© 2001 International Monetary Fund

August 2001
IMF Country Report No. 01/144

Japan: 2001 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2001 Article IV consultation with Japan, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 22, 2001,** with the officials of Japan on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 12, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **August 3, 2001** updating information on recent economic developments.

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during its August 3, 2001 discussion** of the staff report that concluded the Article IV consultation.

The documents listed below will be separately released.

Recent Economic and Policy Developments paper
Selected Issues paper

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to Publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623 7430 • Telefax: (202) 623 7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

JAPAN

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the
2001 Consultation with Japan

Approved by Yusuke Horiguchi and Leslie Lipschitz

July 12, 2001

- This report is based on discussions held in Tokyo during May 10–22. The staff team comprised Messrs. Collyns (head), Ostry, Callen, Mühleisen, Kalra, Nagaoka (all APD), Mr. Hayward (MAE), and Mr. Hunt (RES). Mr. Yoshimura (Executive Director) and Mr. Toyama (Alternate Executive Director) also took part in the discussions. Supporting information and analysis are provided in companion papers on *Economic and Policy Developments* and *Selected Issues*. A small staff team will return to Tokyo in late July for an update on economic and policy developments.
- The team met with senior officials at the Cabinet Office (CAO); Ministries of Public Management, Home Affairs, Posts and Telecommunications (MPHPT); Finance (MoF); Health, Labor and Welfare (MHLW); Agriculture, Forestry and Fisheries (MAFF); Economy, Trade and Industry (METI); and Land, Infrastructure, and Transport (MLIT); the Financial Services Agency (FSA); the Fair Trade Commission (FTC); the Bank of Japan (BoJ); the Deposit Insurance Corporation (DIC); the Resolution and Collection Corporation (RCC); and with business and financial sector representatives.
- The Managing Director visited Tokyo over May 28–30 and held meetings with Finance Minister Shiokawa, Economics Minister Takenaka, Financial Affairs Minister Yanagisawa, and BoJ Governor Hayami.
- Japan has accepted the obligations of Article VIII, Sections 2, 3, and 4. The exchange system is free of restrictions on the making of current international payments and transactions apart from those notified under Decision 144 (see Appendix I).
- Japan has subscribed to the Special Data Dissemination Standard, using a flexibility option on the timeliness of dissemination of data on general government operations.
- The authorities have indicated their willingness to publish this staff report.
- The principal author of this report is Mr. Ostry.

Contents

Page

I. Introduction 3

II. Recent Economic and Policy Developments 4

III. Economic Outlook 19

IV. Policy Discussions 20
- A. Financial Sector Issues 21
- B. Corporate Restructuring and Structural Reforms 26
- C. Fiscal Policy 30
- D. Monetary Policy and Exchange Rate Issues 33
- E. Other Issues 34

V. Staff Appraisal 38

Boxes
1. How Bad is the Bad Loan Problem? 22
2. Barriers to Faster Productivity Growth 27
3. Real Estate and the Macroeconomy 29
4. The Zero Bound on Nominal Interest Rates and its Implications for Monetary Policy in Japan: A MULTIMOD-based Analysis 35
5. The Impact of Yen Depreciation on Asian Countries 36

Figures
1. Selected Real Economic Indicators, 1990–2002 5
2. Indicators of Business Activity, 1990–2001 6
3. Consumption Indicators, 1990–2001 7
4. Information Technology Indicators, 1997–2001 9
5. Indicators of Prices and Labor Market Conditions, 1990–2001 10
6. External Sector Indicators, 1990–2002 11
7. Selected Financial Indicators, 1990–2001 13
8. Monetary and Exchange Rate Indicators, 1990–2001 14
9. Summary of Fiscal Indicators, FY 1990–2005 16

Tables
1. Selected Economic Indicators, 1994–2002 43
2. General Government Operations 44
3. Indicators of External and Financial Vulnerability 45
4. Indicators of Linkages Between Japan and Asia 46

Annexes

I. Fund Relations 47

II. Fiscal Consolidation and Public Debt Stabilization 48

III. Data Issues 51

I. INTRODUCTION

1. **A year ago, a moderate economic recovery seemed finally to be getting under way in Japan in the context of a buoyant global economy.** At the conclusion of the 2000 Article IV consultation last August, Executive Directors urged the authorities to step up structural reforms to secure healthy medium-term growth, while maintaining macroeconomic policy support until the recovery took firm root (Annex I).

2. **Last year's modest recovery has now given way to renewed weakness.** While GDP grew by 1½ percent in 2000, activity has slowed sharply since last summer, as the high-tech driven expansion succumbed to the US and global electronics slowdown. Slow progress with bank and corporate restructuring and questions about the long-term fiscal situation—after a decade of fiscal stimulus—have undercut confidence, while stock price declines and a further deterioration in asset quality have again raised doubts about the stability of Japanese banks. Short-term prospects are bleak, clouded by concerns that Japan could re-enter a cycle of slowing activity, rising bankruptcies, and a deteriorating banking system.

3. **There is now a broad consensus that sustained recovery will not be achieved until the roots of Japan's economic problems are addressed.** As discussed in *Post Bubble Blues* (Bayoumi and Collyns, eds, IMF, 2000), Japan's decade of slow growth in the 1990s reflects both the excess stocks of capital and debt from the bubble years that have yet to be unwound, as well as the slow adjustment to the forces of globalization and technical change, as Japan has lagged in shifting to innovation and productivity as the engines of growth.

4. **The new government under Prime Minister Koizumi that took office in April has made a strong commitment to addressing Japan's deep-seated economic problems.** It has announced wide-ranging plans to accelerate bank and corporate restructuring, to push through fiscal reforms as a first step towards consolidation, and to undertake comprehensive regulatory reform. Moreover, in a clear break with the past, it has signaled that it would not shy away from getting the job done even if this required a difficult transitional period. This said, these are still early days, and much of the government's program remains to be worked out in detail. Moreover, while the government's high degree of popular support provides a window of opportunity to achieve real change, the political situation remains fluid. Important Upper House elections are scheduled for late July, and the government's ability to push through reforms in the face of resistance from vested interests remains to be established.

5. **Against this background, the Article IV consultation discussions focused on identifying the reform priorities to restore the basis for healthy growth over the medium term, and the policies to contain any adverse short-term impact on activity in the near term as bank and corporate restructuring pick up.** The mission strongly supported the authorities' commitment to accelerate restructuring, notwithstanding concerns about Japan's immediate prospects in a period of slowing global growth. There was agreement that the appropriate response to short-term economic weakness was not to dilute or delay restructuring, but rather to implement reforms to expand employment and investment opportunities as the old economy downsizes while maintaining supportive macroeconomic policies. In this regard, the mission stressed the need to tailor the pace of fiscal consolidation to economic circumstances, and for a more vigorous monetary policy to

combat deflationary pressures—particularly critical given the potential for such pressures to intensify as the restructuring process gets underway.

II. Recent Economic and Policy Developments

6. **The Japanese economy expanded by 1.5 percent in 2000 (double the previous year's rate), mainly on account of a turnaround in business investment and net exports** (Table 1; Figure 1). Business fixed investment made the largest contribution, buoyed by an expanding high-tech sector (especially telecommunications and electrical machinery), and underpinned by a double-digit pickup in profits. Exports of IT products also surged, turning the external contribution to growth from a small negative figure in 1999 to a sizable positive number in 2000. Private consumption was stagnant, however, as ongoing corporate restructuring depressed households' take-home pay and the decline in the stock market and pessimism about longer-term prospects dampened consumer sentiment. Residential investment growth was also very modest, despite the extension of mortgage tax relief. Public investment underwent a sharp contraction, especially in the second half of the year, reflecting the waning impact of the November 1999 supplementary budget.

7. **Although the picture for the year as a whole is reasonably clear, the pattern of growth during 2000 is more difficult to discern from demand side data, reflecting continuing problems with data quality**. GDP figures were quite volatile, with a surge in the

Japan: Growth of Real GDP by Component (at 1995 prices)
(Percent change from the previous period)

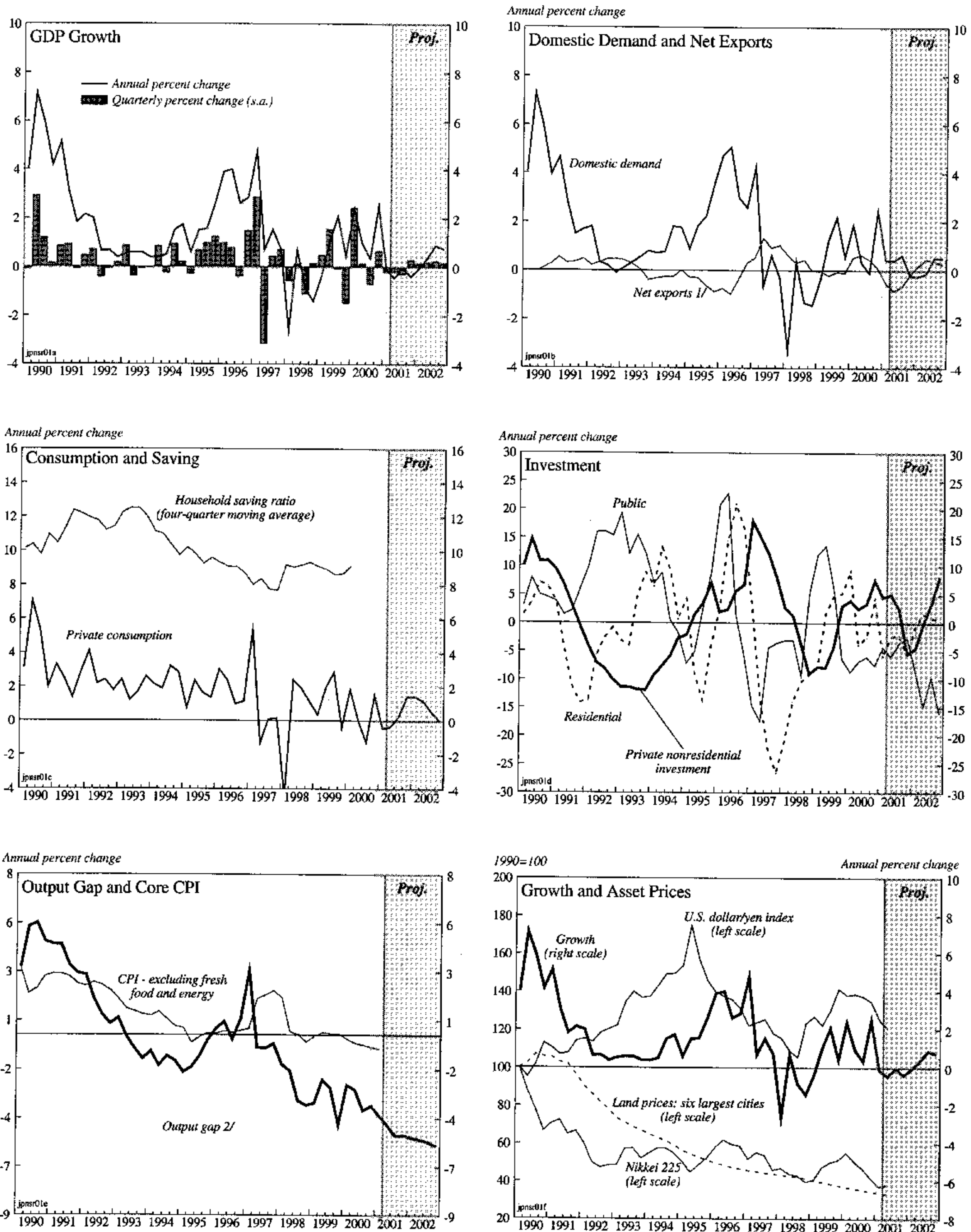
	1980–89 Average	1990–99 Average	1999	2000	2000 Qtr 1	2000 Qtr 2	2000 Qtr 3	2000 Qtr 4	2001 Qtr 1
Real GDP	4.0	1.7	0.8	1.5	2.4	0.1	-0.7	0.6	-0.2
Of which:									
Private final domestic demand	4.4	1.3	0.0	1.4	2.1	-0.7	0.4	1.2	-0.5
Private consumption	3.5	2.0	1.2	0.5	2.0	0.1	0.0	-0.6	0.0
Residential investment	3.8	-2.0	0.8	1.6	4.6	-5.3	0.5	4.5	-5.2
Business fixed investment	8.1	0.4	-4.3	4.4	1.9	-2.5	1.5	6.7	-1.0
Public investment	0.4	4.3	6.1	-7.3	1.5	4.0	-11.9	-0.6	5.2
Foreign balance (contribution)	0.1	0.1	-0.1	0.4	0.4	0.1	-0.1	-0.4	-0.2

Sources: Nikkei Telecom; WEFA; and Nomura database.

first quarter, followed by stagnation in the following two quarters, and then a rebound at year-end. Moreover, the behavior of the individual demand components in the national accounts appears at odds with other indicators—retail sales plunged at the beginning of last year when private consumption supposedly surged, and weakening capital goods production and shipments data seem inconsistent with the fourth quarter pickup in business investment in the national accounts (Figures 2 and 3).[1] This suggests that, despite recent improvements,

[1] Part of the strength of business investment toward the end of last year reflected a rush to finish new stores prior to the implementation of new regulations on store siting.

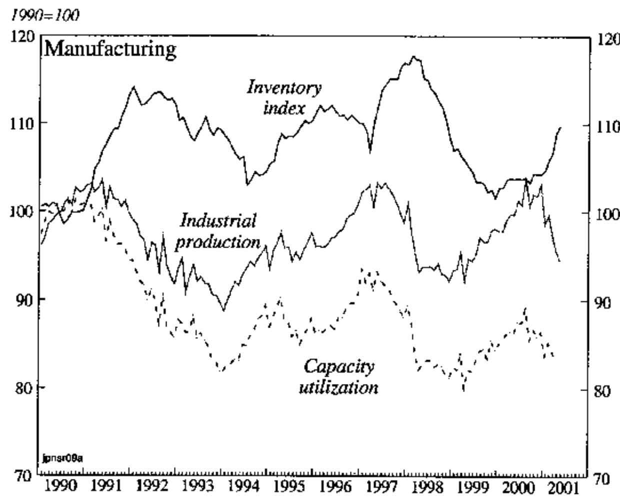
Figure 1. Japan: Selected Real Economic Indicators, 1990-2002

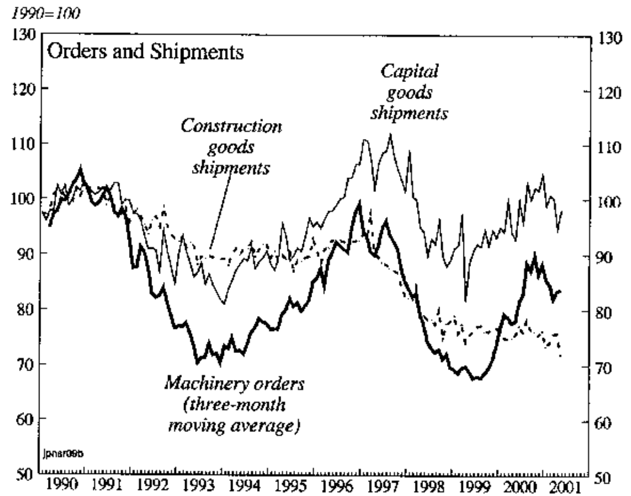


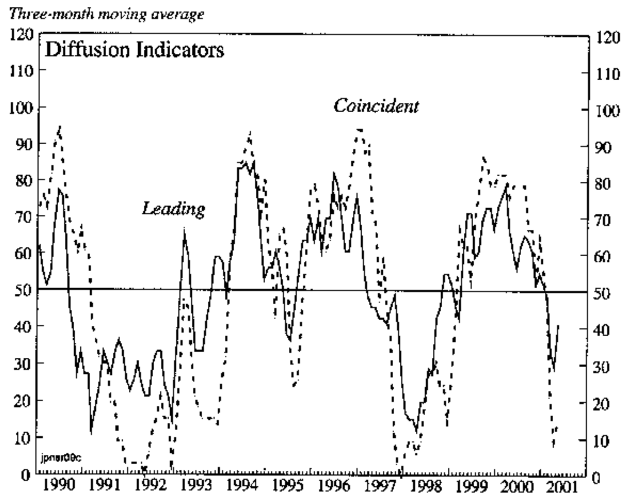
Sources: Nikkei Telecom; and staff estimates.

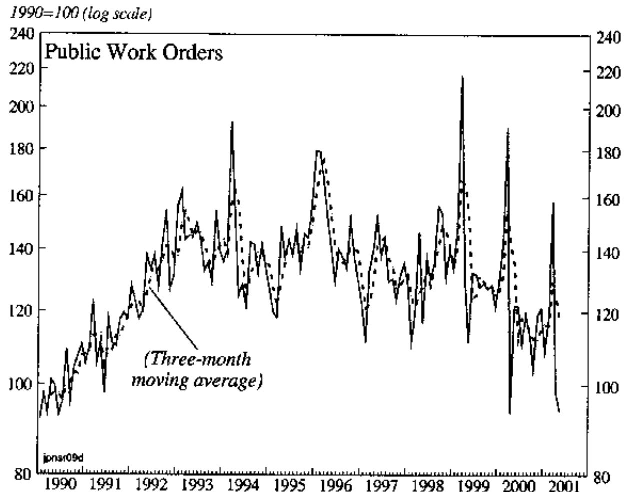
1/ Contribution to GDP growth.
2/ Staff estimates.

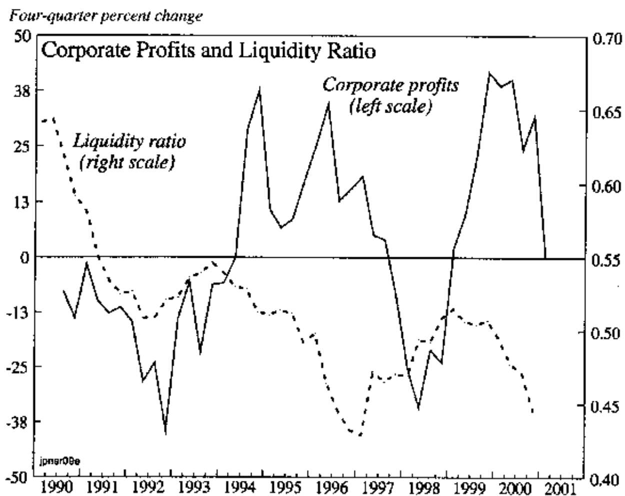
Figure 2. Japan: Indicators of Business Activity, 1990-2001 1/

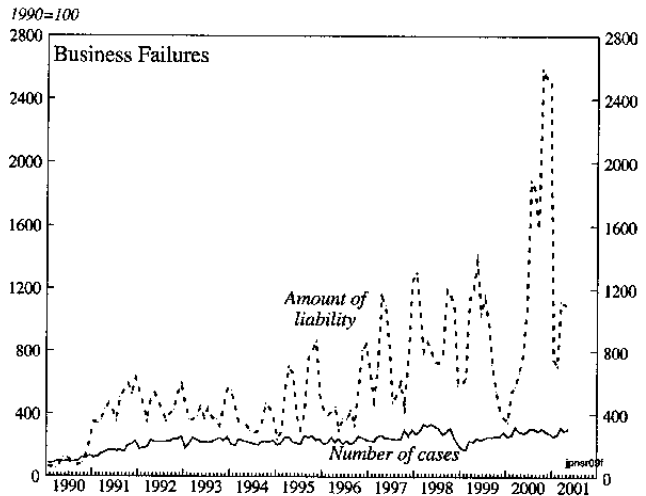








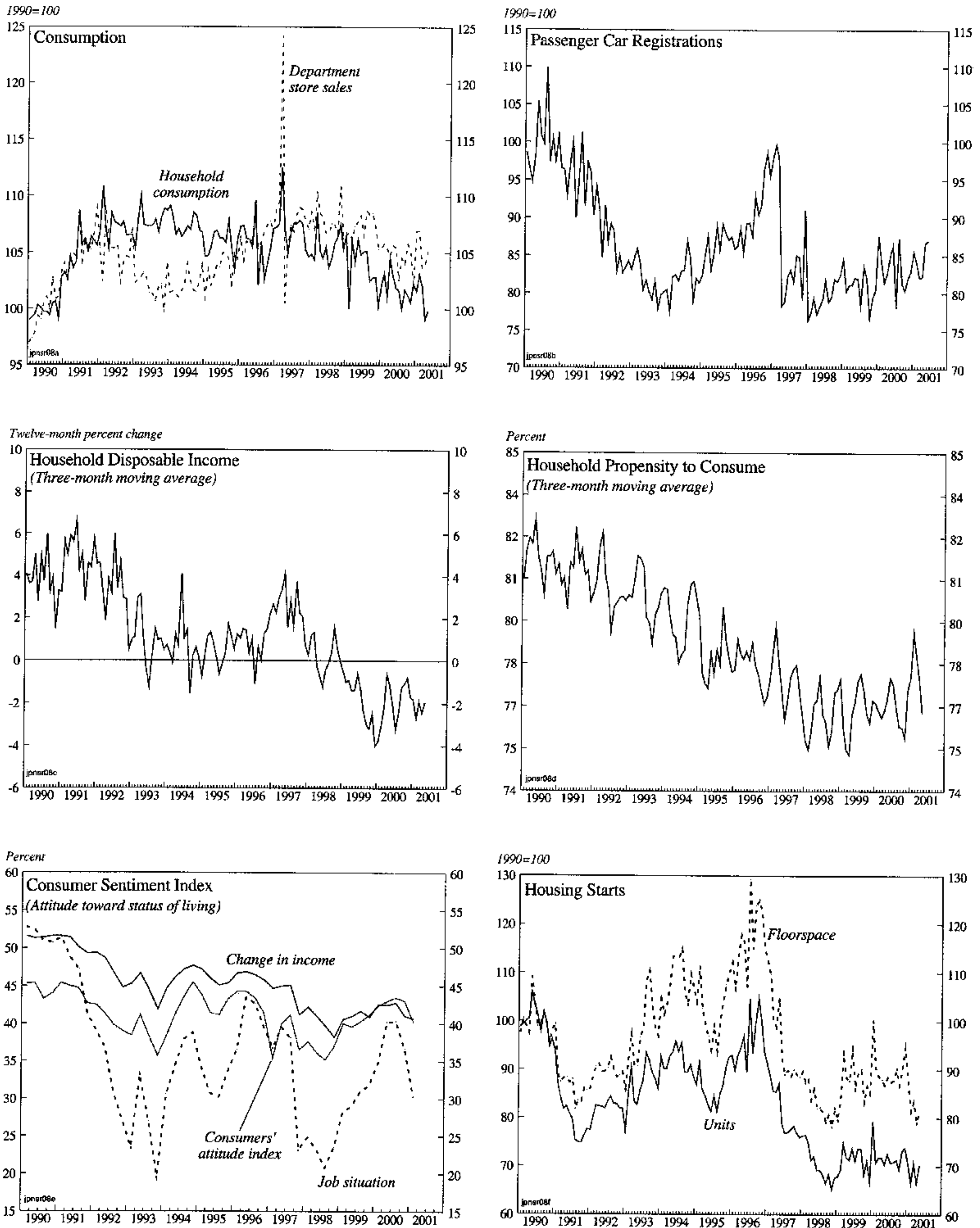




Source: Industrial Statistics Monthly.

1/ Seasonally adjusted data except for diffusion indicators.

Figure 3. Japan: Consumption Indicators, 1990-2001 1/



Sources: Nikkei Telecom; and WEFA.

1/ Seasonally adjusted data.

longstanding problems—including with the coverage of surveys used for the quarterly national accounts—have not yet been fully resolved (Annex III).[2]

8. **The picture that emerges from the production-side data is more clearly that the underlying pace of activity slowed as the year progressed.** Industrial production (IP) and the all-industry index—the best proxy for GDP from the supply side—both appear to have peaked around the third quarter. The contribution of the high-tech sector to IP and exports also softened from midyear, reflecting the global IT downturn and weaker profits (Figure 4).

9. **Growth turned negative in the first quarter of 2001.** Business investment and exports were undermined by the downturn in overseas markets (especially for high-tech products). Private consumption was flat despite a boost coming from purchases of home appliances ahead of the introduction of a new recycling law on April 1, while residential investment declined. Strong growth in public investment related to the November 2000 supplementary budget provided some support to the economy.

10. **Indicators of excess capacity—always difficult to judge in the context of ongoing structural change—have worsened since the middle of last year.** The unemployment rate has increased modestly to almost 5 percent over the year to mid-2001. Capacity utilization rates, which had recovered through 1999 and early 2000 (although remaining well below historical averages), have fallen back since mid-2000, consistent with assessments of excess capacity and inventories in recent *Tankan* surveys. Finally, the staff's production-function based estimate of the output gap has also widened since mid-2000, to about 4 percent of potential GDP in early 2001.

11. **On most measures, deflationary pressures intensified during 2000 and early 2001.** Excluding perishable food and energy, year-on-year changes in the CPI fell from -0.2 percent in the first quarter of 2000 to -0.7 percent in the first quarter of 2001, while the downward movement in the domestic WPI also became more pronounced (Figure 5). Nominal monthly earnings, which were rising in the first half of 2000, stagnated in the second half of the year in line with the deterioration in labor market conditions.

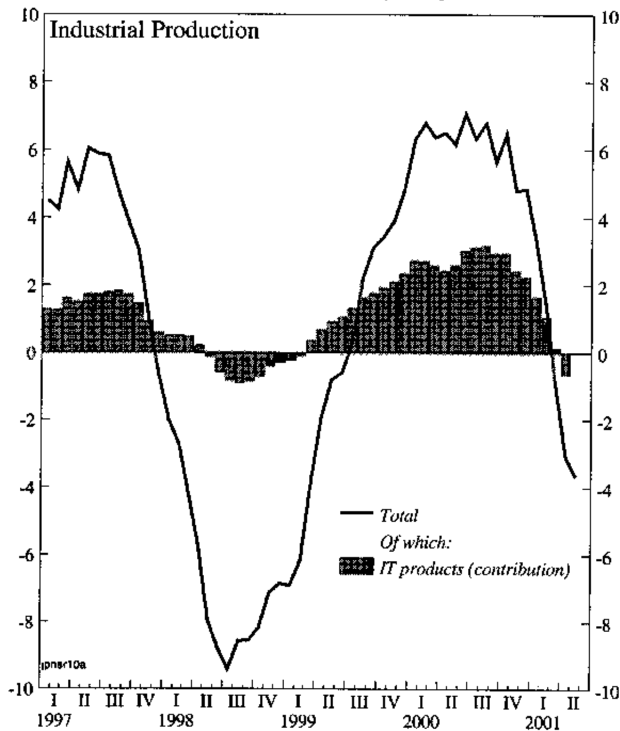
12. **Net exports narrowed in 2000, while capital outflows rebounded.** Export volumes slowed and then declined in early 2001, while imports picked up as a result of higher oil prices. However, a pickup in investment income, reflecting a recovery in profits by Japanese overseas subsidiaries, helped to offset the impact on the current account surplus. Following the retrenchment in 1999, outward direct investment increased last year, while net portfolio outflows also rose, reflecting a reassessment of prospects for Japan's stock market and a widening of the interest rate differential against Japan (Figure 6 and Table 3).

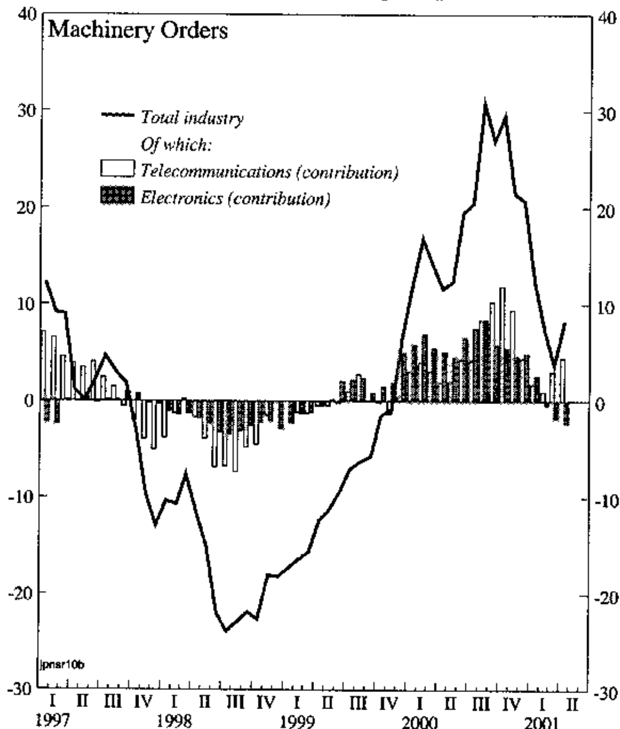
13. **Deteriorating prospects took their toll on equity prices and the yen.** From a peak of nearly 20,000 in March 2000, the Nikkei index shed about two-fifths of its value over the

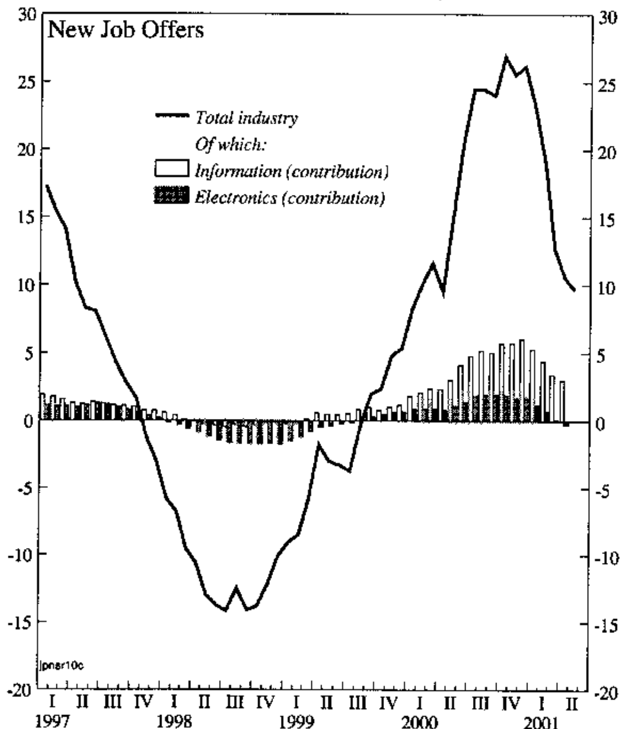
---

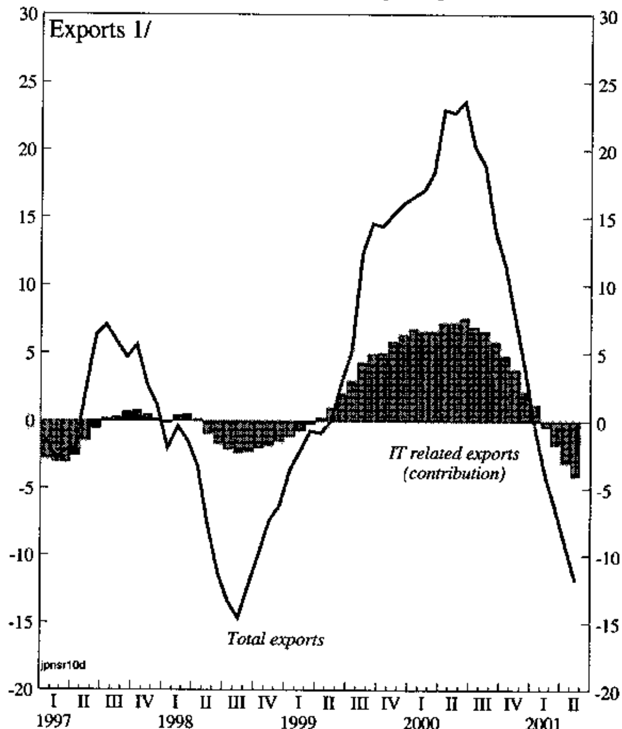
[2] These problems are likely partly responsible for the much greater volatility of the quarterly GDP figures, and the much greater errors in short-term forecasts, in Japan than in other major industrial countries (see Box 1.2 in *World Economic Outlook*, October 2000).

Figure 4. Japan: Information Technology Indicators, 1997-2001





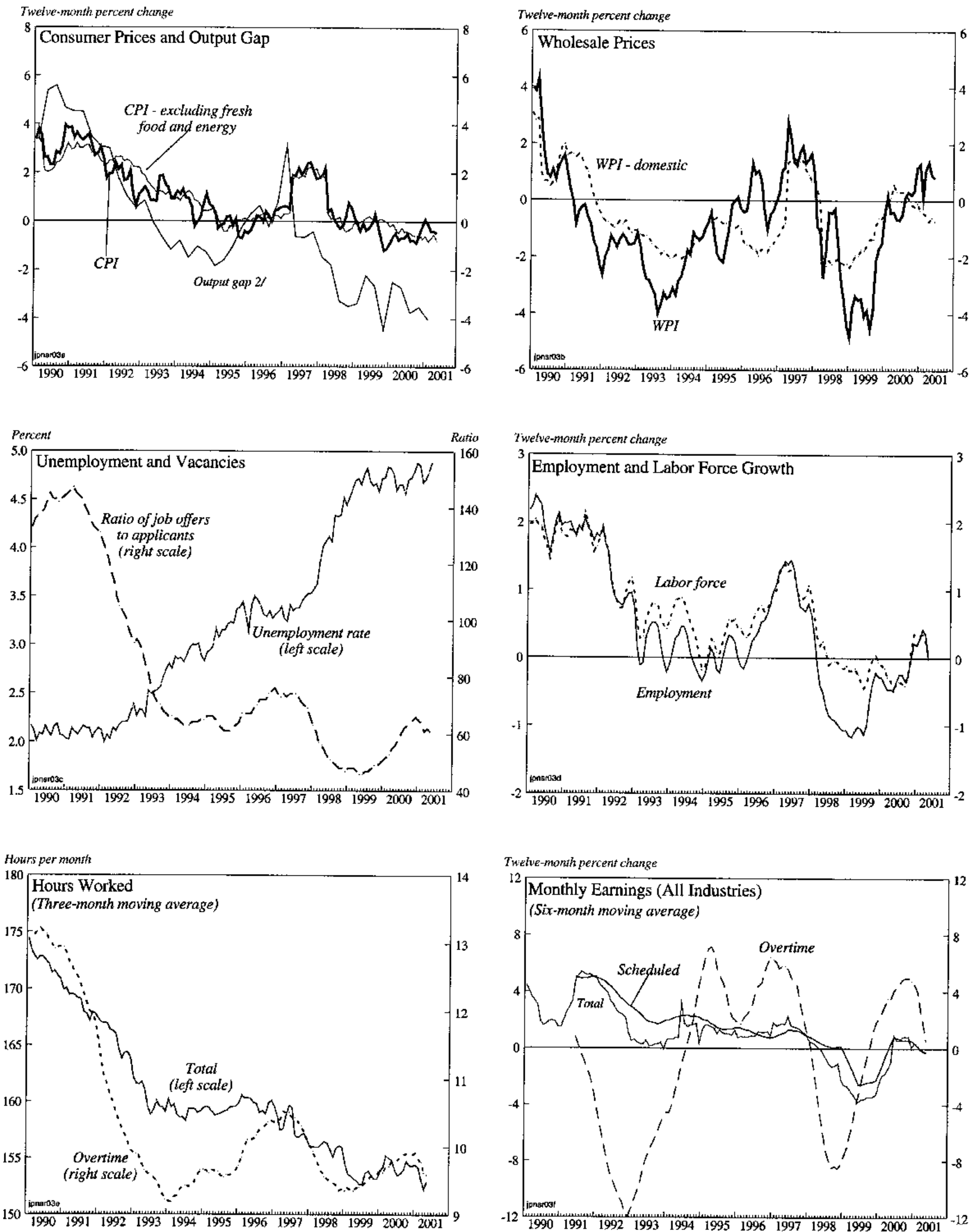




Sources: Ministry of Economy, Trade and Industry; Cabinet Office; Ministry of Finance; and Japan Tariff Association.

1/ Customs clearance basis; in U.S. dollar terms.

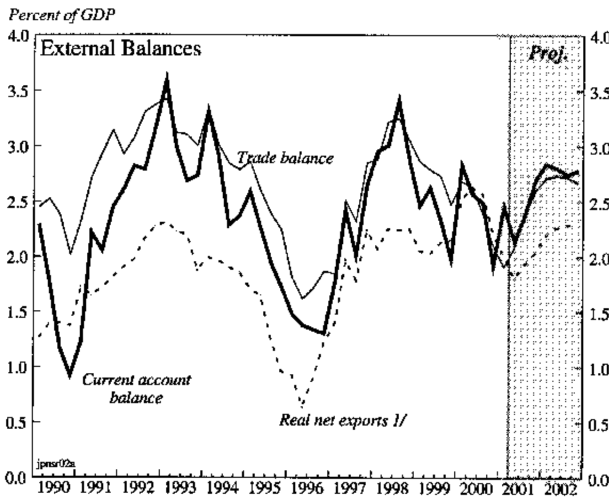
Figure 5. Japan: Indicators of Prices and Labor Market Conditions, 1990-2001 1/

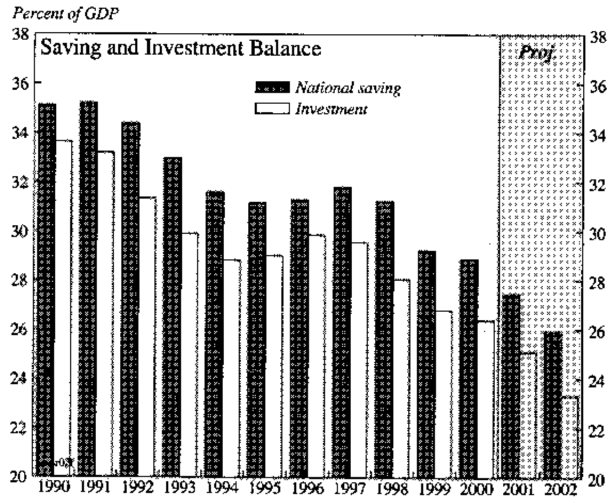


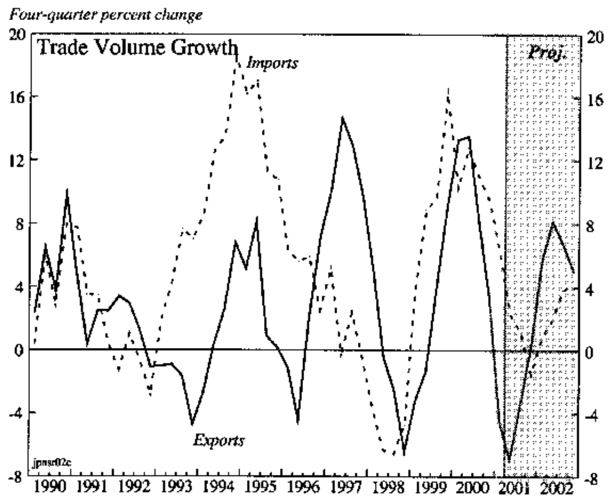
Sources: Nikkei Telecom; and WEFA.

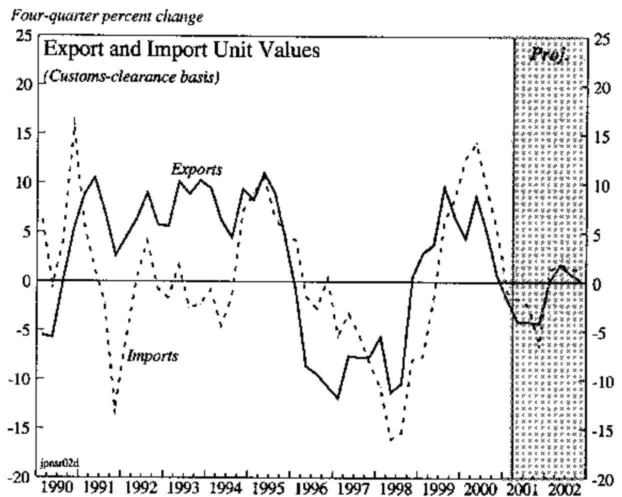
1/ Seasonally adjusted data.
2/ Staff estimates.

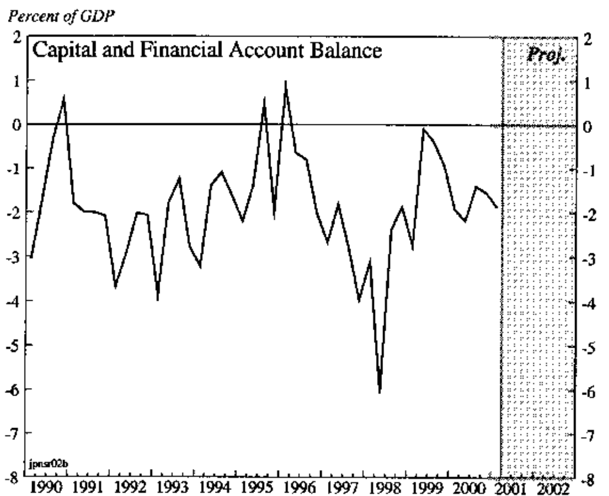
Figure 6. Japan: External Sector Indicators, 1990-2002 1/

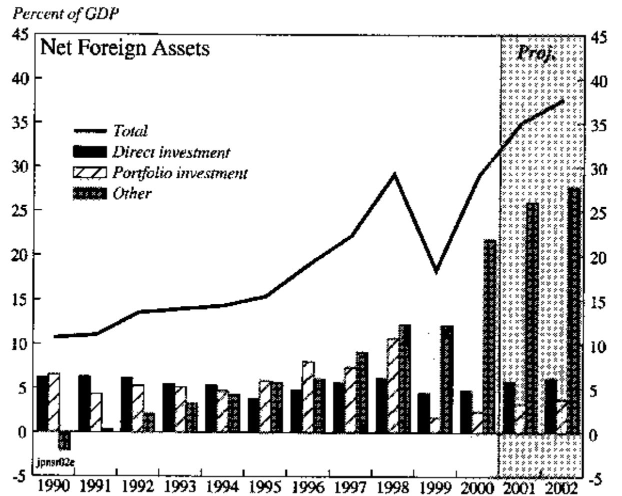












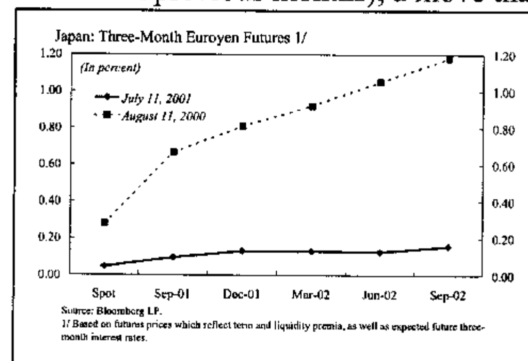
Sources: Nikkei Telecom; WEFA; and staff estimates and projections.

1/ Real net exports of goods and services on a national accounts basis.

following year (bringing it to a 16-year low). The Topix—whose composition was constant over this period (unlike that of the Nikkei)—fell by about a third. The downturn reflected not only the worldwide sell-off in technology stocks, but also unwinding of cross-shareholdings in Japan and increasing concern about slow progress with restructuring and boosting corporate rates of return. Japan's equity market rebounded following the easing of monetary policy in March and the selection of a pro-reform Cabinet in April, although prices have since fallen back. The economy's cyclical deterioration and recent monetary policy easing have also driven the yen lower since early 2000. Over the past year, the yen has fallen by 15 percent against the dollar and about 10 percent in effective terms (Figures 7 and 8).

14. **Faced with a weakening economy, the BoJ backed away from its decision last August to abandon the zero interest rate policy (ZIRP).** Indeed, with hindsight, last August's interest rate rise appears to have come at just the time when activity peaked. Amid growing signs of a faltering recovery, the BoJ sought to ease the policy stance in February 2001, including by establishing a Lombard facility to provide loans on demand at the official discount rate (ODR), lowering the ODR from 0.5 percent to 0.25 percent, and reducing the target for the uncollateralized overnight call rate—the BoJ's main policy instrument which determines funding costs in the interbank market—to 0.15 percent.

15. **In mid-March, concerned that the recovery had "paused", the BoJ adopted a new framework for monetary policy.** While overnight rates are to be market-determined, the new framework sets a target for current account balances at the BoJ, initially at around ¥5 trillion (about ¥1 trillion above the average balance held in previous months), a move that brought the overnight call rate effectively back down to zero.[3] The BoJ indicated that the new policy will remain in place until year-on-year changes in the CPI excluding perishables rise stably to zero or above, and that outright purchases of long-term government bonds (so-called "rinban" operations) will be increased if needed to achieve the reserves target. At this point, the market expects overnight rates to remain close to zero at least until mid-2002.



Source: Bloomberg LP.
1/ Based on futures prices which reflect term and liquidity premia, as well as expected future three-month interest rates.

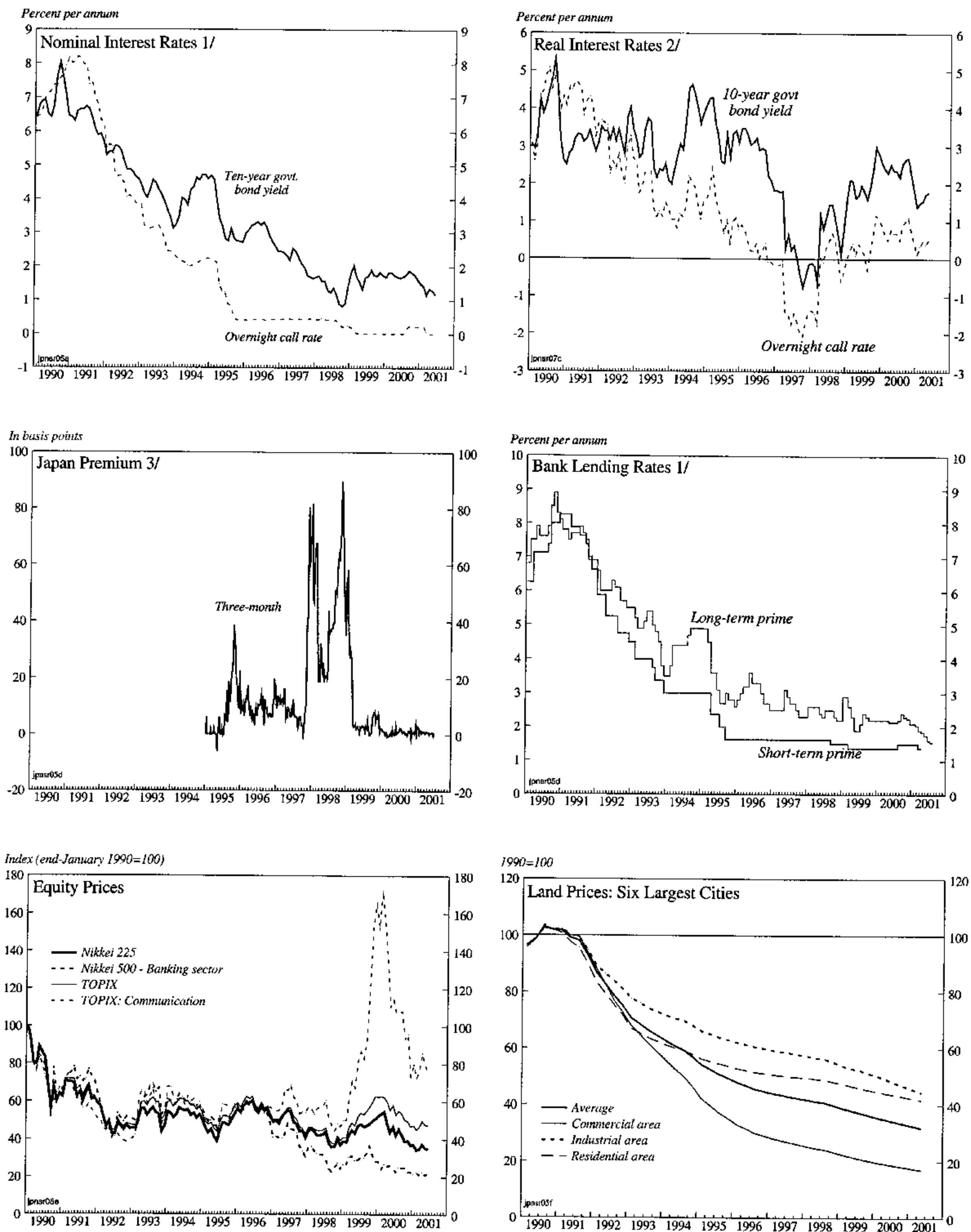
16. **The FY2000 budget, together with the supplementary package passed at the end of the previous year, kept the fiscal stance roughly neutral, even as public investment continued to decline in relation to GDP.**[4] Revenues benefited from a pickup in corporate taxes (associated with strong profits growth) and receipts related to the maturation of a large volume of 10-year postal savings deposits. Expenditures kept up as a result of the moderate increase in core spending in the annual budget, the autumn 1999 fiscal stimulus package—which included real water spending of 1½ percent of GDP (half on public works)—and rising social security benefits (particularly on the medical side). Including social security (but

---

[3] Current account balances consist of bank and other financial institution deposits at the BoJ.

[4] The FY2000 budget runs from April 1 through March 31, 2001.

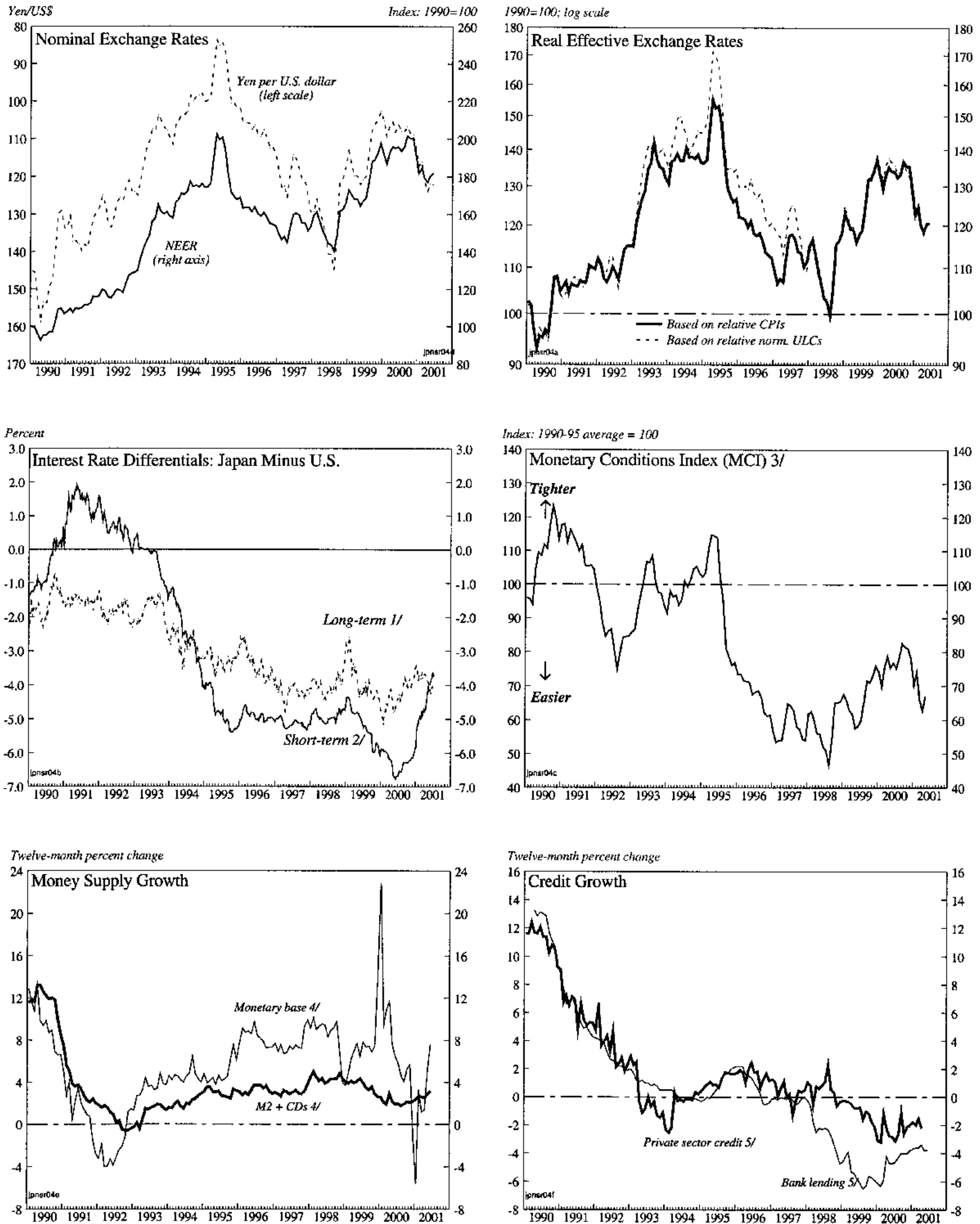
Figure 7. Japan: Selected Financial Indicators, 1990-2001



Sources: Nikkei Telecom; Bank of Japan; WEFA; and Bloomberg, LP.

1/ End of period.
2/ Nominal rates deflated by the CPI.
3/ Average U.S. dollar LIBOR of Fuji Bank, Bank of Tokyo-Mitsubishi, and Norinchukin bank minus the LIBOR fix from 1/21/1999; previously, Sumitomo Bank was included in the average.

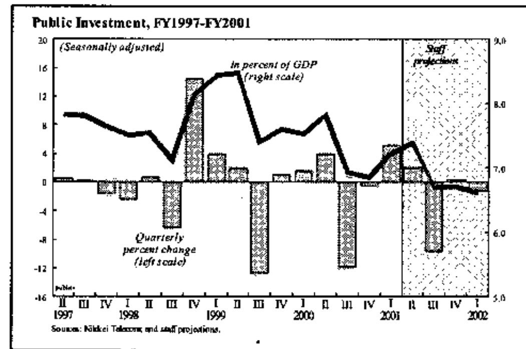
Figure 8. Japan: Monetary and Exchange Rate Indicators, 1990-2001



Sources: IMF, Information Notice System; Nikkei Telecom; WEFA; and staff estimates.

1/ Ten-year government bond yield.
2/ Three-month CD rate.
3/ An increase indicates a tightening of monetary conditions. The MCI is a weighted average of changes in the real interest rate and the real effective exchange rate.
4/ Period average.
5/ End-period.

excluding government support to the banking sector), the structural deficit remained at about 5½ percent of GDP in FY2000 (Table 2; Figure 9). With local authorities—concerned with their rising indebtedness—continuing to cut back on their own capital spending, however, public investment is estimated to have declined by ½ percent of GDP.



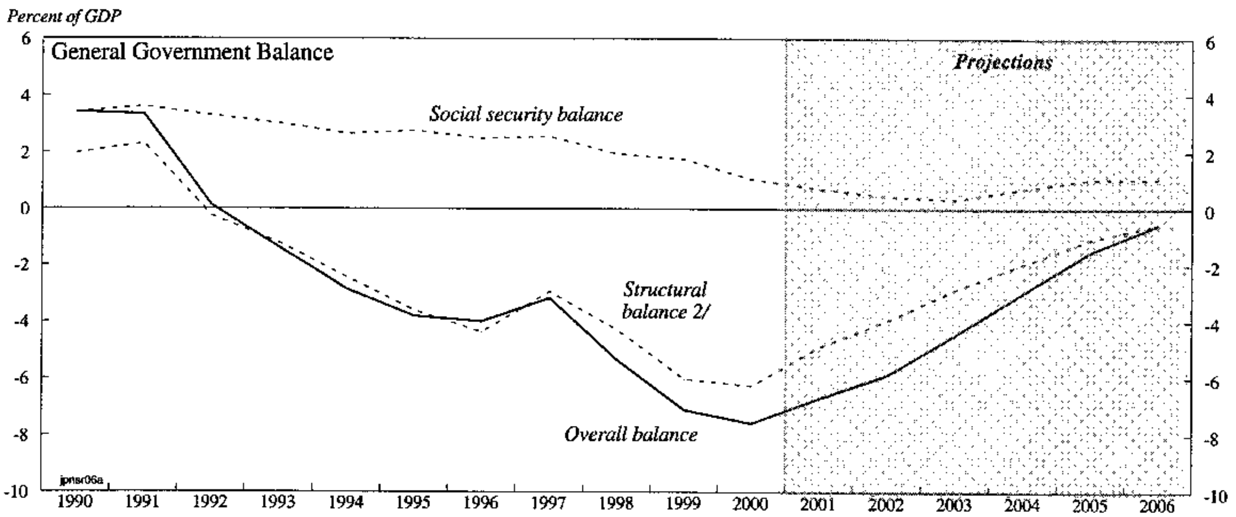
17. **Long-term government bond yields declined after mid-2000 despite surging government borrowing and debt, as well as sovereign credit rating downgrades.** Reasons include banks' willingness to absorb new JGB issues given the dearth of profitable lending opportunities. The FY2000 budget was financed through a record ¥32.6 trillion in net JGB issues, and gross general government debt is estimated to have risen to about 130 percent of GDP last year. Reflecting these trends and the lack of a credible strategy to put public finances on to a sustainable footing, Standard & Poors downgraded Japan's long-term sovereign ratings in early 2001 from AAA to AA+ (level with Italy's rating among the G-7), following similar downgrades by other rating agencies last year.

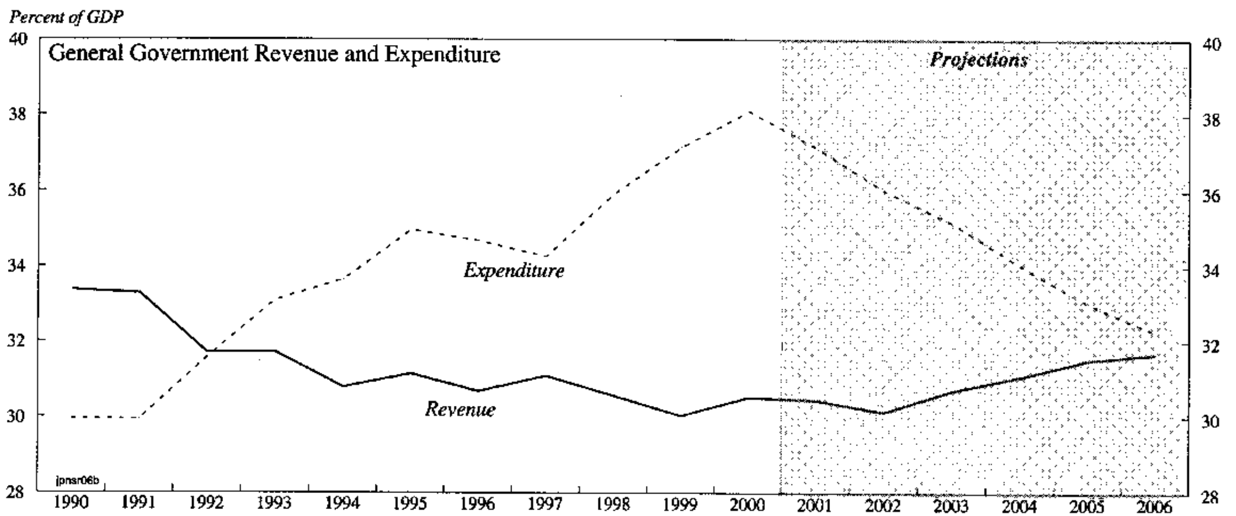
18. **Progress by major banks in improving core profitability and disposing of problem loans has continued to be slow.**

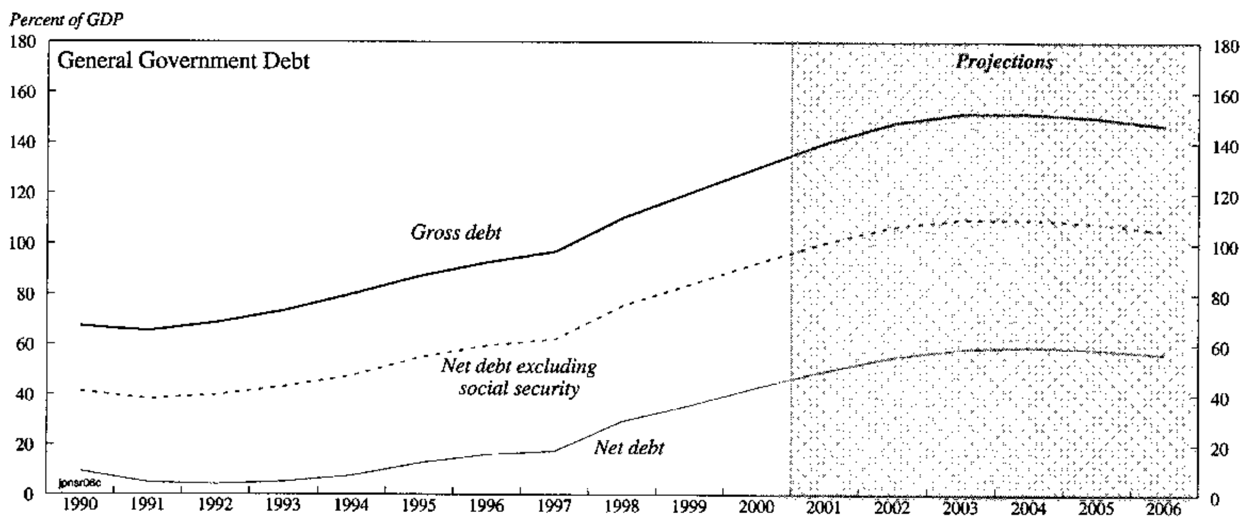
- While banks have begun to diversify their income sources (including by boosting fee income, albeit from a low base), FY2000 financial results showed weaker operating profits, as interest rate margins narrowed and restructuring efforts, including in the context of recent mergers among major banks, have proceeded slowly. Major bank share prices have fallen up to 50 percent since the mergers were announced.
- At the same time, loan-loss charges in FY2000 were about triple the rate envisaged at the start of the year, with little reduction in the stock of nonperforming loans, suggesting that new bad loans are emerging as fast as old ones are written off. Moreover, analysts continue to have serious doubts about the rigor of banks' credit quality assessments and provisioning practices, the more so in view of banks' still sizable exposure to the moribund retail and construction sectors.

19. **Lack of progress in boosting major banks' underlying health is compounded by their growing vulnerability to market risk.** Banks have realized substantial hidden gains on their equity portfolios (still nearly ¥38 trillion by book value) to help defray loan-loss charges in recent years. At early July stock price levels, however, latent gains on such holdings have effectively vanished, and movements in equity prices will directly impact Tier-1 capital from September 2001, which is the first reporting period under the new mark-to-market rules. Banks also face risks from their JGB holdings, which now comprise about

Figure 9. Japan: Summary of Fiscal Indicators, FY 1990-2006 1/







Sources: Ministry of Finance; Cabinet Office; and staff estimates and projections.

1/ The fiscal year is from April to March.
2/ Including social security; excluding bank support.

¥80 trillion (10 percent of assets), about 2½ times the 1998-level.[5] Reflecting these and other risks, subordinated debt spreads for some of the major trust banks have widened in recent months and a number of banks have suffered ratings downgrades.

20. **Problem loans are also taking their toll on the smaller deposit-taking institutions.**

- While regional banks have raised regulatory capital over the past year and have little exposure to the stock market, their performance continues to be undercut by widespread problem loans—which rose by more than ¥2 trillion during the latest reporting period—reflecting in part surging bankruptcies among SMEs. Six regional banks utilized public capital before the authority to inject such funds expired.

- Emerging results from inspections of credit cooperatives confirm expectations of weak asset quality and credit assessment standards. The government closed four credit cooperatives in December, bringing to 12 the number of failures in FY2000.

21. **Lingering banking sector weaknesses need to be viewed alongside recent and prospective changes in the public support framework.** The authority to inject public funds into weak but solvent banks under the Early Strengthening Law expired in March 2001. Such authority will expire in the case of credit cooperatives in March 2002. Removal of the blanket deposit guarantee is scheduled for March 2002, at which time deposit insurance coverage will be limited to ¥10 million.[6] Under the revised Deposit Insurance Law, a new emergency account provides for ¥15 trillion (3 percent of GDP) to ensure the stability of the financial system in case of systemic threat.

22. **The life insurance sector remains distressed**. Policy cancellations and sluggish sales continued to depress premium income in FY2000, magnifying the problem of negative spreads (the gap between guaranteed returns on policies and returns on assets). Solvency margin ratios for the major life insurers, while on average still about triple the mandated 200 percent minimum, fell by about 180 percentage points during FY2000, not least because of the stock market's impact on insurers' latent profits.[7] The bankruptcy of Tokyo Mutual in

---

[5] Market analysts estimate that every 100 point drop in the Topix below an estimated break-even level of 1,270 (compared to 1,249 on July 12, 2001) would reduce major banks' average Tier-1 capital by about ¥2½ trillion (about 11½ percent of Tier-1 capital). Market estimates further suggest that a 100 basis point rise in JGB yields would lead to a valuation loss at major banks of about ¥1.1 trillion. FSA estimates of market risk are somewhat smaller than those of market analysts—about two thirds as large for both changes in the Topix and JGB yields.

[6] Liquid deposits are to be fully covered until March 2003.

[7] The solvency margin measures an insurance company's ability to maintain payments to policyholders against exposure to different categories of risk. The solvency margin ratio compares the sum of an insurer's capital, reserves, unrealized gains and other items, to its overall risk exposure.

March 2001 brought to seven the total number of failures of mid-sized life insurers over the past four years, and has been followed by steps to tighten the measurement of the solvency margin ratio.

23. **A number of previously-legislated structural reforms have gone into effect over the past year.**

- A **new corporate reorganization procedure**—the Civil Rehabilitation Law (CRL)—which took effect in April 2000, allows simpler filing, protection of vital assets from secured creditors, and more effective implementation of agreed restructuring plans (along the lines of US Chapter 11). This streamlining of procedures has contributed to a sharp increase in filings.
- **Accounting changes**—including the phased implementation of marking-to-market in FY2000–01—are helping to increase transparency. **Commercial Code and related tax changes** to facilitate corporate spinoffs and mergers took effect from April 2001. Further legislation to bring more fundamental reforms to improve corporate governance—including reducing the excessive role of insiders on corporate boards—is now being prepared, to be presented to the Diet early next year.
- While most of the **big bang financial reforms** were in place by end-1999, the remaining reforms—relating for example to the liberalization of barriers to entry of banks into the insurance business—were completed in October 2000.
- **Fiscal Investment and Loan Program (FILP)** reform—including the elimination of the compulsory transfer of deposits from the postal savings and pension systems to the Trust Fund Bureau—has begun to be implemented from April 2001.
- Progress has been made in forging a more **competitive telecommunications market**. However, while connection charges are being reduced, they are nevertheless expected to remain high by international standards. Inefficient distribution also remains a concern in the electricity and gas sectors.
- After a significant delay, legislation introducing **private portable defined-contribution pension schemes** was passed in June 2001, although contribution limits are much less generous than for comparable 401-K plans in the US. The scheme is to go into effect in October.

24. **A major package to accelerate bank and corporate restructuring was unveiled in April 2001, and further details—together with an outline of the government's overall structural reform agenda—were provided in a blueprint released at the end of June.**

- The centerpiece of the bank and corporate restructuring package is the accelerated removal of nonperforming loans (NPLs) to bankrupt and near-bankrupt borrowers from major banks' balance sheets within two years, and removal of newly-emerging NPLs within three years of such classification.[8] Bad loan disposal would involve

[8] Removal is preferable to partial write-off up to the value of collateral, because it eliminates the risk that banks would need to provision against further falls in collateral value.

assets being sold or restructured, either through an out-of-court workout or by pushing the borrower into bankruptcy proceedings. Any such loans that remained on banks' balance sheets at the end of the two or three year period would be sold to the Resolution and Collection Corporation (RCC). Banks and firms would be encouraged to agree to out-of-court restructuring in exchange for debt forgiveness or debt-equity conversion, subject to guidelines to be established by relevant ministries and the business and bankers' associations. In addition, banks' aggregate equity holdings would be limited relative to their shareholders' equity, and a Banks' Shareholding Acquisition Corporation (BASAC) would be established to facilitate the scaling down of bank equity holdings. Public guarantees would be available to the BASAC to back loans it takes out to purchase shares from the banks, except in the case of shares being repackaged into mutual or exchange-traded funds or some shares being bought back by their issuer.

- The seven-point plan announced by the Council on Economic and Fiscal Policy (CEFP) at end-June is wide-ranging, but remains to be fully fleshed out. Key elements include: regulatory reforms, tax reforms, and reforms of state-run corporations (including the option of privatizing the postal savings system) to improve competition and economic efficiency, promote business start-ups and the expansion of the IT sector, and expand employment opportunities; fiscal reforms including reduced earmarking of revenues, more careful vetting of public works spending, the introduction of more self-reliance by local authorities in financing their operations, and steps to improve the medium-term orientation of fiscal policy and pave the way for fiscal consolidation; as well as social security reforms to restore confidence in the system and put its finances on a sound footing.

III. Economic Outlook

25. **The near-term outlook is bleak, with GDP expected to decline by ¼ percent for 2001 as a whole.** Private **consumption** is likely to be stagnant, depressed by payback from the spending brought forward to the first quarter, and the drag from corporate restructuring, high unemployment, and declining incomes. Leading indicators of **business investment** (including machinery orders and the *Tankan*) suggest that capital spending will continue to decline through the summer and fall, reflecting the cyclical deterioration in sales and the weak outlook for corporate profits. **The external contribution to growth**—which has been negative since mid-2000 reflecting a sharp slowing and subsequent decline in exports—will continue to be adversely impacted by the external environment despite the weakening of the yen, although some recovery in net exports is expected later this year assuming that the global IT market turns around. **Public investment**, which picked up early in 2001, is expected to fall back from the third quarter, reflecting the waning impact of last November's stimulus package. The staff is projecting a reduction in the general government's structural deficit this year of ½ percent of GDP.

26. **Growth is projected to recover modestly to about ½ percent in 2002**. The pickup would be prompted by a turnaround in the US and improved global prospects more generally—including, as suggested by the latest industry forecasts, in the global electronics market—providing the basis for a stronger external contribution to growth and a pickup in business investment during the year. However, the pace of recovery would be constrained by fiscal consolidation—a fiscal contraction estimated at about 1 percent of GDP next year—and the short-term impact of bank and corporate restructuring. Faster bad loan disposal is

expected to raise unemployment. Analysts estimate that additional labor shedding of 300,000–500,000 people might flow from implementing the bad loan disposal package—which could bring the unemployment rate to 5½ percent over the next 1–2 years; the authorities consider that the increase may be somewhat less, based on the results from a government-commissioned research project, which suggested a range of 100,000–200,000 job losses.

27. **While the staff's near-term forecast is below the latest consensus, the downside risks remain sizeable.** The weak economy could give rise to renewed pressure on equity prices and a further increase in bad loans, raising the risk of a vicious cycle of slowing growth, rising corporate bankruptcies, and a loss of banking system confidence. There is also the risk of a sharper fiscal contraction, given uncertainties about the impact on the fiscal stance of the general government of the ¥30 trillion target for net JGB issue in FY2002. On the external side, prospects for a recovery in exports beginning in late 2001 depend on a timely rebound in the US economy and the global electronics market, which is not assured. More generally, the economic impact of planned structural reforms is very difficult to gauge. While rigorous economic restructuring is likely to lead to considerable downsizing of inefficient enterprises, there is a potential offset on activity in the form of increased confidence and better opportunities for healthy firms in dynamic sectors.

28. **Beyond next year, the staff is projecting a return to more robust growth and a gradual closure of the output gap over the medium term, but this will not be achieved in the absence of thorough-going restructuring.** Achieving a sustained recovery will depend very much on seeing through the structural reforms the new government has committed to, in order to remove obstacles to a durable turnaround in corporate performance and a period of strong domestic demand led growth. During Japan's so-called "lost decade" of the 1990s, the economy managed to grow by about 1.7 percent per year, thanks in part to stimulative macroeconomic policies, a benign external environment, and benefits from high-tech sectors now more fully captured in the national accounts. While much weaker than in the previous decade, it is doubtful that growth at even this rate would now be sustainable in the absence of genuine economic restructuring, given the impact on the economy's potential of Japan's banking and corporate sector problems, the limitations of macro policy stimulus, and the impact of population ageing.[9] The gradual pickup in potential growth to about 2 percent under the staff's medium-term projections is premised on such constraints being eliminated.

IV. Policy Discussions

29. **The Article IV mission took place very soon after the new government took office in Tokyo which meant that, while the authorities were able to convey the general direction of the economic strategy, many of the details had yet to be worked out.** The content of the new government's commitment to finally establish a sound basis for healthy economic growth over the medium term has become clearer in the period since the mission,

---

[9] Estimates by Bayoumi in *Post-Bubble Blues* suggest that the negative supply shock associated with financial system distress in Japan in 1998 may have shaved 1–2 percentage points from Japan's potential growth rate. The impact of population ageing on potential growth is taken up in "Population Ageing in Japan: Demographic Shock and Fiscal Sustainability" by Faruqee and Mühleisen, IMF WP/01/40.

including in the context of the reform blueprint released at the end of June. That blueprint clearly recognizes the importance of revitalizing Japan's economy to meet the challenges posed by globalization, to be achieved by deep structural reforms to promote competition and enhance the role of market forces. Minister Takenaka sees a period of slow (0–1 percent) growth as inevitable over the next 2–3 years, as Japan finally tackles the problems in the bank, corporate, and fiscal sectors, but also a payoff in a higher rate of potential growth—led by domestic demand—over the medium term (to perhaps 2–3 percent annually).

A. Financial Sector Issues

30. **While expressing confidence in the stability of the banking system, the authorities attached a very high priority to addressing what they considered to be two remaining fundamental weaknesses—a high burden of problem loans and an excessive exposure to equity price risk**. They noted that perceptions of systemic risk—as measured for example by the Japan premium—have effectively disappeared, and that banks have a comfortable cushion of regulatory capital (much in excess of the Basel standards). There are no signs of a credit crunch at present, and banks have continued to make progress in strengthening overall risk management and internal controls over loan classification and provisioning. This said, disposal of NPLs needed to be accelerated, in the officials' view, since such loans were placing a continuing drag on bank profitability and on corporate performance. Moreover, excessive exposure to market risk through banks' still very large equity holdings continued to undermine confidence. These two issues were being addressed in the context of the April package.

31. **Officials emphasized that, with continued efforts to ensure rigorous enforcement of loan classification standards and strengthen provisioning practices, banks had now generally recognized the broad magnitude of the bad loan problem**. They considered that loan classification standards in Japan were now fully comparable to those in other major industrial countries, and that provisioning requirements for loans to borrowers in danger of bankruptcy were actually more stringent than in the US (70 percent instead of 50 percent), while provisions for "need attention" loans were in line with actual loan loss rates over the past three years. While regulatory forbearance had been a problem in the early 1990s, the period since the creation of the FSA in 1998 had witnessed a sea change, with inspections now guided by a manual that was fully in line with practice elsewhere in the industrial world. In the officials' view, the greater pressure applied by FSA inspectors and external auditors had been an important factor behind the sharp increase in banks' loan loss charges in FY2000, a point corroborated by the banks themselves and a number of private analysts.

32. **Private analysts in Tokyo had a significantly more pessimistic assessment, which was based on higher assumed loss rates on the current stock of NPLs and additional migration of "need attention" loans to the NPL categories** (Box 1). Analysts continue to feel that collateral values are overstated (despite a sizable buffer against estimated market value enforced by the FSA), particularly as liquidation of real estate collateral frequently occurs at depressed prices owing to the absence of a liquid market. Their other major concern is that many "need attention" loans are likely to migrate to the nonperforming categories over time, particularly given the concentration of such loans to severely-indebted companies in the weakest sectors of the economy. While these companies may have been able to service loans at current low nominal interest rates, many would be unlikely to survive once interest

Box 1. How Bad is the Bad Loan Problem?

Despite banks' continued efforts to write off nonperforming loans (NPLs) in FY2000, outstanding bad loans were broadly unchanged as new NPLs emerged faster than expected. As of September 2000, major banks' NPLs to bankrupt or near-bankrupt borrowers amounted to ¥14½ trillion; major and regional banks together reported gross non-performing loans of ¥32 trillion, compared to ¥11–12 trillion in general and specific reserves. However, a wider amount of loans may be at risk. The total face value of loans by major and regional banks to borrowers whose financial condition requires attention or who are either bankrupt or close to bankruptcy amounts to ¥111 trillion (22 percent of GDP), of which ¥47 trillion is covered by "superior" collateral or guarantees. The remaining ¥64 trillion is either covered by "ordinary" collateral (mostly real estate) or unsecured. Once credit cooperatives are included, the total value of loans to classified borrowers rises to ¥151 trillion (30 percent of GDP) of which ¥70 trillion is covered by superior collateral.

Some market analysts raised questions about the magnitude of the bad loan problem. Using a variety of different methodologies, analysts consider that additional loan loss charges of ¥20–30 trillion (equivalent to 4–6 times major and regional banks' annual operating profits) could be required for adequate provisioning. Such calculations mostly reflect higher assumed losses on ¥75 trillion worth of gray-zone loans—loans that are not officially classified as nonperforming but require attention—and further declines in collateral values, largely reflecting banks' large exposure to borrowers in weaker sectors of the economy (see scenario IV in the sensitivity analysis table and Chapter IV of the *Economic and Policy Developments* Paper for further details). The FSA considers that loan classification and provisioning practices are appropriate, and in line with practices in other major industrial countries (see scenario I and para. 30–32 in the text). Officials noted that these practices are endorsed by external auditing firms which are required to approve bank financial statements.

Sensitivity Analysis for Uncovered Loan Losses of Major and Regional Banks
(Based on banks' self-assessment as of September 2000)

	Loan Amount (¥ trillion)	Loss Ratio—Scenarios I	II	III	IV
		(In percent)			
Normal loans	410.1	½	1	1½	2
Loans to at-risk borrowers secured by superior collateral 1/	47.4	1	2	3	4
Loan secured by ordinary collateral					
Borrowers requiring attention	50.5	10	18	25	35
Bankrupt borrowers 2/	10.5	20	30	45	60
Loans to bankrupt borrowers with doubtful recovery value 2/	2.7	80	85	90	100
Unrecoverable loans to bankrupt Borrowers 2/	0.01	100	100	100	100
		(In trillions of yen)			
Total	521.2	11.7	19.4	27.4	36.8
Uncovered loan losses 3/	...	0.0	7.7	15.7	25.1

Sources: Financial Services Agency; staff calculations.

1/ Collateral refers to both loan collateral and loan guarantees.

2/ Bankrupt borrowers include *de facto* bankrupt borrowers and borrowers in danger of bankruptcy.

3/ Banks are assumed to hold a combined ¥11.7 trillion in general and specific provisions.

If bad loans were provisioned in line with analysts estimates, a number of weaker banks could become technically insolvent and many others would probably fall below minimum capital requirements. Moreover, slightly more than half of Tier-1 capital consists of deferred tax assets (which will expire unless banks record substantial profits over the next five years), public capital, and preferred equity instruments. The small size of shareholder equity contrasts with banks' large exposure to market risk from holdings of stocks and JGBs (see paras. 19 and 38–39 in the text).

Major Banks' Regulatory Capital (September 2000)

	¥ Trillion	Percent[1]
Total regulatory capital	41.3	11.3
Tier I capital	22.8	6.4
Deferred taxes	5.5	1.5
Public capital (pref. stocks)	6.2	1.7
Other preferred securities	0.9	0.3
Other	10.2	2.9
Tier II capital	18.8	5.3
Public capital (sub. debt)	2.5	0.7
Memorandum items:		
Regional banks I	12.1	10.3
Regional banks II	3.0	8.2
Shinkin banks	5.8	9.8
Credit cooperatives	1.0	7.6

Source: FSA.

[1] Percent of risk-weighted assets

rates rise, and once the government pushes ahead with deregulation and curbs on wasteful public spending. For this reason, the recent experience with loan losses might well not provide a particularly good guide to losses likely to be faced in the future. Loans to the real estate, construction, and retail sectors would be particularly at risk. In response to such concerns, FSA officials indicated that the large amount of "need attention" loans were a source of income for banks, and that the associated risks were manageable, particularly as banks continue to make progress with their credit risk assessments under the FSA's supervision.

33. **The mission proposed participation in the FSAP as a way to shed light on the issue and suggested that the FSA itself become more engaged in trying to narrow differences in views in this area.** While the mission was not in a position to assess independently the size of any under-provisioning in the banking system, it shared some of the analysts' concerns—including that historical loan loss rates may not provide a good guide for future losses in Japan's special circumstances, that the long period of economic weakness is likely to lead to down-migration of "need attention" loans in the future, and that rising interest rates and regulatory reforms could have similar effects. It thus suggested that the FSA continue to press banks hard to identify credits that are showing signs of deterioration at an earlier stage and to apply a more forward-looking approach to setting provisioning levels. On the FSAP, FSA officials were still considering the issue—a principal concern was the significant demands that participation would place on the agency's already-strained staff resources—but they indicated a willingness to continue the dialogue with the Fund on the bad loan issue.

34. **A difficult issue remains the appropriate role for public capital injections.** FSA officials considered that, while regulatory capital may come under pressure at some banks, the system as a whole remains well capitalized and there is thus no present need for another round of public capital injections. They further stressed that an across-the board capital injection at the present juncture would raise serious moral hazard concerns. The mission expressed concern that a significant pickup in loan-loss charges (related to an aggressive approach to dealing with the bad loan problem or to a general deterioration in the economy) could lead to some banks becoming undercapitalized and that, in the present environment, banks would find it difficult to raise additional capital from the market. Under such a scenario, the staff felt there would be little alternative to using public funds, and that a willingness to act would be essential to avert a credit crunch and a potential loss of systemic confidence. Officials replied that, under such a scenario, the FSA's strategy would in the first instance be to seek a market solution, including a rights issue or a merger. As a last resort, they pointed out that the public support framework would continue to enable public funds to be injected into banks if a systemic risk arises. The mission stressed the need to condition receipt of public funds on strong restructuring plans, involving management changes, participation in debt workouts, and achieving satisfactory returns on equity within a defined period.

35. **Given moral hazard concerns, the authorities have no intention to further delay reimposing partial deposit insurance beyond next April's deadline.** Analysts agreed with this approach, indicating that the existing framework—even after the removal of the blanket guarantee—would permit official intervention in important cases to protect the full range of

deposits and credits, thus avoiding a systemic loss of confidence. The mission stressed the need to act proactively, including by providing public funds as necessary in the event of emerging bank weaknesses, in order to maintain confidence under the new system where the risks of contagion would clearly be significantly greater than at present. Early intervention would be critical under a scenario in which weaker institutions faced pressures from a surge in loan loss charges associated with a deep recession and more pervasive corporate distress.

36. **FSA officials considered that final disposal of major banks' bad loans would be a significant step forward**. They noted that these loans represented the hard core of bad assets that had remained on banks' books for years: final disposal would require banks to sever ties with their weakest borrowers or to negotiate restructuring plans that would allow lending to resume. Since only loans to bankrupt or near-bankrupt borrowers were covered, provisioning rates were already very high so there would be little impact on bank capital. Elements of the disposal process announced after the mission raise some concerns for the staff, however. In particular, the potential for banks to postpone resolving their bad loans on the expectation that the RCC would eventually take them over (potentially at an unrealistic price) raises the risk that little restructuring will take place over the next two years. A second worry is that the RCC, which could find itself with a much larger bad loan portfolio in two years' time, might move too slowly in disposing of its problem assets—its track record thus far heightens such concerns.

37. **The mission stressed the need for major banks to accelerate resolution of a broader set of their troubled loans and for the regional banks—which make up half the system—also to be covered**. Because the government's plan covers only major banks' NPLs to bankrupt and near-bankrupt borrowers, it leaves about one third of their reported NPLs—that is NPLs to "special attention" borrowers—not bound by requirements of accelerated disposal. In addition, there was considerable merit in accelerating resolution of many of the major banks' gray-zone loans—that is loans that "need attention" but are still performing—especially credits to heavily-indebted and loss-making companies in the weakest economic sectors (including construction and retail). With respect to the regional banks, the mission stressed that these institutions' significant role in the banking system and the NPL problem underscored the need to establish a timetable for disposing of their bad loans. Officials voiced concerns about the impact of faster disposal on SMEs and regional economies, while noting that, to the degree that regional banks had bankrupt or near-bankrupt borrowers in common with the major banks, bad loan disposal would be accelerated in such cases also.

38. **The authorities considered that the establishment of the proposed BASAC would help to reduce banks' excessive exposure to market risk**. The intention was to stipulate a mandatory upper limit of 100 percent on a bank's equity holdings in relation to its shareholders' equity (a subset of its regulatory capital), to be achieved within a certain timeframe. Given that most major banks now exceed this level, they would be forced to unload their excess shares within the time frame established by the regulation, which could lead to excessive market weakness. The BASAC provided a mechanism to smooth out the process of selling shares back to the market. Banks would be expected to provide an initial capital subscription to the BASAC, but public guarantees would be provided to back bank loans that the BASAC would take out to allow it to acquire banks' unwanted shares (except for those that are to be repackaged into mutual or exchange-traded funds, as well as a part of those to be bought back by issuers). Risks would be shared between the banks and the

government—commercial banks had their own capital subscriptions at risk while the state would absorb losses if such subscriptions were wiped out by the BASAC's losses on equity sales.

39. **The mission raised a number of concerns with the proposal, including that the scheme would tend to dilute the disciplining effect of stock prices on corporate behavior and could result in public capital being effectively transferred to the banks in a nontransparent and unconditional manner**. It stressed that, if the BASAC were established and public guarantees used, then strict limits on the amounts and transparent conditions for purchase and resale to the market should be set.

40. **The mission made the case for further strengthening the regulatory framework to lay the basis for a sound banking system on an enduring basis**. While vigorously addressing the NPL problem was a vital first step, a competitive banking system would require that other concerns—particularly low profitability, poor-quality capital base, and the excessive role of public financial intermediation—be addressed.

- **The mission urged the FSA to set more demanding profitability objectives in the context of business improvement plans (BIPs) under negotiation with banks that received capital injections in 1999**. In cases where failure to meet profit targets reflected weak management (rather than higher loan-loss charges), the FSA should exercise its right to impose sanctions—including conversion of preferred into ordinary shares and the subsequent replacement of bank management. The mission also stressed the need to structure future BIPs to ensure that they provide appropriate incentives to recognize loan-losses at an early stage, and that banks are not burdened by requirements to lend to specific sectors (e.g., SMEs) as under the previous BIPs.

- **The mission noted that the poor quality of bank capital, and the fact that banks with exclusively domestic operations were required to achieve only a 4 percent CAR, argued for setting more demanding capital standards**. The mission recommended that capital adequacy standards be gradually raised to 8 percent for all deposit-taking institutions, and rules on tax-deferred assets—which are less demanding in Japan than in the US for example—should be tightened.

- **While agreeing on the need to continue raising the FSA's resources, the mission argued for providing the agency with more autonomy to allow it to continue to rigorously enforce its supervisory mandate**. Officials responded that the FSA's independence from political pressure had not been compromised since its creation.

41. **Postal savings reform and reforms of government financial institutions are being studied to increase competition and the efficiency of financial intermediation**. More detailed proposals are now being prepared, which could include considering privatization of the postal savings system and other agencies. MPHPT officials referred to the need for reforms to take account of the postal savings system's role in providing basic financial services throughout the country, including in rural areas where such provision was not profitable, and the higher cost associated with handling small-lot deposits. While agreeing that carefully-implemented privatization was a welcome longer-term goal, the mission noted that banks' ability to raise their profitability could also be facilitated by early steps to level the playing field—in terms of taxes and regulations—between public financial institutions and commercial

banks. In the mission's view, social objectives should be dealt with explicitly in the budget, and would not be compromised by downsizing of public financial intermediation in Japan more generally.

42. **The authorities were committed to addressing deep-seated weaknesses among small deposit-taking institutions ahead of the removal of the blanket deposit guarantee next March.** FSA officials noted that the first round of inspections of the credit cooperatives had confirmed longstanding concerns regarding credit and investment management. While further interventions and closures were likely in coming months, they considered that the timetable nevertheless allowed the main problems to be addressed in sufficient time.

43. **The FSA noted the recent progress in strengthening regulation and supervision over life insurance companies.** In particular, recent steps to improve the calculation of the solvency margin would enhance supervisors' ability to detect early warning of difficulties, while complementary reforms—including relaxing regulations on dividend payments to enable life insurers to strengthen their internal reserves—were also under consideration. At the end of June, the Financial System Council recommended further efforts to improve disclosure of financial results, to facilitate the strengthening of capital, to enhance corporate governance, and to provide procedures to allow life insurance companies to reduce guaranteed rates of return outside of reorganization proceedings.

B. Corporate Restructuring and Structural Reforms

44. **The success of the authorities' strategy to accelerate corporate restructuring through more rapid bad loan disposal depends very much on the quality of the workout agreements that are reached.** The mission expressed concern that the proposed approach—stressing voluntary agreements between creditors and debtors along the lines of the London Approach—presented risks. A particular concern is that banks that have in the past been reluctant to press for needed changes at the firm level (or for exit through court-sanctioned bankruptcy) could be tempted to agree plans that provide only a façade of restructuring in exchange for modest debt forgiveness. The mission suggested use of explicit quantitative markers to assess the adequacy of restructuring, or that agreements be vetted by independent experts. The authorities recognized such risks, but thought that guidelines being prepared by the business and bankers' associations and various government ministries would help to ensure that agreements were ambitious enough to achieve a durable turnaround in corporate performance. Moreover, the plans would ultimately have to satisfy the banks' external auditors and the FSA—since appropriate loan classification ultimately depended on a view about the borrower's viability as a going concern under its proposed business plan.

45. **Complementary efforts are needed to support the workout process.** Relaxing regulations that limit banks' ownership in individual firms to less than 5 percent would facilitate restructuring, given the important role that debt-equity conversions may play in the workout process. The introduction of consolidated corporate taxation would face firms with appropriate incentives to adopt a more rational corporate structure. An early review of employment protection legislation—which still inhibits firms' ability to retrench workers (Box 2)—would also be desirable.

Box 2. Japan—Barriers to Faster Productivity Growth

While the authorities have implemented a number of structural reforms during the 1990s, the piecemeal approach has limited the impact on deep-seated rigidities. Consequently while Japan's export-oriented manufacturing companies set international best standards, productivity levels in the domestically-oriented sectors fall far short of levels achieved in other industrial countries. Recent studies have highlighted a number of areas where Japan fares particularly poorly:[1]

- **Competition.** Although the legal basis for competition policy is generally sound, competition enforcement has not been effective. This partly reflects the fact that, in some sectors, including telecommunications and electricity, there is no clear separation of the government's regulatory and policy functions, while legal enforcement by the Fair Trade Commission (FTC), although becoming more vigorous, remains limited. Other aspects of the regulatory system also tend to impede competition in key sectors. For example, in the retail sector, under the Large Scale Retail Location Law, the requirement for stores over 1,000 square meters to obtain the approval of prefectural government, has in practice slowed the entry of large retail stores, while the Urban Development Law has tended to impede large scale developments such as shopping malls (see McKinsey Global Institute, 2000). In the construction sector, zoning laws restrict the scale of housing developments (see Box 3). In telecommunications, competition has been limited by the lack of clear information to applicants on the minimum requirements to receive licenses, high interconnection charges, fragmented regulations on rights of way and facility sharing, and the lack of transferability of telephone numbers (which gives an advantage to incumbents) (OECD, 2000).
- **Labor market.** While labor compensation is quite flexible over the cycle, business surveys and the combination of rising unemployment and vacancy rates suggest there are considerable labor mismatches within and across industries. Employment protection laws, underpinned by judicial precedents that set strict conditions before dismissals can occur, and the practices of lifetime employment and age-dependent wages, limit labor mobility between declining and expanding sectors of the economy. Notwithstanding some liberalization, restrictions still remain on the range of professions that can be handled by private job placement and temporary employment agencies.
- **Barriers to entrepreneurial activity.** The rate of business start-ups in Japan is currently at historic lows, and is well below the levels in the United States. Entrepreneurship is hindered by the complicated and time consuming public approvals process, which requires businesses to obtain multiple licenses and permits to commence operations, and the relative lack of financing available for startups, particularly in the "new economy" sectors (compared to the U.S., Japanese venture capital firms tend to invest in later-stage companies in more traditional activities). The social stigma against business failure also raises the effective hurdle for entry for many potential entrepreneurs.
- **Relatively low IT usage.** A number of faster growing industrial countries have benefited considerably from the expansion of ICT usage in recent years. Recent studies by the Economic Planning Agency (EPA) and Goldman Sachs have found that the contribution to labor productivity growth from ICT capital deepening in Japan has increased in recent years.[2] However, while Japan is a significant ICT producer and has been a leader in some market segments (notably mobile telephones), overall ICT usage, although increasing, remains quite low by global standards. Consequently, addressing some of the impediments to greater IT penetration in the economy—including high connection fees and barriers to new business start-ups—could provide an important stimulus to growth.

Selected Comparisons of ICT Penetration

	Japan	U.S.	Australia	U.K.
Percent share of world ICT production [1]	25	30	0.4	4
Population with access to PCs (percent)	32	59	46	34
Investments in IT equipment [2]	16	19	17	26
Population with internet access	37	56	44	34

Source: Japanese authorities; OECD; and Daveri (2000).
[1] As of 1997.
[2] As of 1997. In percent of business investment.

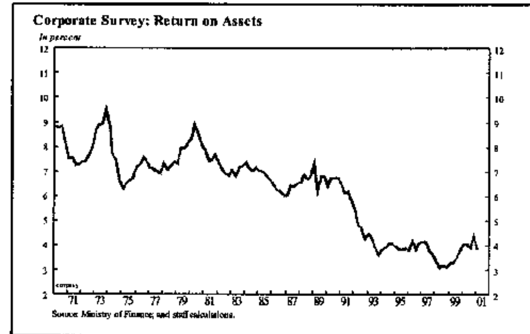
[1] OECD, *Review of Regulatory Reforms* 1999; OECD, Economic Surveys of Japan, 2000; McKinsey Global Institute, 2000, "Why the Japanese Economy is Not Growing: Micro Barriers to Productivity Growth;" Nicoletti, G., S. Scarpetta, and O. Boylaud, 1999, "Summary Indicators of Product Market Regulation with an Extension to Employment Protection Legislation," OECD Economics Department Working Paper No.226; and Edwards, J. and J. Schanz, 2001, "Faster, Higher, Stronger: An International Comparison of Structural Policies," Structural Economics Research Papers No. 3, Lehman Brothers Global Economics.

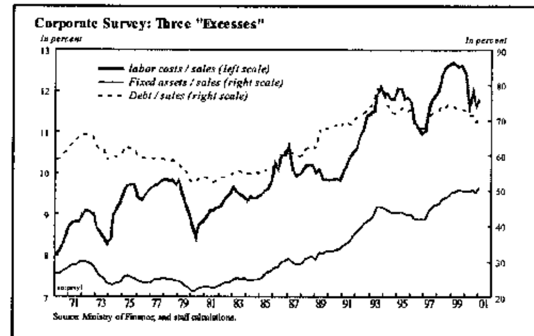
[2] See Economic Planning Agency, *Economic Survey of Japan, 1999–2000*, and Goldman Sachs, 2000, "The IT Revolution: New Data on the Global Impact." The EPA estimate that ICT capital deepening contributed about ¾ of a percentage point to labor productivity growth during 1996–99 compared to a zero contribution in the first half of the 1990s. These estimates are somewhat lower than those reported by Goldman Sachs who estimate that the contribution of ICT capital deepening to labor productivity growth was a little over 1 percentage point during 1996–99 compared to ½ percentage point during 1990–95. Goldman Sachs also find a spillover from ICT capital to TFP, although the contribution has not increased in recent years.

46. **The authorities and mission agreed that the short-term burden on the economy from corporate restructuring could be reduced by regulatory reforms aimed at boosting economic opportunities and steps to strengthen the social safety net.**

- *Competition.* Lack of competition helps to explain why Japan's domestically-oriented industries have been far less productive than those in the export sector; the large public works program has also helped to keep inefficient construction firms afloat. Problems span a range of sectors, including retail—where local authorities have tended to impede the expansion of more efficient large-scale stores—and telecoms, electricity, and gas, where conflicts of interest have arisen between the government's role as an owner and as a regulator (see Box 2). The mission recommended the establishment of independent regulators in the telecommunications and other utility sectors to address such conflicts, and greater autonomy and resources for the Fair Trade Commission to allow it to better fulfill its competition policy mandate.

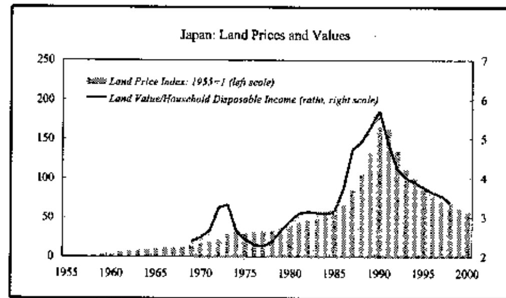
- *Corporate governance.* The slow progress in boosting corporate rates of return and unwinding the excesses (of debt, capital, and labor) from the bubble period reflects in no small measure longstanding weaknesses in corporate governance. The authorities considered that new accounting standards had already helped to improve transparency, which was increasing pressure for restructuring. Moreover, banks' increasing willingness to exert appropriate discipline on borrowers and the comprehensive revision of the Commercial Code to be submitted to the Diet early next year—which provides a greater role for external directors and strengthens managerial accountability—would also improve governance. The mission suggested that such efforts be supplemented by steps to strengthen the fiduciary role of institutional investors, for example, along the lines of the US Employee Retirement Income Security Act (ERISA): for pension funds, such a move would help to better align pension managers' incentives with policyholders' interests.





- *Real estate market.* The mission welcomed the focus on real estate deregulation in the CEFP's reform blueprint, and stressed that policies to encourage a turnaround in the sector could provide a boost to demand and relieve corporate balance sheet pressures. It emphasized the need to liberalize zoning regulations and laws on rentals and land-leases, as well as to review elements of the tax system which may create disincentives to realizing capital gains on real estate (Box 3). It also noted that faster loan disposal by the RCC would help to improve market liquidity, as well as acting as a signal to banks to accelerate sales of their own holdings. Faster disposal by the RCC would be

Box 3. Real Estate and the Macroeconomy



The sharp and prolonged decline in land prices in Japan during the 1990s shattered the post-war "land myth" (*Tochi Shinwa*). Except in 1975, land prices rose almost continuously for 3½ decades starting in 1955. During the heady half decade of the bubble years beginning in 1985, land prices in the six largest cities rose by about 200 percent, contributing around 75 percent of the ¥1,000 trillion increase in household wealth (three times annual disposable income). However, with average annual declines of 10 percent for a decade, by 2000 prices had fallen back to their 1985 levels, wiping out an estimated ¥450 trillion in household wealth.

The land price bust has taken a toll on consumer confidence and business sentiment, and been a major cause of financial sector weakness. The decline in land prices resulted in a sharp deterioration in household and corporate balance sheets, applying a continuing drag on consumption and business investment. Similarly, financial institutions—especially the trust and long-term banks which acquired the largest exposure to real estate related lending during the upswing—were hard hit by the falling prices. A recent survey suggests that 25–40 percent of banks' bad loans remain concentrated in real estate industries.

The slow adjustment of the real estate market reflected a number of factors. Banks did not face appropriate incentives to liquidate collateral, reflecting both regulatory forbearance which allowed inadequate provisioning, and very low interest rate levels. In addition, relatively underdeveloped markets for asset-backed securities thwarted one avenue for banks to shed real estate collateral from their balance sheets. A third factor related to slow and costly foreclosure and bankruptcy procedures, although the newly streamlined Chapter-11 style legislation will help to some extent. And finally, strong relationships cemented by bank cross-shareholdings discouraged aggressive action to deal with problem loans backed by real estate collateral.

Reform measures to speed up adjustment in the real estate sector should aim to:

- ***Streamline the regulatory regime.*** *Liberalization of zoning regulations*, especially in the larger cities, would facilitate the consolidation of small and vacant lots and the implementation of large-scale housing or commercial development projects. Along the same lines, there is room for easing, subject to safety requirements, the *building codes* for high-rise structures to allow fuller utilization of stipulated limits on floor-to-land area. Another key area for action is the *laws on rentals and land-leases*. The current laws (the Land Lease Law and the House Lease Law) make it extremely difficult for landlords to reclaim the use of their property except for "rightful cause"—an event that has been interpreted very narrowly by the courts. This has limited active investment in residential housing and complicated the process of converting old structures into new, more efficient housing.
- ***Tax changes to liquify the real estate market.*** The current tax system is characterized by high land transaction taxes and also a sizable tax burden on short-term capital gains, both of which tend to hamper turnover in the real estate market. Reducing transactions and short-term capital gains taxes would help to encourage more turnover and redevelopment. In addition, lock-in effects related to low land valuation for property tax purposes and the structure of the inheritance tax need to be addressed.
- ***Broaden real estate securitization.*** An important step was taken with the Real Estate Investment Trust (REIT) Law, which became effective in November 2000. The development of a Japan-REIT market and the securitization of real estate is expected to help deliver much needed liquidity to the sector from equity markets and stimulate market transactions. It is also intended to encourage the separation of development, ownership, and management functions—all of which are currently handled by the private-sector comprehensive real estate companies.
- ***Facilitate debt workouts in exchange for viable corporate restructuring plans.*** The recent package to accelerate bank and corporate restructuring is a step in the right direction. The process of restructuring would benefit from a close examination of the *bankruptcy and collateral laws* to remove obstacles to speedy acquisition and liquidation, and recovery of fair value, of loan collateral.

critical in the context of any increase in the size of its balance sheet in 2–3 years' time associated with sales of remaining problem assets to the RCC by the major banks.

- *Social safety net and labor mobility.* To ease the burden from retrenchments as corporate restructuring picks up, there was agreement on the need to strengthen the social safety net and enhance labor mobility. While the authorities were considering how best to do this, the mission recommended lengthening the eligibility period for the unemployment benefit and increasing funding for private retraining programs. It also called for further steps to liberalize job placement and dispatching services to reduce labor market mismatches. While labor mobility should be enhanced by the introduction this fall of portable private pension schemes, the mission noted the importance of ensuring that the parameters for such schemes are sufficiently flexible to promote their adoption.

C. Fiscal Policy

47. **The authorities considered that fiscal consolidation was one of the most pressing challenges of structural economic reform.** While the detailed approach was still being worked out, the initial focus would be on expenditure cuts rather than tax increases. In the authorities' view, scope clearly existed to reduce public works spending—where Japan was an outlier in comparison with other major industrial countries—and the government had already announced its intention to eliminate the ear-marking of revenues for specific purposes (e.g., road construction) as a significant first step to better expenditure management. Other elements being considered included public enterprise reform, tax reform, social security reforms and changes in central-local government fiscal relations.

48. **The authorities explained that a political commitment had been made to limit net JGB issues in FY2002 to ¥30 trillion and restore primary balance over the medium-term.** The official medium-term projection for net JGB issues in FY2002 was ¥3.3 trillion (0.7 percent of GDP) above the targeted amount, so significant measures would be required. While no firm commitment had been made as to the composition of the cuts, officials indicated that there was scope to reduce public works spending and possibly also transfers to local authorities. Once corporate restructuring had allowed a return to solid growth—which could take up to three years—the authorities considered that restoring primary balance was a feasible objective, although no timeframe for securing this goal had yet been established.

49. **The impact on the fiscal stance in FY2002 of the ceiling on JGB issues is difficult to assess.**[10] The mission noted that measures to achieve the bond issue target next year might need to be larger than suggested by the authorities' medium-term projection, since the economic assumptions on which that projection is based—2 percent nominal and real growth—now look optimistic. Another concern is that if the authorities resort to cuts in local tax transfers, this could imply larger adjustment at the general government level,

[10] Typically, JGB issues are used to finance the general account of the central government. The impact of such a restriction on the overall deficit of the central government is unclear because of the variety of different possible sources of financing for special accounts.

given the potential for multiplier effects on the already financially strained position of many local governments. The latter issue highlights the need to focus on the general government balance in setting fiscal targets, rather than on the general account of the central government which was less relevant economically. While the complexity of Japan's fiscal accounts makes it difficult to evaluate the implications for the structural deficit of the bond issue target (see the accompanying Report on the Observance of Standards and Codes (ROSC): Fiscal Transparency Module), officials did not dispute staff estimates which suggest that a fiscal contraction of about 1 percent of GDP could occur next year.

50. **While welcoming the initial focus on a fiscal consolidation strategy, the mission cautioned that it was important not to withdraw stimulus too quickly as long as growth prospects remained weak**. Given the downside risks to the growth outlook, the staff suggested that a supplementary budget might again be needed in the fall—focused as far as possible on measures to expand the social safety net and facilitate resource reallocation rather than on low-value public works—in order to reduce the likely size of the fiscal contraction next year. In view of the limited effectiveness of automatic stabilizers in Japan (see the chapter by Mühleisen in *Post Bubble Blues*), the size of the supplementary budget would need to be fine-tuned in light of updated information on Japan's economic prospects in the autumn. In response to the mission's concerns, officials indicated that the impact on aggregate demand of cuts in low-value public works might be relatively small owing to the low multiplier associated with such spending; the mission considered that the cuts would inevitably have some adverse impact on activity, although improved efficiency of public spending might dampen the effect, by boosting confidence in Japan's longer-term prospects and reducing private saving in line with the smaller expected future tax burden. This said, the authorities certainly recognized the importance of not getting locked into commitments that could result in too rapid a pace of consolidation and the need to be responsive to economic developments. On the supplementary budget, they replied that a decision would be made in the fall on the basis of information available at the time.

51. **The authorities' fiscal consolidation blueprint clearly recognizes the need to set fiscal policy in the context of a medium-term macroeconomic framework**. Given the steeply rising path of public debt in recent years, the authorities agreed with the mission that an important goal for the medium term was to stabilize the debt/GDP ratio, and then to reduce it. Staff calculations suggest that debt stabilization would require reducing the general government's structural deficit by around ¾ percent of GDP per year over a five year horizon, or adjustment of about ½ percent of GDP a year over a 10-year horizon, although the specific results are sensitive to the assumed evolution of interest rates and growth rates (Annex II). Further efforts would then be needed to achieve a significant primary surplus and reduce the debt ratio to leave room for the demographic pressures that are expected to peak in about two decades' time.[11] To give credibility to the authorities' strategy in this area, the mission recommended that a medium-term debt target be publicly established (perhaps in the context of a fiscal responsibility law), together with the broad objectives and directions of tax, expenditure, and social security policies. Detailed short-term targets could be affirmed in annual budgets, giving flexibility to respond to evolving economic conditions.

[11] See also the in-depth analysis of this issue in IMF Country Reports Nos. 00/98 and 00/143.

52. **As recognized in the government's seven point plan, the scale of fiscal consolidation required would necessitate action across a broad range of measures.** The needed steps would likely include reductions in public works spending, broadening the personal income tax base by reducing exemptions, some increase in the consumption tax rate, a further round of pension reforms, and steps to contain the growth of public medical care costs. The need for a broad approach is underlined by the fact that, on current policies, the fiscal position is likely to deteriorate in coming years, reflecting the sharply rising budgetary contributions to meet pension and health care costs.

53. **Even prior to embarking on full scale consolidation, the mission noted the importance of pressing ahead with fiscal reforms that would ease the transition to consolidation down the road.**

- **Reorienting public spending.** The mission agreed with the authorities' assessment that there was significant scope to reorient spending away from low-quality public works. The de-earmarking of certain revenue sources, together with more thorough cost-benefit vetting of projects, would improve the quality of public investment, providing room for spending to expand the social safety net and for deficit reduction. Reduced public works spending would also help to accelerate economic restructuring as resources were reallocated away from such sectors as public construction.
- **A more market-oriented FILP.** While welcoming the recent reforms, the mission suggested that the economic benefits depended on significantly raising the share of projects that pass a market test: in FY2001 (the first year under the new regime), only 3 percent of FILP spending will be market-financed. The mission welcomed the consideration being given to reform of the public enterprise sector, including privatizing a number of public corporations. It suggested that corporations that continue to receive public funds should be run on commercial lines, with explicit subsidies targeted to meet specific social objectives.
- **Social security reform.** The mission stressed the need for the forthcoming health care reform bill to be ambitious enough to rein in the rapid growth in costs, by increasing copayments and controlling hospital- and pharmaceutical-related costs. While welcoming the impact of last year's pension reforms on reducing projected unfunded liabilities, the mission nevertheless stressed the need for further efforts to put the system on a sound footing. Needed measures would likely involve steps to contain growth in pension benefits, as well as increases in contribution rates.
- **Tax reform.** The mission welcomed the suggestion by the government's tax commission to reduce personal income tax exemptions, given the significant revenue gains that could accrue over the medium term from such a move. It reiterated the desirability of introducing taxpayer ID numbers to facilitate base broadening and improve tax administration, and welcomed efforts to strengthen local government finances including by providing local authorities with more revenue-raising authority.

54. **The mission stressed the need to address the shortcomings in fiscal transparency identified in the ROSC module report that has been circulated separately.**

- **More timely and comprehensive information on the fiscal stance.** The authorities recognized the desirability of reducing the lag and raising the frequency of data on the general government's fiscal position, and were examining how best to do this in the context of their very decentralized system and the large number of local governments.
- **More medium-term orientation.** There was general agreement between the authorities and mission on the need for annual budgets to be set in a more fully articulated medium-term context—indeed this had been a key recommendation of the Council on Economic and Fiscal Policy in its framework paper announced in late June. While the authorities recognized that uncertainty about the future course of fiscal policy could be reduced by setting initial budgets to achieve the desired fiscal stance, they nevertheless commented that the institution of the supplementary budget had merit—since it was easier to expand an initially conservative stance than to trim budgeted expenditures that became excessive in light of subsequent economic developments.

D. Monetary Policy and Exchange Rate Issues

55. **BoJ officials stressed that the monetary policy framework introduced in March had a number of advantages over the ZIRP.** First, there was potential for a larger impact on expectations, since the BoJ was committed to maintain the framework until prices stopped declining rather than until deflationary concerns had been dispelled (the condition for suspending the ZIRP), and had been more explicit about how the test would be evaluated. Second, the quantity-based framework provided more room to ease even at zero interest rates—something that clearly was not possible under the ZIRP—although the Policy Board had not decided the circumstances under which further easing would be warranted. Officials said that the framework had worked quite well so far, in the sense that the BoJ had achieved its reserve target although there had been occasions in which repo auctions had failed, and the impact of the policy was still being actively studied.

56. **While the Policy Board recognized that the present policy stance was unlikely to deliver an end to deflation over the next year—its members' forecasts confirmed as much—it was far from clear to BoJ officials what more could be done to improve the situation.** First, a higher target for current account balances might be difficult to achieve even if the BoJ made use of the flexibility within the present framework to purchase more JGBs. Since the market was already flush with liquidity, such additional purchases might simply lead to reduced demand at the short end—a phenomenon the BoJ had already observed in recent auctions even with the present target. Second, the transmission mechanism at zero interest rates was uncertain—aggressive purchases of JGBs might even raise the risk premium rather than serving to lower longer-term yields. Fundamentally in the BoJ's view, ongoing deflation in Japan reflected both structural and macroeconomic factors at this point—in such circumstances, it was not clear that there was much more that monetary policy could do.

57. **The mission urged the BoJ to use all instruments at its disposal to combat deflation and its associated economic costs.** Indeed, the case for policy easing was amplified by the new government's commitment to faster corporate restructuring, which could lead to more intense deflationary pressures. The risk that progressively raising the

reserves target through additional JGB purchases would lead to a higher risk premium should not be overstated—particularly in the present environment in which a new government had already committed itself to a process of gradual fiscal consolidation. More likely, a further easing of policy would likely be transmitted to the economy through some further yen weakening and a pickup in equity prices—as had occurred in the immediate aftermath of the adoption of the present policy—which was desirable to support recovery and mitigate deflationary pressures. In the mission's view, a greater risk was that failure to act could lead to movements in the opposite direction—as markets became disappointed that the BoJ was unlikely to use the flexibility in the policy framework, as had been hoped initially.

58. **To improve the effectiveness of further policy actions, the mission recommended that the BoJ commit to a timeframe for eliminating deflation and to a medium-term target for inflation**. Not only would embracing an inflation targeting framework along these lines help to underpin the public's expectations, it would also serve to guide the BoJ's future policy actions vis-à-vis the objective and help to reduce risks of a deflationary spiral (Box 4). Officials had some sympathy for inflation targeting as a monetary framework in more normal circumstances, but they expressed doubts about its usefulness in a situation in which policymakers lacked effective instruments to ensure that positive inflation was achieved. This was why, in its March statement, the BoJ had only committed to maintaining the current policy until prices stabilized, rather than committing to actually stabilizing prices within a certain period.

59. **MoF officials considered that movements in the yen over the past year broadly reflected fundamentals**. As a result, there had been no need to intervene in the foreign exchange market over this period, except last September in the context of coordinated action to support the euro. Officials indicated that, as long as exchange rate movements continued to reflect fundamentals including the stance of monetary policy, they would not resist such moves. They had no intention to try to engineer a depreciation of the yen, however. They would continue to be concerned by abrupt movements in the yen in either direction, although they agreed with the mission that the consequences for the region of a weaker yen would be more manageable than during the Asia crisis, given the adoption of more flexible exchange rate regimes in many countries and their healthier external debt profiles (Box 5). The mission stressed that, while the potential impact of a weaker yen on the region and on global current account imbalances needed to be recognized, the resulting concerns should not deflect the pursuit of a vigorous monetary policy aimed at combating deflationary pressures in Japan.[12]

E. Other Issues

60. **While welcoming recent progress, the mission noted a number of weaknesses in economic statistics that continue to complicate the monitoring of developments and the formulation of macroeconomic policies**. Despite recent improvements in statistical

---

[12] While the yen appears moderately undervalued in effective terms relative to medium-term fundamentals on the basis of the CGER methodology (which admittedly raises issues of its own given uncertainties about Japan's future potential growth rate and pace of structural change), this is not inappropriate from a cyclical standpoint.

Box 4: The Zero Bound on Nominal Interest Rates and its Implications for Monetary Policy in Japan: A MULTIMOD-based Analysis

Larry Summers predicted that the zero-nominal-interest-rate floor could become a critical constraint on monetary policy in an era of low inflation, because it would limit the scope for monetary authorities to reduce real interest rates to stabilize output and inflation.[1] Recent experience in Japan has fully borne out this prediction, as price deflation has implied positive real interest rates despite BoJ efforts to ease monetary policy. Subsequent research efforts examining this issue have followed two tracks. The first investigated how the design of the monetary policy framework, as summarized by policy rules and the choice of the target rate of inflation, can mitigate the extent to which the zero floor on nominal interest rates becomes binding.[2] The second track examined what other policy channels, besides the short-term nominal interest rate, are available to stimulate the economy once the zero constraint becomes binding.[3]

Following both of these research tracks, the IMF's macroeconomic model MULTIMOD was used to study the implications for Japan of the zero constraint on nominal interest rates. The analysis assumes that the systematic component of monetary policy in Japan can be broadly characterized as following a Taylor rule.[4] Under this rule, the short-term real interest rate is adjusted in response to deviations of output from potential and deviations of core inflation from target. The analysis considers what different target rates of inflation and modifications to the basic monetary policy rule imply for the effectiveness of policy given that the nominal interest rate cannot be pushed below zero. The key results are as follows:

- In Japan, target rates of inflation below two percent notably increase the likelihood that the zero constraint on nominal interest rates will become binding. Because of the estimated sensitivity of inflation to demand conditions in MULTIMOD's Japan block, negative aggregate demand shocks in Japan can drive nominal interest rates down to the zero bound more easily than in other industrial countries.
- The negative implications of the zero bound are exacerbated if the monetary authority's estimates of potential output embody persistent errors that are positively correlated with the business cycle, implying that the output gap tends to be underestimated (in absolute value) in both recessions and booms.
- Once the constraint has become binding, a credible monetary-policy commitment to increasing future inflation can help stimulate aggregate demand.[5] The analysis suggests that either a clearly articulated temporary price-level target or a permanent increase in the target rate of inflation can generate the expectations of future inflation that lower expected real interest rates to stimulate private demand. The important caveat here is that private agents need to believe the commitment to future inflation.
- In terms of avoiding the negative implications of the zero bound on nominal interest rates, the most important component of the monetary policy framework appears to be the numerical value for the inflation target. Policymakers should target a sufficiently high rate of inflation. In the case of Japan, this analysis suggests that the optimal value for the inflation target may be as high as 2.5 percent.[6]
- Modifications to the basic monetary policy rule that alter the way policy responds to stabilize output and prices can help to mitigate the negative implications of the zero bound on nominal interest rates. The changes examined include stronger responses to output and inflation gaps, price-level targeting, and a commitment to unwind all declines in the aggregate price level resulting from periods of deflation.

[1] Larry Summers "How Should Long-Term Monetary Policy be Determined," *Journal of Money, Credit and Banking*, 1992.
[2] See Reifscnieder D. and J. Williams, (1999), "Three Lessons for Monetary Policy in a Low Inflation Era." *Finance and Economic Discussion Series*, Board of Governors of the Federal Reserve System, and the references provided therein.
[3] See Lars Svensson (2000) "The Zero Bound in an Open Economy: A Foolproof Way of Escaping From a Liquidity Trap." Paper available at: http://www.iies.su.se/leosven/, and the references provided therein.
[4] The rule is referred to as a forward-looking Taylor rule because the measure of inflation expectations that enters into the calculation of the real interest rate is forward-looking. In addition, the measure of the equilibrium real interest rate in MULTIMOD also has an important forward-looking dimension—for details see Hunt B., and D. Laxton "The Zero Bound on Nominal Interest Rates and its Implications for Monetary Policy in Japan," IMF Working Paper (2001, forthcoming).
[5] It is important to recognize that credibility of the policy initiative is an assumption underpinning each of the simulations. Three such initiatives were considered. The first consisted of committing to restore the price level to where it was prior to the shock. The second consisted of a 15 percent depreciation in the nominal yen/dollar exchange rate combined with a commitment to inflate the price level to a point 5 percent above where it was before the onset of the shock. The third was a two percentage point increase in the target rate of inflation.
[6] This is based only on the implications of the zero bound and does not take into account other arguments such as biases in published price indices and inflation required to allow for relative price changes in the face of downward nominal rigidities.

Box 5. The Impact Of Yen Depreciation On Asian Countries

The recent decline in the yen has raised concerns that—as in 1997—depreciation of the Japanese currency could exacerbate weakness in the region. While Asia has become relatively less reliant on trade with Japan in recent years, the linkages between Japan and the Asian region remain significant, with around 12 percent of Asian exports being sold to Japan and 20 percent of imports coming from Japan. Similarly, while Japanese FDI has declined in relative importance in many Asian countries and Japanese banks have reduced lending to the region, Japan remains an important source of capital to the region.

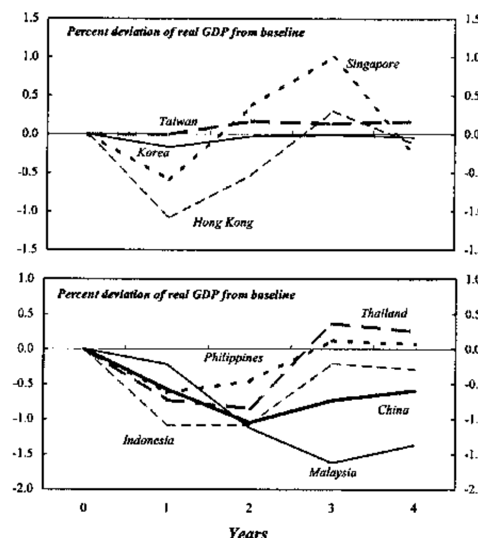
The relative importance of trade and financial links with Japan varies among countries in the region:

- **Indonesia has the most significant trade links with Japan** as 22 percent of its exports go to the Japanese market (about one-half petroleum), followed closely by China and Thailand at 16 percent. Hong Kong SAR and Singapore, at 6 percent and 7 percent respectively, have the lowest reliance (Table 4).
- **Thailand has the highest exposure to Japanese banks**, with nearly 37 percent of its external bank debt owed to Japanese banks, while Taiwan POC has the lowest at 17 percent.
- **Japanese FDI is most important in Singapore and Thailand**, accounting for one quarter of inflows, whereas it is relatively less important in China and the Philippines.
- **Thailand has the highest proportion of external debt denominated in yen**, at 32 percent. Indonesia and the Philippines have the highest external debt-to-GDP ratios among the nine countries, and 21 percent and 27 percent of these debt stocks, respectively, are denominated in yen. However, external debt levels have been reduced in Asian countries since the financial crisis, reducing their vulnerability to external shocks.

Given these interdependencies, economic and financial developments in Japan have important implications for the region. Two multi-country macroeconomic models—the Oxford Economic Model (OEM) and the G-cubed (Asia-Pacific) model—were used to assess the impact of a 10 percent nominal depreciation of the yen on real GDP in nine Asian countries.

The OEM simulations suggest that real GDP in the Asian countries would generally decline by ½ to ¾ of a percent relative to the baseline in the first year after the depreciation, although in a number of countries activity begins to recover in the second year.[1] The largest first-year impact is estimated to be in Hong Kong and Indonesia and the smallest in Taiwan POC and Korea. However, in the second year, real GDP growth in five of the nine countries is higher than in the baseline as exports respond to stronger growth in Japan, the real yen exchange rate begins to appreciate as inflation picks up in Japan, and the benefits of easier monetary policy in the countries feed through. By the third year, real GDP is higher than in the baseline in all countries except China, Malaysia and Indonesia. These simulations make the technical assumption of an initially unchanged exchange rate of the Asian currencies against the dollar. In practice, depreciation against the dollar would provide a partial cushion against the negative initial impact of yen depreciation, except for countries that fix their exchange rates against the dollar (China, Malaysia).

Figure 1. Japan: Impact of Yen Depreciation on Real GDP
(10-percent nominal depreciation)



Source: staff simulations from the OEM.

The simulations from the G-cubed (Asia-Pacific) model suggest a favorable impact of yen depreciation on the Asian region related to an increase in Japan's risk premium.[2] The depreciation was modeled by permanently raising the risk premium on Japanese financial assets by ¾ percentage point. Real GDP in most Asian countries is modestly higher than in the baseline, even in the first year after the depreciation. For Asia, the negative impact on net exports is more than offset by the higher capital inflows (that mirror the capital outflows that take place from Japan following the rise in its risk premium). These inflows lower real interest rates and boost investment. If, instead, the depreciation is brought about by monetary expansion in Japan, there is little impact on GDP in the region as the positive impact on activity from stronger growth in Japan is offset by the more depreciated yen.

[1] The simulation was conducted as a 10 percent nominal depreciation (relative to baseline) of the yen against the U.S. dollar with the assumption that all other currencies initially remain unchanged vis-à-vis the dollar.

[2] In these simulations, the exchange rates adjust in a forward-looking manner to satisfy an uncovered interest parity condition (adjusted for risk premia). The central bank in each country is assumed to operate a fixed monetary rule. See T. Callen and W. McKibbin, "Japan and Asia: Policies and Prospects," in the accompanying *Selected Issues* paper.

methodology—including the move to SNA93 and the new methodology for seasonal adjustment—the national accounts remain very volatile, while doubts persist about the comprehensiveness of the survey coverage for private consumption. Lack of timeliness of consolidated fiscal data also hamper surveillance. The authorities noted that a new, large sample, survey of expenditure on consumer durables would be introduced later this year to try and improve the reliability of the private consumption statistics. The mission stressed the need to address these and other outstanding data deficiencies (Annex III). Japan has subscribed to the Special Data Dissemination Standard (SDDS), and has made use of the flexibility option on timeliness of dissemination of data on general government operations.

61. **The authorities reiterated their strong commitment to multilateral liberalization within the WTO framework**. Japan is continuing to press for a comprehensive approach—including investment, dumping, competition, labor, and environmental issues—in the negotiations toward the launch of a new round in November. The mission noted, however, that all countries would need to show flexibility in order to reconcile the different positions among the major players. Officials saw no conflict between their multilateral approach to trade liberalization within the WTO framework and their simultaneous pursuit of bilateral FTAs with some countries.[13] The mission welcomed Japan's expansion of duty- and quota-free access of least-developed country exports to its markets.[14] The mission noted that high levels of agricultural protection in Japan—including tariff peaks up to 500 percent on some products—needed to be reduced; in response, the authorities reiterated their concerns about food security. With respect to the anti-bribery initiative, Japan accepted the OECD's Convention on Combating Bribery of Foreign Public Officials in International Business Transactions in October 1998, after making the necessary amendment to its domestic laws (Unfair Competition Prevention Law) to criminalize the act of bribing foreign public officers.

62. **The mission commended the authorities' ongoing commitment to ODA—Japan remains the world's largest provider of such assistance (0.27 percent of GDP in 2000)**. It also welcomed the very high ratio of untied to total assistance—the fourth highest among DAC members. While noting a reduction in ODA in FY2000 reflecting the one-off contribution to the AsDB's Asian Currency Crisis Support Fund in 1999, it encouraged the authorities to maintain Japan's high ODA level, and to augment resources for LDCs and for social objectives. The mission welcomed Japan's negotiation of swap agreements with selected Asian countries under the Chiang Mai initiative (complementary to the use of Fund financial resources), which would make a contribution to preventing and managing financial crisis in the region. It also welcomed Japan's leadership at the Okinawa summit in expanding debt relief to qualified commercial claims and to accelerate implementation.

---

[13] Japan began negotiations with Singapore in early 2001 on an Economic Partnership Agreement. Negotiations now underway with Korea and Mexico on investment agreements may become platforms for future FTAs.

[14] Effective from April 2001, the number of least developed countries eligible for duty- and quota-free access of exports was expanded to 46 (from 42 previously) and 360 industrial products were added to the list of items for the preferential treatment.

V. STAFF APPRAISAL

63. **The new government in Tokyo has a window of opportunity to address the deep-seated structural problems that lie at the root of Japan's lackluster economic performance over the past decade.** The strong popular support enjoyed by the reformist administration must now be leveraged to deliver real economic change. Continued muddling through or a watering down of the program in response to vested interests would simply prolong economic weakness and increase the risk of crisis—as the deep imbalances in the banking, corporate, and fiscal sectors are simply not sustainable. The preferred course by far is to finally face the true extent of the bad loan problem in the banking system, accelerate the process of restructuring distressed corporates, liberalize regulatory impediments to create employment and investment opportunities as the old economy downsizes, and embark on tax and spending reforms needed to restore a sustainable fiscal position.

64. **While such a strategy has the best chance of reinvigorating the economy in the medium term, there is a need for supportive macroeconomic policies to cushion the short-term impact on economic activity and for the authorities to respond aggressively in the event that downside risks to the outlook materialize.** Monetary policy should be vigorously implemented to deliver an end to deflation over the next year and set with a view to achieving modest positive inflation thereafter. Just as important, the withdrawal of fiscal stimulus that is currently underway should remain modest until recovery is established. The immediate focus of fiscal policy should thus be on reforms to pave the way for consolidation down the road together with a reprioritization of expenditure, rather than on sharp cuts in the overall level of fiscal support to the economy. Additional macroeconomic policy support would likely be needed if downside risks to the growth outlook materialized and the economy looked headed for a prolonged recession. In this context, it will be important to use the public support framework proactively to address banking weakness that would be likely to result from more pervasive corporate distress.

65. **The authorities have appropriately identified banking sector problems as a top priority. Vigorous implementation of the recent package, together with strong complementary measures, will be needed to turn this sector around.**

- **Loan classification and provisioning standards need further tightening.** While the FSA has made headway in this area, there remains room for banks to strengthen credit assessments and to adopt a more forward-looking approach to provisioning. The FSA should also consider directing banks to raise general provisions in view of the continued down-migration of gray-zone loans to problem categories. Japan's early participation in the FSAP would help to shed further light on this issue.

- **A timetable for disposal of problem loans should be set for all deposit-taking institutions, not just the major banks.** The expectation should be that only a small fraction of the most intractable of banks' problem assets would be sold to the RCC in 2–3 years' time. While there are legitimate concerns about the potential impact on SMEs and regional economies of faster disposal by regional banks and credit cooperatives, the significant role of such institutions in the banking system and the NPL problem implies a need for setting a timetable for disposing of their bad loans as

well. Finally, the RCC should be much more proactive in disposing of its problem assets and face more ambitious deadlines for doing so.

- **While banks' exposure to the stock market remains excessive, the proposal to establish a Bank Shareholding Acquisition Corporation to reduce their equity holdings raises concerns**. The continued reduction in bank exposure to equity price risk would preferably be achieved without public sector financial involvement. If public funds or guarantees are used, strict limits on the amounts and transparent conditions for purchase and resale to the market should be established.

66. **Targeted public capital injections may be needed to offset the impact on bank capital from more aggressive provisioning and loan disposal**. In view of continued low profitability and doubts about solvency, raising capital from the market is unlikely to be an option at present in many cases. While insolvent institutions should be allowed to exit, under-capitalized banks with healthier prospects will need public funds to prevent a credit crunch and maintain systemic confidence. Such funds should be conditional on strong restructuring plans, however, involving participation in debt workouts and achieving satisfactory returns on equity within a defined period; in cases where banks fail to meet agreed conditions, the FSA should exercise its right to impose sanctions—including conversion of preferred shares into ordinary shares and the subsequent replacement of bank management. Time is of the essence in view of the scheduled end of the blanket deposit guarantee next March, and the greater risk of contagion from individual bank weaknesses thereafter.

67. **Broader reforms are needed to strengthen the regulatory framework and lay the basis for a sound banking system.**

- *Regulation and supervision*. Capital adequacy requirements should be gradually raised to 8 percent for all deposit-taking institutions, rules on tax-deferred assets tightened, and quarterly disclosure of financial results made mandatory. Greater autonomy for the FSA would reduce risks of political influence on supervisory issues.
- *Less public financial intermediation*. The government's intention to consider options for privatizing the postal savings system and reducing the role of public financial institutions is welcome. Social objectives—including access to banking services in rural areas—can be met without requiring as pervasive a role for public financial intermediation as in the past. Leveling the playing field between private and public institutions—in terms of taxes and regulations—would help to achieve needed downsizing and improve the environment for private institutions to raise their profitability. Privatizing the postal savings system, if implemented carefully, would help increase competition and efficiency of financial intermediation more generally.

68. **Prompt action is needed to further strengthen the regulation and supervision of life insurance companies**. While recent steps to strengthen the calculation of the solvency margin are welcome, remaining gaps in the regulatory regime need to be filled.

69. **The program to accelerate banks' disposal of bad loans will be a success only if it achieves deep restructuring in distressed firms and prompt exit of nonviable entities**. There are risks that informal workout agreements under negotiation could continue to postpone serious restructuring in the hope of an economic recovery. Guidelines for such

workouts thus need to ensure that restructuring plans are sufficient to achieve a durable turnaround in performance. The FSA has a key role here—since loan classification ultimately requires a view about the borrower's viability under the proposed business plan—which could be complemented by requiring credible outside experts to vet corporate restructuring agreements. Supporting efforts—including, on the tax side, the enactment of consolidated corporate taxation—would also help bring about a more rational corporate structure in Japan.

70. **Removing impediments to efficient resource use in Japan's domestic sectors could yield significant productivity gains over the medium term**, while generating investment and employment opportunities that could help cushion the impact of corporate restructuring. Action in the following areas could yield particularly significant returns:

- *Regulatory reform.* The authorities' recent reform blueprint clearly recognizes the need to broaden the competition policy framework and strengthen its enforcement. The establishment of independent regulators in the telecommunications, electricity, and gas sectors would help to spur competition and reduce conflicts of interest arising from the government's role as owner-regulator in these sectors. The Fair Trade Commission's resources and independence should be strengthened. Remaining barriers to imports and to domestic distribution, including in the agricultural sector, should be reduced to enhance competitive forces.
- *Corporate governance.* Plans to comprehensively amend the Commercial Code to place a greater emphasis on external directors and improve managerial accountability are welcome. Complementary steps are needed to better align the incentives of pension managers with the interests of policyholders.
- *Labor market.* Restructuring efforts would be facilitated by amending employment protection legislation to provide companies with greater scope to adjust employment levels, including in the context of informal debt workouts. At the same time, the social safety net should be strengthened to cushion the impact on retrenched workers—including by lengthening the eligibility period for unemployment benefits, and expanding resources for retraining. Further efforts to liberalize job placement and dispatching services would help to reduce mismatches in the labor market.
- *Real estate market.* Further reforms, for example liberalizing zoning regulations and laws on rentals and land-leases, and reducing tax impediments, would create value in the market. Accelerated disposal of land collateral would help land prices to finally bottom out: in this context as well, a more active role for the RCC is desirable, as it would not only help to improve liquidity in the real estate market, but also would act as a signal to banks to move more rapidly in selling their own real estate collateral.

71. **The government's initial focus on a medium-term strategy to put government and social security finances on a firm footing is welcome**. Such a strategy should aim to establish a medium-term debt target, and the broad objectives and directions of tax, expenditure, and social security policies. Detailed short-term targets could then be affirmed in annual budgets, providing flexibility to respond to evolving economic conditions.

72. **In the near term, fiscal policy should remain responsive to changing economic circumstances**. For FY2002, the government should not get locked into commitments that

could result in too rapid a pace of fiscal consolidation. A supplementary budget is likely again to be needed later this year, focused as far as possible on measures that expand the social safety net rather than on low-quality public works programs.

73. **While the process of consolidation should be gradual, upfront fiscal reforms would help provide the building blocks and establish the credibility of the program.**

- *Improve the quality of government expenditure.* Recent proposals to eliminate earmarking of revenues in special accounts for specific purposes (e.g., road construction) are welcome. Ongoing efforts to cut inefficient public works projects and weed out questionable bidding practices should also be stepped-up.
- *Increase the market-orientation of the FILP.* The share of projects financed by market borrowing should be raised significantly. Public corporations that continue to be financed through the FILP should be run on commercial lines, subsidies for fulfilling specific social objectives should be explicit, and investment projects should be tested against a rigorous comparison of costs and benefits.
- *Further social security reforms.* A further round of pension reforms will be needed to eliminate the still significant unfunded liabilities in the system. The intention to implement a comprehensive medical care reform package next year is welcome and should include significant initiatives to contain the growth in costs.
- *Tax reforms.* To facilitate broadening of the tax base and improve tax administration, taxpayer identification numbers should be introduced at an early opportunity. The deteriorating financial position of local authorities highlights the need for steps to reduce the imbalance between their spending and revenue-raising authority.

74. **Shortcomings in fiscal transparency, highlighted in the recent ROSC report, merit attention**. Budget documentation should comprehensively report on the central and general government finances, and provide medium-term projections based on a sound macroeconomic framework. Some progress has been made, but what is currently published remains inadequate for assessing the macroeconomic impact of fiscal policy. The absence of timely quarterly data on the fiscal aggregates generates similar concerns. Recourse to supplementary budgets should be reduced, and the desired fiscal stance formulated in the initial budget.

75. **While the new monetary policy framework is a welcome sign of the BoJ's willingness to tread new ground, the present policy stance is unlikely to eliminate the downward pressure on prices within a reasonable timeframe**. For this reason, the BoJ should not delay in raising its quantitative target, together with complementary measures to provide liquidity as needed, including increases in *rinban* operations.

76. **There are also likely to be benefits from enhancing the transparency of the monetary policy framework**. In particular, the effectiveness of the current policy would be enhanced if a reasonable timeframe for eliminating deflation were specified, in order to increase the impact on price expectations. There would also be benefits from adopting a modest positive inflation target for the medium term to reduce the risks of getting stuck in a deflationary trap.

77. **While an easier monetary policy stance would likely give rise to further yen weakening, this will be helpful from a cyclical standpoint.** Regional concerns are likely to be more contained than during the Asia crisis, given the adoption of flexible exchange rates in many countries and their healthier external debt profiles.

78. **Progress has been made in upgrading economic statistics, but remaining weaknesses continue to undercut the monitoring of developments and formulation of policy.** Recent improvements in the national accounts statistics, including the new estimation methodology for public investment, are welcome. However, consumption data remain volatile, and further work is needed to improve the quality of household surveys used in the estimation of the data. Data deficiencies in the fiscal area also need to be addressed.

79. **Recent measures to ease market access for LDCs are welcome.** To improve competitive forces in the agricultural sector, further efforts to reduce agricultural protection are desirable. Leadership and flexibility on the part of Japan will be critical in achieving the consensus needed to successfully launch the new global trade round and help contain protectionist pressures that would seriously damage the prospects for global growth.

80. **Japan remains the world's largest provider of ODA, and efforts to maintain this high level are welcome.** Initiatives taken over the past year as the chair of the G-7 Summit have played an effective role in promoting and expanding the HIPC debt relief initiative. The expansion of duty- and quota-free access of LDC products to Japan's markets should play an important role in international efforts to support economic development.

81. **It is proposed that the next Article IV consultation with Japan take place on the standard 12-month cycle.**

Table 1. Japan: Selected Economic Indicators, 1994-2002

Population: 126.9 million (2000)
GDP per capita: US$37,470 (2000)
Quota: SDR 8,241.5 million

	1994	1995	1996	1997	1998	1999	2000	Proj. 2001	Proj. 2002
Growth (percent change)									
Real GDP	1.0	1.6	3.3	1.9	-1.1	0.8	1.5	-0.2	0.5
Domestic demand	1.3	2.1	3.8	1.0	-1.4	0.9	1.1	0.3	0.2
Private consumption	2.5	1.5	1.9	1.1	0.2	1.2	0.5	0.2	0.8
Residential investment	7.4	-5.8	13.4	-15.3	-13.9	0.8	1.6	-4.0	0.6
Business investment	-6.5	2.5	4.2	13.2	-2.3	-4.3	4.4	1.6	1.7
Government consumption	2.8	4.3	2.8	1.3	1.9	4.0	3.6	2.0	1.7
Public investment	3.6	-0.3	9.3	-10.4	-2.6	6.1	-7.3	-4.1	-12.2
Stockbuilding 1/	-0.2	0.6	0.3	0.0	-0.6	-0.2	0.1	0.1	0.0
Net exports 1/	-0.2	-0.5	-0.4	1.0	0.3	-0.1	0.4	-0.5	0.3
Exports of goods and services	3.4	4.1	6.4	11.3	-2.3	1.3	12.1	-2.9	5.4
Imports of goods and services	7.7	12.8	13.2	1.2	-6.8	2.9	9.9	2.4	3.0
Saving-Investment (percent of GDP)									
Gross national saving	30.7	30.2	30.6	30.9	29.9	28.6	28.5	28.1	27.6
Gross domestic investment	28.1	28.2	29.2	28.7	26.9	25.9	26.0	25.7	24.8
Inflation (annual average)									
CPI	0.7	-0.1	0.1	1.7	0.6	-0.3	-0.6	-0.7	-0.7
GDP deflator	0.1	-0.4	-0.6	0.3	-0.1	-1.4	-1.7	-0.9	-1.1
Unemployment rate (annual average)	2.9	3.1	3.3	3.4	4.1	4.7	4.7	5.0	5.5
Government (percent of GDP)									
General government									
Revenue	31.2	31.1	31.0	30.8	30.5	30.1	30.4	30.4	30.3
Expenditure	33.5	34.6	35.2	34.1	35.0	36.9	38.3	37.3	36.3
Balance	-2.2	-3.5	-4.2	-3.2	-4.5	-6.8	-8.0	-6.9	-6.0
Balance excluding social security	-5.0	-6.3	-6.7	-5.8	-6.5	-8.6	-9.2	-7.7	-6.5
Structural balance 2/	-1.9	-3.2	-4.3	-3.4	-3.6	-5.4	-5.5	-5.2	-4.1
Money and credit (percent change, end-period)									
M2 plus CDs	2.9	3.2	2.9	3.8	3.9	2.6	2.2	3.2 4/	...
Broad liquidity	3.7	4.1	3.5	3.3	3.1	2.4	3.2	3.0 5/	...
Domestic credit	-0.4	1.8	1.4	1.3	2.6	2.9	2.6	4.5 6/	...
Bank lending	-0.2	2.1	-0.4	0.0	-4.7	-5.9	-3.8	-3.8 4/	...
Interest rate									
Three-month CD rate (annual average)	2.1	1.1	0.5	0.5	0.6	0.1	0.2	0.01 7/	...
Official discount rate (end-period)	1.8	0.5	0.5	0.5	0.5	0.5	0.5	0.25 7/	...
Balance of payments (in billions of US$)									
Exports, f.o.b.	386.0	429.4	400.2	409.2	374.4	403.9	459.6	428.0	460.1
Imports, f.o.b.	241.5	297.2	316.7	307.8	251.6	280.5	342.8	333.3	345.2
Current account balance	130.6	111.4	65.8	94.1	121.0	106.8	116.9	102.2	118.4
Percent of GDP	2.7	2.1	1.4	2.2	3.1	2.4	2.5	2.4	2.8
Terms of trade (percent change)	7.1	0.5	-6.9	-3.9	6.7	4.7	-5.1	-0.8	-0.7
Change in reserves	25.4	58.7	36.8	6.9	-7.4	77.3	49.3	...	...
Total reserves minus gold (in billions of US$)	125.9	183.2	216.6	219.6	215.5	286.9	354.9	356.0 4/	...
Exchange rates (annual average)									
Yen/dollar rate	102.2	94.1	108.8	121.0	130.9	113.9	107.8	125.1 7/	...
Real effective exchange rate 3/	143.5	149.5	126.7	117.8	107.4	120.1	127.4	120.4 4/	...

Sources: Nikkei Telecom; and staff estimates and projections as of July 3, 2001.

1/ Contribution to GDP growth.
2/ Including social security, excluding bank support.
3/ Based on normalized unit labor costs; 1990=100.
4/ June 2001.
5/ May 2001.
6/ April 2001.
7/ July 11, 2001.

Table 2. Japan—General Government Operations

(In percent of GDP)

	FY1998	FY1999 Est.	FY2000 Est.	FY2001 Proj.	FY2002 Proj.	CY1998	CY1999 Est.	CY2000 Est.	CY2001 Proj.	CY2002 Proj.
General government balance	-5.4	-7.1	-7.6	-6.7	-5.9	-4.5	-6.8	-8.0	-6.9	-6.0
Social security balance	1.9	1.7	1.0	0.7	0.5	2.1	1.8	1.2	0.8	0.5
General government excluding social security	-7.3	-8.9	-8.6	-7.4	-6.3	-6.5	-8.6	-9.2	-7.7	-6.5
Of which:										
Taxes and fines	17.3	16.8	17.2	17.2	17.0	17.2	16.8	17.1	17.2	17.1
Consumption	9.2	9.4	9.8	9.6	9.3	9.1	9.4	9.6	9.7	9.3
Investment	5.8	5.6	5.2	4.9	4.1	5.6	5.8	5.3	5.1	4.3
Support for banks	0.2	0.7	0.8	0.0	0.0	0.0	0.3	1.3	0.0	0.0
Structural balance (including social security, excluding support for banks)	-4.1	-5.3	-5.5	-4.9	-4.0	-3.6	-5.4	-5.5	-5.2	-4.1
Change in structural balance (including social security, excluding support for banks)	-1.1	-1.3	-0.2	0.6	0.9	-0.2	-1.8	-0.1	0.3	1.1
Impact on aggregate demand	0.3	0.6	0.3	-0.8	-1.4	-0.3	1.0	0.2	-0.4	-1.6
Gross debt	...	...	...	...	...	110.2	120.1	130.2	140.0	148.0
Net debt (excluding social security system)	...	...	...	...	...	75.9	84.2	92.8	100.8	107.1

Source: Staff estimates, based on the following assumptions:

Growth: Real GDP growth is projected to be -0.2 percent in CY2001 and 0.5 percent in CY2002. Each percentage point increase in growth raises the general government balance by about 0.3 percentage points of GDP.

Stimulus Packages: The projections take account of the FY2000 supplementary budget and the FY2001 budget. The ¥11 trillion stimulus package announced in October 2000 includes additional public investment of ¥5 trillion (headline figure), most of which would take place in the first half of CY2001. Local governments are projected to largely offset their share in the stimulus package with cuts in own-account expenditures elsewhere. For FY2002 projections, the impact of a ¥30 trillion cap on new JGB issues on public investment is factored into the calculations, which also assume a "typical" supplementary budget of ¥1 trillion (to take place towards end-2001).

Support for Banks: Under Japanese fiscal accounting, the budgetary impact of capital made available to the DIC for dealing with bank closures occurs at the time the money is spent.

Impact of Aggregate Demand: These calculations assume that changes in the structural component of taxes and transfers have an elasticity of ½ while changes in consumption and investment spending have an elasticity of 1.2. Interest tax revenue on maturing postal saving deposits (estimated at roughly ¥3.5 trillion in FY2000-FY2001) is assumed to have zero elasticity. Net lending and capital transfers, including land acquisition and depositor protection, have a multiplier of zero. The calculations include the impact of changes in the social security balance and changes in public enterprise investment.

Table 3. Japan: Indicators of External and Financial Vulnerability

(In percent of GDP, unless otherwise indicated)

	1995	1996	1997	1998	1999	2000
External indicators						
Real exports of goods and services (percent change)	4.1	6.5	11.2	-2.3	1.4	12.1
Real imports of goods and services (percent change)	12.8	13.2	1.2	-6.8	3.0	9.9
Terms of trade (percent change)	0.5	-6.9	-3.9	6.7	4.7	-5.1
Current account balance	2.1	1.4	2.2	3.1	2.4	2.5
Capital and financial account balance	-1.3	-0.6	-2.8	-3.1	-1.0	-1.9
Of which :						
Inward portfolio investment	-1.7	-2.4	-1.7	-2.9	-3.7	-1.8
Inward direct investment	-0.4	-0.5	-0.6	-0.6	-0.5	-0.7
Other investment liabilities (net)	-0.1	0.8	-2.8	-1.4	0.1	-0.3
Official reserves (US$ billion)	182.8	217.9	220.8	215.9	288.1	361.6
In months of imports of goods and services	5.4	6.0	6.4	7.4	9.1	9.8
Broad money (M2 + CDs) to reserves ratio	3.1	2.3	2.1	2.1	1.9	1.6
Foreign assets of DMBs (US$ billion)	1169.5	960.7	1064.0	833.2	682.5	787.8
Foreign liabilities of DMBs (US$ billion)	803.0	736.0	762.5	612.5	478.8	568.7
Net international investment position (US$ billion)	817.6	891.0	958.7	1153.6	829.1	1377.9
Of which :						
External loan liabilities	1039.3	950.1	969.9	805.9	708.9	766.0
External public sector debt (gross) 1/	161.0	156.0	216.6	217.6	208.3	249.5
External loan liabilities to exports ratio	2.2	2.1	2.1	1.9	1.6	1.5
External interest payments to exports (in percent) 2/	25.8	8.4	7.4	7.2	4.5	3.9
Nominal effective exchange rate (percent change)	6.7	-12.7	-4.2	0.3	15.2	10.2
Financial market indicators						
General government gross debt	87.1	92.5	96.9	110.3	120.3	130.3
Interest rates (percent, end-year)						
3-month Gensaki rate	0.23	0.25	0.23	0.14	0.07	0.32
3-month Gensaki rate, real	0.63	-0.35	-1.56	-0.45	1.14	0.52
3-month interest rate spread vis-à-vis U.S.	-4.93	-4.62	-4.93	-4.28	-5.16	-5.51
Stock market index (TOPIX, percent change, end-year)	1.2	-6.8	-20.1	-7.5	58.4	-25.5
Banking sector risk indicators						
Total loans to assets (in percent)	53.4	52.5	50.9	49.9	47.3	44.3
Total loans to deposits (in percent)	107.5	107.6	107.0	105.1	98.9	97.8
Share of real estate sector in total lending (in percent)	13.5	13.8	14.2	14.2	14.5	14.9
Share of non-performing loans in total loans						
(in percent, end-fiscal year) 3/ 4/	6.6	4.9	5.5	8.5	8.1	7.9
Risk-weighted capital ratio (in percent, end-fiscal year) 4/	9.1	9.0	9.5	11.6	11.8	11.8

Sources: Nikkei Telecom; WEFA; IMF, International Financial Statistics; Fitch IBCA; and staff estimates.

1/ Public sector debt securities and other loan liabilities.
2/ Other investment income, debit.
3/ The definition of non-performing loans was broadened in FY97 and again in FY98.
4/ Major banks.

Table 4. Indicators of Linkages Between Japan and Asia
(In percent, as of 2000)

	Share of exports to Japan	Exports to Japan (percent of GDP)	External debt/ GDP	Share of debt denominated in ¥	Share of bank lending from Japanese banks[1]	Share of FDI from Japan
Indonesia	22	8	97	21	25	13
Thailand	16	9	66	32	37	25
Korea	11	4	28	17[2]	18	16
Hong Kong SAR	6	7	...	...	32	...
Malaysia	13	13	48	30[2]	27	14
Philippines	14	7	76	27	18	7
Singapore	7	11	...	...	27	23
China	16	4	14	16[2]	18	7
Taiwan POC	10	6	...	...	17	10

Sources: BIS; CEIC Database; IFS; WEO; and staff calculations.

[1] Calculated from BIS data (December 2000).
[2] Refers to long-term debt in 1998.

JAPAN—FUND RELATIONS
(As of May 31, 2001)

I. **Membership Status**: Joined 8/13/52; Article VIII

II.	**General Resources Account**:	**SDR Million**	**% Quota**
	Quota	13,312.80	100.0
	Fund holdings of currency	9,279.14	69.7
	Reserve position in Fund	4,034.45	30.3

III.	**SDR Department**:	**SDR Million**	**% Allocation**
	Net cumulative allocation	891.69	100.0
	Holdings	1,902.22	213.3

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**:

Japan maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, with the exceptions of restrictions maintained against Iraq and Libya, pursuant to UN Security Council Resolutions 661 and 748. These restrictions were notified to the Fund (EBD/90/261) in accordance with Executive Board Decision No. 144-(52/51).

VIII. **Article IV Consultation**:

The 2000 Article IV Consultation discussions were held during May 15–26, 2000; the Executive Board discussed the Staff Report (SM/00/98) and concluded the consultation on August 4, 2000. In the Summing Up, Directors urged the authorities to maintain supportive macroeconomic policies until the recovery had become robust, while pressing ahead with structural reforms to lay the foundation for sustained medium-term growth. While emphasizing the need for a credible strategy for eventual fiscal consolidation, Directors stressed that the withdrawal of fiscal stimulus should wait until the recovery was on a firmer footing. Directors cautioned against moving away from the "zero interest rate" policy at that time, even as some directors acknowledged the BOJ's desire to return to a more normal monetary environment.

FISCAL CONSOLIDATION AND PUBLIC DEBT STABILIZATION

This annex presents a simple analysis of the amount of fiscal adjustment required to stabilize the public debt ratio. Using the accounting relationship between debt and budget deficits, the primary balance necessary to stabilize the debt-to-GDP ratio in the year t can be computed as:

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

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 values for the nominal interest rate paid on government debt and the nominal GDP growth rate, respectively. The amount of fiscal consolidation 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 around -3½ percent of GDP in FY2001). This note provides a measure of the adjustment required and indicates the sensitivity of this measure to changes in r, g, and the true horizon for achieving stabilization.

The appropriate measure of public debt for Japan has been the subject of some debate.[1] In the following analysis, net debt and primary balance for the general government *excluding social security*, are used as the measures of d and b^p, respectively. As regards r, a measure of average interest costs derived from the interest paid on government debt which reflects past debt contracted at different maturities and interest rates is used. As interest rates on government bonds have generally been declining in recent years, the current value of r is higher (roughly 3¼ percent) than the current yield on 10-year JGBs (1¼ percent). With an average debt maturity of about 4–5 years, the projected future changes in JGB yields affect the average interest rate only gradually—a fact that is taken into account in the following calculations.

The required fiscal adjustment—the reduction in the structural primary deficit needed to stabilize the debt ratio for various combinations of real growth rates and real JGB yields—are tabulated below, under two different stabilization horizons (5 and 10 years, respectively).[2] For simplicity, it is assumed in both scenarios that growth and interest rates on new debt converge in a linear fashion to their steady-state values by 2005, and the adjustment in the structural balance is also assumed to be linear over the adjustment period.[3]

The staff's current baseline forecast corresponds to a scenario in which real growth converges to a medium-term potential of about 2 percent, and real JGB yields rise to 2½ percent by 2005. In this case, fiscal adjustment of 3¾ percent of GDP—sufficient to generate a structural primary balance by FY2006—would stabilize net debt (excluding social security assets) at 110 percent of GDP, compared to an estimated 100 percent of GDP in

---

[1] See IMF Staff Country Report No. 00/98, Box 1 and OECD, *Gross and Net Debt Measures in Japan*, 1998.

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

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

2001 (Baseline Scenario Table). The required fiscal adjustment would be smaller, however, were the potential growth rate to increase, and correspondingly higher if the growth rate were to fall. Variations in JGB yields also change the required fiscal adjustment. For example, if real interest rates fell to around 1 percent, the required adjustment would be ½ percent of GDP smaller than in the baseline scenario.

Adjustment in Primary Structural Balance of General Government (Excluding Social Security) Needed to Achieve Net Debt Stabilization by FY2006 (In percent of GDP)

		Steady-state real JGB yield				
		1.0	2.0	2.5	3.0	4.0
Steady-state real GDP growth rate	0.5	4.8	5.1	5.3	5.5	5.8
	1	4.3	4.6	4.8	4.9	5.3
	2	3.2	3.5	**3.7**	3.8	4.2
	3	2.2	2.5	2.6	2.8	3.1
	4	1.1	1.4	1.6	1.8	2.1

Source: Staff calculations.

Note: Table shows adjustment required by FY2006 under a consolidation process, starting from a structural primary deficit of 3.6 percent of GDP in FY2001. GDP growth and JGB yields are assumed to increase linearly to their steady-state values by 2005 and remain constant thereafter.

A more gradual consolidation effort to stabilize net debt by 2010 scenario would require approximately the same cumulative shift in the structural balance, but spread out over a longer period. However, the slower adjustment under this scenario would lead to higher debt accumulation in the interim and stabilization of debt at a higher level of about 117 percent of GDP.

Adjustment in Primary Structural Balance of General Government (Excluding Social Security) Needed to Achieve Net Debt Stabilization by 2010 (In percent of GDP)

		Steady-state real JGB yield				
		1.0	2.0	2.5	3.0	4.0
Steady-state real GDP growth rate	0.5	4.7	5.3	5.7	6.0	6.6
	1	4.1	4.7	5.0	5.3	6.0
	2	2.9	3.5	**3.8**	4.2	4.8
	3	1.9	2.4	2.7	3.0	3.6
	4	0.8	1.4	1.7	2.0	2.6

Source: Staff calculations.

Note: Table shows adjustment required by FY2010 under a consolidation process, starting from a structural primary deficit of 3.6 percent of GDP in FY2001. GDP growth and JGB yields are assumed to increase linearly to their steady-state values by 2005 and remain constant for the remainder of the projection period.

Japan: Baseline Scenario for Medium-Term Debt Consolidation

General Government excluding social security	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006
			(In trillions of yen)			
Balance	-37.5	-33.3	-29.7	-26.2	-22.6	-18.7
Primary	-21.6	-17.5	-13.3	-8.9	-4.3	0.6
Net interest payments	-15.9	-15.8	-16.4	-17.3	-18.3	-19.3
Net debt (excluding social security)	511.3	544.6	574.3	600.4	623.1	641.8
			(In percent of GDP)			
Balance	-7.4	-6.4	-5.6	-4.8	-4.0	-3.2
Primary	-4.2	-3.4	-2.5	-1.6	-0.8	0.1
Net interest payments	-3.1	-3.0	-3.1	-3.2	-3.3	-3.3
Structural balance	-6.8	-6.1	-5.4	-4.7	-3.9	-3.2
Structural Primary balance	-3.6	-3.0	-2.3	-1.5	-0.8	0.1
Net debt (excluding social security)	100.3	104.9	108.3	110.3	111.1	111.1
			(In percent)			
Memorandum items:						
Implied interest rate	3.2	3.1	3.0	3.0	3.0	3.1
JGB yield	1.2	1.8	2.4	2.9	3.5	3.5
In real terms	2.0	0.8	1.4	1.9	2.5	2.5
Nominal GDP growth	-0.4	1.8	2.2	2.6	3.0	3.0
Real growth	0.4	0.8	1.2	1.6	2.0	2.0
Deflator	-0.8	1.0	1.0	1.0	1.0	1.0
Nominal GDP (¥ trillion)	509.7	519.0	530.4	544.3	560.8	577.7

Source: Staff calculations.

JAPAN—DATA ISSUES

1. Japan has subscribed to the Special Data Dissemination Standard (SDDS).

2. **National accounts**

- The Japanese System of National Accounts was revised in 2000 by the Economic Planning Agency (which was transferred into the Cabinet Office in January 2001) to reflect the *1993 System of National Accounts (SNA93)*. The data revision involved, among other things, the inclusion of spending on computer software in investment expenditure and depreciation on social capital in public consumption, and revision of the benchmark year to 1995. Improvements in the seasonal adjustment method were also introduced to take account of leap year, trading-day, and other shift factors. More recently, a new methodology has been introduced to calculate estimates of quarterly public investment. The data have been revised for only the period starting in 1980.

- However, the national accounts data remains volatile, particularly for private consumption. This appears to be due to small sample surveys, particularly for single person households, and short sampling periods. A new survey of consumer expenditure on big-ticket goods and services will be introduced later this year in an attempt to reduce the volatility in these items in the consumption estimates.

- Preliminary estimates of Japan's quarterly GDP data are released by the ESRI about 2⅓ months following the end of the relevant quarter—similar to industrial countries, but slower than the U.S. and that planned for the E.U.[1] The publication date is not available until one week in advance of the data release. More complete annual national accounts data are only available with a lag of about eight months, severely limiting their usefulness for current analysis.[2]

- The GDP data on some key components of demand are available only with the release of the annual data, including the breakdown of trade flows into goods and services, of business investment into structures and equipment, and of private consumption into durables and nondurables.

- Preliminary estimates for the income side of the national income accounts (with the exception of household employment income) are not provided, in part because estimates for profits are based on an imputed quarterly pattern for annual data.

- The ESRI relies on other agencies and organizations to compile the underlying source data used to construct the national accounts, and faces coordination

---

[1] The ESRI now releases "flash" estimates at the same time as the preliminary estimates, so the public can be made aware of the differences in results.

[2] The data are available in hard copy and electronic format after about 8 months, and are published in an annual report after one year.

problems with data providers in influencing the design of surveys and administrative collections to serve national accounts purposes.

- The methodology used to construct preliminary GDP estimates is not well understood outside of the ESRI.

3. **Fiscal**

- Fiscal accounts distinguish between general (or ordinary) accounts for core government functions, and special accounts that are partly financed through borrowing from the Fiscal Investment and Loan Program (FILP). Information on the central government general account is readily available, but published consolidated accounts—which incorporate special accounts—are insufficient to calculate a consolidated deficit as borrowing is included in revenues.
- There exist more than 3,000 independent prefectures and municipalities, the finances of which are only partly consolidated with a delay of about two years.
- Data on general government operations—including disaggregation by major government sector—are available with the release of the annual national accounts data, implying a lag of about 8 months in assessing these operations.
- The government published its first balance sheet in October 2000. While the data on liabilities were largely as expected, the assessment of assets and contingent liabilities is likely to need considerable improvement, including through more comprehensive coverage of local governments, FILP agencies, and public corporations.
- The authorities have not reported fiscal data for publication in the *GFS Yearbook* since 1994. Thus, the *GFS 2000 Yearbook* includes data for the consolidated central government and local governments through 1993 and 1989, respectively.

4. **External trade**

- While monthly data on merchandise trade and the balance of payments are released on a timely basis, there is no predetermined schedule for their release.
- External data in the national accounts differ from corresponding series in the balance of payments.

5. **Labor market**

- The definition of employment and labor force participation in the labor force survey differ from standardized OECD definitions, which may lead to an understatement of the unemployment rate.

6. **Monetary and financial sector**

- Japan has chosen to make use of the "extensive branch banking network" flexibility of the SDDS and will continue to disseminate banking sector data with

a one-month lag for money stocks and total credit. The breakdown of credit to government and credit to the private sector, which is published as the monetary survey in the Bank of Japan's "*Financial and Economic Statistics Monthly*," is disseminated normally with a lag of two months. Data on the external position of the banking sector are disseminated 6–7 weeks after the reference month.

7. **Recommendations for data improvements**

In the short term, there is need to:

- improve the timeliness and periodicity of the fiscal data (particularly given the importance of monitoring fiscal consolidation efforts on a comprehensive basis);
- publish more timely estimates of quarterly GDP data;
- provide greater detail on the quarterly components of spending and national income;
- set fixed release dates for key data, including the national accounts and external trade;
- continue to improve the household expenditure surveys;
- improve the seasonal adjustment of the national accounts and other important economic data; and
- release more information on the methodology used to construct the national accounts from other economic indicators.

Over the longer term, efforts should be directed to:

- bringing the definition of labor market activity into line with OECD standardized definitions; and
- moving data production to a single, independent agency staffed with professional statisticians.

Japan: Core Statistical Indicators

(As of June 30, 2001)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of latest observation	6/30/01	5/01	5/01	6/21/01	5/01	6/30/01	5/01	5/01	4/01	1999	2001:Q1	End-2000
Date received	6/30/01	6/01	6/01	6/28/01	6/01	6/30/01	6/01	6/01	6/01	4/01	6/01	4/01
Frequency of Data	D	M	M	Every 10 days	M	D	M	M	M	A	Q	A
Frequency of Reporting	D	M	M	Every 10 days	M	D	M	M	M	A	Q	A
Source of data	C	C	C	C	C	C	C	C	C	C	C	C
Mode of Reporting	E	E	E	E	E	E	E	E	E	E	E	E
Confidentiality	Unre-stricted	Unre-stricted	Unre-Stricted	Unre-Stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted
Frequency of publication	D	M	M	Every 10 days	M	D	M	M	M	A	Q	A

Statement by the IMF Staff Representative
August 3, 2001

1. **This statement provides an update of information that has become available since the release of the staff report** (SM/01/221, 7/13/01). It reflects further discussions held in Tokyo during July 25–26 with senior government officials and private sector analysts. The statement covers the political situation, recent monthly data, policy developments, and financial market developments. This information does not alter the thrust of the staff appraisal.

2. **The ruling LDP-led coalition secured a solid victory in the July 29 Upper House elections, strengthening Prime Minister Koizumi's mandate to pursue structural reforms.** Of the 121 seats up for election, the LDP won 65 and its coalition partners an additional 14. The coalition increased its majority in the Upper House by two, and now holds 140 of the 247 seats. The Prime Minister said that details of his structural reform program would become available in three stages during the remainder of the year.

3. **Recent data suggest that economic activity likely contracted in the second quarter, following the 0.2 percent (quarterly rate) decline in the first quarter.**

- Industrial production declined by 0.7 percent (m/m) in June and by 4 percent (quarterly rate) in the second quarter. The weakness in the industrial sector also now appears to be spreading. The all-industries production index (the closest supply-side proxy of GDP) declined in both April and May, after registering modest growth in the first quarter. In response to declining demand, firms have reduced employment levels, and the unemployment rate edged up to 4.9 percent in June.

- Retail sales and spending by worker households in real terms fell sharply in the second quarter as purchases of household appliances dipped after the introduction of a new recycling law on April 1. Shipments of capital goods have weakened, consistent with indications in the June *Tankan* survey that firms intend to reduce capital expenditures this financial year. Based on public works contracts and construction data, it is likely that public investment declined in the second quarter, while residential investment has fallen further.

- Weakness in overseas markets, particularly for high-tech products, has continued to undermine exports, with volumes declining by 6 percent (quarterly rate, customs clearance basis) in the second quarter. Import volumes fell by 2½ percent.

- Year-on-year declines in the CPI continued at unchanged rates in June. The overall CPI declined by 0.5 percent, while the core CPI, which excludes perishable food and energy, declined by 0.6 percent.

On balance, these developments are consistent with the staff's forecast in the staff report that real GDP will decline by ¼ percent in 2001 as a whole. We expect real GDP to decline in the second and third quarters, but to rebound modestly in the fourth quarter.

4. **Macroeconomic policies remain much as described in the staff report**. The new monetary policy framework has worked more smoothly over the past two months than in the March–April period, partly reflecting some technical changes introduced to the auction process which have made under-subscriptions much less likely. Regarding fiscal policy, the Government has announced that it will finalize the guidelines for FY2002 budget proposals by August 10. Officials have again reiterated to the staff that a supplementary budget will only be considered after the release of the second quarter national accounts in September. If such a fiscal package were to be implemented, officials indicated that it would likely place less emphasis on public works spending, in favor of other steps (including expanding the social safety net).

5. **With regard to the bad loan problem, Financial Services Minister Yanagisawa has recently indicated that nonperforming loans may be higher than indicated in banks' self-assessments**. This assessment is based on the ongoing FSA inspection round for major banks, where NPLs (loans in the "needs special attention," "near bankrupt" and "bankrupt" categories) were found to be about 25 percent higher than under the banks' self assessments. The FSA has announced that it will carry out follow-up inspections at the major banks over the next two months to assess whether they have corrected the loan classification problems identified. The FSA also plans to begin conducting its regular inspections of the major banks on an annual basis, rather than once every 18–24 months as at present. During the recent staff visit, FSA officials reiterated their view that provisioning standards and practices in Japan were in line with those in other major countries. They believed that only loans to borrowers in the "need special attention" category or below should be classified as nonperforming, and were concerned that conservative provisioning without an objective basis could bring about an artificial reduction in bank profits before dividend payments and impinge on shareholder interests. The FSA considered that, for accounting purposes, banks should accumulate provisions based on objective data, such as historical loss rates, while for risk management purposes lending policies and loan conditions should be adjusted according to credit risk.

6. **Further details have emerged about specific aspects of the April and June banking sector policy packages**. To facilitate the use of debt-to-equity swaps in corporate restructuring agreements, operational guidelines have been revised to clarify when exemptions will be made to the 5 percent limit (stipulated in the Banking Law) on a bank's equity holding in a company. Specifically, exemptions will be considered provided that banks dispose of their excess equity holdings promptly after the completion of the firm's restructuring plan. The government has also provided an outline for the funding of the

Banks' Shareholding Acquisition Corporation (BASAC), which is to assist banks in unwinding their share portfolios. According to the proposal, member banks would be expected to provide a total of ¥10 billion in initial capital, plus additional subordinated contributions worth 8 percent of their share sales to the BASAC. The government would provide up to ¥2 trillion in guarantees for loans to fund share purchases (except in the case of shares being repackaged into mutual or exchange-traded funds or some shares being bought back by their issuer), although guarantees would only be invoked if member contributions proved insufficient to cover losses in the first instance. The proposal is still subject to further debate, however, and the limit for government guarantees may be reviewed in the context of discussions preceding the necessary budget appropriations.

7. **The authorities have clarified the proposal to expand the role of the Resolution and Collection Corporation (RCC) in absorbing major banks' remaining nonperforming loans in 2–3 years time**. It is expected that the involvement of the RCC in the loan disposal process will permit the resolution of the most difficult cases that—owing to legal complexities or the involvement of crime syndicates—the banks do not have the expertise or legal leverage to handle themselves. To facilitate its expanded role, a new section will be created within the RCC to deal with corporate restructuring and to conduct judicial and voluntary workouts through the Civil Rehabilitation Law and the Guidelines on Voluntary Workouts, which will be finalized in September. The RCC will also expand its role in securitization of NPLs and real estate collateral, including by obtaining a trust bank license. Because of its track record on purchases (on average it has paid less than 5 percent of the face value of loans in recent years), officials and private analysts felt the risk that the RCC would purchase bad loans from banks at inflated prices was low.

8. **The Council for Regulatory Reform has recently issued its interim report on deregulation**. The report focuses mainly on the need for reform in social services where deregulation has been slow. The Council's report recommends measures to encourage private sector involvement in the management of hospitals and other medical facilities, and further deregulation in the elderly and child care sectors to permit greater private sector service provision. It also proposes measures to revitalize the real estate market, as called for in the government's April economic package, including the systematic disclosure of real estate transaction prices to increase transparency and liquidity in the market. The Council has proposed that the reforms it has identified be completed within three years.

9. **Equity and bond markets have weakened in recent weeks**. Concerns about the worsening economic outlook have undermined sentiment in the equity market. The Nikkei and Topix have both fallen by 8½ percent over the past month. The bond market has also weakened, with yields on 10-year government bonds rising by around 20 basis points to 1.35 percent. The yen has remained broadly unchanged against the U.S. dollar (at ¥124.8/$) and in nominal effective terms.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 01/85
FOR IMMEDIATE RELEASE
August 10, 2001

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2001 Article IV Consultation with JAPAN

On August 3, 2001, the Executive Board concluded the Article IV consultation with JAPAN.[1]

Background

The Japanese economy expanded by 1.5 percent in 2000 mainly on account of a turnaround in business investment and net exports. Business fixed investment made the largest contribution, buoyed by an expanding high-tech sector, and underpinned by a double-digit pickup in profits. Exports of IT products also surged, turning the external contribution to growth from a small negative figure in 1999 to a sizable positive number in 2000. Private consumption was stagnant, however, as ongoing corporate restructuring depressed households' take-home pay and the decline in the stock market and pessimism about longer-term prospects dampened consumer sentiment. Public investment underwent a sharp contraction, especially in the second half of the year reflecting the waning impact of the November 1999 supplementary budget.

The underlying pace of activity slowed during the course of 2000, and growth turned negative in the first quarter of 2001 as business investment and exports were undermined by the downturn in overseas markets (especially for high-tech products). Private consumption was flat despite a boost coming from purchases of home appliances ahead of the introduction of a new recycling law on April 1, while residential investment declined. Strong growth in public investment related to the November 2000 supplementary budget provided some support to the economy.

---

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the August 3, 2001 Executive Board discussion based on the staff report.

For 2001 as a whole, activity is expected to be broadly flat. Private consumption is likely to be stagnant, depressed by payback from the spending brought forward to the first quarter, and the drag from corporate restructuring, high unemployment, and declining incomes. Leading indicators of business investment suggest that capital spending will continue to decline through the summer and fall, reflecting the cyclical deterioration in sales and the outlook for corporate profits. Net exports—which have contributed negatively to growth since mid-2000—will continue to be adversely impacted by the external environment, especially for IT products, although the yen's depreciation may soften the impact. Public investment, which picked up early in 2001, is expected to fall back from the third quarter, reflecting the waning impact of last November's stimulus package.

On most measures, deflationary pressures intensified during 2000 and early 2001. Excluding perishable food and energy, year-on-year changes in the CPI rose fell from -0.2 percent in the first quarter of 2000 to -0.7 percent in the first quarter of 2001. Nominal monthly earnings, which were rising in the first half of 2000, began to turn down in the second half of the year in line with the deterioration in labor market conditions. Indicators of excess capacity have also worsened since the middle of last year, while the unemployment rate has hovered near its year-end peak of 4.9 percent.

The trade balance narrowed in 2000, while capital outflows rebounded. Export volumes slowed and then declined in early 2001, while imports picked up as a result of higher oil prices. However, a pickup in investment income, reflecting a recovery in profits by Japanese overseas subsidiaries, helped to offset the impact on the current account surplus. Following the retrenchment in 1999, outward direct investment increased last year, while net portfolio outflows also rose, reflecting a reassessment of prospects for Japan's stock market and a widening of the interest rate differential against Japan.

Deteriorating prospects took their toll on equity prices and the yen. From a peak of nearly 20,000 in March 2000, the Nikkei index shed about two-fifths of its value over the following year (bringing it to a 16-year low). The Topix—whose composition was constant over this period (unlike that of the Nikkei)—fell by about a third. The downturn reflected not only the worldwide sell-off in technology stocks, but also unwinding of cross-shareholdings in Japan and increasing concern about slow progress with restructuring and boosting corporate rates of return. Japan's equity market rebounded following the easing of monetary policy in March and the election of a pro-reform Cabinet in April, although prices have since fallen back. The economy's cyclical deterioration and recent monetary policy easing have also contributed to a significant weakening of the yen since early 2000.

Faced with a weakening economy, the BoJ sought to ease the stance of monetary policy in early 2001. In February, a Lombard facility to provide loans on demand at the official discount rate (ODR) was established, the ODR was reduced from 0.5 percent to 0.25 percent, and the target for the uncollateralized overnight call rate—the BoJ's main policy instrument which determines funding costs in the interbank market—was lowered to 0.15 percent. In mid-March, concerned that the recovery had "paused", the BoJ adopted a new framework for monetary policy. The framework sets a target for current account balances at the BoJ, initially at around ¥5 trillion (about ¥1 trillion above the average balance held in previous months), a move that

brought the overnight call rate effectively back down to zero. The BoJ indicated that the new policy will remain in place until year-on-year changes in the CPI excluding perishables rise stably to zero or above, and that outright purchases of long-term government bonds (so-called "rinban" operations) will be increased if needed to achieve the reserves target.

The FY2000 budget, together with the supplementary package passed at the end of the previous year, kept the fiscal stance roughly neutral last year, even as public investment continued to decline in relation to GDP. Revenues benefited from receipts related to the maturation of a large volume of 10-year postal saving deposits. Expenditures kept up as a result of the moderate increase in core spending in the annual budget and the sizable stimulus package in November 1999.

Progress by major banks in improving core profitability and disposing of problem loans has continued to be slow. Banks' FY2000 financial results showed weaker operating profits, as interest rate margins narrowed and restructuring efforts, including in the context of recent mergers among major banks, have proceeded slowly. At the same time, loan-loss charges were about triple the rate envisaged at the start of the year, with little reduction in the stock of nonperforming loans. Lack of progress in boosting the major banks' underlying health is compounded by their growing vulnerability to market risk. Outside the major banks, the smaller deposit-taking institutions continue to face serious challenges to improve credit quality, and the life insurance sector remains distressed.

A major package to accelerate bank and corporate restructuring was unveiled in April 2001, and further details—together with an outline of the government's overall structural reform agenda—were provided in a blueprint released at the end of June. The centerpiece of the bank and corporate restructuring package is the accelerated removal of nonperforming loans (NPLs) to bankrupt and near-bankrupt borrowers from major banks' balance sheets within two years, and removal of newly-emerging NPLs within three years of such classification. Banks and firms would be encouraged to agree to out-of-court restructuring in exchange for debt forgiveness or debt-equity conversion, subject to guidelines to be established by relevant ministries and the business and bankers' associations. In addition, banks' aggregate equity holdings would be limited relative to their shareholders' equity, and a Banks' Shareholding Acquisition Corporation (BASAC) would be established to facilitate the scaling down of bank equity holdings.

Executive Board Assessment

Executive Directors noted that last year's modest economic recovery in Japan had now given way to renewed weakness, reflecting the U.S. and global electronics slowdown, the slow progress with bank and corporate restructuring, and questions about the long-term fiscal situation. Directors were concerned that Japan could reenter a cycle of slowing activity, rising bankruptcies, and a deteriorating banking system, which would, in turn, exacerbate the global downturn.

Against this background, Directors welcomed signs that the new government is committed to addressing Japan's deep-seated economic problems. The reform blueprint of the Council on

Economic and Fiscal Policy—which emphasizes the importance of revitalizing Japan's economy by addressing problems in the financial sector, undertaking fiscal reforms, and accelerating structural policies to promote competition and enhance the role of market forces—was seen as an excellent basis for action. While Directors recognized that restructuring could adversely affect output and employment in the short run, they stressed that Japan has little choice but to embark on the long-delayed restructuring needed to achieve sustained medium-term growth. They considered that the short-term impact could be contained if the restructuring is accompanied by reforms that open up new investment and employment opportunities, by supportive macroeconomic policies, and by a strengthening of the social safety net.

Directors stressed that addressing the problems in the banking sector, in particular by resolving the long standing problem of a large volume of nonperforming loans, is key to restoring healthy growth in Japan. They noted that turning the sector around will require vigorous implementation of the April Package, together with strong complementary measures. While welcoming the progress already made by the Financial Services Agency (FSA) in strengthening loan classification and provisioning standards, Directors saw room for the banks to improve their credit assessments and to adopt a more forward-looking approach to provisioning. They noted questions raised by private analysts about the magnitude of the bad loan problem, and urged early participation in the FSAP to help shed more light on these issues.

Most Directors observed that targeted capital injections may be needed to offset the impact on bank capital of more aggressive provisioning and loan disposal. While unviable financial institutions should be encouraged to exit, undercapitalized banks with healthier prospects are likely to need public funds to prevent a credit crunch and maintain systemic confidence. Some Directors expressed concern that more generous capital injections might reduce banks' efforts to raise capital in the market. To minimize moral hazard, most Directors emphasized that receipt of such funds should be conditional on strong restructuring plans involving participation in debt workouts and achieving satisfactory returns on equity within a defined period. In cases where banks fail to meet these agreed conditions, it will be critical for the government to take appropriate action, including through the conversion of preferred shares to ordinary shares and the replacement of bank management. Given the scheduled removal of the blanket deposit guarantee next March, Directors noted the importance of moving quickly on these issues.

Directors emphasized that the long-term success of the program to accelerate bad loan disposal depends on achieving the restructuring of distressed firms and the prompt exit of nonviable entities. Some Directors saw risks that the informal workout agreements now being considered could result in the continued postponement of serious restructuring. They underlined the need for restructuring plans to be rigorous enough to achieve a durable turnaround in corporate performance. Directors viewed the FSA as having a key role to play in this area, as appropriate loan classification requires an assessment of the borrower's viability under the proposed business plan. They also saw benefit from having restructuring agreements vetted by credible outside experts.

Directors stressed that removal of existing impediments to the efficient allocation of resources is a vital part of the reform agenda. In the view of many Directors, vigorous pursuit of structural reforms on a broad front is needed to help generate new investment and employment opportunities, and to boost productivity growth over the medium term. In this regard, Directors stressed the need to broaden the competition policy framework and strengthen its enforcement, and to overhaul the regulatory apparatus in key areas such as telecommunications, electricity, and gas. They also noted the need to strengthen corporate governance through comprehensive amendments to the Commercial Code to place a greater emphasis on the role of external directors and to improve managerial accountability. Amendments to existing employment protection legislation are desirable, to provide companies with greater scope to adjust employment levels, including in the context of informal debt workouts. Complementary measures to strengthen the social safety net, including by expanding resources for retraining, would help to cushion the impact on retrenched workers. Directors recommended the implementation of measures to increase the efficiency of the real estate market, including by liberalizing zoning regulations and laws on rentals and land-leases, while accelerating the disposal of land collateral (including by the Resolution and Collection Corporation) to help land prices to finally bottom out.

Directors supported the authorities' focus on developing a medium-term fiscal strategy to put government and social security finances on a firm footing. In their view, such a strategy should aim to establish medium-term debt and deficit objectives, as well as set out the broad objectives and directions of tax, expenditure, and social security policies. Within this framework, detailed short-term targets could be affirmed in annual budgets, providing flexibility to respond to evolving economic conditions.

In the near term, most Directors emphasized that fiscal policy should remain responsive to changing economic circumstances, and cautioned the authorities against getting locked into commitments that could result in too rapid a pace of fiscal consolidation. A few were less convinced about the need for a supplementary budget in the near term, remarking that a clear departure from the pattern of stimulating fiscal packages may be a strong confidence-boosting move. Nevertheless, most Directors agreed that, should a supplementary budget be needed later this year, it should focus as far as possible on measures that support restructuring, including steps to expand the social safety net, rather than on low-quality public works programs.

Directors identified a number of areas where they believe that upfront fiscal reforms could help provide the building blocks for, and establish the credibility of, the authorities' medium-term consolidation program. Measures to improve the quality of government expenditure was seen as essential, including through the elimination of the earmarking of revenues for specific purposes (e.g., road construction). Directors also saw benefits from increasing the market orientation of the Fiscal Investment and Loan Program by requiring a greater proportion of project financing to come directly from private capital markets. Directors noted that a further round of pension reforms will be necessary to eliminate the still sizable projected net unfunded liabilities of the system without a large increase in contribution rates, while next year's proposed medical care reform package will need to include significant initiatives to contain the growth in medical costs. They considered that the early introduction of taxpayer identification

numbers would improve tax administration and facilitate the needed broadening of the tax base down the road. Steps to reduce the imbalance between the spending and revenue-raising authority of local governments to improve expenditure management and accountability at the local level are also desirable. Directors also encouraged the authorities to address the shortcomings in fiscal transparency that were highlighted in the ROSC report.

While Directors welcomed the Bank of Japan's (BoJ) new monetary policy framework, most Directors thought that the present policy stance was unlikely to eliminate downward pressure on prices within a reasonable time frame. Most Directors therefore suggested that the BoJ should not delay in raising its quantitative target for current account balances, while being prepared, if necessary, to increase purchases of longer-term government securities to meet the higher target. However, as the banking sector is already highly liquid and there is uncertainty as to whether the low level of bank credit stems from supply or demand factors, some Directors were skeptical about the effectiveness of a further easing of monetary policy. It was noted that an easier monetary policy stance could give rise to further weakening of the yen, but that a depreciation would aid the economic recovery. Most viewed such a development as more manageable now for the Asian region than during the Asian crisis, due to the adoption of flexible exchange rates in many countries and their healthier external debt profiles. A few Directors expressed concern about the potential impact of persistent easing of the yen on Japan's neighboring countries, in view of Japan's important influence in the region.

Some Directors argued that the effectiveness of monetary policy could be enhanced if the BoJ were to specify a reasonable timeframe for eliminating deflation. They saw benefits from adopting a modest positive medium-term inflation target to reduce the risks of getting stuck in a deflationary trap. Others doubted, however, that such a target would be credible in the current environment, as it is not clear that policymakers have the instruments needed to achieve such a target.

Directors welcomed the progress that has been made in upgrading the quality of economic statistics, but expressed concerns that remaining weaknesses continue to undercut the monitoring of developments and the formulation of policy. They particularly emphasized the need to improve the estimates of private consumption in the national accounts and the quality and timeliness of fiscal data.

Directors welcomed recent measures to ease market access for developing countries, and strongly commended the authorities for the continued high level of ODA provided by Japan. They stressed that further efforts to reduce agricultural protection are desirable, and noted that leadership and flexibility on the part of Japan will be critical in achieving the consensus needed to successfully launch the new global trade round and to help contain protectionist pressures that could seriously damage the prospects for global growth.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2001 Article IV Consultation with Japan is also available.

Japan: Selected Economic Indicators

	1998	1999	2000	Proj. 2001	
	(Percent changes, unless otherwise noted)				
GDP	-1.1	0.8	1.5	-0.2	
Private consumption	0.2	1.2	0.5	0.2	
Nonresidential investment	-2.3	-4.3	4.4	1.6	
Residential investment	-13.9	0.8	1.6	-4.0	
Public investment	-2.6	6.1	-7.3	-4.1	
Public consumption	1.9	4.0	3.6	2.0	
Stockbuilding (contribution to growth)	-0.6	-0.2	0.1	0.1	
Foreign balance (contribution to growth)	0.3	-0.1	0.4	-0.5	
Exports of goods and services	-2.3	1.3	12.1	-2.9	
Imports of goods and services	-6.8	2.9	9.9	2.4	
Inflation					
GDP deflator	-0.1	-1.4	-1.7	-0.9	
CPI	0.6	-0.3	-0.6	-0.7	
Unemployment rate (period average, percent)	4.1	4.7	4.7	5.0	
Industrial production	-7.2	1.0	5.4	...	
Current account balance					
Billions of U.S. dollars	121.0	106.8	116.9	102.2	
Percent of GDP	3.1	2.4	2.5	2.4	
General government balances (percent of GDP)					
Balance including social security	-4.5	-6.8	-8.0	-6.9	
Balance excluding social security	-6.5	-8.6	-9.2	-7.7	
Structural balance 1/	-3.6	-5.4	-5.5	-5.2	
Money and credit (end period)					
M2 + CDs	3.9	2.6	2.2	3.2	2/
Bank lending	-4.7	-5.9	-3.8	-3.8	2/
Exchange rates (period average)					
Yen/dollar rate	130.9	113.9	107.8	125.1	3/
Real effective exchange rate 4/	107.4	120.1	127.4	120.4	
Interest rates (period average)					
3-month CD	0.6	0.1	0.2	0.01	3/
10-year government bond	1.3	1.7	1.7	1.3	5/

Sources: Nikkei Telecom and IMF staff estimates.

1/ Including social security, excluding bank support.

2/ June 2001.

3/ July 11, 2001.

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

5/ January–July.