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I will start with a few comments on fiscal policy exit strategies in general and then turn to more specific comments on unwinding public interventions in the financial sector.

One of the serious challenges in an exit strategy is determining the appropriate time to begin its implementation. In Japan, the government had supported the economy with a series of fiscal stimulus measures from 1992 to 1996. It unwound those measures in 1997 through the combination of a legally binding fiscal consolidation path, tax increases, and medical benefit reforms. The international community broadly supported these moves toward exit. For instance, in June 1997, the communiqué of the Denver Summit called for appropriate structural reforms in the fiscal area as a priority for Japan, and in July 1997, Japan's Article IV Consultation endorsed these fiscal correction measures. While it is difficult to draw a firm conclusion as to whether the 1997 measures are an example of the premature implementation of an exit strategy, I will raise three points based on this experience.

First, when assessing economic conditions, we have to be vigilant not only about macroeconomic indicators, such as growth and employment but also about the progress made in balance sheet adjustments in the corporate or household sectors since these adjustments are a drag on economic activity.

Second, we must take into consideration the aggregate impact of various fiscal policy measures on the macroeconomy, which could affect expenditures, revenue, and social benefit reforms.

Third, we have to be mindful of the potential impact of external shocks on both the domestic economy and financial markets. We might have underestimated the degree to which the Asian financial crisis in the second half of 1997 may have undermined financial market confidence.

With regard to the challenges that are specific to fiscal policy exit strategies, I can raise a few more issues. As the IMF pointed out in its proposed principles for exit strategies, achieving fiscal sustainability will be a complex process and will take a long time. For instance, in December 1996, the Japanese government decided on the basic elements of a fiscal consolidation path, but it was not until November 1997—almost one year

later—that Japan’s Parliament approved a related law. The process for the increase in Japan’s consumption tax rate was even longer, as the increases were originally called for in 1994 but did not become effective until April 1997.

These issues highlight two additional challenges. First, we have to face the reality that each major fiscal policy measure needs to go through a different domestic political process, and it is difficult to manage the timing of implementation. Second, we must be aware of a significant time lag between the decision and its implementation as well as between its implementation and effects.

On the topic of unwinding public interventions in the financial sector, I will address three points.

The first point is the importance of applying a step-by-step approach, with a clear timeline, while paying due attention to the economic environment. Japan started offering a 100 percent deposit guarantee in June 1996, in the midst of the financial sector turmoil. The government had initially set a sunset-clause to take effect for this measure at the end of March 2001. Nonetheless, due to the sluggish economic environment, it postponed its expiration and took a gradual approach. Japan lifted this 100 percent guarantee for time deposits in April 2002 but maintained the 100 percent guarantee for savings accounts until March 2005.

The second point concerns government guarantees. Their use can be effective when the government needs a large financial commitment to anchor financial market confidence, although upfront cash provisions are not necessarily required. For instance, in dealing with the financial sector problems of the late 1990s, the Japanese government set guarantees (which I will give here in dollar terms) of more than \$550 billion for borrowing by the Deposit Insurance Corporation, which operates deposit insurance systems and addresses banking sector problems. At its peak in 2001, the Deposit Insurance Corporation used about \$260 billion of this guarantee. Thereafter, as the economic environment improved, banks started to unwind government interventions, and use of the guarantee decreased to less than \$100 billion in 2007. Capital injections from the Deposit Insurance Corporation to viable banks reached about \$140 billion; to date, 75 percent of the injected capital has been returned, and the government has not yet incurred any losses.

That brings up the issue of unwinding government guarantees. Some types of guarantees, such as those for the Deposit Insurance Corporation, could continue to exist as a permanent scheme, enabling the government to deal with problems of banking sector solvency. In fact, this scheme allowed our government to promptly address the problems of several banks in the aftermath of the current financial crisis. On the other hand, it is desirable to continuously review another type of guarantee scheme aimed at addressing credit bottlenecks and promoting bank lending to specific sectors: In 1998, Japan introduced a special guarantee scheme to facilitate bank lending to small and medium-size enterprises (SMEs). To cover the potential losses of bank lending to SMEs under this scheme, the Japanese government set a guarantee of around \$340 billion. By March 2001, loans had been extended up to the guarantee amount, and the scheme was terminated as originally planned.

The third point is the importance of appropriate arrangements for institutional guarantee schemes. Due to the unprecedented problems in the banking sector, the above-mentioned special guarantee scheme for SMEs presents some extraordinary features, such as very few conditions for its application and a 100 percent guarantee. In addition, most of the lending under this scheme was made without any collateral. This institutional setting was one reason why the losses from the scheme turned out to be much larger than originally estimated by the government, with fiscal costs of more than \$30 billion. This cost highlights the importance of making sure that the guarantee scheme will both prevent moral hazard and ensure an appropriate distribution of potential risks.