and the second quarter of 1999, as the authorities responded to the weakening of activity following the financial turmoil by implementing fiscal stimulus packages of ¥16 trillion in April 1998, and ¥23 trillion in November 1998, with the public works component of the stimulus packages being about ¥16 trillion (about 3 percent of GDP). As the effects of these stimulus packages wore off, public investment fell by about 8½ percent in the third quarter of 1999 which, along with the contraction in private demand, resulted in a sharp decline in GDP in the third quarter of 1999. The authorities responded by announcing another stimulus package in November 1999 of ¥18 trillion, of which the allocation to public investment was ¥6.8 trillion. The effects of this package are yet to be felt on public investment, which slumped by 7½ percent in the first quarter of 2000; public works orders figures, however, suggest a strong pickup in the second quarter, but this is unlikely to be sustained.

26. **The down-phase of the inventory cycle appears now to have come to an end, and restocking is providing a modest positive impulse to the economy currently**. After a rapid build up of inventories in 1996—which contributed almost ½ a percentage point to growth in that year—destocking continued essentially unabated, with a negative contribution to growth of almost ⅔ of a percentage point in 1998. As the inventory-shipment ratio fell steeply in 1999, the process of destocking flattened out, and inventories have provided a modest contribution to growth in the first quarter of 2000 (see Figure I.11). However, with the inventory-

Figure I.11. Japan: Residential Investment and Inventory Investment, 1990-2000





Sources: Nikkei Telecom; WEFA; and staff estimates.

shipment ratio rising in recent months, it is not clear how much longer the positive contribution to growth from inventories can be sustained.

27. **Despite the improvement in the global environment in 1999, the external sector's support for the economy has been muted by yen strength.** The external sector's contribution to growth turned negative following the sharp appreciation of the yen in the second half of 1998. After reaching a low of ¥146 per dollar in August 1998, the yen reversed course, and appreciated sharply to about ¥110 per dollar by early 1999. The depreciation of about 10 percent that occurred in the immediate aftermath of the implementation of the zero interest rate policy proved to be transitory, as the yen quickly strengthened again amid signs of a recovery in the summer of 1999, and has been trading in the ¥105–110 per dollar range in recent months. Export volumes grew modestly in 1999 overall, dampened by the appreciation of the yen, although the strength of the Asian recovery has contributed to an uptrend since mid-1999 (Figure I.12). Import growth was strong in 1999, considering the weak state of domestic demand, and has been attributed to an increase in import penetration arising from an intensification of deregulation initiatives as well as a recovery in intra-industry trade in the East Asian region as the impact of the crisis waned. Increased imports from Japanese subsidiaries located abroad, and Y2K related stockpiling in the fourth quarter were also factors influencing the strong growth of imports last year. The external sector's contribution to growth was a substantial 0.8 percentage points in the first quarter of 2000, as the import stockpiles from the previous quarter were unwound, and exports notched a strong performance.

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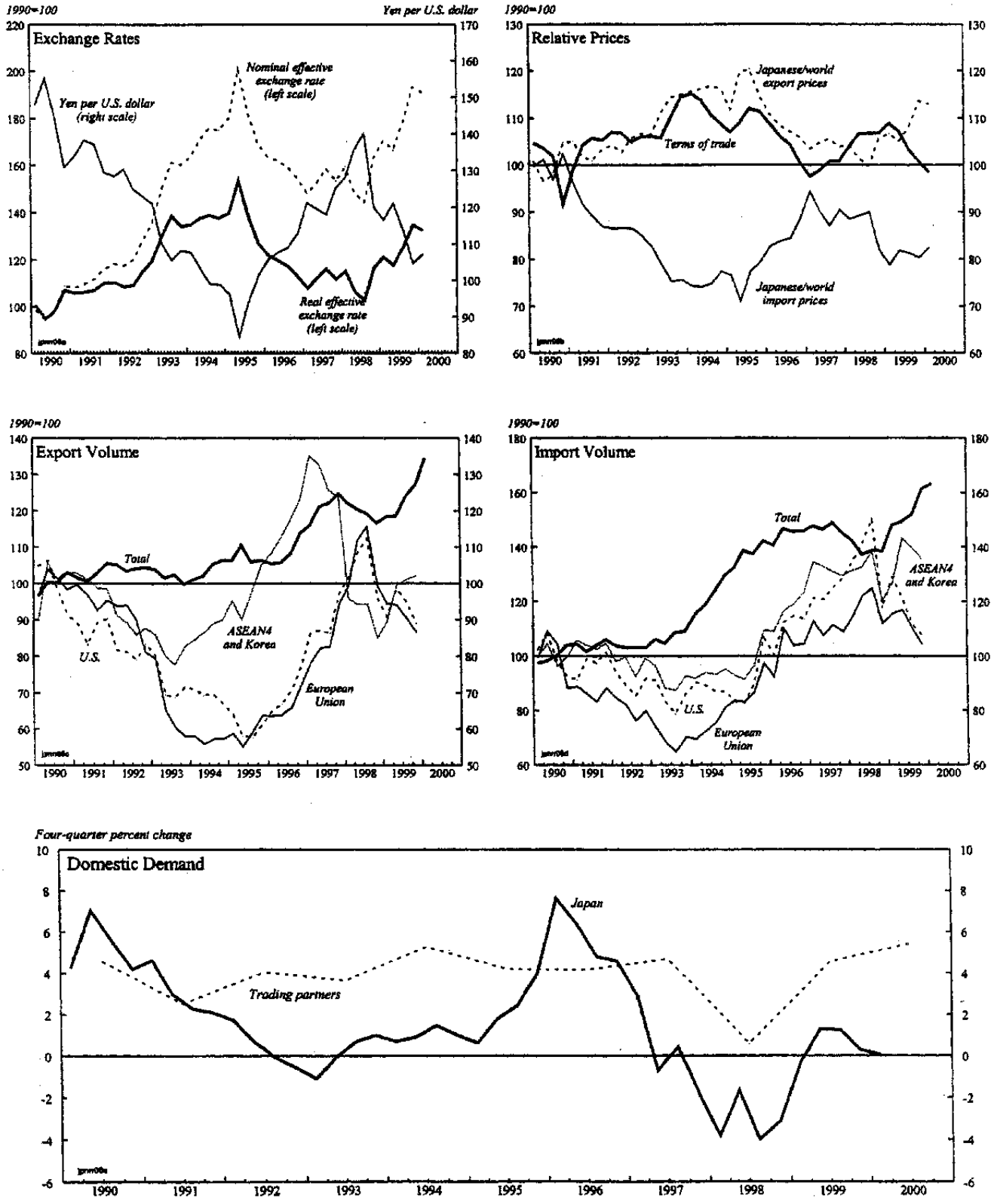
Figure I.12. Japan: External Sector Developments, 1990-2000



Sources: Nikkei Telecom; WEFA; and staff estimates.

II. Fiscal Policy Developments[1]

1. **Fiscal policy has been strongly expansionary for most of the past decade.** Except for a brief interruption in FY1997—when policy was tightened in response to a short-lived economic upswing—the general government deficit has expanded since the early to mid-1990s, with public works spending and tax reductions supporting aggregate demand in the face of an unprecedented economic downturn. Particularly in 1998, when the economy slipped into recession, the government passed two large stimulus packages that led to a substantial widening of both central and local government deficits in the following year. With a further package in November 1999, fiscal policy has maintained its stimulative stance, and the general government deficit excluding social security is again expected to reach above 9 percent of GDP in FY2000 (Figure II.1).[2]

2. **The resulting strain on public finances has made stimulus policies more difficult to maintain.** A decade of expansionary fiscal policy has resulted in an increase in net general government debt (excluding social security assets) from about 40 percent of GDP in 1990 to a projection of almost 100 percent of GDP by the end of FY2000. In addition to generating concerns about the sustainability of fiscal policy, high public debt levels have begun to hamper the implementation of stimulus measures, especially since local governments increasingly are being forced into fiscal consolidation as they approach statutory deficit ceilings. The room for the Fiscal Investment and Loan Program (FILP) to support expansionary government policies is also increasingly limited by a fall in fresh inflows from postal savings and welfare contributions, and by the maturation of a substantial amount of long-term postal savings deposits that were incurred during the high-interest period of the early 1990s.

3. **The weak economy has highlighted the need for reforms in the social security system.** Low income growth has translated into a rising shortfall of pension and health insurance contributions, erasing much of the surplus these schemes had in earlier years. The deteriorating financial condition of pension and health insurance systems, combined with the prospect of a dramatic aging of the Japanese population over the next decades, has prompted reform efforts with the aim of restoring the long-term viability of the social security system. The Diet passed a pension reform bill that has considerably reduced future liabilities of the public pension system, and bills to introduce private defined-contribution pension plans and curb increases in medical spending are to be reintroduced in the coming months. However, these reforms would need to be supplemented by further measures to reduce the need for a sharp increase in social security contributions and government transfers in the future.

4. **These issues will be discussed in greater detail in this chapter.** The following sections focus on (i) central government stimulus policies; (ii) financial difficulties of local governments; (iii) public debt dynamics and fiscal consolidation; (iv) postal savings and the FILP; and (v) fiscal reforms.

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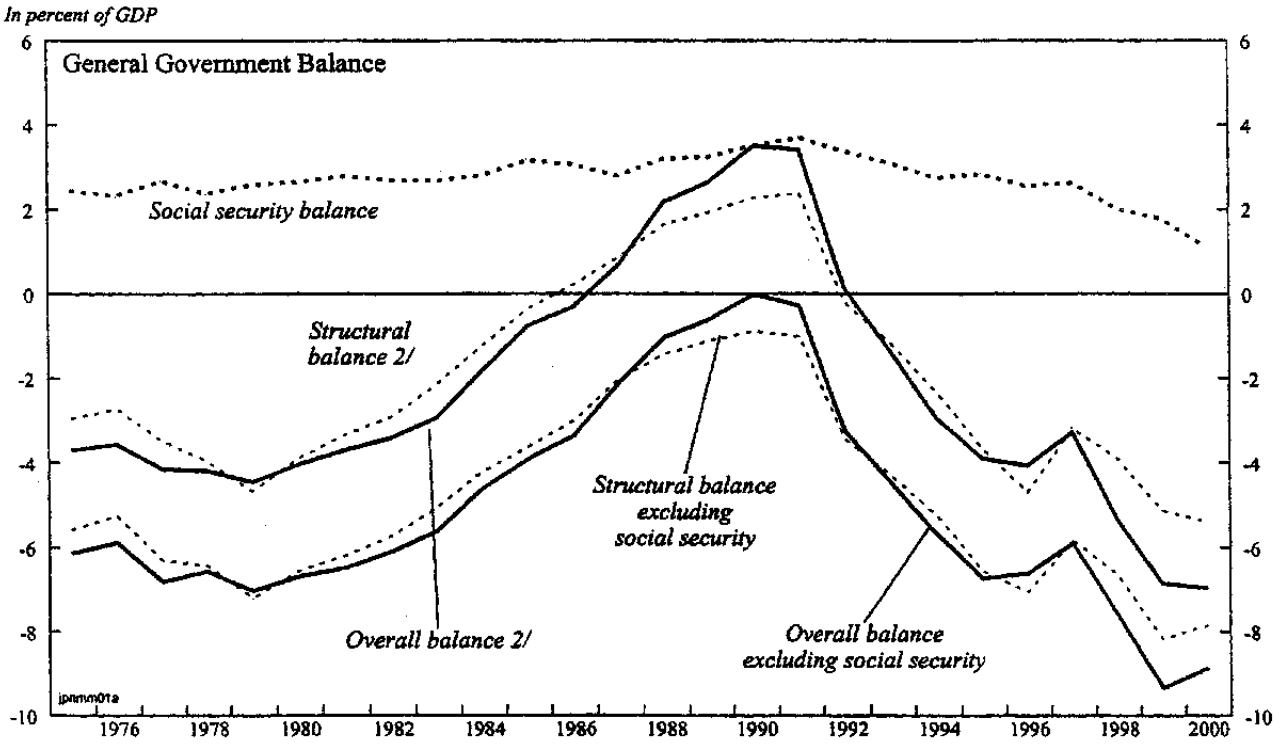
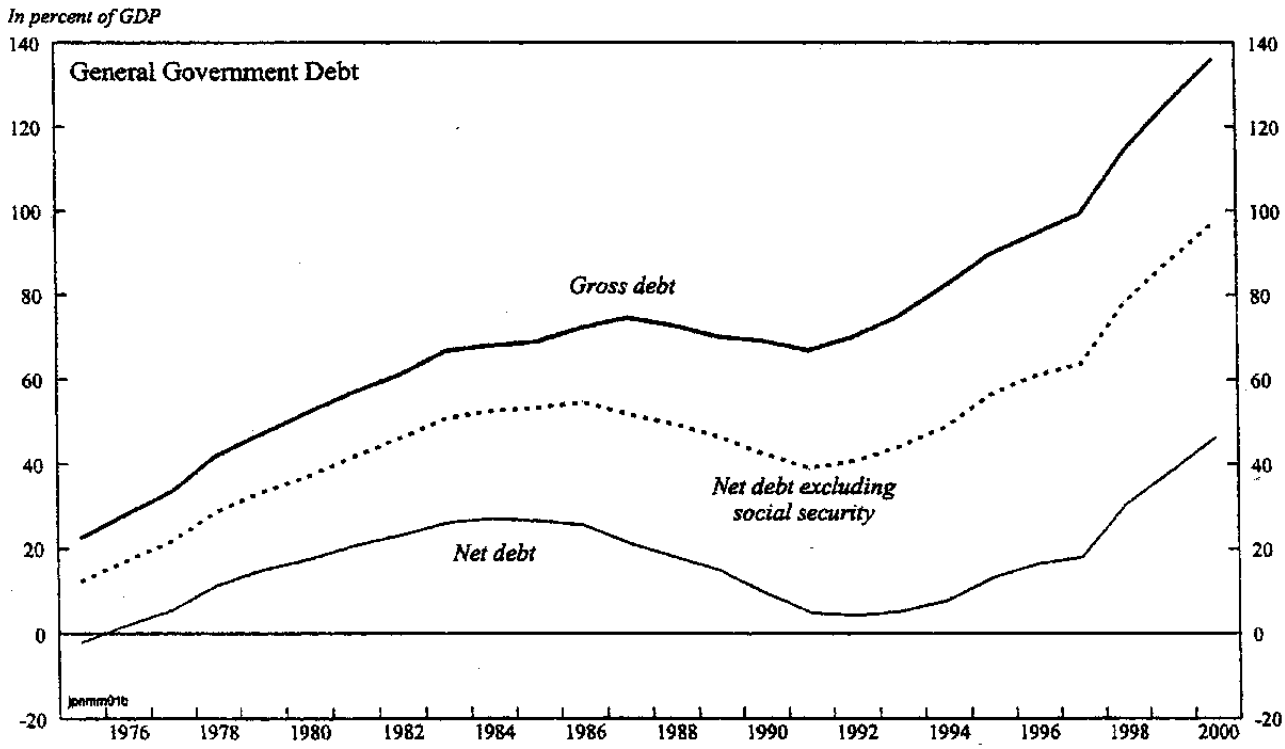
[1] Prepared by Martin Mühleisen (ext. 38686).

[2] The fiscal year starts on April 1.

Figure II.1. Japan: Summary of Fiscal Indicators, FY 1975-2000 1/





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

1/ The fiscal year is from April to March.
2/ Excluding bank support.

A. Central Government Stimulus Policies

5. **The government's main tool for implementing expansionary fiscal policies has been a series of large stimulus packages in recent years** (Table II.1).[3] Japan's annual budget process is mainly geared toward providing financing for entitlement programs and medium- to long-term developmental plans, and initial budgets therefore tend to react less to the economic cycle than in other countries. Automatic stabilizers are also relatively small, owing to the low cyclical variability of unemployment and social welfare benefits. The government therefore responded to the economic downturn with several mid-year stimulus programs that contained spending measures for all layers of the public sector, including government financial institutions (GFIs) and the FILP. The most important components have been public works spending and tax cuts financed through supplementary budgets of central and local governments (so-called "real water" measures), but the packages have also included other elements, such as loan commitments by GFIs, especially for small and medium-sized enterprises (SMEs), public loan guarantees, employment measures, and projects for other public sector agencies that have largely been financed through the FILP.

6. **The government's stimulus efforts reached a peak in FY1998** with the announcement of two major packages (in April and November), amounting to a combined 8 percent of GDP, more than half of which was to be provided through real water measures. The implementation of these packages was mostly felt in calendar 1999, however, due to the 3–6 month gestation period for public works projects, and owing to the fact that most of the tax measures were implemented through the FY1999 initial budget. Nevertheless, the two associated supplementary budgets practically doubled the central government's bond issue in FY1998 compared to the year before (to 7 percent of GDP), and contributed to a sharp turnaround in the overall general government deficit, following a period of consolidation in FY1997 (see Figure II.1).[4] At the same time, the government signaled its commitment to maintain fiscal stimulus until the economy recovered by suspending the Fiscal Structural Reform Act (FSRA) which had prescribed a medium-term target for the general government deficit (excluding social security) of 3 percent of GDP by FY2005.

Developments in FY1999

7. **Following the usual practice, the initial budget for FY1999 was formulated in relation to the initial budget of the previous year.** Although the central government planned to increase public works spending by about 10 percent over the FY1998 initial budget, this was insufficient to maintain the pace of public investment after the impact of the FY1998 stimulus packages faded in mid-1999, and after accounting for cutbacks at the local

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[3] A detailed examination of the composition and impact of stimulus programs is contained in Mühleisen (2000).

[4] A separate supplementary budget, passed in October 1998, authorized bond issues and public guarantees worth ¥65 trillion (13 percent of GDP) for resolving problems in the domestic banking system. The government also authorized ¥20 trillion in special loan guarantees extended by regional credit-guarantee associations through March 2000.

Table II.1. Japan: Summary of Economic Stimulus Packages, 1993–1999

(In trillions of yen, unless otherwise indicated)

Date proposed	1993		1994	1995	1998		1999
	April	September	February	September	April	November	November
Total package	13.2	6.2	15.3	14.2	16.7	23.9	18.1
(In percent of GDP)	2.8	1.3	3.2	3.0	3.3	4.8	3.6
Tax reductions	0.2	0.0	5.9 1/	0.0	4.6 1/	6.0 2/	0.0
(In percent of GDP)	0.0	0.0	1.2	0.0	0.9	1.2	0.0
Public investment 3/	7.6	2.0	4.5	6.5	7.7	8.1	6.8
(In percent of GDP)	1.6	0.4	0.9	1.4	1.5	1.6	1.4
Land purchases 4/	1.2	0.3	2.0	3.2	1.6	...	...
(In percent of GDP)	0.3	0.1	0.4	0.7	0.3	...	...
Increased lending by Housing Loan Corp. 5/	1.8	2.9	1.2	0.5	0.0	1.2	2.0
(In percent of GDP)	0.4	0.6	0.3	0.1	0.0	0.2	0.4
Increased lending by government-affiliated Financial institutions	2.4	1.0	1.5	2.6 6/	2.0	6.9	7.4
(In percent of GDP)	0.5	0.2	0.3	0.5	0.4	1.4	1.5
Other	0.0	0.0	0.2	2.6	0.8	1.7	1.9
(In percent of GDP)	0.0	0.0	0.0	0.0	0.2	0.3	0.4

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

1/ Temporary measures.
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 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.

government level. Moreover, the decision to front-load public works spending in FY1999, with the aim of minimizing carry-over of investment projects into FY2000, likely contributed to a sharp drop-off in public investment in the second half of the year (Figure II.2).

8. **The budget included permanent tax rate cuts to replace earlier tax rebates.** The final tax provisions featured ¥9¼ trillion in tax reductions, of which ¥7 trillion (1.4 percent of GDP) became effective in FY1999. The majority of the cuts consisted of permanent income tax rate cuts, particularly a reduction in the corporate income tax rate from 46 percent to 40 percent, as well as a cut in the top personal income tax rate from 65 percent to 50 percent. However, although personal income tax liabilities were reduced by close to 20 percent on average, the direct effect on household disposable income was likely small since these measures only replaced expiring temporary tax rebates from FY1998.[5]

9. **As the incipient recovery faltered in the second half of 1999, the government reacted with another large stimulus package in November,** including measures worth ¥18 trillion (3½ percent of GDP).

- *Real water spending* accounted for ¥7¾ trillion (1½ percent of GDP), consisting mainly of public works measures.[6]

- The remainder of the package aimed at extending *support to SMEs, housing and employment*, mainly through an extension of loan guarantees and steps to increase lending by GFIs. Funds were also provided to cover losses incurred by the Deposit Insurance Corporation during the nationalization of LTCB.

- The bulk of the central government's share of the package was implemented through a *¥7 trillion supplementary budget* in December 1999, which included additional public works spending of ¥3½ trillion, as well as ¥1 trillion in funds relating to the introduction of nursing care insurance—the bulk of which was used to finance a delay in premium collection by half a year (see below).

10. **The overall central government deficit for FY1999 is expected to increase to about ¥39 trillion (8 percent of GDP),** or ¥8½ trillion more than envisaged in the FY1999 initial budget (Tables II.2 and II.3). Besides the large supplementary budget in December, the overshoot was also caused by a sharp increase in welfare spending (¥2 trillion), partly a result of rising unemployment. Other contributing factors included a June 1999

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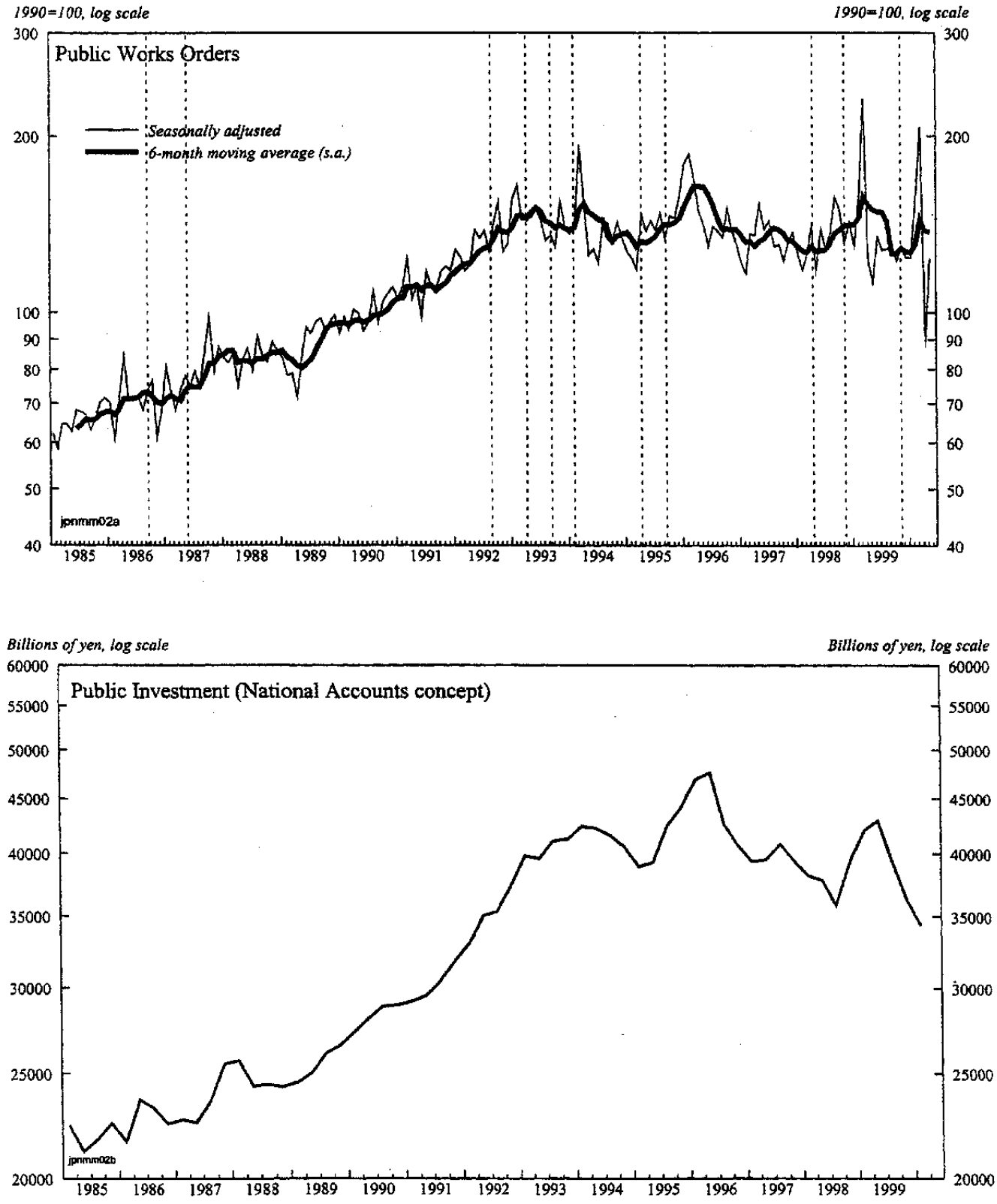
[5] Other measures in the FY1999 budget included an extension of the period for which mortgage holders qualified for special tax deductions from six to 15 years (for house purchases taking place by December 2000). Moreover, the securities transactions tax was repealed as of April 1999, withholding taxes were suspended for Finance Bills and Treasury Bills (if registered with the Bank of Japan), and nonresidents were being exempted from withholding tax on government bonds from September 1999.

[6] Public works orders increased sharply in early 2000 in response to the package, but the impact on the national income accounts has yet to be felt (see Figure II.2).

Figure II.2. Japan: Public Investment Indicators, 1985-2000 1/



Sources: Economic Planning Agency; and Ministry of Construction.

1/ Dotted lines indicate the introduction of fiscal stimulus packages.

Table II.2. Japan: Tax Receipts of the Central Government General Account, FY1995–2000

(In billions of yen)

	1995	1996	1997	1998			1999		2000
		Settlement		Initial	Revised	Settlement	Initial	Revised	Initial
				(In billions of yen, fiscal years)					
Individual income tax	19,515	18,965	19,183	20,555	17,173	16,996	15,685	15,067	18,680
Corporate income tax	13,735	14,483	13,475	15,274	11,720	11,423	10,428	9,799	9,947
Taxes on goods and services	11,372	11,750	14,810	16,514	15,761	15,597	15,899	15,785	15,278
Of which:									
Consumption tax	5,790	6,057	9,305	10,818	10,204	10,074	10,376	10,376	9,856
Liquor tax	2,061	2,071	1,982	2,058	1,929	1,898	1,981	1,867	1,860
Gasoline tax	1,865	1,915	1,926	1,996	1,996	1,998	2,045	2,045	2,078
Tobacco tax	1,042	1,080	1,018	1,020	1,040	1,046	896	896	900
Custom duties	950	1,024	953	947	822	869	785	785	730
Stamp revenue	1,941	1,969	1,681	1,824	1,562	1,608	1,521	1,584	1,511
Other	4,418	3,869	3,840	3,408	3,127	1,019	850	850	841
Total tax and stamp revenue	51,391	52,060	53,942	58,522	50,165	49,432	47,119	45,678	48,659
				(Percentage change) 1/					
Individual income tax	-4.4	-2.8	1.1	7.2	-10.5	-11.4	-8.7	-11.4	24.0
Corporate income tax	11.1	5.4	-7.0	13.4	-13.0	-15.2	-11.0	-14.2	1.5
Taxes on goods and services	1.4	3.3	26.0	11.5	0.6	5.3	0.9	1.2	-3.2
Total tax and stamp revenue	1.8	0.2	3.6	8.5	-7.0	-8.4	-6.1	-7.6	6.5

Source: Data provided by the Japanese authorities.

1/ Compared to latest available data of the previous year.

Table II.3 Japan: Central Government General Account Budget, FY1995–2000
(In billions of yen)

	1995	1996	1997	1998			1999		2000
		Settlement		Initial	Revised	Settlement	Initial	Revised	Initial
Expenditures	75,939	78,848	78,470	77,669	87,991	84,392	81,860	89,019	84,987
Of which:									
Social security	14,543	15,032	15,385	14,843	16,008	15,658	16,095	19,112	16,767
Public works	12,795	12,340	11,067	8,985	14,855	13,034	9,931	12,235	9,931
Defense	4,720	4,815	4,950	4,940	4,960	4,956	4,932	4,915	4,936
Official aid	1,034	1,061	1,083	980	1,114	1,082	988	998	984
National debt service 1/	12,820	16,084	15,926	17,263	18,150	17,699	19,832	20,272	21,965
Of which:									
Interest payments	10,708	10,725	10,600	11,589	11,219	10,796	11,368	10,907	10,743
Transfer of local allocation tax to local government	12,302	13,945	15,481	15,870	14,305	14,305	13,523	12,444	14,930
Revenues	56,585	55,442	58,751	62,111	53,991	54,083	50,810	49,444	52,377
Taxes and stamp duties	51,931	52,060	53,941	58,522	50,165	49,432	47,119	45,678	48,659
Miscellaneous	4,654	3,382	4,810	3,589	3,826	4,651	3,691	3,766	3,718
Deficit	19,354	23,406	19,719	15,558	34,000	30,309	31,050	39,575	32,610
Financing	19,354	23,406	19,719	15,558	34,001	30,309	31,050	39,575	32,610
Bond issues	21,247	21,748	18,458	15,557	34,000	34,000	31,050	38,616	32,610
Deficit-financing bonds	4,807	11,041	8,518	7,130	16,950	17,000	21,710	25,500	23,500
Construction bonds	16,440	10,707	9,940	8,427	17,050	17,000	9,340	13,116	9,110
Others									
Carried over surplus	-1,894	1,658	1,261	1	1	-3,691	0	959	0
Carry in	2,725	4,619	2,961	1	1	1,700	0	5,391	0
Carry out	-4,619	-2,961	1,700	0	0	-5,391	0	-4,432	0
Memorandum items:									
General expenditure 2/	50,816	48,819	47,064	44,536	55,537	52,389	46,888	56,303	48,092
				(In percent of GDP)					
Expenditures	15.5	15.7	15.5	14.9	17.8	17.0	16.5	18.0	17.1
Revenues	11.6	11.0	12.2	12.0	10.9	10.9	10.2	10.0	10.5
Deficit	4.0	4.7	3.9	3.0	6.9	6.1	6.3	8.0	6.5
Bond financing	4.3	4.3	3.7	3.0	6.9	6.8	6.3	7.8	6.5
Deficit financing bonds	1.0	2.2	1.7	1.4	3.4	3.4	4.4	5.2	4.7
Public works	2.6	2.5	2.0	1.7	3.5	3.4	1.9	2.6	1.8

Source: Data provided by the Japanese authorities.

1/ Includes repayments of principal and running costs.

2/ Total expenditure excluding debt service and local allocation tax transfers.

supplementary budget containing ¥500 billion in employment measures and support for corporate restructuring, and a tax shortfall of about ¥500 billion (net of local tax transfers).

The FY2000 Budget

11. **In an effort to secure the emerging recovery, the initial budget for FY2000 was designed to extend fiscal stimulus into FY2000.** However, although planned expenditure levels exceeded those of the FY1999 budget, the projected deficit for FY2000 is again sharply lower than the central government's revised estimate for FY1999 (see Table II.3). The main elements of the budget included the following:

- Central government *general expenditure* was slated to increase by 2½ percent over the initial FY1999 budget, largely on account of rising transfers to social security.[7] The increase in transfer payments mostly relates to the introduction of the nursing care insurance scheme, which was budgeted to require direct central government subsidies of ¥1.2 trillion in FY2000.

- Allocations for *public works spending* remained unchanged from the previous year's initial budget. The government decided not to front-load investment spending as in FY1999, but the basic expenditure pattern—a buildup in the first half of the year, followed by a decline in the second half—is likely to be repeated.

- The budget also included substantial measures for *safeguarding the financial system.* Spending limits for the Deposit Insurance Corporation were increased by ¥10 trillion in support of failed banks (of which ¥6 trillion could be used to cover depositor losses) and an additional ¥400 billion in government guarantees was provided in support of the Life Insurance Policyholder Protection Fund (Box II.1).

12. **Tax revenue is expected to increase for the first time in three years, owing to a ¥4 trillion (0.8 percent of GDP) interest tax windfall** for central and local governments from maturing postal savings deposits. The government's own proposed tax measures—which extend further support to residential investment and corporate start-ups—will account for some ¥200 billion in revenue losses. The measures include an extension of special mortgage tax deductions for another six months to June 2001, and an exemption for most of the capital gains from sales of stocks in SMEs and venture businesses that are bought during a five-year term beginning in FY2000 and held for at least three years before a company goes public. To offset revenue losses, the government lowered income tax deductions for families with children by about 20 percent.[8]

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[7] General expenditure excludes debt service payments and transfers of local allocation tax.

[8] The government also introduced a bill on the tax treatment of contributions to private defined-contribution pension plans, which has however not yet passed the Diet (see below).

Box II.1. The Fiscal Cost of Bank Support Measures

In FY1998, the government authorized a total of ¥60 trillion in public funding in support of the financial system (see the 1999 *Economic and Policy Developments Paper*). Most of these funds are to be used for capital injections or government guarantees to the Deposit Insurance Corporation (DIC), which are expected to be eventually recovered, but the DIC was also authorized to spend ¥7 trillion in non-recoverable funds to cover depositor losses (this limit was raised by ¥6 trillion in the FY2000 budget). At the time of authorization, the government issued special bonds to the DIC for redemption once the actual losses occurred. The redemption of these bonds implied actual government expenditure, reflected also in the fiscal deficit on a national accounts basis, which was financed by ordinary bond issues (through initial and supplementary budgets) and other means (e.g., proceeds from sales of NTT shares, and budgetary surpluses from previous years).

Compared to the authorized limit of ¥13 trillion, cumulative expenditure on depositor protection amounted to ¥4.8 trillion (1 percent of GDP) through the end of FY1999. Following ¥1.2 trillion in expenditures in FY1998, mainly on resolving the case of Hokkaido Takushoku, the DIC spent a total of ¥3.6 trillion to cover depositor losses in FY1999, of which ¥3.2 trillion were related to the sale of LTCB in March 2000. Private analysts expect the sale of NCB to lead to losses of around ¥3 trillion, which would bring the total of public funds actually spent to about ¥8 trillion by the end of FY2000.

13. **The budget implies a net bond issue of ¥32.6 trillion, a five-fold increase since 1990** (Table II.4). Over the same period, the amount of outstanding central government bonds has roughly doubled, and is projected to reach an estimated ¥364 trillion (73 percent of GDP) by the end of FY2000. Total central government debt, which includes borrowing from the FILP and other sources, reached ¥492 trillion (100 percent of GDP) at end-FY1999, and is slated to increase to around ¥530 trillion (106 percent of GDP) by end-FY2000.

Table II.4. Japan—Central Government Bond Issues, FY1999–2000

(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	26.0	166.3	34.7
1995	12.6	22.0	21.2	46.6	225.2	46.0
1996	21.0	22.4	21.7	48.3	244.7	48.9
1997	16.7	18.5	18.5	49.9	258.0	50.6
1998	15.6	34.0	34.0	76.1	295.2	59.2
1999	31.1	38.6	...	78.7	331.7	66.9
2000	32.6	...	...	85.9 2/	364.0 2/	73.2

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

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

14. **As a result of the budget proposals, the staff projects that, on a national accounts basis, the general government deficit (excluding social security) will remain roughly unchanged at 9 percent of GDP in FY2000** (Table II.5). This projection assumes that local governments will cut back sharply on independent investment projects (see below) and that a

small (¥1 trillion) supplementary budget will be passed in the autumn. Official projections show that the general government deficit (excluding social security) will fall from 10.7 percent of GDP in FY1999 to 9.4 percent of GDP in FY2000. However, these figures are based on appropriations data and do not fully adjust for the fact that much of the public works spending appropriated in FY1999 will not occur until FY2000.[9] The structural deficit (including social security, but excluding bank support)—which reflects more closely the impact on aggregate demand—is projected to increase by ¼ percentage point of GDP.

Table II.5—General Government Operations, 1997–2000
(In percent of GDP)

	FY1997	FY1998	Est. FY1999	Proj. FY2000
General government balance	-3.3	-5.6	-7.6	-7.7
Excluding social security	-5.9	-7.6	-9.3	-8.8
Of which:				
Taxes and fines	18.2	17.9	16.9	17.4
Consumption	9.9	10.2	10.3	10.4
Investment	5.7	6.0	5.7	5.5
Change in structural balance (including social security, Excluding bank support)	1.5	-0.7	-1.2	-0.3

Source: Staff estimates.

B. Local Government Operations

15. **Reflecting the close relationship between central and local governments in Japan, local authorities have had to take on a major burden in efforts to stimulate the economy**. 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.

16. **Partly as a result, the financial situation of local governments has deteriorated since the early 1990s, which has prompted consolidation efforts that run counter to the central government's stimulus objectives**. On the basis of settlement data, the consolidated local government deficit rose from 1 percent of GDP in FY1990 to 2¾ percent of GDP in

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

Table II.6 Japan: General Government Public Works Projects

(In billions of yen)

	1991	1992	1993	1994	1995	1996	1997	1998
Solo projects	18,432	21,491	25,651	24,505	23,488	22,953	20,845	21,544
Central government 1/	3,759	4,427	7,777	7,459	6,383	6,216	5,393	6,895
Local government	14,674	17,065	17,874	17,046	17,104	16,738	15,452	14,650
Joint projects 2/	8,802	10,244	11,493	11,184	12,547	11,915	11,061	11,945
Financed by:								
Central government	3,662	5,245	5,907	5,748	6,412	6,124	5,674	6,140
Local government	5,140	4,999	5,586	5,435	6,136	5,791	5,387	5,805
Financial contribution of local governments to central projects	1,039	1,260	1,340	1,088	1,462	1,254	1,236	1,693
Total public works	28,273	32,995	38,483	36,776	37,496	36,123	33,142	35,182
Implemented by:								
Central government	4,798	5,687	9,117	8,547	7,845	7,470	6,629	8,588
Local government	23,476	27,308	29,367	28,229	29,652	28,653	26,513	26,594
Financed by:								
Central government	7,421	9,671	13,684	13,208	12,795	12,340	11,067	13,034
Local government	20,853	23,324	24,799	23,569	24,701	23,782	22,075	22,148
Memorandum items								
Central government share in joint projects	41.6	51.2	51.4	51.4	51.1	51.4	51.3	51.4
Share of public works financed by central government	26.2	29.3	35.6	35.9	34.1	34.2	33.4	37.0
Share of public works implemented by local government	83.0	82.8	76.3	76.8	79.1	79.3	80.0	75.6
Total public works (percent of GDP)	6.1	7.0	8.1	7.7	7.7	7.2	6.5	7.1

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.

FY1998 (Table II.7), which was partly related to an increase in public investment.[10] At the same time, there has been a marked rise in personnel costs, and interest payments have increased with mounting debt. In recent years, efforts to contain fiscal deficits have led to large expenditure cuts, mostly in independent investment projects—a sharp contrast to projections in the Local Government Finance Plan (LGFP), which have aimed at broadly stable investment-to-GDP ratios since 1995.[11]

17. **The recent contraction in local government budgets is partly a consequence of statutory limitations on local government borrowing**. Local authorities risk losing their financial independence if their fiscal deficit exceeds thresholds established in the Local Fiscal Restructuring Law.[12] 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. One of the most ambitious consolidation programs has been implemented by Tokyo Prefecture, which has resorted to drastic cuts in payroll spending, social entitlements, and construction projects (Box II.2).

18. **To avoid a falloff in stimulus as a result of local consolidation efforts, the government has taken steps to alleviate the financial burden on local governments.** Although the amount of tax transfers to local authorities in principle depends on central government revenue collections, additional funds for local governments have been secured through loans incurred by the Special Account for Local Allocation and Transfer Tax. These loans, which are to be repaid jointly by central and local governments, have steadily increased to some ¥8 trillion (1¾ percent of GDP) in both FY1999 and FY2000. The loans were in the past provided by the Trust Fund Bureau but—owing to the anticipated outflow of postal savings deposits—will be financed from private sector financial institutions in FY2000. The outstanding liabilities of the Special Account for Local Allocation Tax are projected to amount to ¥38 trillion (7½ percent of GDP) by end-FY2000, of which ¥26 trillion will have to be repaid by local governments.

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[10] Under 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 in the guidelines for *Government Finance Statistics*.

[11] The LGFP is an indicative initial budget plan for the local government sector—compiled jointly with the central government—that forms the basis for the allocation of tax transfers.

[12] 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).

Table II.7. Japan: Local Government Operations

(in percent of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total revenue (excl. borrowing) 1/	16.4	16.1	16.2	16.1	16.2	16.0	16.4	...	...
Tax revenue	11.1	10.7	10.4	10.6	10.7	10.7	11.0	...	...
Local taxes	7.3	7.0	6.8	6.9	7.0	7.1	7.2	...	...
Transfers	3.7	3.7	3.6	3.7	3.7	3.6	3.7	...	...
Other	5.3	5.3	5.7	5.5	5.5	5.3	5.4	...	...
Total expenditure	18.2	18.7	18.7	19.3	18.6	18.1	18.8	...	...
Mandatory current spending	6.8	6.9	7.1	7.2	7.2	7.4	7.6	...	...
Of which: Personnel	5.1	5.2	5.3	5.3	5.2	5.3	5.4	...	...
Of which: Interest	0.7	0.7	0.8	0.8	0.8	0.9	0.9	...	...
Discretionary current spending	5.2	5.2	5.3	5.5	5.3	5.1	5.4	...	...
Investment	6.2	6.6	6.3	6.6	6.1	5.6	5.8	...	...
Of which: Construction	6.1	6.4	6.1	6.4	5.9	5.5	5.7	...	...
Balance	-1.8	-2.6	-2.5	-3.2	-2.4	-2.1	-2.4	...	...
Financing	1.8	2.6	2.5	3.2	2.4	2.1	2.4	...	...
Borrowing (net)	2.2	3.1	3.0	3.7	2.9	2.5	3.0	...	...
Borrowing (gross)	3.0	3.9	3.9	4.6	3.9	3.7	4.3	...	...
Bonds	2.2	2.8	3.0	3.5	3.1	2.8	3.0	...	...
Other	0.9	1.1	0.9	1.2	0.8	0.9	1.2	...	...
Amortization	-0.8	-0.9	-0.9	-0.9	-1.0	-1.2	-1.3	...	...
Other 2/	-0.4	-0.5	-0.5	-0.5	-0.5	-0.4	-0.5	...	...
Memorandum items:									
Local government debt	16.7	19.2	22.2	25.5	27.6	29.5	32.8	...	...
Of which: Bonds	13.0	14.8	16.8	19.0	20.5	22.1	24.2	...	...
Debt service payments	1.5	1.6	1.7	1.8	1.9	2.0	2.2	...	...
Local Government Finance Plan									
Total revenue	13.8	14.5	14.7	14.4	14.1	14.2	15.1	15.4	15.5
Local tax	6.9	7.1	7.2	6.7	6.7	6.7	7.4	7.8	7.1
Local allocation tax	3.1	3.3	3.2	3.2	3.2	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	2.9	2.5	2.6	2.7	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	0.1	1.0	1.0	1.0	1.1
Total expenditure	15.0	15.6	16.0	16.5	16.3	16.8	17.5	17.6	17.8
Debt service	1.2	1.3	1.4	1.8	1.5	1.7	1.9	2.1	2.3
Wages and salaries	4.2	4.4	4.6	4.6	4.5	4.5	4.7	4.7	4.8
General administration	2.9	3.1	3.3	3.3	3.3	3.4	3.6	3.7	3.9
Investment	4.8	5.1	5.6	5.9	6.0	6.1	6.2	5.9	5.9
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	0.6	0.5	0.6	0.7	0.5
Deficit (=Bond issue)	-1.2	-1.1	-1.3	-2.1	-2.2	-2.6	-2.4	-2.2	-2.3

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

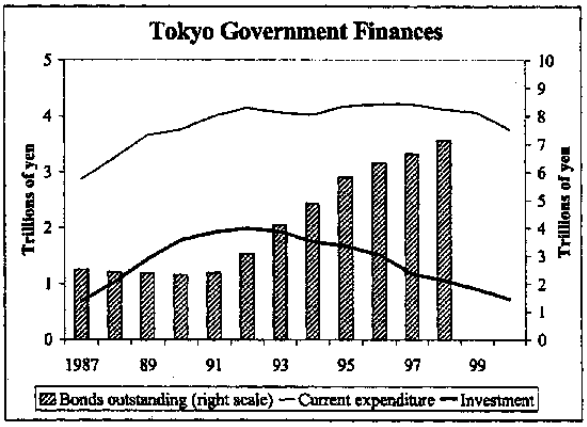
1/ Using data provided by the authorities, the staff has reclassified financing items which are treated as revenues in the official statistics.

2/ Including classification errors and omissions.

Box II.2 Local Government Finances—The Example of Tokyo Prefecture

The finances of the Tokyo Metropolitan region—Japan's largest and wealthiest prefecture—have deteriorated along with those of other local governments. In FY1998, Tokyo accounted for close to 12 million inhabitants (10 percent of Japan's population) and 12½ percent of total local government expenditures. Owing to the concentration of bank and corporate headquarters in the city, Tokyo is the richest among Japan's prefectures, which is reflected in the fact that the Tokyo Metropolitan government (TMG) is the only local authority that does not receive local allocation tax transfers from the central government. However, the strong dependence on own tax revenues has worked against Tokyo as local government tax collections have plummeted in recent years.

Faced with increasing revenue shortfalls, the initial reaction of TMG has been to sharply reduce public works spending. Investment expenditure has dropped by almost a third since its peak in FY1992, while current (or "ordinary") spending has remained almost untouched. These cuts have brought investment spending back to its levels in the mid-1980s, eliminating much of the excess of the bubble years, when a series of large construction projects led to a tripling of investment expenditure from ¥0.7 trillion to ¥2 trillion between 1987 and 1992.



Public investment cuts alone were not sufficient, however, to prevent a dramatic increase in TMG debt. In anticipation of an economic recovery—which in the end failed to materialize—and partly as a result of central government stimulus policies, expenditure reductions did not keep pace with the decline in revenues, which implied a sharp rise in TMG bond financing. This has brought the prefecture close to the bond issuance and deficit limits prescribed by the Local Finance Law (exceeding the deficit limit would imply the imposition of direct central government control over Tokyo's finances). The amount of outstanding bonds has roughly tripled to ¥7 trillion since 1991, and TMG's total liabilities—as identified in its recently published balance sheet—amount to ¥17 trillion, or 2½ times annual tax revenues.

In response to its delicate financial situation, Tokyo has responded with an austerity package that is intended to generate permanent savings of ¥630 billion (two thirds in expenditure, one third in revenues) over the next four years, relative to a ¥6 trillion budget. The first ¥200 billion in measures have been incorporated in the FY2000 budget, which projects a further 20 percent investment cut, but—partly owing to additional temporary measures—also includes a 7 percent decline in ordinary expenditure. Savings are to be achieved mainly through a reduction in welfare spending, a 4 percent salary cut, and a planned 5 percent reduction in the work force (to about 180,000). The proceeds of the controversial bank tax (projected at around ¥100 million; see main text) will only boost revenue from FY2001 onwards.

While these steps have helped Tokyo to preserve fiscal independence, a return to full financial health will take considerable time. Rising debt service costs, higher welfare obligations toward the elderly, high maintenance costs on existing public infrastructure, and political resistance to further spending cuts are likely to limit expenditure reductions in the future, while the scope for investment cutbacks may also begin to narrow. In addition, TMG may need to cover liabilities arising from failed investments projects, such as those associated with "third sector corporations" (public-private partnerships) that were heavily involved, e.g., in the development of Tokyo Bay. Although asset sales could provide a temporary boost to revenues, TMG holds predominantly land-related assets that will be difficult to sell as long as the real estate market remains depressed.

Local Government Taxes

19. **Taxation issues are at the heart of the malaise of local government finances.** A sustained improvement in local finances depends on the restoration of tax revenues, following their sharp decline during the recession. Local revenues, including tax transfers, depend primarily on direct taxes and are thus prone to strong cyclical swings. Own-revenue collections dropped by almost one percent of GDP in the 1990s and, following a temporary recovery subsequent to the consumption tax increase in 1997, are projected to dip again below 7 percent of GDP in FY1999 (see Table II.7). Corporate tax revenues especially have plummeted as enterprises have increasingly reported losses on their balance sheets.

20. **Most local governments have tried to find alternative revenue sources,** including by intensifying collection efforts, reducing tax delinquency, and exploring ways to raise existing taxes or introduce new taxes. New tax measures have fallen into two categories, depending on their legal basis:

- A number of local governments have announced plans to introduce new taxes on the basis of a new **decentralization law** that came into effect in April 2000. Some types of taxation now no longer require formal approval by the central government, although local governments still have to consult with the Ministry of Home Affairs which attempts to maintain overall consistency of the local tax structure. New levies have generally been raised on very specific activities, (e.g., waste disposal, gambling, hazardous goods storage) and are unlikely to yield significant revenues.

- The Tokyo and Osaka prefectures recently passed bills to tax the gross profit (as opposed to net income) of major financial institutions at 3 percent over five years, yielding an expected ¥100 billion per year in the case of Tokyo. This measure—implemented despite opposition by the central government—is based on a **loophole in the existing tax legislation** that allows local authorities to raise business taxes on a base other than profits (so-called "external" taxes) if a business activity is unique to their jurisdiction. The two governments have levied this tax on banks by claiming a unique concentration of banking headquarters in their prefectures.[13]

21. **However, the restoration of local tax revenues requires a fundamental change in the local tax structure.** The stopgap measures passed by local governments generally focus on very narrow tax bases—that appear politically easy to exploit—and carry potentially distortionary side-effects, without constituting the basis for a sustained recovery in revenues. Putting local revenues on a more stable footing would require *inter alia* a general review in the corporate tax structure, with a view toward shifting the tax base to criteria that are less subject to cyclical fluctuations (as has recently been suggested by the central government's Tax Commission). More generally, local fiscal management would benefit from a reduction in the vertical imbalance in Japan's fiscal structure, which allocates 60 percent of total tax

[13] Had the governments levied the tax on all enterprises doing business in their prefectures, they would not have been able to claim unique circumstances, and would thus have had to obtain permission from the Ministry of Home Affairs.

revenue to the central government, while local governments account for 65 percent of government expenditure not related to social security.

C. Public Debt and Fiscal Consolidation

Assets and Liabilities of the General Government

22. **In the latter half of the 1990s, Japan's fiscal deficit and gross debt have surpassed that of other major industrial countries.** Even adjusting for Japan's weak cyclical position, the general government's fiscal deficit has been far above the G-7 average for several years in a row, and Japan replaced the U.S. as the largest issuer of public debt in 1999 (Table II.8). This stands in sharp contrast to earlier periods, when Japan was known for its conservative fiscal policy that resulted in sizeable fiscal surpluses and low public debt.

Table II.8. General Government Finances, 1999
(In percent of GDP)

	Canada	France	Germany	Italy	U.K.	U.S.	Japan
Actual balance	2.8	-1.8	-0.7[1]	-1.9	0.3	0.0[1]	-9.2[1]
Structural balance	3.3	-0.8	0.7[1]	-0.5	0.1	-0.2[1]	-8.1[1]
Gross debt	88.1	58.6	61.1	114.9	44.8	62.4	125.4
Net debt	56.7	49.0	52.4	108.8	39.0	50.6	38.1
Net debt, excluding Social security	...	...	53.1	...	...	59.1	87.9

Source: IMF *World Economic Outlook*, April 2000; staff estimates.

[1] Excluding social security.

23. **However, the general government also holds sizeable assets that have kept net debt comparatively low.** According to the Japanese national accounts, general government *gross debt* has reached 125 percent of GDP at the end of 1999, although *net debt* (at close to 40 percent of GDP) is still small by international standards. The difference—some 85 percent of GDP in asset holdings—reflects the partly funded nature of the pension system, as well as the government's major role in financial intermediation:

- The pension system has accumulated significant assets (50 percent of GDP) to fund benefit payments for future retirees. The bulk of these assets—together with the deposits of the postal savings system—has in the past been invested through the FILP by the Ministry of Finance's Trust Fund Bureau. The assets therefore consist of government bonds as well as loans to central and local governments and public financial institutions (see below).

- The remaining 35 percent of GDP in financial assets are held by the central and local governments. The exact breakdown of these holdings is difficult to determine, given the lack of information on them in the fiscal accounts, but a considerable part is likely

to include foreign exchange reserves and investments in public sector enterprises (Table II.9). Some government agencies also hold government bonds that could in principle be directly offset against government liabilities.[14]

24. **Since assets of the social security system are more than offset by future pension obligations, they are generally excluded when assessing Japan's debt situation.** At current pension contribution rates, the pension system's asset holdings would not be sufficient to finance the gap between future pension obligations and revenues. Indeed, the projected net liabilities of the pension system—currently estimated at around 60 percent of GDP—is relatively large by major industrial-country standards, although the staff estimates that it has been reduced by about 30 percent of GDP as a result of the recent pension reform (see below).[15] Therefore, the staff most frequently uses the concept of *net debt excluding social security assets* which—at nearly 90 percent of GDP—is significantly higher than in most other industrialized countries.

25. **The general government's net obligations—including contingent liabilities—may be somewhat higher than suggested by the net debt figures.** The true value of government assets is difficult to estimate, partly because of lack of liquidity, and the possibility that some of the investments may represent soft loans that may not be repaid.[16] While the default rate on loans by government financial institutions has so far been low (bad loans account for about 1-2 percent of the total loan portfolio), many large public infrastructure investments appear to generate significantly less than budgeted returns, which may imply significant contingent liabilities for the government (as happened in the case of the Japanese National Railway Settlement Corporation (JNRSC)). The government may also need to cover contingent liabilities arising from government guarantees. The total amount of outstanding government-guaranteed bonds and loans amounted to ¥52 trillion (10 percent of GDP) in March 2000, and the government may also be called on to cover losses related to ¥43 trillion in guarantees extended by regional credit guarantee associations to cover bank loans to SMEs (including ¥21 trillion in outstanding special loan guarantees that have been extended since 1998).[17]

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[14] For example, non-profit corporations run by the Postal and Welfare Ministries use FILP funds for portfolio investments that mostly involve government bonds.

[15] These results have been obtained from the model described by Mühleisen in this year's *Selected Issues* paper. They are roughly consistent with Chand and Jaeger (1996), who obtained an estimate of 108 percent of GDP for the pension system's net projected liabilities, taking account of information relating to the 1994 pension reform.

[16] See OECD, *Gross and Net Debt Measures in Japan*, 1998.

[17] The regional credit guarantee associations paid out ¥801 billion in guarantees during FY1999. Government losses from the special guarantee scheme—which expires in March 2001—have amounted to ¥200 billion so far, implying a 1 percent loss rate.

Table II.9. Japan: Closing Stocks of Financial Assets and Liabilities by the Sub-sectors of General Government, 1998

(End of calendar year; in billions of yen)

Yen	Total	Central govt.	Local govt.	Social security
Financial assets	416,732.6	153,024.0	38,184.4	239,289.8
(1) Currency and transferable deposits	3,603.6	208.5	3,124.6	270.5
(2) Other deposits	104,615.0	47,237.6	19,640.1	37,737.3
(3) Short-term government securities	6,458.4	6,458.4	0.0	0.0
(4) Bonds, long term	24,886.8	8,259.4	1.5	16,625.9
(5) Corporate shares	727.5	517.8	90.4	119.3
(6) Loans by public sector	31,497.9	17,933.5	9,021.3	7,152.3
(7) Life insurance	20,998.1	3,505.9	0.0	17,492.2
(8) Transfers from general government	4,678.5	4,678.5	0.0	0.0
(9) Trade credit and advances	1.4	1.4	0.0	0.0
(10) Other financial assets	219,265.4	64,223.0	6,305.5	159,892.3
Financial Liabilities	569,097.1	441,213.0	140,182.7	1,467.0
(1) Short-term government securities	32,128.0	32,128.0	0.0	0.0
(2) Bonds, long term	342,046.9	296,932.8	45,114.1	0.0
(3) Loans by private sector	16,573.8	3,967.2	12,606.6	0.0
(4) Loans by public sector	171,352.3	90,205.7	82,288.8	1,467.0
(5) Trade credit and advances	197.0	23.8	173.2	0.0
(6) Other liabilities	6,799.1	17,955.5	0.0	0.0
Net financial liabilities	152,364.5	288,189.0	101,998.3	-237,822.8

Source: Economic Planning Agency, National Account Statistics.

Debt Stabilization: How Sensitive Is It To Interest Rates and Growth?

26. **Substantial fiscal adjustment will be required over the medium-term to keep debt ratios from getting worse.** To assess the extent of consolidation that may have to be undertaken, the following presents a sensitivity analysis of fiscal dynamics relative to alternative assumptions about real GDP growth and government bond yields:

- For given growth and interest rate assumptions, the primary deficit necessary to stabilize the debt-to-GDP ratio in the year t is given by the following formula:

$$b_t^p = (r_t - g_t)/(1+g_t)\, d_t$$

where b^p is the target for the primary balance in percent of GDP, d is the debt-to-GDP ratio, and r and g are the steady-state values for the nominal interest rate paid on government debt and the nominal growth rate, respectively. The amount of fiscal measures necessary to stabilize the debt-to-GDP ratio (the "required adjustment") can then be calculated as the difference between the value of b^p and the current cyclically-adjusted primary balance (estimated at –4½ percent of GDP in FY2000). This exercise assesses the required adjustment under different assumptions for r and g, based on a simulation of the resulting debt path over the next decade.

- Since social security assets should be excluded in net debt calculations (see above), the relevant variables b^p and d refer to net debt and primary balance for the general government excluding social security, respectively. The interest paid on government debt is an implied interest rate that reflects past debt contracted at different maturities and interest rates. As interest rates have generally been declining in recent years, the value of r at present is higher (at roughly 3½ percent) than the current 10-year JGB yield (about 1¾ percent). With an average debt maturity of about 5–6 years, future changes in JGB yields will affect the average interest rate only gradually—a fact that is taken into account in the following calculations.

- The results of the analysis are presented in Table II.10. The table shows the required change in the general government's structural primary deficit to achieve debt stabilization by 2010, given combinations of real growth rates and real JGB yields in that year.[18] For simplicity, it is assumed that growth and interest rates increase in a linear fashion to their steady-state values by 2005, while the adjustment in the structural balance would be linear over the full 10-year period, except for FY2001 when large support measures for failed banks expire.[19]

27. **The results highlight the importance of growth for fiscal consolidation.** The staff's current WEO forecast corresponds to the scenario in which growth converges to its

[18] Inflation is assumed to be flat at 1 percent a year throughout.

[19] Variations in the paths of interest rates and growth towards their endpoints have only small effects on the required adjustment.

medium-term potential of about 2 percent, and real JGB yields rise to 3½ percent by 2005. In this case, a reduction of 5½ percentage points of GDP in the general government's structural primary deficit would stabilize net debt (excluding social security assets) at around 118 percent of GDP, compared to an estimated 97 percent of GDP in 2000. The required fiscal adjustment would be 1¼ percentage points of GDP smaller, however, were the potential growth rate to increase to 3 percent, and it would be higher by the same amount if the growth rate fell to 1 percent. Variations in JGB yields also affect the required adjustment. For example, if real interest rates remained at present levels, the needed adjustment would be 1 percentage point of GDP smaller than in the baseline scenario.

28. **What would be the payoff for public debt of faster consolidation**? A simulation using the same underlying growth and interest rate path as in the WEO scenario—an admittedly implausible assumption given the short-term impact of consolidation on growth—suggests that to stabilize the net debt ratio by 2005, the required improvement in the structural primary balance would be 5 percent of GDP over 5 years, compared to the WEO baseline of 5½ percent of GDP over 10 years. Faster adjustment would also result in a lower (stable) net debt ratio of 108 percent of GDP.

Table II.10. Change in General Government Primary Structural Balance (Excluding Social Security) Needed to Achieve Debt Stabilization by 2010

(In percent of GDP)

		Steady-state real JGB yield				
		2.0	3.0	3.5	4.0	5.0
Steady-state real GDP growth Rate	0.5	6.5	7.2	7.5	7.8	8.5
	1	5.9	6.5	6.8	7.2	7.8
	2	4.6	5.3	**5.6**	6.0	6.6
	3	3.5	4.2	4.5	4.8	5.4
	4	2.5	3.1	3.4	3.7	4.3

Source: Staff calculations.

Note: The table shows the change in the general government's primary structural balance required to stabilize debt relative to GDP by FY2010 under a gradual consolidation process, starting from a structural primary deficit of 4.6 percent of GDP in FY2000. GDP growth and JGB yields are assumed to increase in a linear fashion to their steady-state values by 2005. The central cell refers to the staff's baseline scenario.

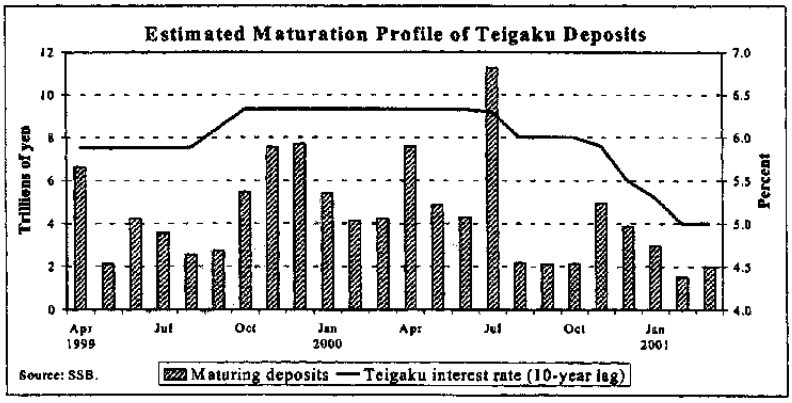
D. Postal Savings and the FILP

29. **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 is 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".

30. **In recent years, the FILP has been used to support the government's stimulus efforts, but this has become more difficult as deposit inflows have slowed.** Measures announced as part of the 1998 and 1999 stimulus packages have included substantial additional FILP loans, mainly to improve credit conditions in the economy and extend financial support to local governments. At the same time, however, inflows of funds into the TFB from the postal savings and pension systems began to decline in FY1999, largely in response to weak income growth. The shortfall in deposit inflows was offset by reductions in government bond holdings of almost ¥20 trillion during FY1999, achieved by not rolling over maturing securities (Figure II.3).

31. **For FY2000, the expected withdrawal of funds from the postal savings system—related to the maturation of some ¥106 trillion in postal savings deposits over the next two years—leaves little room for further FILP stimulus.** The postal savings system holds roughly ¥250 trillion (50 percent of GDP) in deposits, largely in 10-year fixed-term savings instruments (*teigaku*), which have been fully invested in the FILP. About 40 percent of these funds were deposited between April 1990 and March 1992, when *teigaku* interest rates were at their peak, and are now about to mature. On the assumption that deposit holders would retain about 70 percent of deposits eligible for roll-over, the Ministry of Post and Telecommunication (MPT) has estimated that about ¥50 trillion in funds would flow out of the postal savings system by March 2002.[20]

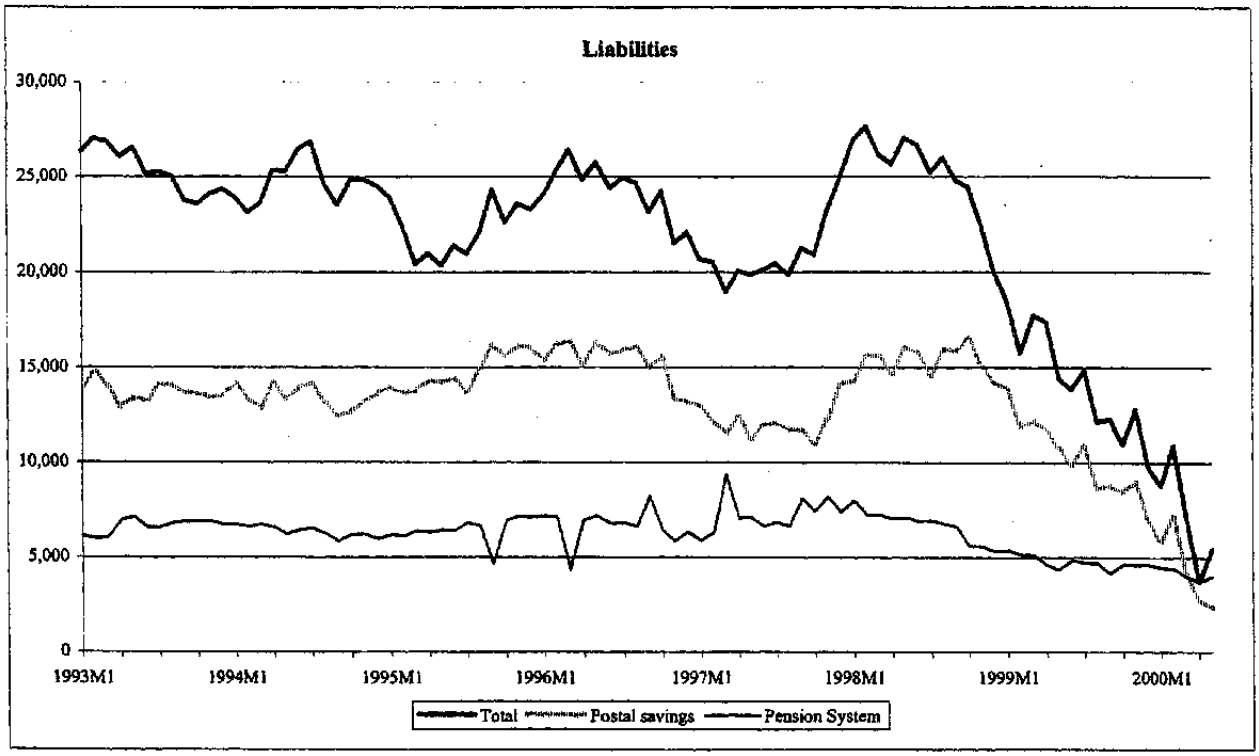


32. **Although the expected outflow of funds has led to sharp cutbacks in the FILP's overall size, its general lending program will be largely preserved.** Overall FILP spending in FY2000 is budgeted to decline to ¥43.7 trillion (8¾ percent of GDP), a 20 percent reduction compared to the revised outcome for FY1999, but most of the cuts will affect investment in financial instruments (Table II.11). General FILP spending—loans to special accounts of the central government, local governments, and government financial

[20] Maturing deposits will be subject to ¥9 trillion in taxes, while accumulated interest in excess of the ¥10 million deposit cap accounts for ¥16 trillion, leaving ¥81 trillion in deposits eligible for rollover.

Figure II.3. Japan: Trust Fund Bureau Operations

(12-month change in assets and liabilities; in billions of yen)



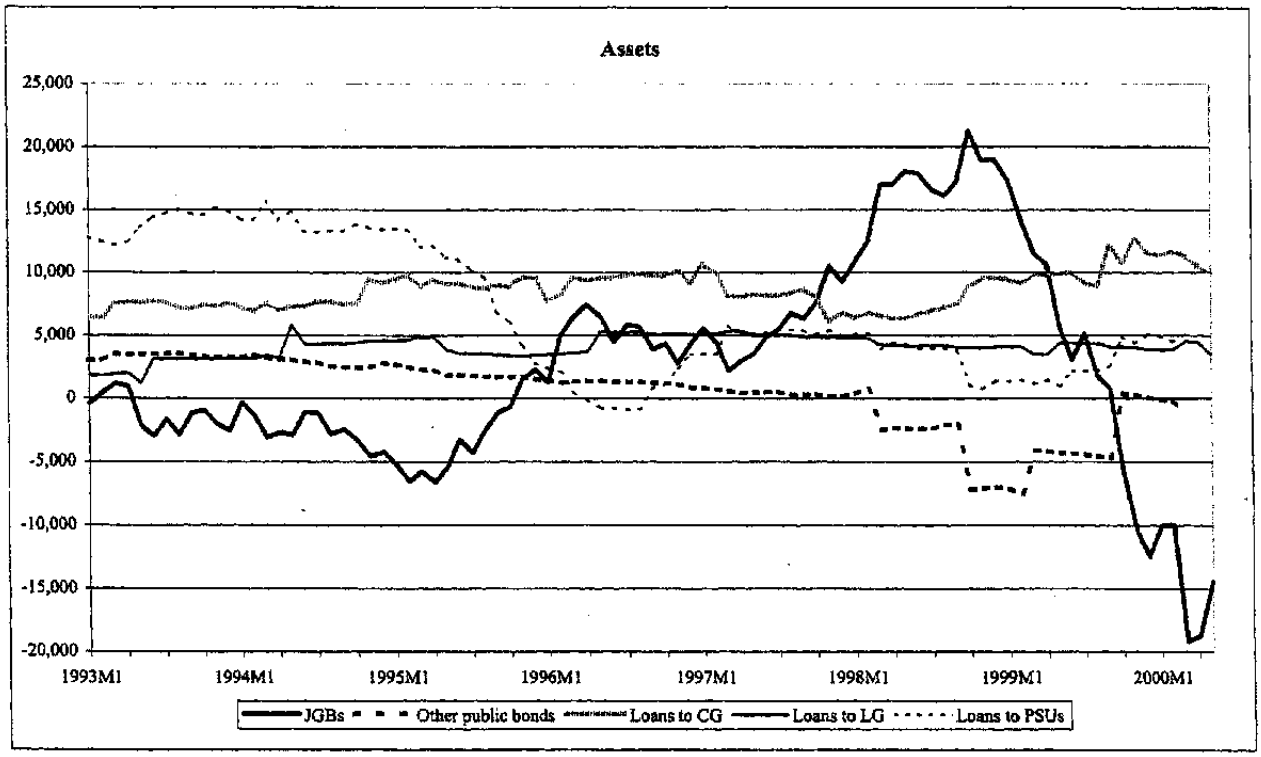


Table II.11. Japan: Fiscal Investment and Loan Program (FILP), FY1995–2000

(In trillions of yen)

	1995	1996	1997	1998		1999		2000
		Actual		Initial	Revised	Initial	Revised	Initial
Sources of funds	52,939	50,877	57,200	57,759	71,395	52,899	54,313	43,676
Trust Fund Bureau	42,405	39,706	47,272	48,096	61,126	43,716	44,800	33,305
Postal savings	16,393	11,522	15,597	11,400	...	11,500	...	0
Welfare and national pensions	7,730	7,319	7,697	6,000	...	4,310	...	2,720
Repayment and other	18,283	20,865	23,978	30,696	...	27,906	...	30,585
Industrial investment special account	77	58	55	64	457	104	214	110
Postal life insurance fund	7,228	8,133	7,016	7,100	7,101	6,580	6,580	6,380
Government-guaranteed bonds and Borrowing	3,229	2,981	2,858	2,500	2,711	2,500	2,719	3,881
Uses of funds	45,039	50,877	51,440	57,759	71,395	52,899	54,313	43,676
Purchase of government bonds	2,851	4,976	4,800	7,800	11,000	0	0	0
FILP	42,189	45,901	46,640	49,959	60,395	52,899	54,313	43,676
Portfolio investments 1/	7,950	8,591	12,030	13,300	17,300	13,550	13,550	6,210
General FILP	34,239	37,310	34,610	36,659	43,095	39,349	40,763	37,466
Central government projects (special accounts)	930	828	745	585	665	375	388	363
Government nonfinancial enterprises	8,679	8,374	8,022	7,248	7,700	6,897	7,113	6,384
Government financial agencies	14,628	18,878	17,115	20,927	24,155	24,098	24,267	22,845
Of which:								
Housing Finance Corporation	4,970	10,121	6,372	9,918	...	10,118	10,118	10,387
Local governments	9,629	8,891	8,433	7,600	10,250	7,740	8,740	7,650
Other	373	339	294	299	324	240	255	225
Memorandum items:								
Increase in General FILP (in percent) 2/	-16.2	9.0	-7.2	5.9	24.5	-8.7	-5.4	-8.1
General FILP as a percent of GDP 2/	7.0	7.4	6.8	7.4	8.7	8.0	8.3	7.5

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/ Compared to latest available data of the previous year.

institutions—is expected to shrink by only about 8 percent, as the Postal Ministry has agreed to a reduction in funds for portfolio investment of more than ¥6 trillion.[21]

Liquidity Management

33. **In anticipation of increased liquidity needs, the TFB has now completely withdrawn from the primary government bond market, and has begun to raise cash through a series of repo auctions**:

- The TFB decided in late 1998 to shift its securities portfolio toward shorter-term maturities, including through a halt of fresh purchases of long-term government bonds (JGBs). For FY2000, the TFB announced that it would also cease to replace maturing JGB holdings, although it would continue to acquire ¥200 billion in 10-year JGBs in the secondary market every month to contribute to market stability. Unlike in the previous year, this was well anticipated by market participants, and did not result in a sudden rise in yields.
- To avoid the need for extensive sales of its bond holdings—which could provoke adverse market reactions—the TFB has embarked on reverse repo auctions to raise liquidity for redemptions of postal savings deposits. The TFB has so far raised ¥900 billion in three auctions, which were heavily oversubscribed.

In view of the risk that unanticipated deposit outflows could prompt a liquidity crisis, the TFB has concluded an agreement with the Bank of Japan regarding possible BoJ interventions during repo auctions. Over a period of two years, the BoJ would stand ready to inject liquidity in the event that the TFB could not secure necessary funds through regular auctions. However, in order to avoid market perceptions that the BoJ was effectively underwriting government debt, the agreement specified that the BoJ would only intervene in two distinct circumstances, either if the sum of bids fell short of the total auction amount, or if rapid withdrawals of postal savings required the TFB to seek liquidity significantly in excess of average auction amounts. The actual amount of liquidity provided and the related interest rate would reflect market conditions. The repos are of a maturity of up to 3 months and can be rolled over. However, rollovers that would extend the maturity of a repo to more than 3 months are subject to BoJ approval, and the outstanding amount of such rollovers can not exceed ¥7.8 trillion (an amount equivalent to cumulative JGB purchases by the TFB in secondary markets).

34. **Based on the experience of the first three months, the Postal Ministry has so far been successful in retaining the bulk of maturing deposits.** During April–June, slightly less than 60 percent of ¥11 trillion in maturing funds were redeposited in the postal savings system. Once interest tax on maturing deposits and funds in excess of the ¥10 million deposit limit are excluded, the redeposit rate was around 75 percent, indicating that the marketing effort of the postal authorities has so far paid off. However, the postal savings system could

[21] The FILP consists of the "general" FILP and portfolio investments. Portfolio investments are managed by non-profit institutions run by the Postal and Welfare Ministries, which gives the two ministries some role in allocating the funds collected by their respective postal savings and welfare systems.

still face large outflows when interest rates pick up. A large part of maturing funds have been parked in ordinary postal savings which can be withdrawn at any time. Moreover, the interest penalties for premature withdrawals of *teigaku* deposits are negligible, and savers therefore have the option of shifting investments at short notice.

The Quality of FILP Assets

36. **The historic default rate on FILP loans has been low.** The FILP currently does not carry bad loans on its portfolio, and default among FILP agencies has been rare. At the end of 1997, a special account relating to the National Forestry Service was unwound, with outstanding FILP loans of ¥3½ trillion that had to be partly covered by the central government. However, the more spectacular ¥27 trillion failure of the JNRSC mostly reflected a funding gap at the time of the privatization of Japanese Railways that was temporarily covered by FILP funds.

37. **The low default rate reflects the fact that most FILP investments and loans are directed to public sector institutions.** Indeed, more than 50 percent of FILP assets—which currently amount to some ¥440 trillion (90 percent of GDP)—are directly backed by central or local governments, including government securities, loans to general and special accounts of the central government, and loans to local governments (Table II.12). While these assets are regarded as carrying minimal default risk, market observers have raised concerns about the quality of the ¥195 trillion (40 percent of GDP) in loans to GFIs and public enterprises (which are jointly referred to as FILP agencies):

- The bulk of funds lent to FILP agencies has gone to **government financial institutions** (some ¥140 trillion as of end-FY1999), which have so far not reported significant financial difficulties. The finances of GFIs (including, e.g., the Housing Loan Corporation, the Development Bank of Japan, and the Japan Bank for International Cooperation) have reportedly been less affected by the recession than those of private sector banks. Despite a sharp increase in FY1999, the amount of officially reported bad loans has so far remained at around 1–2 percent of the total loan portfolio, which may reflect the long-term developmental nature of GFI lending. However, GFIs generally operate with much lower capital than private institutions, and thus remain vulnerable to loan defaults.

- Larger problems are likely to exist among **non-financial FILP agencies** which account for the remaining ¥55 trillion in FILP loans. There are numerous examples of large infrastructure investments by FILP agencies (e.g., the Japan Highway Public Corporation) that appear not to generate sufficient profits to cover future debt payments. While it is unclear to what extent such investments will be protected against default, the government will likely need to provide additional funds to cover losses of some of these projects in the future.

FILP Reform

38. **A bill to increase the effectiveness of the FILP and align its activities to a greater degree with market principles will take effect as of April 2001.** In May 2000, the Diet

Table II.12. Japan: Trust Fund Bureau Operations

(In trillions of yen)

	End fiscal year							May
	1993	1994	1995	1996	1997	1998	1999	2000
Assets	326.3	346.7	373.2	392.1	418.3	436.0	443.1	442.9
Securities	89.2	83.9	96.6	96.4	107.9	111.2	92.1	...
Long-term government bonds	61.7	55.9	62.4	64.5	81.5	93.0	73.8	73.7
Short-term government bonds	0.8	0.9	4.3	1.3	3.0	1.6	2.8	1.8
Bonds of government related organizations	17.7	20.0	21.3	21.9	19.4	15.3	14.3	...
Financing bills	9.0	7.1	8.7	8.7	4.0	1.3	1.3	1.1
Loans	237.0	262.8	276.4	295.6	310.3	324.7	345.7	...
Loans to general and special accounts	49.9	58.8	68.4	76.5	83.1	92.9	104.2	103.0
Loans to local public organizations	40.5	45.4	49.0	54.3	58.5	62.0	66.5	70.9
Loans to government related organizations	146.6	158.7	159.1	164.8	168.7	169.8	175.0	...
Other	0.1	0.1	0.1	0.1	0.1	0.1	0.0	...
Liabilities	326.3	346.7	373.2	392.1	418.3	436.0	443.1	442.9
Deposits	325.9	346.2	368.1	391.5	417.2	433.3	438.0	437.6
Postal savings	181.5	195.2	211.6	223.1	238.7	251.0	255.1	254.5
Postal life insurance	8.0	7.4	8.5	5.5	6.0	5.3	2.9	3.0
Welfare insurance special account	96.6	103.0	107.4	116.8	124.0	129.1	133.1	132.8
Funds of national annuities	7.5	8.2	8.5	9.6	9.9	10.4	10.9	11.0
Other deposits	32.2	32.3	32.1	36.6	38.5	37.5	36.0	36.3
Other	0.4	0.5	5.1	0.6	1.1	2.8	5.0	5.2
Difference to end of previous year								
Assets	23.6	20.4	26.4	19.0	26.2	17.7	7.0	-0.2
Securities	-3.0	-5.3	12.8	-0.2	11.5	3.3	-19.1	...
Long-term government bonds	-3.1	-5.8	6.5	2.2	17.0	11.5	-19.2	-0.1
Bonds of government related organizations	3.2	2.3	1.3	0.6	-2.5	-4.1	-1.0	...
Financing bills	-1.1	-1.9	1.6	0.0	-4.6	-2.7	0.0	-0.2
Loans	26.6	25.7	13.6	19.2	14.7	14.5	20.9	...
Loans to general and special accounts	7.6	8.8	9.6	8.1	6.6	9.8	11.3	-1.2
Loans to local public organizations	3.4	4.9	3.6	5.3	4.2	3.5	4.5	4.4
Loans to government related organizations	15.6	12.0	0.5	5.7	3.9	1.1	5.1	...
Deposits	23.5	20.3	21.9	23.5	25.6	16.1	4.8	-0.4
Postal savings	12.8	13.8	16.4	11.5	15.6	12.2	4.1	-0.6
Welfare insurance special accounts	6.7	6.4	4.4	9.4	7.2	5.1	4.0	-0.3
Funds of national annuities	0.8	0.6	0.4	1.0	0.4	0.4	0.5	0.1
Other deposits	2.1	0.1	-0.3	4.5	1.9	-1.0	-1.5	0.3

Source: Ministry of Finance.

approved a reform bill which abolishes the compulsory deposit of postal savings and pension reserves with the TFB, but also provides the institutional framework for bond issues that will become necessary to sustain FILP operations from FY2001. The reform includes the following components:

- The **compulsory transfer of deposits** from the postal savings and pension systems to the TFB will be **abolished**. Fresh deposits are henceforth to be managed by the respective ministries themselves.[22] The ministries have agreed to continue to fund existing FILP loan obligations and underwrite about half of fresh FILP bonds in FY2001. The amount of bond underwriting will then be gradually reduced to zero over a transition period of 7 years. Principles for prudential portfolio management by the MPT and the Ministry of Health and Welfare are currently being worked out.

- To ensure continued funding for the FILP, the government will be authorized to issue **additional government bonds** (*zaito* bonds) and financing bills. In addition, individual FILP agencies are encouraged to issue individual agency bonds. While the government may guarantee such bond issues in limited circumstances, the bulk of agency bonds is expected to be issued without guarantees.

- In order to prepare for agency bond issues and facilitate **stronger Diet supervision** over the FILP, the government has begun to conduct **subsidy cost analyses** that are intended to assess the long-term viability of agency activities, including by identifying future government subsidies required to maintain financial balance.[23]

39. **While the legal framework for the reforms has been established, details regarding their implementation have not yet been released.** The government's proposals contain a clear commitment to reduce the need for government funding of the FILP, but future efficiency gains will be linked to the degree to which FILP agencies have to genuinely compete for market funds. Some GFIs with an easily marketable loan portfolio (e.g., the Housing Loan Corporation) appear on course to increasingly tap markets through asset-backed securities in the near future, but most other FILP agencies have not yet announced plans to issue substantial amounts of unguaranteed bonds in FY2001.

E. Fiscal Reforms

Public Pension Reform

40. **In March 2000, the Diet approved a far-reaching pension reform bill.** The bill contained provisions to cut lifetime pension benefits by around 20 percent for future retirees, sufficient to limit future increases in pension contribution rates in both the (basic) National Pension and (earnings-related) Employee Pension Insurance (EPI) schemes by a substantial

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[22] The TFB itself is to be replaced by a yet-to-be established government agency.

[23] A pilot study has identified the need for subsidies worth ¥5 trillion over the next 20-30 years for five major agencies that account for a combined ¥110 trillion of FILP loans.

margin.[24] The impact of the bill can be assessed against the actuarial calculations conducted by the government. Prior to the pension reform, the contribution rate required to maintain the solvency of the EPI was calculated at 34½ percent of monthly wages by 2025 (compared to today's level of 17.35 percent, paid equally by employer and employee). Following the reforms, this rate is now estimated at 25¼ percent. For the National Pension, the corresponding numbers are ¥26,400 in monthly flat-rate contributions by 2025 prior to the reform, compared to ¥18,200 after the reform (the current rate is ¥13,300).[25]

41. **The main provisions of the bill are the following**:

- Earnings-related benefits will be cut by 5 percent for new retirees from April 1, 2000. However, a grace period will effectively delay the actual reduction until FY2004.

- Increases in earnings-related pension payments will be indexed to the CPI instead of disposable income.

- The age of eligibility for earnings-related pensions will be gradually increased from 60 to 65 between 2013 and 2025 (for men) and 2018 and 2030 for women. The age of eligibility for a (reduced) basic pension will also be raised gradually from 60 to 65, beginning in FY2001, and the reduction in monthly benefits will be 30 percent.

- Similar to the regulations for those aged 60 to 64, employees between 65 and 70 will have to pay pension contributions from April 2002, and will receive a reduction in benefits if their combined income from pension and salary exceeds certain limits.

- Beginning in April 2003, a uniform pension contribution rate will be applied to both monthly wages and bonuses. Under the current system, the contribution rate applied to bonuses is 1 percent. The change is designed to be revenue-neutral, with an initial combined rate of 13.58 percent.

42. **The bill will also raise transfers to the basic pension scheme from one third to one half of benefits from FY2004** (at a cost to the government of ½ percent of GDP per year). This will take some of the burden off current employees, whose earnings-related contributions are partly used to subsidize general basic pension benefits. The government also formally decided to keep pension premiums at present levels for the time being, owing to the fragile state of the recovery. Other relief measures include the halving of national pension contributions by persons in lower income brackets from April 2002.

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[24] The Ministry of Health and Welfare estimates that an average household with 40 years of contributions to an employee-pension plan will be paid ¥418,000 in FY2025, ¥10,000 less than if they were receiving benefits today. The estimated total lifetime pension payment to a salaried worker who is currently 40 years old will fall from ¥61 million to ¥51 million under the current system.

[25] Critics have pointed out that the need for future contribution increases could be higher, if the fertility rate does not recover as currently projected in the official populations models.

Private Defined-Contribution Pension Plans

43. **The planned introduction of private defined-contribution pension plans would offer employees an alternative to existing corporate pension plans.** The current pension system allows companies to establish privately-run pension plans that benefit from favorable tax treatment (Employees' Pension Funds and Tax-Qualified Pension Plans). These plans are on a defined-benefits basis, and have been managed by company-selected fund managers. In recent years, many such plans have accumulated large unfunded liabilities, mainly a result of sagging returns on pension assets. To offer companies the possibility of capping their pension exposure, and allow individuals the possibility to take greater responsibility in determining their future retirement income, the government decided in 1999 to establish private defined-contribution pensions. Besides generating higher returns, defined-contribution plans could also favor labor mobility, since existing private pension plans encourage workers to remain with a single employer in order to maximize ultimate benefit payments.

44. **In the context of the FY2000 budget, the government forwarded legislation to the Diet regarding the tax treatment of such pension plans.** The government's proposals would make contributions to defined-contribution schemes tax-deductible subject to specified limits, and pension benefits would practically be tax-exempt if they were to be paid out as annuities. Tax deductions differ, however, across the following categories:

- *Subscribers to defined-contribution pension plans* would be able to deduct up to ¥180,000 in contributions from income tax each year.

- *Contributions to pension plans* would only be tax-deductible for workers whose companies have no corporate pension funds, and salaried workers would not be allowed to add defined-contribution plans to their existing corporate pension.

- *Contributions by employers* of up to ¥432,000 per employee would be tax-deductible, provided the company had no other corporate pension funds. Otherwise, the maximum deductible would be ¥216,000.

- *Self-employed subscribers* would be able to deduct up to ¥816,000 in annual contributions from taxable income.

45. **The bill has not yet passed the Diet.** The government's initial plan was to introduce defined-contribution pensions in the fall 2000, but this date has already been moved to 2001.

Health Care Reform

46. **Compared to other major industrial countries, health expenditure in Japan has been fairly low in relation to GDP** (Table II.13). Although the system exerts only limited control on demand, and private suppliers have incentives to provide excessive quantities of some services, health spending is on a level comparable to countries with nationalized health services, such as the U.K. While underlying factors that have contributed to Japanese longevity probably also imply less need for medical services, strict price controls and

increases in co-payments in recent years have also been effective in keeping overall expenditure low.[26] This is likely to change, however, as the Japanese population grows older.

Table II.13. Public Health Expenditure, 1995
(in percent of GDP)

	Canada	France	Germany	Italy	U.K.	U.S.	Japan
Total health expenditure	9.6	9.8	10.4	7.7	6.9	14.2	7.2
Of which:							
Public expenditure	6.9	7.7	8.2	5.4	5.9	6.6	5.7

Source: *OECD Health Data, 1997.*

47. **The health care reform debate in Japan has therefore centered around the question of the extent to which costs of old-age medical care can be contained.** Old-age medical care is financed through government transfers (at 30 percent) and cross-transfers from other health insurance schemes, as well as small patient contributions. Owing to low co-payments and intensive treatment, the costs of old-age medical care have recently skyrocketed: the average annual increase of old-age medical costs over the past decade was about 8½ percent, compared to 2 percent for other medical expenditure. Persons over 65 consume roughly four to five times as much in health services as younger persons, putting upward pressure on contribution rates and raising concerns over the future of the system once a larger share of the population retires.[27]

48. **The introduction of nursing care insurance (from April 2000) could lead to some savings in medical costs.** Besides providing an additional safety net for families with elderly relatives, the new scheme has been designed to cut costs in old-age medical care which has so far provided partial nursing services (mainly through extended hospital stays). Half of the estimated annual cost of ¥4.3 trillion for the nursing care scheme are to be financed by additional health insurance contributions (from workers above the age of 40 and residents aged 65 or more), beginning in FY2001. Individual contributions will be around ¥1,500 per month (US$14) for workers, and somewhat larger on average for residents older than 65, depending on the available level of service in a particular region.[28] The remaining half of the costs is to be borne by central and local governments (25 percent each).

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[26] In the WHO's *World Health Report 2000*, Japan's health care system obtained the highest performance rating, and ranked among the 10 most cost-efficient health care systems.

[27] The National Health Insurance scheme posted a ¥100 billion deficit in FY1998, likely to be followed by a similar deficit in FY1999. The combined deficit of corporate health plans was ¥210 billion in FY1999.

[28] The elderly are exempt from premiums for the first 6 months of FY2000, and pay only half the premium for one more year. Worker contributions have been reduced for one year.

49. **A recently introduced reform bill that envisages higher co-payments by elderly patients is still under debate in the Diet.**[29] The bill's main provision is a rise in co-payments by the elderly to 10 percent (compared to 20–30 percent for younger persons) from a flat rate of at most ¥1000 per hospital day, which would however be subject to monthly limits between ¥3000 and ¥5000, depending on the nature of treatment, but would exclude co-payments for pharmaceuticals. Moreover, co-payments for high-cost medical treatments would be raised for all patients, albeit by relatively small amounts.

Fiscal Transparency

50. **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.** Fiscal policy operates under well established principles of fiscal responsibility, but it is extremely difficult for outside observers to monitor fiscal developments, gauge the current stance of fiscal policy, and assess the need for corrective measures during the fiscal year. The main problems relate to the following:

- **Important fiscal information is presented with a significant time lag and not in a format that lends itself easily to macroeconomic analysis.** The authorities report consolidated fiscal accounts for general government with a 12-month lag, which is related to a delay in data reporting by some 3,200 local authorities. The information is provided only in the context of the national income accounts, in a classification that is not compatible with GFS standards.

- **The budget process suffers from a confusing distinction between initial and supplementary budgets.** The implementation of counter-cyclical fiscal policy through large supplementary budgets has implied volatile quarterly swings in public works spending—c.f. the decline in output caused by the sharp fall in public works spending in the second half of 1999. The diminished role of initial budgets also creates uncertainty about the immediate path of fiscal policy. For example, while the government indicated that it plans to maintain a "neutral" budget in FY2001, the fiscal stance in 2001 will depend crucially on decisions yet to be made on the FY2000 supplementary budget.

- **The absence of a clear medium-term fiscal policy framework invites speculation about future public deficit and debt levels**, and may contribute to instability in bond and foreign exchange markets. Although the authorities regularly publish a five-year fiscal forecast, this is based on a linear extrapolation of recent trends rather than a detailed assessment of factors likely affecting revenue and expenditure in the future or indications about the authorities' future fiscal plans.

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[29] Spending on medical care is expected to drop by 4 percent in FY2000, with a substantial chunk of services being taken over by nursing care providers. However, the overall uptrend in health care spending will continue, with costs expected to increase by 2½ percent if nursing care expenses are included.

51. **The government has taken steps to improve transparency in selected areas.** The government is currently working on a national balance sheet that would provide information on the consolidated assets and liabilities of the central government's General and Special Accounts. Publication of a pilot version is expected for this fiscal year. At the same time, guidelines for the compilation of balance sheets by local governments have recently been drawn up, and the Tokyo prefecture independently published its first consolidated balance sheet in May 2000 (see Box II.2). The government also intends to improve transparency in the annual budget formulation process, including by publication of the guidelines for evaluating budget requests, and by introducing a policy review system, whereby the performance of government agencies would be evaluated against policy targets. Possibilities for linking the outcome of policy reviews to budget allocations in coming years are also being studied.

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III. Monetary Developments[1]

A. Monetary Policy Developments

1. **Financial markets were relatively stable over the past year, including around the turn of the millennium**. The Bank of Japan's (BOJ) policy interest rate, the uncollateralized overnight call rate, remained at virtually zero—the February 28 blip was due to concerns about possible computer problems on February 29 (Figure III.1). Other short-term money market rates, including the 3-month *Gensaki* rate, were also stable. The yield on newly-issued 10-year government bonds fluctuated in a 50 bps range (about 1.5–2.0 percent), compared to a 150 bps range during 1998–99. Bank funding premia, including the 3-month Japan premium, the spread between the 3-month certificate of deposit rate and the *Gensaki* rate, and the premium on 2-year bank deposits relative to same-maturity government paper, were relatively small and rose only modestly in response to concerns about possible computer problems at the end of calendar and fiscal 1999 (Figure III.2).

2. **The stance of monetary policy remained unchanged over the past year**. The BOJ Monetary Policy Board announced in February 1999 that it would guide the overnight call rate to "as low as possible" and added in April 1999 that it would maintain this policy "until deflationary concerns are dispelled" (the so-called zero interest rate policy). Since then, the monetary policy guideline has remained the same except for some minor changes in October 1999, when the Policy Board dropped language about avoiding excessive volatility in short-term financial markets and maintaining market function, as the volume in the call money market had stabilized at about half its previous level and financial institutions were not experiencing any difficulties in procuring or disposing of funds.[2] The tightening of monetary conditions in the summer of 1999 reflected the rapid appreciation of the yen. The Policy Board decided not to change the monetary policy stance in response, but did issue a statement in September 1999 explaining why it had decided against further easing (an unprecedented move).[3]

3. **The BOJ expanded the range of its money market operations in October 1999 to help address liquidity demands including those stemming from Y2K**, though the new instruments did not provide substantially new tools to address monetary conditions more

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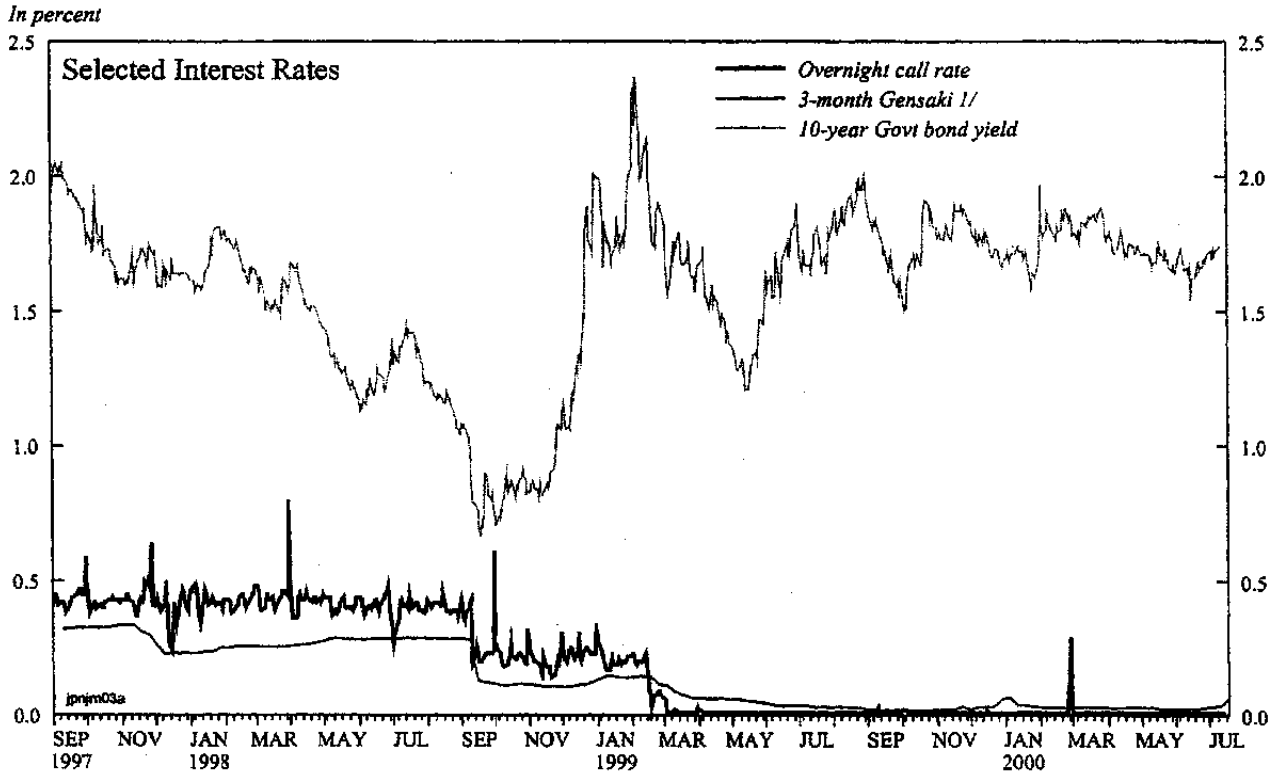
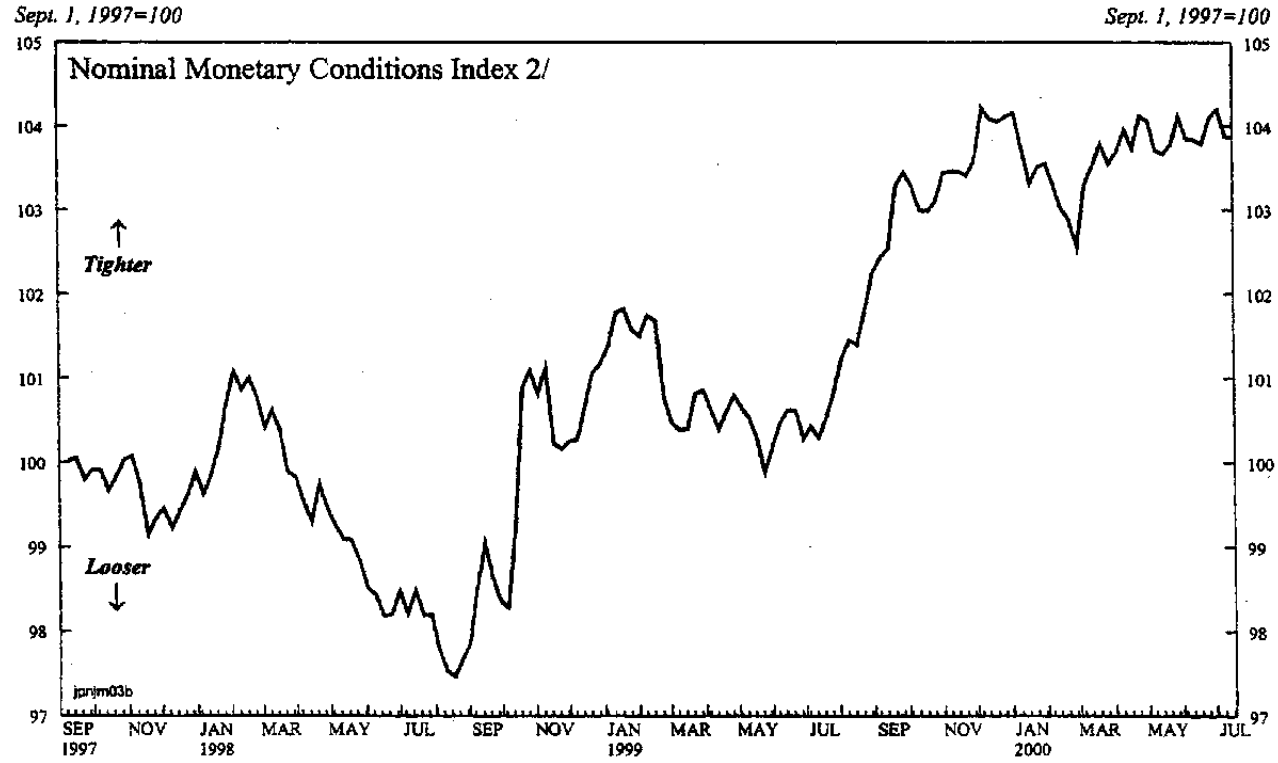
[1] Prepared by James Morsink (ext. 37875).

[2] The current monetary policy guideline is as follows: "The BOJ will flexibly provide ample funds and encourage the uncollateralized overnight call rate to move as low as possible."

[3] In its statement, the Policy Board said that it was concerned about the rapid appreciation of the yen, but noted that the exchange rate was not an objective of monetary policy and that it was too early to reach any conclusions about the impact of the appreciation. The statement also reiterated that increased liquidity injections would simply be accumulated as excess funds at money market brokers and that any effect of additional liquidity injections on market expectations would be small and temporary.

Figure III.1. Japan: Interest Rates and Monetary Conditions, 1997-2000

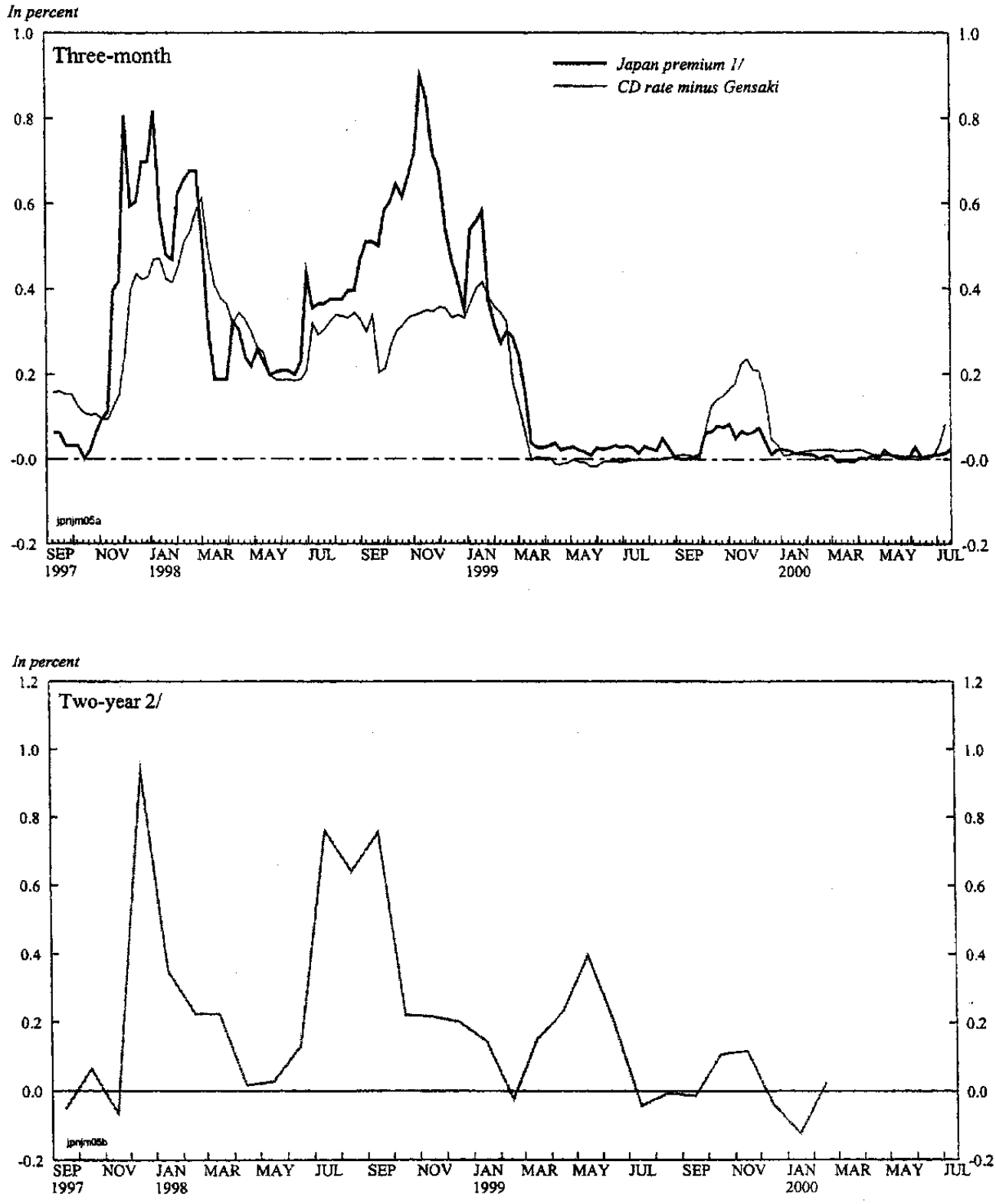




Sources: Nikkei Telecom; WEFA, Nomura Database; and staff calculations.

1/ Gensaki refers to a repurchase operation in government securities.
2/ The monetary conditions index is the weighted sum of short-term interest rates and the exchange rate, where the weights reflect the estimated impact of those variables on aggregate demand. Specifically, a 1 percentage point change in the overnight call rate receives the same weight as a 10 percent change in the nominal effective exchange rate.

Figure III.2. Japan: Bank Funding Premia, 1997-2000



Sources: Bank of Japan, Economic Statistics Monthly; WEFA; and Bloomberg LP.

1/ Average U.S. dollar LIBOR of Fuji Bank, Bank of Tokyo, and Norinchukin bank minus the LIBOR fix from 1/21/1999; previously, Sumitomo Bank was included in the average.
2/ Rate on two-year CDs minus yield on two-year government bonds.

broadly. The BOJ introduced outright purchases and sales of short-term government securities, in addition to its current repurchase operations in these securities. The BOJ also added two-year government securities to longer-dated government paper as eligible instruments for repurchase operations. Finally, the BOJ said that it would be flexible in providing liquidity to meet Y2K concerns, including by dropping the rotation system for participation in money market operations.

4. **The BOJ established a repurchase facility for the government's Trust Fund Bureau (TFB) in March 2000 to avert possible money market volatility resulting from withdrawals from the postal savings system.** As discussed in the chapter on fiscal developments, the maturation of a substantial amount of ten-year postal savings deposits during 2000–01 may put funding pressure on the TFB, as the postal savings system is its key source of financing. After indicating in November 1999 its readiness to provide temporary liquidity to the TFB, the BOJ announced in March 2000 the details of the repurchase facility, which will remain in effect until March 2002: (i) the BOJ will undertake repurchase operations in government bonds if (and only if) a TFB auction of government bonds fails to attract enough market demand; (ii) rollovers that extend the maturity of a repo agreement to more than 3 months are subject to BoJ approval, and (iii) the ceiling on the outstanding amount of such rollovers is ¥7.8 trillion, equal to the amount of government bonds purchased by the TFB from the market between June 1996 and September 1999.[4] Since April 2000, the TFB's monthly auctions of ¥300 billion of government bonds have been fully subscribed, so the BOJ has not made any purchases.

5. **The BOJ's main instruments for adjusting liquidity have remained outright operations in government securities and repurchase operations in government and corporate securities.**[5] To counter upward pressure on bank funding premia stemming from computer concerns, the BOJ injected large amounts of liquidity in December 1999 and March 2000, mostly through outright purchases of short-term government securities and repurchases operations in government securities and commercial bills (Table III.1). This liquidity was reflected in an increase in banknotes in circulation and—especially—a sharp rise in excess deposits at the BOJ in the final days of 1999 to ¥23 trillion. Cumulative excess reserves during the mid-December to mid-January reserve holding period rose to about ¥300 trillion, much higher than in previous months (Figure III.3). While the BOJ re-absorbed this liquidity during the first two weeks of January, with excess deposits returning to pre-Y2K levels by mid-month, excess reserves increased again towards the end of the fiscal year in March 2000. Separately, the recent rise in government deposits is in preparation for the maturation of large amounts of postal savings deposits starting in April 2000.

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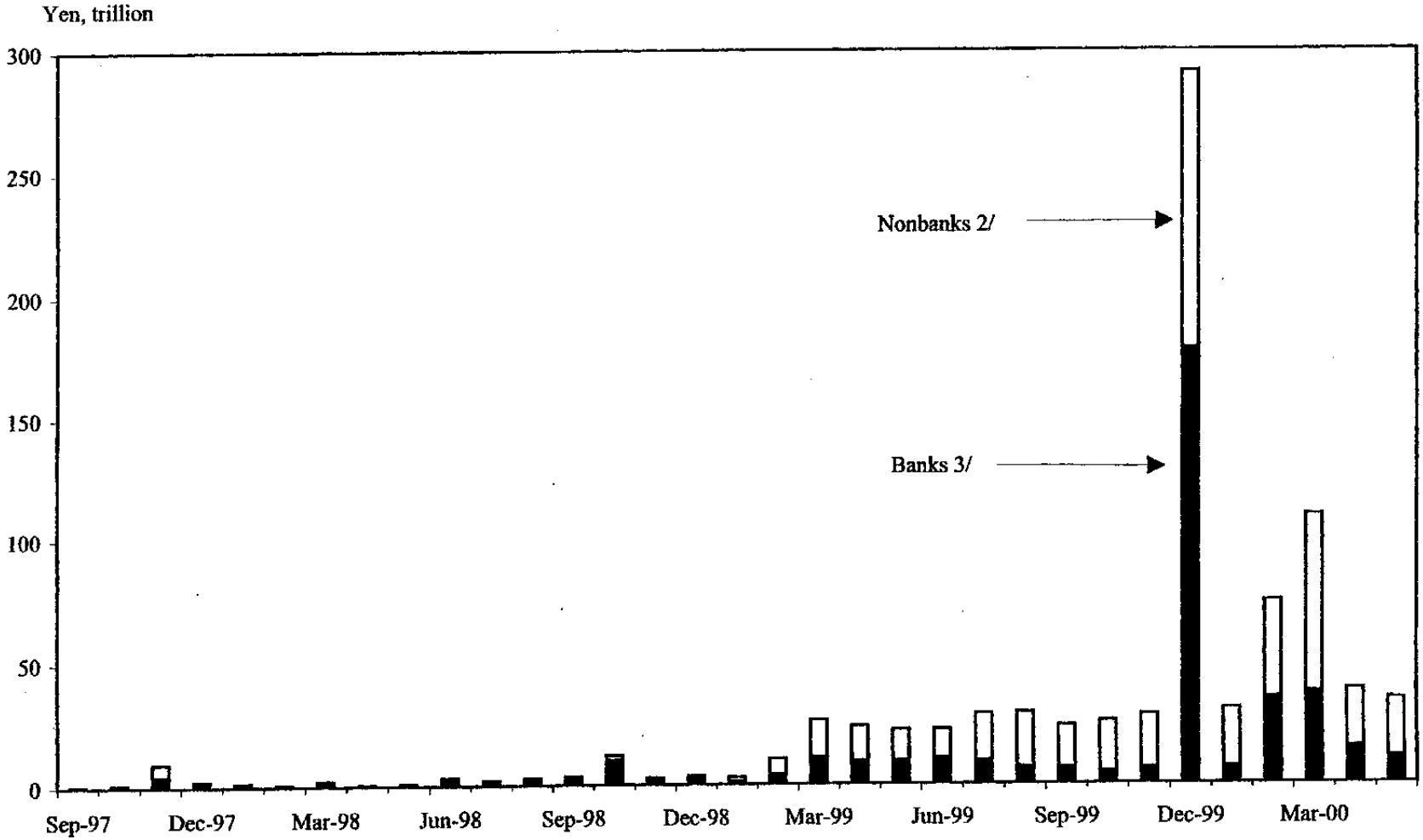
[4] The ceiling is equivalent to 12 percent of the monetary base as of end-May 2000. The BOJ certainly has the instruments to absorb this amount of liquidity, if necessary.

[5] The BoJ's policy is to adjust its holdings of long-term government securities in line with changes in the demand for currency, including through regular purchases of government bonds (so-called *rinban* operations).

Figure III.3. Japan: Excess Deposits at BOJ, 1997-2000 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.

Table III.1. Japan: Monetary Base, 1999–2000 1/
(In trillions of yen, end period)

	March	June	Sept.	Dec.	March	June
Sources	61.5	61.0	61.5	93.0	79.6	64.6
Government bonds	29.7	29.7	27.5	31.7	35.9	33.7
Repos in government bonds	4.1	1.3	1.7	10.0	7.9	6.2
Government bills	19.7	26.3	22.5	37.6	38.7	28.4
Commercial bills	1.2	0.8	1.8	3.6	2.0	0.5
Repos in commercial paper	4.0	2.3	3.9	9.5	3.9	1.9
Sales of BoJ bills (negative item)	-10.0	-5.8	0.0	0.0	-3.8	-5.1
Loans and discounts	8.2	5.3	3.9	4.1	1.7	0.9
Of which:						
Loans to the DIC	6.7	4.0	2.4	2.2	0.3	0.0
Government deposits (negative item)	-2.0	-2.5	-3.5	-6.0	-13.0	-6.4
Others	6.6	3.6	3.7	2.5	6.3	4.5
Uses	61.5	61.0	61.5	93.0	79.6	64.6
Banknotes in circulation	51.3	52.3	51.4	65.4	57.1	55.3
Coins in circulation	4.0	4.0	4.1	4.2	4.1	4.1
Current account balances at the BoJ	6.2	4.7	6.1	23.4	18.3	5.2

Source: Bank of Japan.

1/ Data are only available starting in 1999.

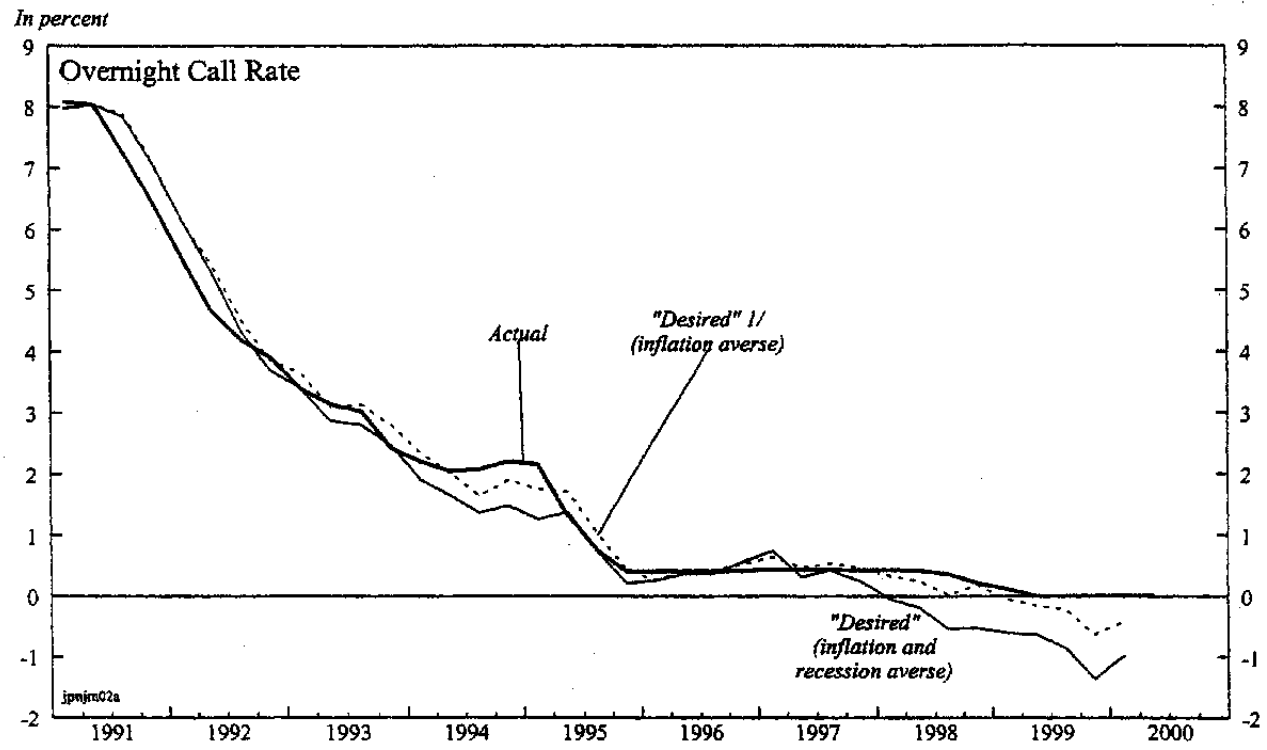
B. Current Stance of Monetary Policy

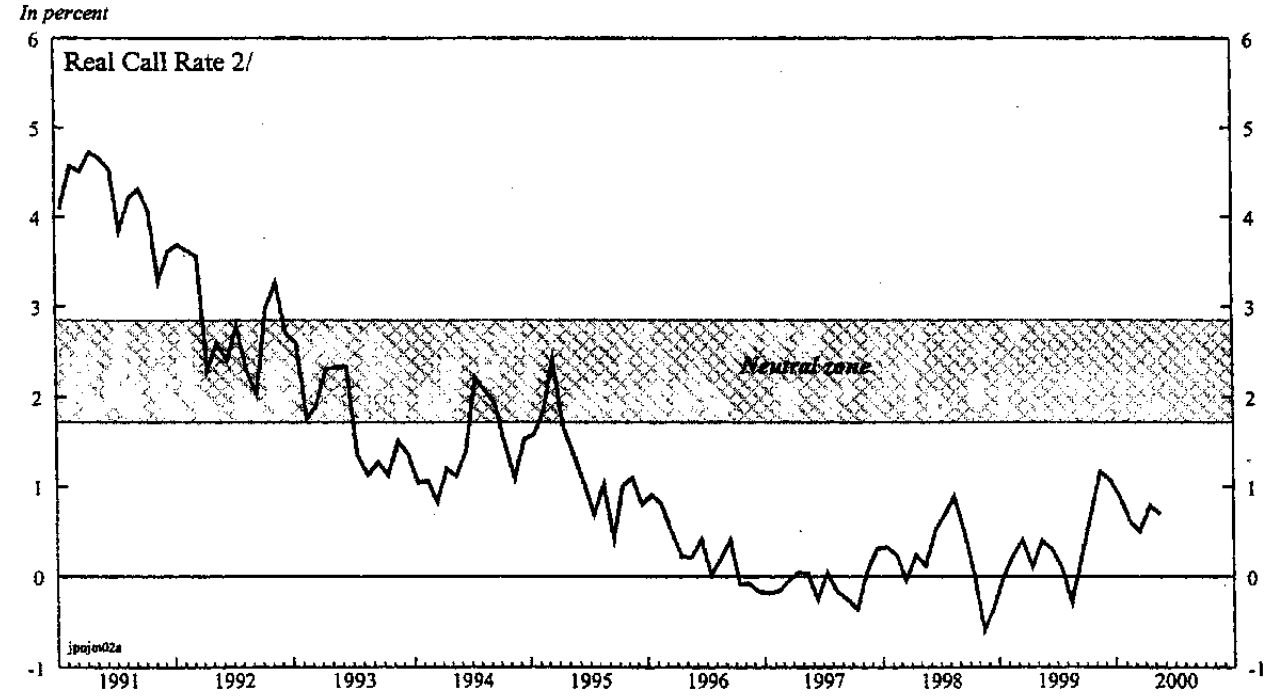
6. **Simple calculations in the spirit of Taylor (1993) suggest that the current monetary policy stance is somewhat tighter than warranted by the current inflation rate and output gap** (Figure III.4).[6] The actual overnight call rate is compared to the "desired" level delivered by a policy reaction function based on a Taylor rule, starting in the second quarter of 1991, when the overnight call rate peaked.[7] In line with Mori, Shiratsuka, and Taguchi (2000), assumptions include interest rate smoothing (a partial adjustment coefficient of 0.85 on the lagged actual call rate) and two sets of weights on the inflation rate and the output gap: one with similar weights (1.5 and 1.0, respectively) and another with much greater weight on the inflation rate than on the output gap (2.0 and 0.3, respectively). During the past year, the "desired" call rates given by both sets of weights have been consistently below the actual call rate, indicating that further monetary easing would have been warranted, though the discrepancies narrowed in the first half of 2000. However,

[6] We use the IMF's standard measure of potential output in Japan, which is based on a Cobb-Douglas production function. For a discussion of the advantages and disadvantages of different measures of potential output in Japan, see Bayoumi (2000).

[7] The second quarter of 1991 is taken as the base period, which pins down the target inflation rate in the Taylor rule. The formula is: $R^*(t) = (1-\lambda)\,[\,\alpha\,(\pi(t) - \pi^*) + \beta\,GAP(t)\,] + \lambda R(t-1)$ where R is the actual call rate, R^* is the desired call rate, π is year-on-year CPI inflation (adjusted for changes in administered prices and indirect taxes), π^* is target inflation, and GAP is the output gap.

Figure III.4. Japan: Indicators of Monetary Policy Stance, 1991-2000





Sources: Nikkei Telecom; and staff calculations.

1/ "Desired" call rates are based on simple Taylor-rule type calculations, as described in the text.
2/ Overnight call rate minus CPI inflation adjusted for changes in indirect taxes and administered prices.

Taylor-rule calculations must be interpreted with caution, as they depend crucially on the estimated output gap, which is especially uncertain at present; in addition, a forward-looking monetary policy would tend to put some weight on the gap between forecast and target inflation, rather than on the gap between actual and target inflation.

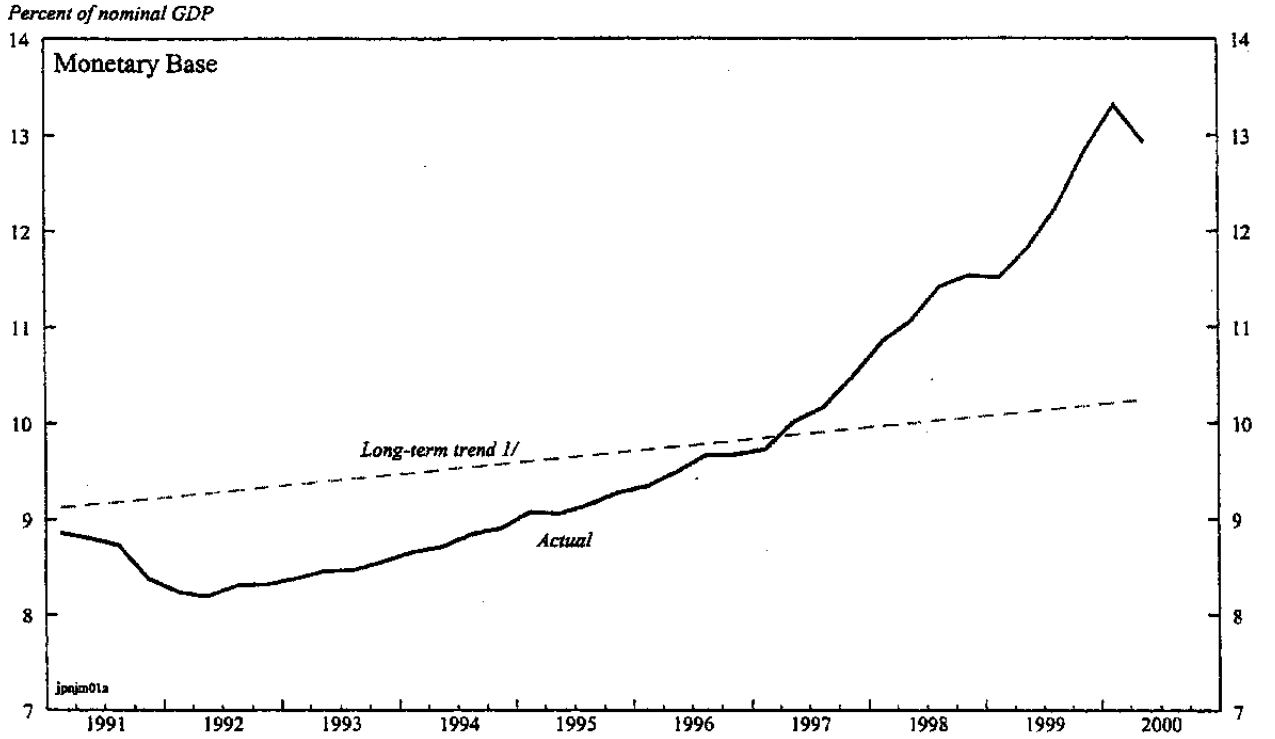
7. **The comparison of the real short-term interest rate with the "neutral" rate, as suggested by Blinder (1998), suggests that monetary policy remains accommodative, though it has become somewhat less so over the past year.** Mori *et al.* (2000), estimate the "neutral" rate by averaging the difference between the official discount rate and realized year-on-year consumer price inflation over the period 1883–1986. The "neutral" rate is considered to lie between 1.72 percent (the average if observations exceeding 10 percent in absolute terms are excluded) and 2.85 percent (the average excluding the period around World War II). Since mid-1999, the real short-term rate has increased from about zero to about ½–1 percent, while remaining well below the "neutral" range.

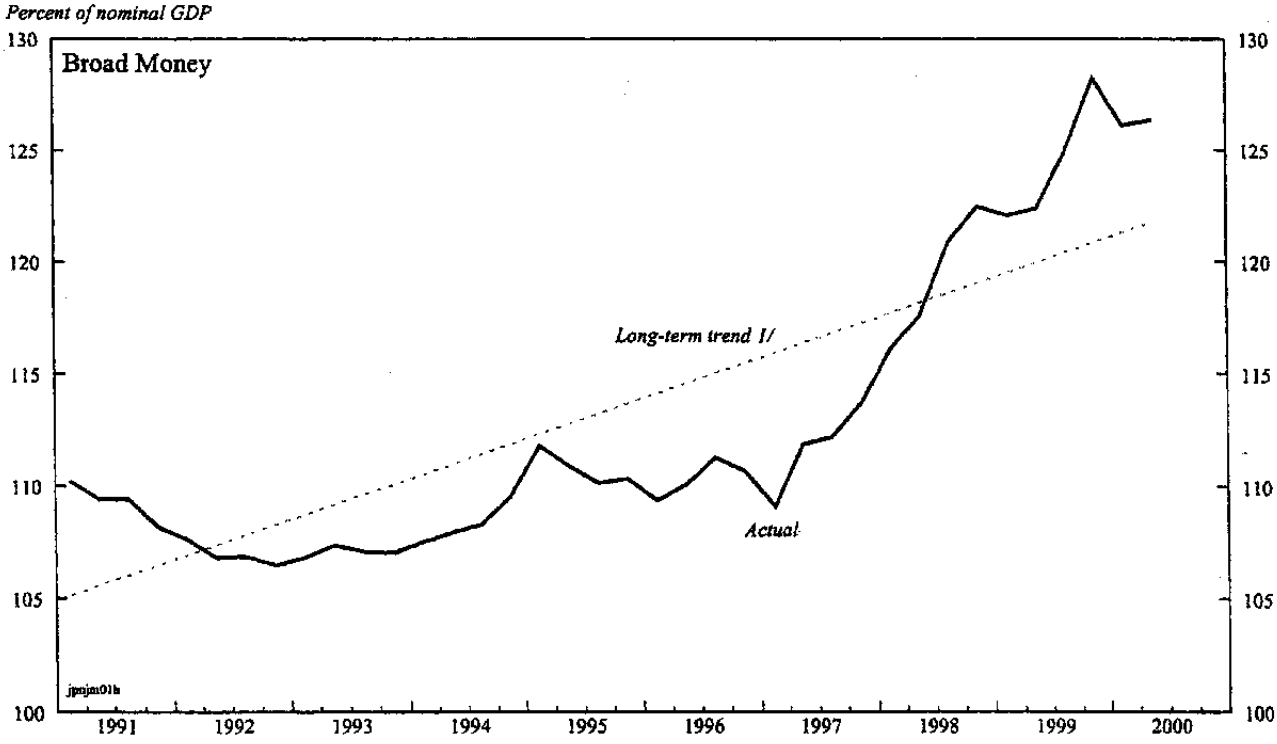
8. **Marshallian *k* (the ratio of money to nominal GDP), which is a less direct indicator of the monetary policy stance, also suggests that monetary policy remains accommodative.** Marshallian *k's* for both the monetary base and broad money (M2+CDs) are compared to their long-term linear trends for the period 1970–2000 (Figure III.5). Marshallian *k* for the monetary base started to exceed its long-term trend in 1997 and the deviation has increased sharply since then. Similarly, the Marshallian *k* for broad money is currently well above its long-term trend, notwithstanding the slowing growth of the nominal stock (see below). While these developments reflected in part demand factors, such as the declining opportunity cost of holding cash balances (for the monetary base) and an increase in the precautionary demand for money (for broad money), they do not provide *prima facie* evidence that the monetary policy stance is too tight.

9. **Even though short-term interest rates are close to zero, various options would be available to ease the monetary policy stance further, although their quantitative effect remains uncertain.**[8] First, the announcement of an explicit inflation target would help to clarify further the BOJ's policy stance and would likely influence inflationary expectations if backed up by other actions. Second, while additional monetary operations in short-term government securities (on which interest rates are already close to zero) would have little effect, purchases of government bonds with non-zero yields could affect economic activity through portfolio rebalancing and the credit channel. The risk of undermining fiscal discipline, moreover, could be addressed by adopting an explicit inflation target; the consequences of BOJ valuation losses on government bonds (as nominal interest rates eventually rise) could be dealt with by having the government indemnify the central bank against such losses. Third, monetary policy also retains its effectiveness through the foreign

[8] See, for example, Bernanke (2000), Krugman (1998), and Svensson (2000).

Figure III.5. Japan: Marshallian k





Sources: Nikkei Telecom; and staff calculations.

1/ Linear trend, 1970-2000

exchange market. While Japan's trading partners would be affected by a more depreciated yen, they would benefit from a stronger recovery in Japan.

C. Money and Credit

10. **Notwithstanding the rapid growth of the monetary base, broad money growth slowed to about 2 percent year-on-year** (Figure III.6). The slowdown reflected primarily a decline in the precautionary demand for money following the stabilization of the financial system and the easing of the credit crunch. Empirical work by the BOJ, reported in Hayakawa and Maeda (2000), defined the precautionary demand for money as "the liquidity demand of the private sector stemming from future uncertainty towards financing" and measured this demand by using firms' impression of their financial position from the quarterly *Tankan* survey. This measure of the precautionary demand for money was crucial to the stability of the estimated long-term relationship between money and economic activity during 1998–99.

11. **The banking system's claims on government rose sharply, while bank lending to the private sector continued to fall.** Based on the monetary survey, the growth of claims on government contributed about 5 percent to broad money growth over recent months, while the decline in claims on the private sector detracted about 2 percent (the changes in net foreign assets and other items net accounted for the remainder). The growth of claims on government reflected primarily banks' heavy purchases of government bonds, which coincided with the massive issuance of bonds to finance the large fiscal deficit (Figure III.7).

12. **Bank lending to the private sector showed no sign of recovery.** The headline figure fell by 4.7 percent year-on-year in May 2000, while the adjusted data, which correct for loan securitization, loan write-offs, and other special items, showed a year-on-year decline of 2.2 percent.[9] The persistent contraction in bank lending reflects several factors: (i) weak demand from corporates, which are able to finance their investment mostly through retained earnings; (ii) weak supply from some troubled banks, which are still trying to reduce risk assets (notwithstanding the overall improvement in banks' willingness to lend, as reported in the *Tankan* survey); and (iii) the secular decline in bank intermediation, as securities markets start to grow (see the chapter on Financial System Issues). The sharp acceleration of the contraction in lending by second-tier regional banks reflects in part the decline in the total amount of government loan guarantees, which supported the main borrowers from second-tier regionals—small and medium-sized enterprises.[10]

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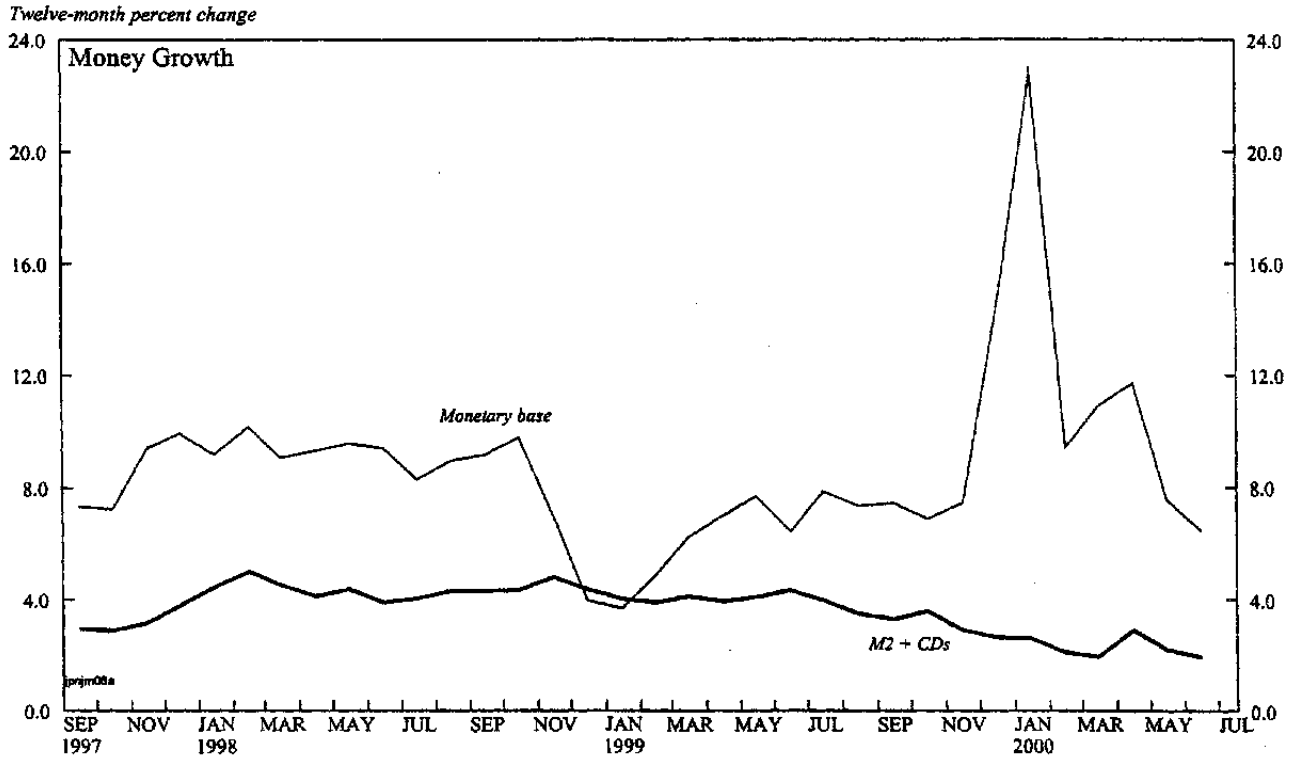
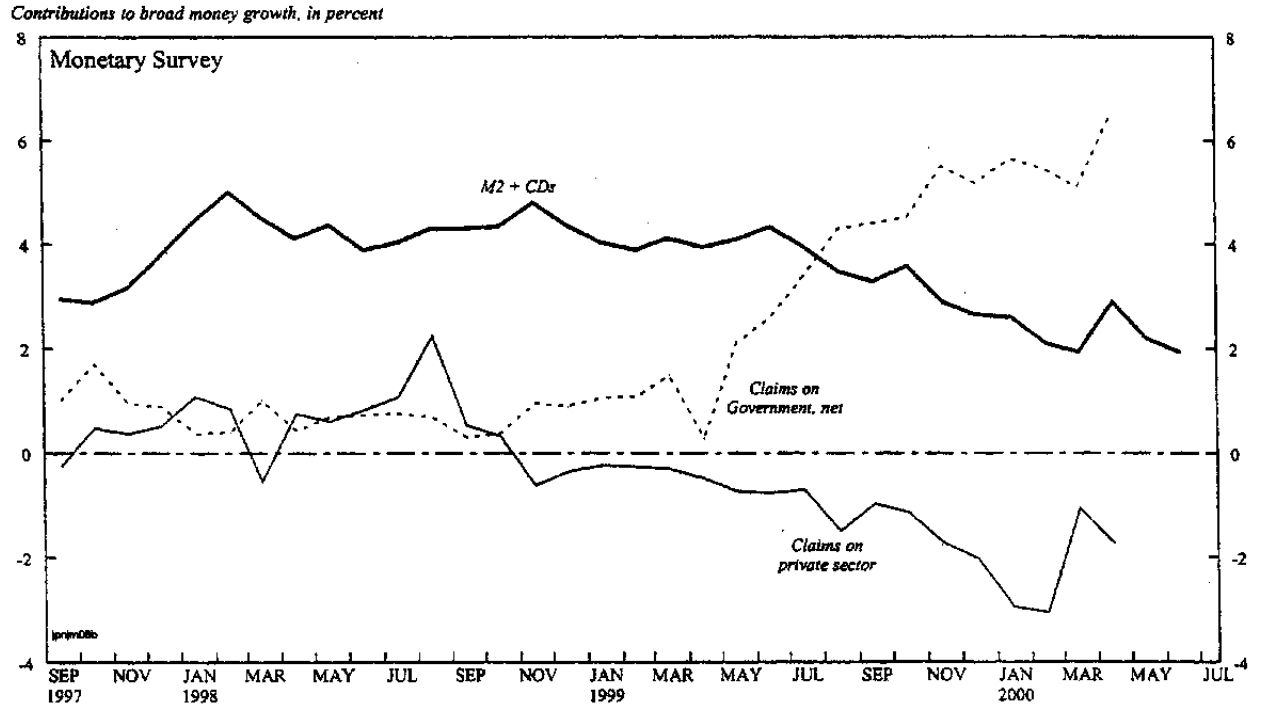
[9] The adjusted data are not shown in Figure 7 because they are only available starting in October 1998.

[10] Eligibility for loan guarantees was tightened in April 2000: firms applying for loan guarantees are now required to submit a business plan.

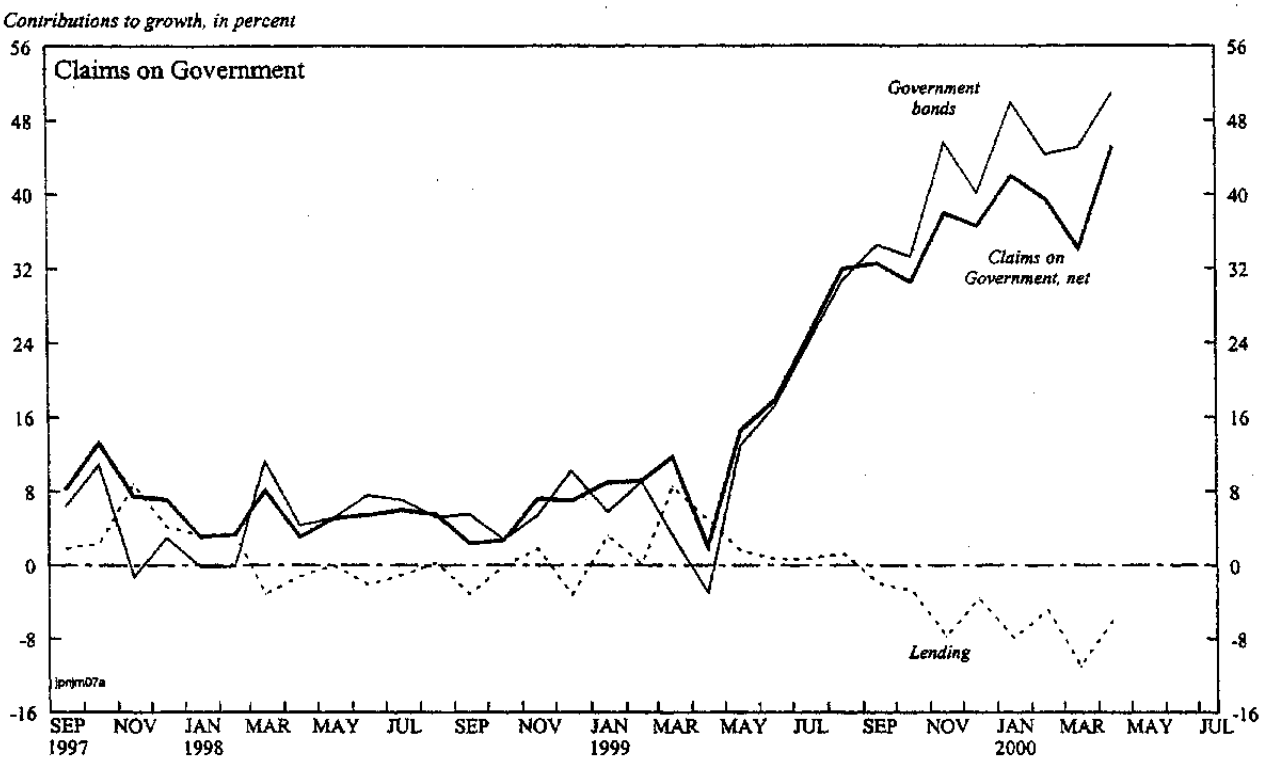
Figure III.6. Japan: Money Growth, 1997-2000

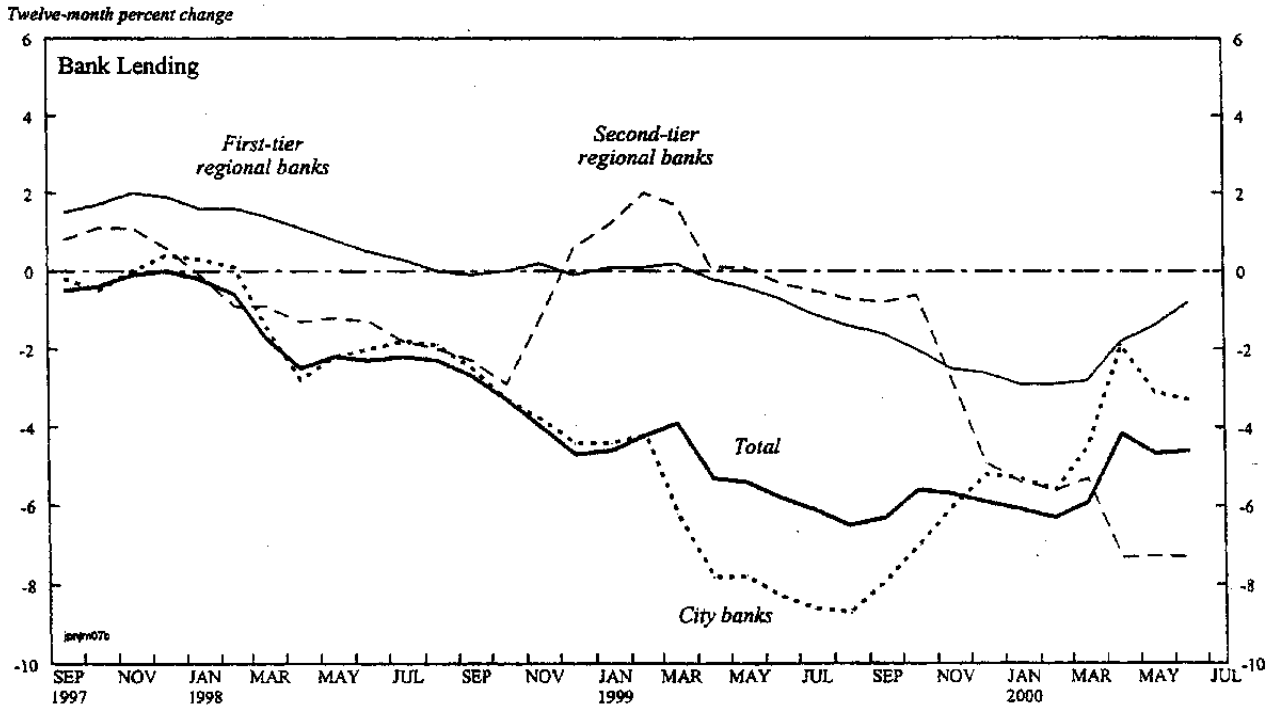




Sources: Bank of Japan, Economic Statistics Monthly; and CEIC Database.

Figure III.7. Japan: Credit Growth, 1997-2000





Sources: Bank of Japan, Economic Statistics Monthly; and CEIC Database.

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IV. Financial System Issues[1]

A. Overview

1. **While concerns about systemic risk in the banking sector have continued to recede, bank restructuring remains at an early stage.** Under the framework established in 1998, further progress has been made in stabilizing the banking system. Major banks' average capital adequacy ratio increased to 11¾ percent in March 2000; the two banks nationalized in late 1998 have been or are about to be reprivatized; and four mega-mergers have been announced, with one breaking *keiretsu* ties. As a result, the Japan premium has remained close to zero since March 1999, apart from a brief rise during the Y2K period (Figure IV.1). However, while the bulk of the bad loan problem may have been addressed by cumulative loan loss charges since 1990 of over ¥50 trillion (10 percent of GDP), concerns remain that the full extent of the deterioration in asset quality has not been recognized and that corporate restructuring will lead to an ongoing flow of new bad loans. In addition, major banks have not yet demonstrated that they have sufficiently ambitious plans to restore core profitability, as reflected in the performance in their stock prices.

2. **Many regional banks have raised capital over the past year, but weaknesses remain among many second-tier regional banks and cooperative-type institutions.** Over the year ended March 2000, more than one third of regional banks raised capital equivalent to 2 percent of their risk-weighted assets, mostly from private sources, increasing the average capital ratio of first-tier regionals to 10 percent and of second-tier regionals to 8 percent as of March 2000. In addition, five regional banks have been intervened. However, a number of the second-tier regionals still have less than 8 percent capital.[2] In addition, weaknesses among cooperative-type institutions remain very serious. Credit cooperatives came under the Financial Supervisory Agency's (FSA) jurisdiction in April 2000; the FSA will be inspecting these institutions through March 2001. The delay in reintroducing limited deposit insurance announced last December was largely related to concerns about weaknesses in this sector.

3. **Further progress in resolving banking problems is essential given the planned removal of blanket deposit insurance in April 2002 and to lay the foundation for sustained growth.** The new framework for limited deposit insurance—including expedited purchase and assumption operations—is expected to improve market discipline, reduce moral hazard, and limit the burden on the taxpayer. However, uncertainty about the magnitude of banks' remaining uncovered losses and their future profitability may lead markets to anticipate liquidity problems well ahead of April 2002, so there is in fact little time left for preemptive restructuring. In addition, banks play an especially important role in financial intermediation in Japan, as securities markets are less well developed than in other major

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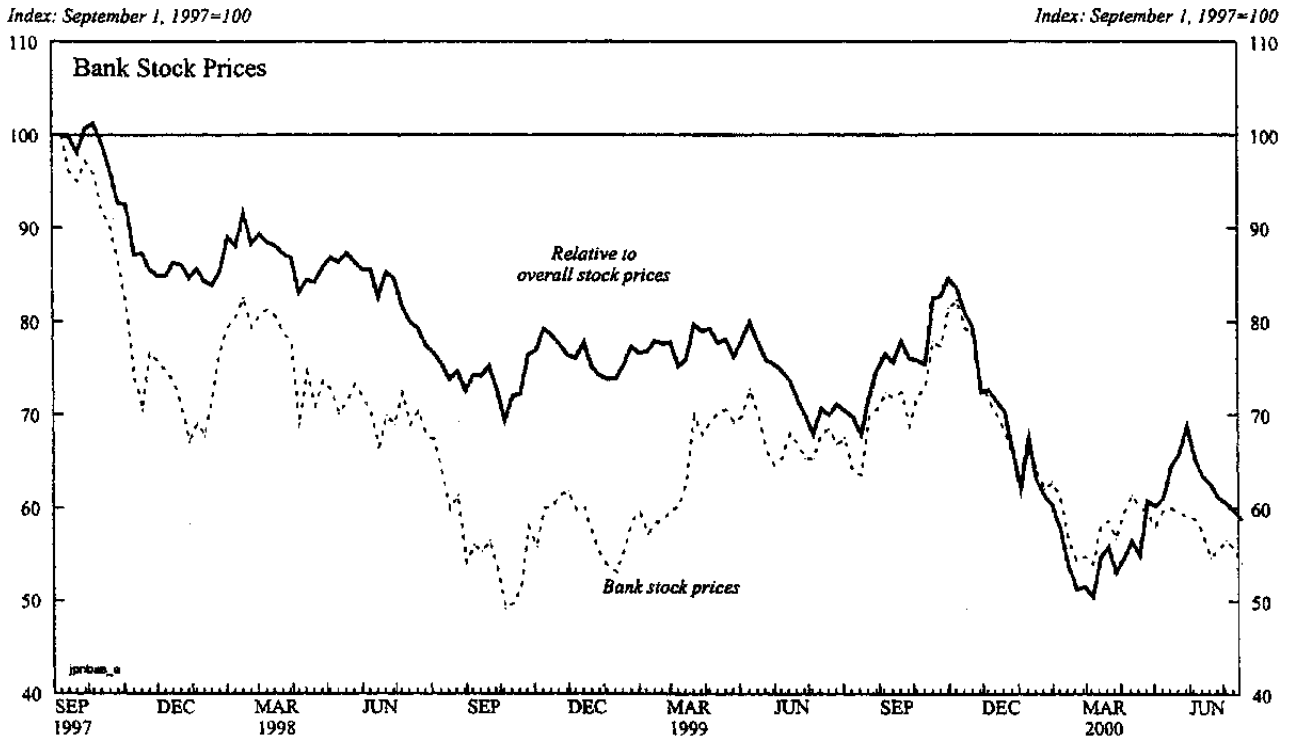
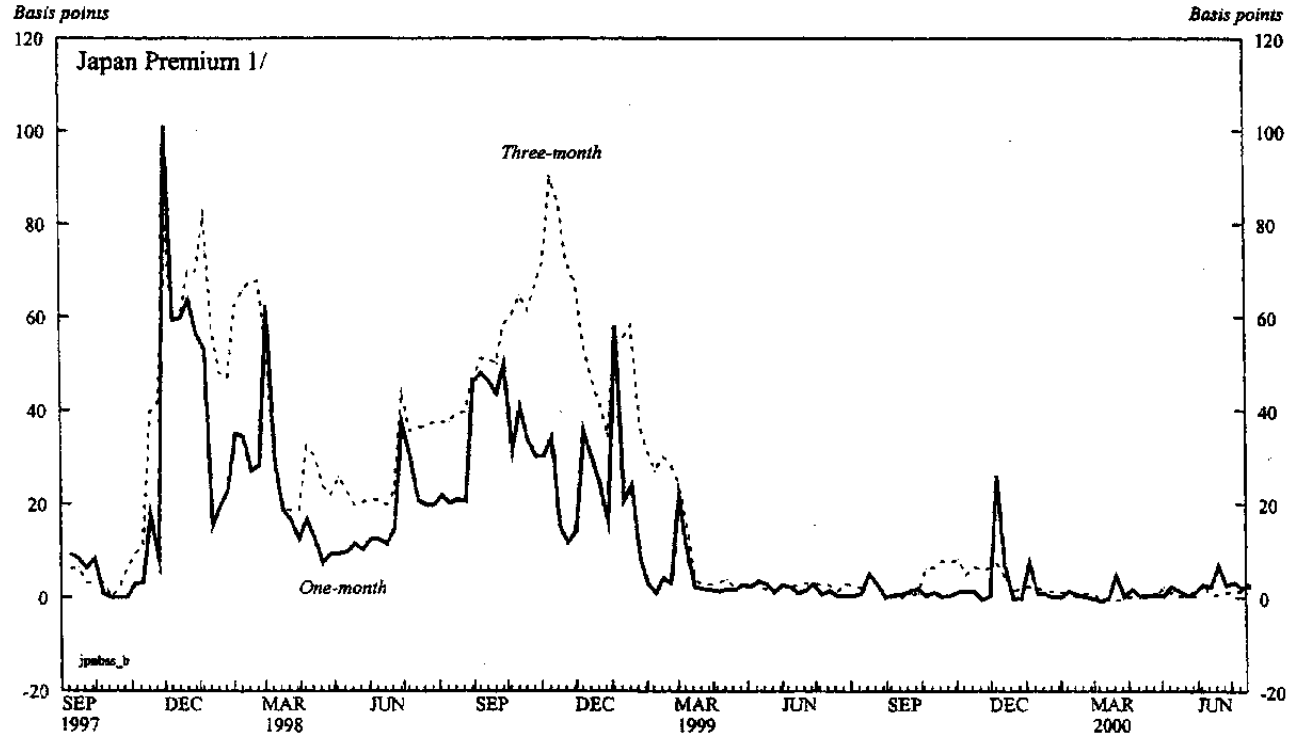
[1] Prepared by James Morsink (ext. 37875).

[2] Banks with exclusively domestic operations are required to hold 4 percent capital, which does not include 45 percent of unrealized gains on securities.

Figure IV.1. Japan: Banking System Strains, 1997-2000





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

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

industrial countries (see Morsink and Bayoumi, 2000). Until banking problems are fully addressed, banks' reduced capacity to take on risk will hinder their role in financial intermediation, as reflected in the continued weakness of bank lending.

4. **The financial position of the life insurance sector deteriorated further over the past year, reflecting returns on assets that fell short of guaranteed returns paid on policies (negative spreads).** Following the implementation of stricter disclosure standards in April 1999, the FSA began in May 1999 on-site inspections of life insurers. After the failure of Toho Mutual Life in June 1999, the FSA intervened in Daihyaku Mutual Life in May 2000. Recently, regulations on the adequacy of policy reserves and triggers for prompt corrective action were tightened, troubled life insurers were allowed to lower future guaranteed rates of return on policies as part of court-supervised reorganization proceedings; demutualization was facilitated; and the government-guaranteed borrowing limit of the Life Insurance Policyholders Protection Fund was raised.

B. Policy Developments

Regulation

5. **The FSA recently tightened bank capital rules, but important shortcomings remain.** The FSA extended in June 2000 the restriction on double-gearing, which previously applied only to banks' investment in nonconsolidated temporary subsidiaries in which the bank's equity stake is above 50 percent, to banks' investment in all nonconsolidated financial subsidiaries (including insurance companies, securities firms, nonbank financial institutions, leasing companies, and asset management advisors). At the same time, the new rule prohibits the consolidation of insurance subsidiaries, given that banks' capital requirements are not designed to cover insurance-specific risks. Banks are now required to deduct investment in any financial subsidiary from their capital, on the grounds that such funds are being used to support the business of the subsidiary and are not available to support the bank's own business.[3] By encouraging banks to invest funds more broadly (outside of corporate groups), the new standard is expected to weaken cross-shareholding.

6. **The capital adequacy standard for domestic banks is still low and the treatment of deferred tax assets is still generous, by international standards.** While banks with international operations—including all major banks—must have capital ratios of at least 8 percent, banks with domestic operations only are required to maintain a capital adequacy ratio of just 4 percent. With regard to deferred tax assets, most countries allow banks to carry assets related to anticipated future tax deductions for loan losses against loans that have already been provisioned against. However, the realization of these assets depends on future taxable income, so regulatory authorities usually impose a ceiling on such assets. In Japan,

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[3] Another firm is a subsidiary if the bank's equity stake is above 20 percent but below 50 percent, or if the stake is below 20 percent but the bank wields effective control. If the bank's stake is above 50 percent, the other firm (except insurance companies) must be consolidated.

the ceiling is five years' taxable profit, while in the United States the ceiling is 10 percent of Tier-1 capital or one year's taxable profit, whichever is lower.

Supervision

7. **The FSA made further progress in improving bank supervision over the past year.** On-site inspections during 1998–99 concentrated on asset quality, particularly the inadequacy of loan classification and provisioning standards, and this led to substantial increases in provisions. Over the past year, banks were inspected on a consolidated basis, including off-shore entities, and inspectors focussed on a broader set of risks—not only credit risks, but also market risks, liquidity risks, and systemic risks. Newly-hired specialists played an important role in helping the FSA to assess banks' overall risk management frameworks. Starting this fiscal year, the FSA is strengthening off-site monitoring by requiring banks to report every month key financial data, such as risks posed by changes in interest rates and share prices, cash positions, and credit exposures. Based on an analysis of these data, the FSA is prepared to make recommendations.

8. **Supervisory resources continued to increase.** The number of inspectors based at FSA headquarters rose from 164 in June 1998 (when the FSA was established) to 249 in March 2000, and is expected to increase to 319 by March 2001. About 20–30 specialized inspectors were hired, with skills in such areas as accounting, legal issues, information technology, and market risks, and supervisory agencies in other countries helped to provide training. In addition, 567 inspectors based in local offices recently came under the FSA's control.

9. **The FSA (Financial Supervisory Agency) became the Financial Services Agency in July 2000.** The most important change was that responsibility for planning financial system laws shifted from the Ministry of Finance (MOF) to the FSA (Table IV.1). At the

Table IV.1. Reallocation of Financial Regulatory Functions

	Previous	July 2000	January 2001
Planning and formulation of legal system	MOF	FSA*	FSA*
Planning of resolution scheme and crisis management	FRC/MOF	FRC/MOF	FSA*/MOF
Resolutions and capital injections based on 1998 legislation	FRC/MOF	FRC/MOF	FSA*
Inspection and supervision	FSA	FSA*	FSA*
Oversight of Deposit Insurance Corporation	FRC/MOF	FRC/MOF	FSA*/MOF
Oversight of Securities and Exchange Surveillance Commission	FSA	FSA*	FSA*

MOF: Ministry of Finance
FRC: Financial Reconstruction Commission
FSA: Financial Supervisory Agency
FSA*: Financial Services Agency

same time, the MOF regained a role in bank resolutions and crisis management. Further changes are planned for early 2001, when the FRC will be merged into the FSA.

Public Money

10. **Public funds authorized to protect depositors were increased by ¥10 trillion,** bringing the total amount of public funds available for dealing with banking system problems to ¥70 trillion ($640 billion or 14 percent of GDP) (Table IV.2).[4] Of the extra ¥10 trillion, ¥6 trillion was in the form of a grant to the Deposit Insurance Corporation (DIC), while ¥4 trillion was in additional loan guarantees to the DIC. This recapitalization was necessary as recent failures of major banks essentially exhausted the initial grant of ¥7 trillion for meeting bank closures. However, in other respects, the amount of public funds available for dealing with banking problems remains ample—only about ¥8 trillion has been used to recapitalize weak but solvent banks.

Table IV.2. Japan: Public Funds Authorized to Deal with Banking Weaknesses
(Trillions of Yen)

	February 1998	October 1998	February 2000
Depositor protection	17	17	27
Grant	7	7	13
Loan guarantees	10	10	14
Recapitalization of weak banks 1/	13	25	25
Nationalization	...	18	18
Total	**30**	**60**	**70**

1/ Thus far, about ¥8 trillion has been injected, mostly in the form of convertible preferred shares.

Disposal of Bad Loans

11. **The Resolution and Collection Corporation's (RCC) loan disposal efforts continued to focus exclusively on loan collection, as opposed to asset sales.** At the same time, the RCC acquired additional bad loans, including from healthy banks. The large overhang of collateral still available for sale has likely contributed to the depressed state of the real estate market—in most areas, land prices continued to fall. By contrast, some private banks sold bad assets at deep discounts, mostly to foreign investment banks and investment funds. Official data are not available, but private analysts estimated that the face value of

[4] In October 1998, the total amount of public funds available to deal with banking problems had been set at ¥60 trillion, of which ¥25 trillion was targeted at the recapitalization of weak but solvent banks, ¥18 trillion at nationalization and bridge banks, and ¥17 trillion at protecting depositors (see Chapter IV in IMF, 1999).

distressed assets sold by private banks since 1997 amounted to about ¥25 trillion (*Financial Times*, April 19, 2000).

Big Bang Reforms

12. **The Big Bang financial reforms, which were largely completed in October 1999, are setting the stage for a radical transformation of the Japanese financial system.** Brokerage commissions were fully liberalized, remaining restrictions on the stock brokerage business of banks' securities subsidiaries were lifted, and insurance companies were allowed to enter the banking business through subsidiaries. The main remaining reforms—to permit cross-sectoral competition between banks and insurance companies—will come into effect in October 2000. The reforms are increasing competition between all types of financial institutions and—by increasing the range of financial instruments available to savers, especially households—will likely encourage a shift in financial intermediation itself to securities markets. While households will likely be slow to change the allocation of their financial assets, a shift away from bank deposits and towards higher-yielding, well-diversified investment trusts appears likely.

13. **At the same time, the authorities are developing guidelines for the entry of nonfinancial companies into the banking business.**[5] The FRC and FSA released in May 2000 draft guidelines, which—among other things—require subsidiary banks to regularly submit financial statements of their principal shareholders, and mandate that measures be adopted to stop a principal shareholder's financial difficulties from spreading to its banking subsidiary. The guidelines, which appear to be broadly in line with best international practice, are expected to be finalized in July 2000; the necessary legal changes are expected to be discussed in early 2001. Sony, the electronics giant, is planning to launch an internet bank, while Ito-Yokado, a supermarket chain, expects to establish a bank focussed on providing settlement services.

Deposit Insurance Reform

14. **The removal of blanket deposit insurance—previously scheduled for March 2001—was postponed by one year** (see chapter on deposit insurance reform in this year's *Selected Issues* paper). The coverage limit of ¥10 million per depositor per bank is now scheduled to go into effect on April 1, 2002. Liquid deposits will be covered in full for an additional year (i.e., until March 2003) in order to avoid the risk of large-scale disruptions (from bank failures) until speedy resolution methods and a variety of private payment services are well-established.[6] The postponement reflected in part the lack of preparedness among smaller financial institutions, including some second-tier regional banks and

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[5] No new banking license has been issued for fifty years.

[6] Liquid deposits are defined as those used for transactions purposes. They include checking and savings deposits, but not time deposits or certificates of deposit.

cooperative-type depository institutions, which could have led to a severe credit crunch and a destabilizing deposit shift from weak to strong banks.

C. Major Banks

Performance

15. **Major banks recorded aggregate net profits in FY1999 (year ending March 2000) for the first time in six years** (Figure IV.2 and Table IV.3). Underpinning the improvement were high gains on investment equities, reflecting a buoyant stock market, which helped to offset another year of substantial loan loss charges. Loan loss charges were ¥4.5 trillion—half the level of the previous year, but three times greater than original projections, reflecting higher-than-expected corporate bankruptcies and debt forgiveness, and falling land prices. Net interest revenue declined slightly, as declining yields on securities (mostly government bonds) more than offset a small increase in loan spreads, while overhead costs fell by 5 percent. The average capital ratio increased slightly to 11.8 percent in March 2000.

16. **Notwithstanding the recent improvement in reported performance, serious concerns remain about capital adequacy and core profitability**. There are three main concerns about capital:

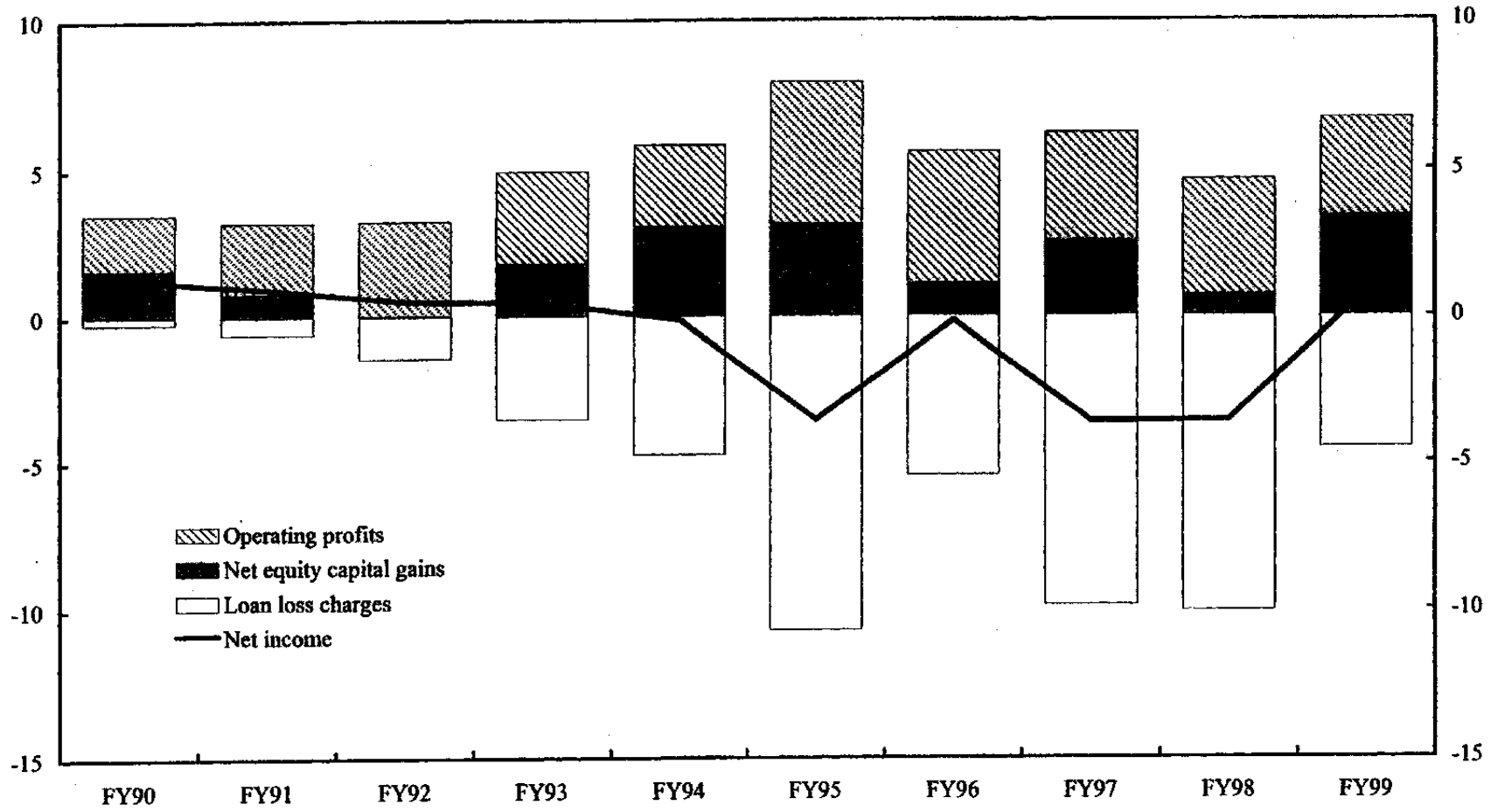
- ***Adequacy of bad loan recognition and provisioning.*** The much higher-than-projected loan loss charges in FY1999 suggests that banks may still be failing to accurately discount the weakness of loan quality. Most private analysts expect substantial loan loss charges to persist for several years, reflecting overly optimistic loan classification, especially with regard to the impact of corporate restructuring on loan quality. Also, loss rates may turn out to be higher than historical experience would suggest, especially for special mention (Class 2) loans, as banks become more active in disposing of bad loans.[7]

- ***Quality of Tier-1 capital.*** Deferred tax assets constitute about one-quarter of major banks' Tier-1 capital, public funds another one-quarter, and preferred securities issued by banks' overseas subsidiaries another one tenth. Excluding these items, "pure" common equity stood at just 2.2 percent.

- ***Increasing vulnerability to market risk.*** As banks have realized "hidden reserves" on their equity investments to absorb losses on their bad loans, the aggregate book value of their equity holdings has risen sharply, to the point where it is now roughly

[7] Major banks' total Class 2 loans amounted to ¥37.7 trillion as of September 1999, according to the summary information released by the FSA on banks' self-assessments of asset quality, which is another source of information on the extent of bad loans.

Figure IV.2. Japan: Major Banks' Profits, FY90-99
(In trillions of yen)



Source: FitchIBCA.

Table IV.3. Japan: Major Banks' Performance

	FY1998	FY1999
	(In trillions of yen)	
Income		
Net interest revenue	5.9	5.8
Fees and commissions	0.7	0.8
Valuation gains	1.9	3.8
Equity holdings	0.7	3.4
Bond holdings	0.7	0.0
Other	0.4	0.4
Overhead costs	4.0	3.9
Loan loss charges	10.4	4.5
Pre-tax income	-5.9	2.0
After-tax income	-3.6	0.8
Nonperforming loans (end-year) 1/		
Claims on high-risk borrowers	23.8	20.8
Claims on bankrupt borrowers	4.2	3.1
Claims on quasi-bankrupt borrowers	12.3	10.1
Partially charged-off loans	7.2	7.6
Claims under close observation	4.3	4.6
Total	28.0	25.4
As percent of total loans	8.5	7.8
Specific reserves	13.2	12.5
As percent of high-risk loans	55.4	60.2
Total nonperforming loans, net of specific reserv	14.9	12.9
As percent of equity	62.0	52.8
Capital adequacy ratio (percent, end-year)		
Tier-1	6.3	6.4
Tier-2	5.3	5.3
Total	11.6	11.8

Source: Fitch IBCA.

1/ As defined by the Financial Revitalization Law. Includes claims on borrowers in legal bankruptcy, past due loans in arrears by 3 months or more, and restructured loans.

equivalent to market value (TOPIX about 1,400). The implementation of mark-to-market accounting in FY2000 implies that valuation losses will immediately impact bank capital.[8] The book value of equity holdings amounted to 150 percent of Tier-1 capital as of March 2000, implying that a 30 percent fall in the stock market would reduce Tier-1 capital by about 50 percent. In addition, major banks' rapidly-growing holdings of long-term government bonds are making them vulnerable to capital losses when interest rates rise.[9]

17. **Major banks' core profitability remains weak compared to internationally active banks in other industrial countries**. For example, return on assets is only about one-third to one-half that of large U.S. banks. Low core profitability is due mainly two factors:

- ***Large-scale prime corporate lending***, which absorbs capital but produces little revenue. Margins for comparable loans are similar in Japan to those in other industrial countries, but Japanese banks have loan portfolios that are heavily concentrated in low-yielding, big company lending. A significant improvement in banks' core profitability depends on shifting these loans to securities markets, by repackaging and selling loans to institutional investors and other nonbank institutions, and expanding more profitable operations, such as consumer and small company lending. Weak profitability is not due primarily to high costs: Japanese major banks have relatively low ratios of costs to revenues, reflecting relatively few staff and small branch networks.[10] Most market analysts' assessment is that banks' existing plans to raise core profitability do not put sufficient emphasis on a reorientation of loan portfolios, as reflected in the weakness of bank stock prices.

- ***Large-scale public financial intermediation***. The significant roles played by the government's Housing Loan Corporation in mortgage lending and the Postal Savings System in deposit-taking result in public financial institutions accounting for about one-quarter each of personal financial assets and household borrowing. Postal savings deposits pay attractive rates and are viewed as being backed by the full faith and

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[8] At present, most banks report the value of their equity holdings at the cost of acquisition, which limits the downside exposure of their balance sheets, though banks using this valuation method may not include any unrealized gains as part of capital.

[9] A 100 bps rise in JGB yields—as occurred between October 1998 and January 1999—would lead to a valuation loss at major banks of about ¥1.1 trillion (about one-third of operating profits or less than 5 percent of Tier-1 capital). By comparison, a 1,000 point fall in the Nikkei stock price index would reduce the market value of equity holdings by about ¥2.2 trillion.

[10] The average ratio of operating costs to revenues (excluding realized gains on investment bonds) was 61 percent for Japanese city banks in 1999, compared to 68 percent for U.S. money center banks (see Atkinson, Ishida, and Ishii 2000).

credit of the government, even though the Postal Savings System pays no taxes or deposit insurance premia, and is not subject to capital adequacy requirements.[11] At the same time, the importance of post offices as providers of essential financial services to outlying areas is unclear, as only 9 of Japan's 3,255 municipal units (cities, towns, and villages) lack any private retail banking facility (see Kuwayama, 1999). The proposed reform of the Fiscal Investment and Loan Program (FILP) only separates its financing from the Postal Savings System and does not address the size of public financial intermediation.

Announced Mergers

18. **During the past year, four mergers between major banks have been announced, which will create four of the five largest banks in the world in terms of assets.**[12] Mizuho Bank will combine Dai-Ichi Kangyo Bank, Fuji Bank, and Industrial Bank of Japan; Sumitomo Mitsui Bank will combine Sumitomo Bank and Sakura Bank; Mitsubishi Tokyo Group will combine Bank of Tokyo-Mitsubishi, Mitsubishi Trust, and Nippon Trust; and a yet-to-be-named entity will combine Sanwa Bank, Tokai Bank, and Toyo Trust. With these mergers, the ten city banks that existed before the 1997–98 financial crisis will be reduced to five, not counting Daiwa Bank, which is pursuing a regionally-oriented strategy (Table IV.4). Even though the four merged banks would together comprise more than 80 percent of major banks' total deposits (Table IV.5), anti-competitive concerns would seem to be limited, as major banks as a whole comprise only about 40 percent of the private banking system in Japan (and only about 30 percent if the postal savings system is included) and the Big Bang financial deregulation is creating more opportunities for both investors and borrowers.

19. **The planned mergers hold the promise of accelerating the pace of bank restructuring and generating significant economies of scale and scope**. All of the mergers offer the potential for consolidation of spending on information systems, the realization of important synergies between different banking specializations (commercial, investment, and trust banking) and geographical strengths of the component banks, and reductions in employment and overlapping branch networks. By cutting across traditional corporate groupings (*keiretsu*), the Sumitomo-Sakura merger—which links the historically rival Sumitomo and Mitsui corporate families—could also quicken the pace of corporate restructuring. To the extent that the merger encourages the weakening of *keiretsu* loyalties,

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[11] Long-term 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 savings 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 savings deposits.

[12] The previously-announced merger between Chuo Trust and Mitsui Trust took place as planned in April 2000, creating Chuo Mitsui Trust Bank.

Table IV.4. Japan: Changing Banking Landscape

Major banks		
As of September 1997	Action	Following mergers
Dai-Ichi Kangyo Bank Fuji Bank Industrial Bank of Japan	Merger announced	Mizuho Bank
Sumitomo Bank Sakura Bank	Merger announced	Sumitomo Mitsui Bank
Bank of Tokyo-Mitsubishi Mitsubishi Trust Nippon Trust	Merger announced	Mitsubishi Tokyo Group
Sanwa Bank Tokai Bank Toyo Trust	Merger announced	Sanwa-Tokai-Toyo
Asahi Bank	...	Asahi Bank
Daiwa Bank	Withdrawal from international operations	Daiwa Bank
Hokkaido Takushoku Bank	Closed	...
Long-Term Credit Bank	Nationalized	Sold to Ripplewood Holdings Renamed Shinsei Bank
Nippon Credit Bank	Nationalized	Expected to be sold to Softbank
Chuo Trust Mitsui Trust	Merged in April 2000	Chuo Mitsui Trust
Yasuda Trust	Became subsidiary of Fuji Bank	...
Sumitomo Trust	...	Sumitomo Trust

Table IV.5. Japan: Deposits of Major Banks 1/

(data are for March 2000)

Pre-merger			Post-merger		
	(Y trillion)	(percent)		(Y trillion)	(percent)
Bank of Tokyo-Mitsubishi	49.8	13.2	Mizuho Bank	110.3	29.3
Dai-Ichi Kangyo Bank	35.4	9.4	Sumitomo Mitsui Bank	69.6	18.5
Sanwa Bank	34.8	9.2	Mitsubishi Tokyo Group	65.5	17.4
Sakura Bank	34.2	9.1	Sanwa-Tokai-Toyo	65.1	17.3
Sumitomo Bank	35.4	9.4	Chuo Mitsui Trust Bank	16.4	4.4
Fuji Bank	40.2	10.7			
Industrial Bank of Japan	27.3	7.2	Other banks	49.4	13.1
Asahi Bank	21.9	5.8			
Tokai Bank	21.0	5.6			
Daiwa Bank	13.0	3.5			
Trust banks	63.3	16.8			
Of which : Mitsubishi Trust	15.0	4.0			
Of which : Nippon Trust	0.7	0.2			
Of which : Toyo Trust	9.3	2.5			
Of which : Yasuda Trust	7.4	2.0			
Total	376.3	100.0	Total	376.3	100.0

Source: Fitch IBCA and staff calculations.

1/ Figures include deposits, certificates of deposit, debentures, and commercial paper.

banks could accelerate the process of bad loan disposal and their credit decisions could improve significantly, which would increase pressure on corporates to strengthen their performance.

20. **However, the impact of the mergers will depend crucially on how much strategic reorientation and restructuring are actually achieved**. While some cost-cutting is desirable, as banks adjust to new competitive pressures such as internet banking, the Japanese banking system already compares favorably with those in other major advanced countries in terms of number of staff or branches. Delivering on existing plans may prove to be more complicated than expected, as past mergers have encountered significant difficulties.[13] Finally, the merger plans do not put much emphasis on shifting low-yielding corporate lending to securities markets.

Nationalized Banks

21. **The two long-term credit banks that were nationalized in 1998 are being reprivatized.**[14] Long-Term Credit Bank (LTCB) was sold in March 2000 to a group of investors led by U.S.-based Ripplewood Holdings, which specializes in corporate turnarounds, and was renamed Shinsei (meaning rebirth) Bank in June. The government has reached a tentative agreement on the sale of Nippon Credit Bank (NCB) with a group of investors led by Softbank, which is one of Japan's most aggressive sponsors of internet businesses and is itself planning a rapid expansion of financial services delivered over the internet.[15] The key elements of the agreements reached between the authorities and the private purchasers were as follows:

- **The new banks' Tier-1 capital** includes ordinary voting shares purchased by the investors, convertible preferred shares contributed by the DIC, and the realization of capital gains on equities portfolios.[16] Tier-1 capital does not include any deferred tax assets. The new banks' capital adequacy ratios are about 13 percent.

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[13] For example, DKB, the product of a 1971 merger between Dai-Ichi Bank and Nippon Kangyo Bank, reportedly remains divided between its two constituent camps. More recent mergers, including Sakura Bank (Mitsui Bank and Taiyo Kobe Bank in 1990), Asahi Bank (Kyowa Bank and Saitama Bank in 1991), and Bank of Tokyo-Mitsubishi (Bank of Tokyo and Mitsubishi Bank in 1996), also are also said to have had trouble paring staff and operations, and melding different business cultures.

[14] Both banks were nationalized in part because their franchises as providers of long-term credit to the industrial sector had largely disappeared.

[15] The other main members of the group are Tokio Marine and Fire Insurance Company and Orix Corporation, a large leasing firm.

[16] The equities portfolios were sold to the DIC, which placed them back with the banks. This arrangement (i) allowed the realization of capital gains, which improved capitalization, (ii)

(continued...)

- **For the first time in Japan, the sales agreements included repurchase agreements,** which help to guard against excessive downside risk from further losses on existing loan portfolios. In both cases, the government will bear losses on existing loans greater than 20 percent of book value (net of reserves) for three years.

- **The total cost to the taxpayer of resolving LTCB and NCB is expected to be about ¥7 trillion ($64 billion),** although there could eventually be capital gains from sales of the DIC's convertible shares.

22. **The reprivatizations of LTCB and NCB represent important steps forward in the process of resolving major banks' problems.** The head of the FRC said that the Ripplewood and Softbank groups' offers were chosen over those of rival bidders because they minimized the taxpayer's burden (least-cost principle). The new Shinsei Bank is expected to focus on fee-generating wholesale operations, such as asset securitization, project finance, and brokering mergers and acquisitions, though foreign investment banks in Japan have reportedly not made much money in these areas. The new NCB is expected to concentrate on making loans to high-tech companies and other start-ups, though this could be an expensive way for Softbank to acquire a banking license. Also, both banks still raise funds primarily through debentures and therefore have weak deposit bases, which may become a problem when interest rates start to rise.

23. **Shinsei Bank recently made use of its repurchase agreement with the government.** LTCB had been an important source of credit for Sogo, a large department store chain, accounting for about ¥200 billion of the retailer's ¥1.7 trillion debt. These loans remained with Shinsei Bank upon reprivatization, but the bank had the right to sell them to the DIC at face value (along with specific loan loss reserves) if loan quality deteriorated significantly. After facing financial difficulties for several years, Sogo asked its creditors in April 2000 to forgive more than ¥600 billion in debt—the largest such request ever made in Japan. The new management of Shinsei Bank declined to grant the request and exercised its put option with the DIC in late June 2000.

Tokyo Tax

24. **The Tokyo municipal government introduced in April 2000 a 3 percent tax on the gross operating profits of large banks.** The tax is expected to yield about ¥110 billion in annual tax revenue to the Tokyo government. However, the impact on banks' after-tax income is expected to be limited, because the new local tax is roughly offset by lower tax obligations on net profits, as the new local tax on gross profits reduces net profits and the tax

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removed the new banks' exposures to the stock market, and (iii) allowed the new banks to retain control of the assets, which protected the franchises that the banks possessed through mutual cross-shareholdings with corporate borrowers.

rate on net profits is reduced by 3 percent.[17] The abruptness of the imposition of the tax may have added to the market's perception of the risk of doing business in Tokyo.

D. Small Banks and Life Insurance

Smaller Deposit-taking Institutions

25. **Many second-tier regional banks and cooperative-type financial institutions have asset quality problems that are more severe than those in large banks.**[18] The summary results of the on-site inspections of second-tier regionals, released in September 1999, showed that bad loan recognition and provisioning were not as advanced as in first-tier regionals. Bad loans (Classes 2–4) at second-tier regionals were found to be 20 percent more than reported in self-assessments, compared to 13 percent more at first-tier regionals. Required loan loss provisions—based on banks' own loan provisioning standards—for these additional problem loans amounted to 1.1 percent of total credit at second-tier regionals, compared to 0.4 percent at first-tier regionals. Average actual provisions were about 50 percent for Class 3 loans to "in danger of bankruptcy" debtors, compared to the FRC guideline of 70 percent.

26. **While a large number of regional banks have raised capital over the past year, capital remains inadequate at many second-tier regionals.** More than one third of regional banks raised capital equivalent to 2 percent of their risk-weighted assets, mostly from private sources, increasing the average capital ratio of first-tier regionals to 10 percent and of second-tier regionals to 8 percent as of March 2000. However, a number of the second-tier regionals still have less than 8 percent capital. Small banks might need higher—rather than lower—capital ratios than large banks, because their lending is more geographically concentrated, making them more vulnerable to adverse shocks.

27. **The authorities have started addressing problems at weak regional banks, through moral suasion, conditional injections of public funds, and interventions:**

- ***Consolidation.*** Reflecting official encouragement, Shonai Bank and Shokusan Bank (both located in the north of Honshu) announced in December 1999 their intention to merge, while North Pacific Bank and Sapporo Bank (both based in Hokkaido) announced in February 2000 a plan to integrate under a holding company.[19] There

[17] Consider the following example: gross profits are ¥500 and expenses are ¥300. Absent the Tokyo tax, net profits are ¥200, the tax on net profits is ¥84 (42 percent), so net income is ¥116. With the Tokyo tax (3 percent of gross profits generated in Tokyo, say 50 percent), net profits are ¥193, the tax on net profits is ¥75 (39 percent), so net income is ¥117.

[18] Second-tier regional banks and cooperative-type financial institutions together account for 40 percent of deposits.

[19] Regional banks generally have higher expense ratios than major banks, mostly because of more extensive branch networks (relative to asset size), so there could be scope to cut costs.

have also been several announcements of joint information technology projects, starting with Bank of Fukuoka and Hiroshima Bank in August 1999.

- ***Recapitalization with public funds***. Six banks (Ashikaga, Hiroshima-Sogo, Hokkaido, Hokuriku, Kukamoto Family, and Ryukyus) submitted restructuring plans and received a total of ¥335 billion in public funds over the past year. The restructuring plans included employment cuts of 12–16 percent, mostly through attrition and curbs on new hiring, branch reductions of 14–21 percent, declines in bonus payments, cuts in the size of boards of directors, increases in lending margins, and greater lending to small and medium-sized enterprises. The DIC purchased preferred shares, convertible subordinated debt, or a combination thereof, and the banks also raised capital from private sources, raising their capital ratios to above 8 percent.

- ***Interventions***. Over the past year, the FSA intervened in five banks (Kokumin, Kofuku, Niigata Chuo, Tokyo Sowa, and Namihaya). The government recently reached preliminary agreements to sell both Kofuku and Tokyo Sowa banks to a U.S. investment group.

28. **However, consolidation among smaller banks is occurring more slowly than among major banks**. Local communities are reluctant to see any change in the status of "their" bank, while zero interest rates reduce the franchise value of "owning" depositors and thus make regional banks less attractive targets for takeovers. Some banks have even persuaded closely-aligned firms to "exchange" deposits for equity, out of concern for the availability of local credit and employment. Also, as in the nonfinancial sector, labor costs are difficult to cut.

29. **The tools for addressing problems in credit cooperatives are now being put into place**. Credit cooperatives came under the jurisdiction of the FSA in April 2000. The FSA—in cooperation with local finance bureaus—plans to conduct on-site inspections of all credit cooperatives by March 2001. Legislation was recently enacted that allows credit cooperatives to issue preferred equity securities (similar to preferred shares issued by banks) and to apply for public funds (until March 2002). Related legislation allows the use of reorganization proceedings under the Commercial Code to deal with failed institutions.

Life Insurance

30. **The overall financial strength of the life insurance sector has continued to deteriorate, reflecting ongoing negative spreads**. Premium income, net investment income, and insurance in force all fell in FY1999. The Japan Rating and Information Service, which rates the claims-paying ability of most large and medium-sized life insurers, assigned investment grades to almost all large life insurers, but to fewer than half of medium-sized life

insurers (Table IV.6). Some companies have announced plans to reorient their business from term life products to taking care of the retirement and healthcare needs of an aging population.

Table IV.6. Ratings of Life Insurance Companies
(ranked by size)

	Claims-paying ability
Nippon Life	AA
Dai-Ichi Mutual Life	A+
Sumitomo Life	A
Meiji Mutual Life	A
Asahi Mutual Life	BBB+
Mitsui Life	BBB+
Yasuda Life	A+
Chiyoda Mutual Life	B+
Taiyo Mutual Life	A
Kyoei Life	B+
Daido Mutual Life	AA-
Fukoku Mutual Life	A+
Nippon Dantai Life	...
Daihyaku Mutual Life	B
Tokyo Mutual Life	BB

Source: Japan Rating and Investment Service, as reported in the Nikkei Weekly, 9/13/1999.

31. **The authorities have made progress in addressing the problems of life insurance companies.** Following the implementation of stricter disclosure standards in April 1999, the FSA began on-site inspections of loan portfolios using stronger examination standards in May 1999, which is leading to more realistic recognition of and provisioning for bad loans. The FSA intervened in Toho Mutual Life in June 1999 and in Daihyaku Mutual Life in May 2000. According to press reports, the FSA also ordered Taisho Life Insurance Company to submit a rehabilitation plan, after the inspection revealed serious weaknesses. Toho's negative net worth (about ¥650 billion) was covered by the Life Insurance Policyholders Protection Corporation (about ¥380 billion) and a reduction in future guaranteed rates of return on life insurance policies (about ¥270 billion). GE Edison Life took over Toho's policies in March 2000. Separately, Aoba Life—the successor of Nissan Mutual Life, which failed in April 1997—was sold in November 1999 to Artemis, the holding company of the French retail group Pinault-Printemps-Redoute.

32. **Legislation was enacted that strengthens the regulation of life insurers and allows them to apply for court-supervised rehabilitation**. Under the new law, life insurers are required to project over five years the main components of their balance sheets and report these to the FSA. At the same time, life insurers are allowed to apply for reorganization under the Corporate Rehabilitation Law and—with court approval—to lower future guaranteed rates of return on policies. The legislation also facilitates the procedures for mutual insurance companies, which are owned by their policyholders (making it difficult for management to raise capital or sell the business), to reorganize as ordinary stock corporations (demutualization). Finally, the legislation increased the government-guaranteed borrowing limit of the Life Insurance Policyholders Protection Corporation by ¥500 billion, as its notional resources have been exhausted by the failure of Toho, and made the guarantee permanent. The government's guarantee of the fund's borrowing—enacted in December 1998—is expected to be withdrawn in March 2001, as originally planned.

33. **The sale of some insurance products through banks, which will be allowed as of April 2001, is expected to increase competition and link the reorganization of the**

insurance industry with that of the banking sector.[20] Hitherto, life insurers have sold policies mostly through salespeople. Anticipating the regulatory change, some insurers have begun strengthening ties with banks, so that these banks will sell their insurance products. The reorganization of marketing systems, especially in-house sales staff, is expected to be key to long-term survival.

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[20] For example, banks will be allowed to sell life insurance products linked to mortgages and fire insurance for home owners.

V. Structural Reform and Deregulation[1]

A. Overview

1. **Structural reform and deregulation have been actively pursued in Japan over a number of years, especially since the Hosokawa administration in 1993.** Recognizing the need for structural reform to reinvigorate the economy, the authorities began developing specific action plans for deregulation. Since then, two three-year deregulation programs (FY1995–97 and FY1998–2000) have been set out and several economic stimulus packages have contained deregulation measures. In 1996, the Hashimoto administration launched a comprehensive structural reform initiative, covering six areas: government administration, economic structure, financial system, fiscal structure, social security, and education (later added), which continues to guide the reform agenda. At the same time, the Regulatory Reform Committee (RRC), the Economic Strategy Council (ESC), the Industrial Competitiveness Council (ICC), and the Economic Council (EC) have provided input into the government's reform efforts (Box V.1).

2. **The following sections discuss recent developments in the field of structural reform and deregulation.** Sections B through D describe steps taken to facilitate corporate restructuring and regulatory reform more broadly, as well as developments in government administrative reform.[2] Section E draws a brief road map for further regulatory reform in Japan that would provide a foundation for sustained economic growth in the future.[3]

B. Corporate Restructuring

3. **The main measures put in place over the past year to facilitate corporate restructuring include the following:**

- **The Industrial Revitalization Law (IRL),** which came into effect in October 1999, offered incentives for corporate restructuring, including through capacity cuts and the pursuit of new business lines. The law provided an extended period of loss carry-forward, accelerated depreciation for new investments, and loan guarantees to firms whose restructuring plans are approved by the authorities. Applications need to be made before the expiration of the law on March 31, 2003.

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[1] Prepared by Takashi Nagaoka (ext. 37613).

[2] Reforms in the fiscal area and financial system are covered in chapters II and IV, respectively.

[3] A rough estimate by the Economic Planning Agency in 1999 suggested that deregulation over FY1990–97 had expanded demand by ¥8.2 trillion per year on average and allowed consumers to save ¥6.6 trillion over 8 years due to lower prices.

Box V.1. Major Councils on Regulatory Reform

The Regulatory Reform Committee (RRC), previously the "Deregulation Committee," was established in January 1998 as the principal vehicle for regulatory reform discussions. 12 members (originally 7) include representatives from the business, labor, and academic communities. The current government program, the "Three-Year Program for Promoting Deregulation (FY1998–2000)," was revised at the end of FY1998 and 1999, on the basis of the RRC's recommendations. Measures taken under the current and preceding (FY1995–1997) programs include the liberalization of the mobile phone, transportation, distribution, and power industries. The financial sector measures implemented under the Big Bang initiative also were part of these programs.

The Economic Strategy Council (ESC) was established in August 1998 to formulate a comprehensive strategy to revive the economy and to build a prosperous economic society in the 21st century. The members comprised 10 business leaders and academics. The ESC report of February 1999, "Strategies for Reviving the Japanese Economy," listed 234 proposals with indications of the necessary legislative response, in three strategic steps.

- First step: Period for intensively dealing with the legacy of the bubble economy (FY1999–2000). Macroeconomic policies should place priority on economic recovery and stabilization of the financial system.
- Second step: Period for returning to growth path and regaining the health of the economy (FY2001–2002). Macro policy stance should be shifted to neutral, once the economy is back to an autonomous recovery path.
- Third step: Period for full-fledged revival of the economy through fiscal consolidation and structural reform (by FY2003).

Many of the measures in the November 1999 stimulus package, including the early submission of bills to facilitate corporate restructuring, reflected the recommendation of the ESC.

The Industrial Competitiveness Council (ICC) was established in March 1999 to evaluate ways to enhance competitiveness of Japanese industries and productivity. The members consisted of 16 Ministers and 17 business leaders. Many ICC recommendations were reflected in the government's policy package of June 1999 to promote employment and support corporate restructuring. In addition to the creation of 700,000 new jobs, renewed focus on job training, and revision of unemployment insurance, the June package included important legislation geared to liberalizing job placement services and worker-dispatching business, facilitating business transfers, and providing economic incentives for corporate restructuring.

The Economic Council (EC), a permanent advisory group reporting to the Prime Minister on the medium- to long-term conduct of economic policy, consists of 23 members. The EC submitted a report, "Ideal Socioeconomy and Policies for Economic Rebirth," in July 1999. The report provided a vision of the economy in 10 years time, dealing with issues such as the establishment of a "knowledge-based" economy, change in Japan's demographics, globalization, and environmental concerns. Its advocated policy guidelines include:

- establishing transparent and fair markets and creating internationally attractive business environment;
- securing variety and dynamism through acceptance of foreign labor;
- promoting scientific technology;
- establishing a secure and efficient social security system;
- imposing environmental principles;
- proactively contributing to the WTO discussion and rule-setting in the international financial market;
- improving transparency and efficiency of government.

- **The Commercial Code** was amended in May 2000 to facilitate corporate spinoffs. The amendment complemented earlier measures to provide flexible options for restructuring, such as rationalization and simplification of the merger process (FY1997) and introduction of equity swaps to facilitate reorganization under holding companies (FY1999).

- **The Civil Rehabilitation Law (CRL)** replaced the former Composition (*Wagi*) Law on April 1, 2000, with provisions resembling those of Chapter 11 in the United States.[4] The law was based on the debtor-in-possession (DIP) principle and expedited procedures to facilitate reorganization, especially among small- and medium-sized enterprises.[5] The DIP principle should encourage the management of ailing firms to start the reorganization process before excessive deterioration of their business. The new law is expected to shorten the court process to around 5 months from 12–14 months previously, lowering the costs for applicants.

- **Accounting standards** are being strengthened significantly. Consolidated financial statements were introduced from April 1999.[6] Valuation based on fair market values ("marking-to-market") is being phased in—on plan assets for employees' retirement benefits, marketable securities, and held-to-maturity debt securities from April 2000, and on other securities held for cross-shareholding purposes from April 2001. These reforms will improve market discipline by enhancing transparency.

- **Labor laws** have been relaxed to enhance mobility and improve the reallocation of labor. Restrictions on job categories for worker-dispatching businesses were mostly lifted in December 1999, although with a limit on the maximum work period.[7] Private job placement services were also liberalized for a broader range of job categories (December 1999). Also, changes in unemployment insurance, effective April 2001, focused on discouraging voluntary unemployment while easing transitional costs on fired workers, thus making it less difficult for firms to shed excess labor.[8]

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[4] Levy (2000b) discusses bankruptcy reform in Japan.

[5] Larger firms tended to file under the Corporate Reorganization (*Kaisha-Kosei*) Law, but this was too costly for smaller firms in terms of money and time.

[6] Accounting standards introduced in April of a particular year are reflected in financial statements released after the closing of that financial year (i.e., after March 31 of the following calendar year).

[7] Exceptions included harbor transportation, construction, security, manufacturing, and medical-care.

[8] The maximum duration of unemployment benefits was increased by 30 days for the involuntarily unemployed, although it was reduced from 300 days to 180 days for the voluntarily unemployed.

4. **The corporate sector has begun to respond to these reform initiatives.** An increasing number of announcements of restructuring plans among major enterprises reflect efforts to cut input and labor costs, focus on core businesses, and search for new profitable opportunities. About 40 applications from a wide variety of companies were made under the IRL through the end of May 2000. Filings for reorganization under the new CRL, mostly from construction and manufacturing companies, are running at an annual rate of about 600, compared to about 300 annual cases under the old Composition Law. There is also growing evidence of voluntary implementation of the improved accounting standards by some large firms, even before the rules become mandatory.

C. Regulatory Reform

5. **Underlying the regulatory reform process is the principle of shifting from prior approval to retrospective supervision.** The regulatory approach in the past imposed direct regulations through prior approval and related administrative actions. In contrast, the new approach will set out clear and specific rules, while conducting supervision only *ex post* on the compliance with the rules. The shift requires more than simply abolition of existing regulations, but also reform of the approach to regulation.

6. **A number of regulatory reforms were put in place based on the "Three-Year Program for Promoting Deregulation (FY1998–2000)."** As of October 1, 1999, half way through the program's duration, about 80 percent of the 917 reforms listed had been started, while 50 percent had been completed. Major achievements include the following:

- **NTT** was split into three providers (two local and one long-distance) under a holding company structure, in July 1999. To reduce telecommunications costs more broadly, legislation in May 2000 modified the calculation method for network connection charges, which should result in reductions in access charges by over 20 percent over a 2-year period starting end-2000.

- A number of steps have been taken to deregulate the **transportation sector**. The liberalization of **air transport**, effective April 2000, eased the requirement for opening up new air routes from prior approval to registration, and granted airlines freedom in their pricing decisions. **Trucking businesses** were permitted to operate in wider zones in early 1999, while the door is to be opened to smaller entrants in FY2000, by reducing minimum requirements on truck ownership. Entry into **coastal shipping** is to be liberalized in October 2000, while the restriction on entry to **shipping by rail** is to be abolished in three years time.

- **Independent power producers (IPP)** were allowed to enter the large-customer retail business from March 2000. Further measures are in train to achieve the goal of bringing down electricity tariffs to internationally comparable levels by FY2001, as stipulated in the Action Plan for Economic Structure Reform of 1997. The plan called for the increase in the ratio of average load capacity to maximum load capacity and a more efficient distribution system to lower the electricity costs.

- On **agriculture**, legislation was enacted to allow private sector entry into the inspection of agricultural products (effective April 2001). A proposal to permit corporations to own agricultural land was submitted to the Diet, but has not yet been legislated. In the future, efforts are expected to focus on replacing price subsidies with direct income aid, based on the principles stipulated in the Basic Law on Food, Agriculture and Rural Areas (July 1999).

- A new regulatory scheme on **large-scale retail stores** came into effect in June 2000. The new law, which replaced the Large Scale Retail Store Law, transferred the regulatory authority regarding large scale retailers to local governments. Depending on local preferences, the new law has the potential to expand the number of large-scale retail sellers in Japan.

- To deal with an incipient shortage of lawyers, **the cap on the number of prospective lawyers** passing the bar exam each year was increased to 1,000 in FY1999, from 800 in FY1998 and 700 before that.

7. **The government expanded the current deregulation program at the end of March 2000**, increasing the number of items from 917 to 1,268. The newly added items included:

- Establishing clear and objective criteria for the allocation of flight slots in overcrowded airports;

- Reviewing recent legislation to enhance labor mobility and restrictions on employee discharges;

- Further encouraging private sector entry into the nursing care business;

- Relaxation of various conditions for qualifying examinations, and subsequent increase in the number of qualified practitioners, including accountants; and

- Liberalizing the management of schools, and facilitating the hiring of foreign language trainers.

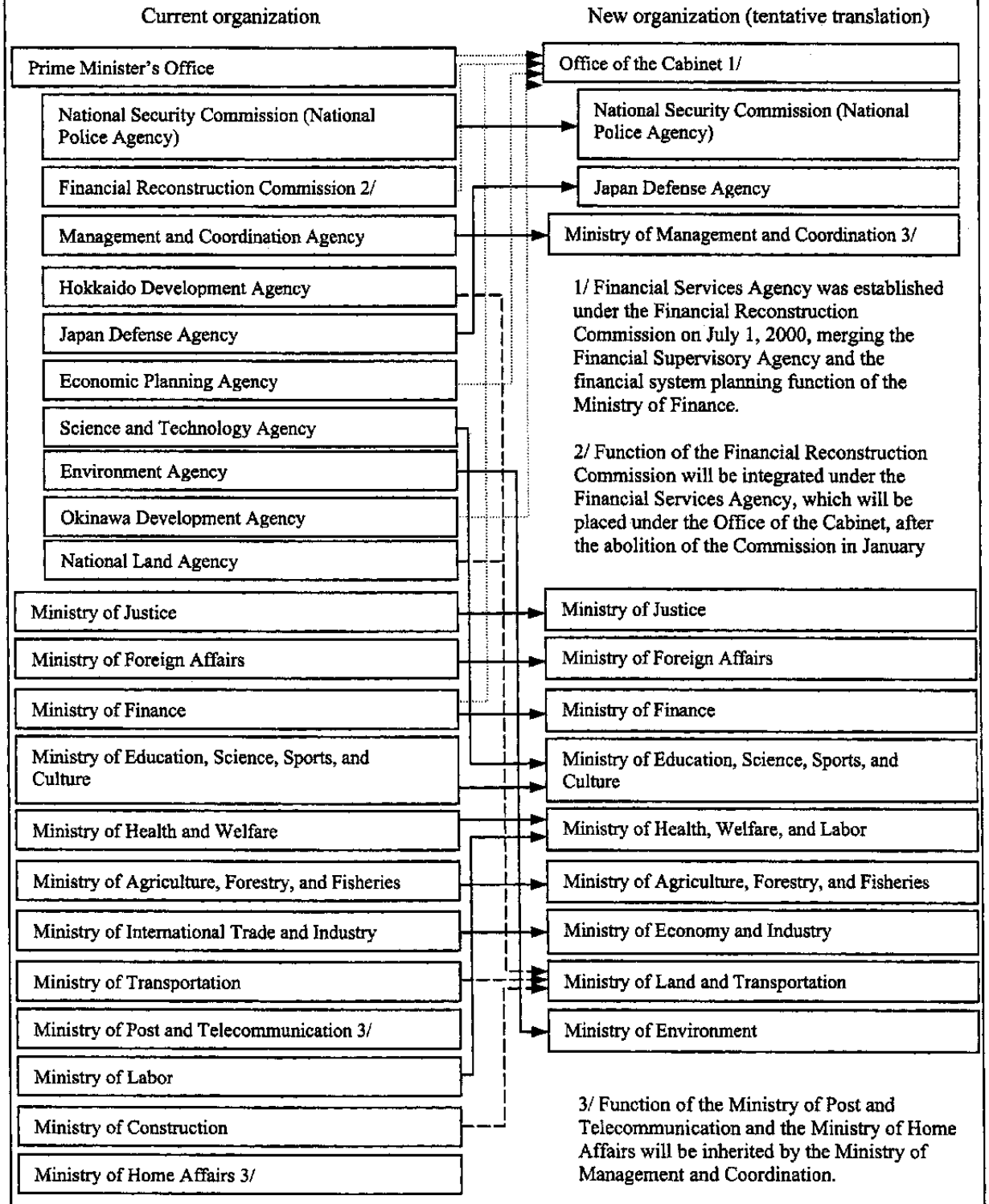
D. Administrative Reform

8. **The reform of government administration is on track following plans laid out in legislation in June 1998**:

- **Preparations are underway for the reorganization of the central government to slim down the bureaucracy**. Legislation in December 1999 completed the legal arrangements for the reorganization, supplementing prior legislation. The number of ministries and agencies will be reduced from 23 to 13 by January 6, 2001 (Box V.2). Some governmental business operations, such as the management of museums and

Box V.2. Reorganization of Central Government

The number of the central government ministries and agencies will be reduced from 23 to 13 on January 6, 2001, following the agenda stipulated in the Basic Law for Government Reform in June 1998 and succeeding laws on the specifics in July 1999.



Source: Nihon Keizai Shimbun, and Mainichi Shimbun.

hospitals, will be separated into 56 independent administrative corporations in April 2001 to trim down the government's role while securing independence and enhancing efficiency.

- **A 25 percent reduction of the number of civil servants is planned by FY2008.** A 10 percent cut will be achieved through limiting recruitment, while the remainder will be secured through the creation of independent administrative corporations. The implied increase in workload on the already small government workforce relative to population size would be addressed by reducing government responsibilities through deregulation and administrative reform. Japan already has many fewer government employees per capita than other G7 countries.[9]

- **In line with the central government reorganization, the number of public corporations with special legal status has been reduced** through mergers and closures. As of October 1, 1999, such entities amounted to 78, down from 92 in 1995, including as a result of the merger that established the Japan Bank for International Cooperation and the Development Bank of Japan.[10] Among the remaining corporations, 24 are expected to downsize their operations.

- **Transparency of government operations will be improved by allowing public access to information held by government from April 2001.** The Law Concerning Access to Information Held by Administrative Organs, legislated in May 1999, established a process for the public to request the disclosure of administrative documents, thereby improving the transparency of government operations.

E. Remaining Agenda

9. **The need for comprehensive reform plans has been voiced by a variety of observers, including in the 1999 OECD report on deregulation.**[11] The priorities are:

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[9] According to a study by the Management and Coordination Agency, Japan's government employees (including national and local civil servants and employees in government corporations, but excluding those in the military) per 1,000 population was 36, compared to 87, 59, 76, and 67 for France, Germany, the United Kingdom, and the United States, respectively, as of FY1998.

[10] The Export and Import Bank of Japan and Overseas Economic Cooperation Fund merged into Japan Bank of International Cooperation, and the Japan Development Bank and the Hokkaido-Tohoku Development Finance Corporation merged into Development Bank of Japan, both on October 1, 1999.

[11] For a summary of the OECD report, see Chapter V on Structural Reforms and Deregulation in the 1999 *Economic and Policy Developments Paper* (IMF Staff Country Report No. 99/114).

- Further liberalization of the distribution network could help to improve efficiency in the **power sector**. The action plan of 1997 targeted a reduction in electricity tariffs from among the highest levels in the OECD to internationally comparable levels by FY2001, in order to enhance competitiveness of Japanese firms. Nevertheless, the price of electricity in Tokyo (for households) is reported to be about 40–60 percent higher than in New York, London, or Paris. As the differences owe to high costs of distribution rather than power generation, liberalization of the distribution network to new entrants, in addition to allowing IPP's entry into the large-lot retail market, has the clear potential to reduce power costs.

- There is further room for price reductions in the **telecommunications sector**. Overall residential telephone service charges in Tokyo are about 20–30 percent higher than in major European cities, and even higher for private high-speed digital lines and internet access compared to U.S. and European cities. Given that the high network connection fees imposed by NTT are one of the major causes, further reductions in NTT's network access charges are critical for bringing down telecommunications costs to international levels by FY2001 (Action Plan of 1997), and to nurture the IT-based economy.

- On **agriculture**, the Basic Law on Food, Agriculture and Rural Areas emphasizes the need to secure a stable food supply as well as to improve agricultural productivity. Passage of legislation to permit corporations to own agricultural land would help introduce much needed economies of scale in farming.

- Further liberalization of the **labor market** to promote flexibility would provide firms with broader options in their efforts to restructure. While the authorities have passed a revised law governing dispatched workers, the new law still has a number of restrictions, for example the limits it places on the maximum work period for such workers and the range of sectors. Also, while the current Labor Standards Law does not impose severe restrictions on labor shedding, judicial precedents suggest substantial difficulties on the part of companies to lay off workers as part of restructuring.

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