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The Need for an Integrated Policy Package to Solve Japan's Trilemma - Using Public Funds to Aid Industrial and Corporate Revitalization -

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1. The Significance of the Fall in Share Prices

Early in 2002, the Japanese economy started to bottom out, on the strength of an export recovery. Since May, however, and particularly since the summer when it fell below ¥10,000, the Nikkei stock average has shown an accelerating downward trend, which has started to affect the entire financial system. October 10 saw the Nikkei reach its lowest level since the bursting of the bubble economy.

One factor behind this fall in share prices is the increasing linkage between Japanese and US share prices amidst growing uncertainty as to the future trend of the US economy. However, a more fundamental cause is that the economic revitalization policies introduced under the Koizumi Administration, under the banner of structural reform, have made insufficient progress and that there is no prospect of halting deflation. Against the background of a continued downward trend of asset prices and the economy in general, the fall in share prices clearly signals that the weaker elements of the economic system - whether individuals, companies, banks or local government bodies - are in danger of failure. The deterioration of the macro economy is shaking the foundations of the financial system, and is also impeding the progress of structural reform.

It was against this background that the Bank of Japan (BOJ) came up with the normally prohibited solution of buying up the shares held by commercial banks. This indicates an acute awareness that, if Japan's unique system, under which the financial position of banks is highly vulnerable to the fluctuation of share prices, is maintained, not only is there little prospect of revitalization of the economy, let alone making progress with structural reform, but there is also the danger of a collapse of the financial system, which would lead to the failure of the economy as a whole. The Koizumi Administration responded to the BOJ's resolution with a Cabinet reshuffle under the banner of accelerating the disposal of non-performing loans, but the markets took the view that this would lead to more ailing companies being wound up or weeded out, and, if anything, the fall in share prices gathered momentum. The fact that Heizo Takenaka, Minister of State for Economic and Fiscal Policy is now also Financial Services Minister, should raise expectations of a radical change in financial administration, but, if anything, has arisen widespread fears that Japan's present bout of deflation will worsen. The markets doubt the efficacy of the deflation countermeasures now on the table, due to be

proposed by the Koizumi Administration, and are still skeptical as to the chances that the Japanese economy will escape the clutches of deflation.

2. The Need to Recognize the Trilemma Facing Japan

The Koizumi Administration has, in theory, set about implementing reforms aimed at halting deflation, but, so far, owing to an excessive emphasis on the ideology of reform, the actual management of the economy has become overly rigid and is running out of options.

Representative examples are the fiscal restraint measures introduced under a climate of economic recession and the arguments for the effective postponement of the introduction of payoff system, which was initially to be implemented, on the pretext of introducing settlement-type savings. Without clear recognition of the trilemma relating to the severe deflation facing the Japanese economy today, it is likely that the gap between ideology and reality will grow still wider.

The trilemma facing Japan today is as follows:

- (i) Accelerating the disposal of non-performing loans may exacerbate deflation.
- (ii) Although the ideological statement that "there can be no economic recovery without structural reform" is true, it will be quite some time before the reforms bear fruit, and, in the short term, they will tend to have a deflationary effect.
- (iii) Failure to take measures to halt deflation and allowing the economy to deteriorate in order to make progress with structural reforms will lead to a fall in share prices and destabilize the financial system.

Given that slowness to dispose of non-performing loans has led to rigidity in the distribution of funds within the Japanese economy, preventing the redistribution of funds to new growth sectors and obstructing economic revitalization (i.e. sustained economic recovery), it is vital that banks and industry should set about resolving the problem of non-performing loans without delay (liquidation or rehabilitation of companies that are encumbered with excessive debts), and bring the financial system back to normal.

However, one important reason for the slow progress in the bad loan cleanup is that, in spite of the efforts made by banks, ongoing deflation and economic deterioration have continued to

generate fresh non-performing loans. Over the six-year period from fiscal 1996 to fiscal 2001, Japanese banks (all banks in Japan basis) have directly or indirectly disposed of a cumulative total of ¥57.4 trillion in non-performing loans (an average of ¥9.6 trillion each year). The reason that the balance of non-performing loans continues to grow unabated is that the amount of fresh non-performing loans generated (a cumulative total of ¥67.8 trillion over the same period, or an annual average of ¥11.3 trillion) has exceeded the amount of disposals. Moreover, it appears that there is a fairly strong correlation between the amount of fresh non-performing loans generated and the state of the real economy.

In fiscal 2001, the Japanese economy recorded its worst performance since records began: real growth of -1.9% and nominal growth of -2.8%. Under these conditions, Japanese banks disposed of non-performing loans amounting to a total of ¥9.7 trillion, but the balance of non-performing loans increased by ¥9.6 trillion. Our estimates suggest that the amount of fresh non-performing loans generated during fiscal 2001 was ¥16.9 trillion, topping the historic high of ¥15.7 trillion recorded in fiscal 1998. This suggests that haste on the part of banks to dispose of non-performing loans not only exacerbates economic deterioration through its deflationary effect and weakens the business sector, but also nips in the bud the future of many small and medium-sized enterprises which, although keen to maintain or increase their competitiveness and to create new businesses, are suffering from the deterioration of economic conditions.

The correct prescription for the problem of non-performing loans is to take measures to prevent the generation of fresh non-performing loans while addressing the issue of winding up or rehabilitating companies encumbered with excessive debts. On an all Japanese banks basis, the balance of "risk loans", many of which are loans to small and medium-sized enterprises, is around ¥80 trillion. If faster deflation leads to a deterioration in "risk loans", the losses could be enormous. As long as the economy continues to register negative growth at the macro level, the problem of non-performing loans cannot be resolved by the financial muscle and self-help efforts of Japan's banks alone. The majority of companies classed as "risky borrowers" are not simply enterprises encumbered with excessive debt but are also enterprises with a good chance of survival once the economy recovers, and the potential to play a leading role in shaping the future of the economy.

In this light, it is clear that the key to the resolution of Japan's present problems lies in the government being able to take a comprehensive view of these problems and to implement a bold change in monetary, fiscal and economic policy, with a view to escaping deflation. The government needs to step up the measures to help dispose of non-performing loans, and, at the same time, coordinate and implement a range of policies with a view to (i) supporting the efforts of the business sector to improve profitability, (ii) fostering new growth sectors of the economy and (iii) help revitalize industries and enterprises.

Naturally, conventional economic stimulus measures centering on lavish spending on public works have only a temporary buoying effect on the economy. It is a self-evident truth that the government spending on public works does not strengthen the competitiveness of companies exposed to international competition nor lead to sustained growth of private-sector demand. Meanwhile, fostering new industries through structural reforms such as deregulation and administrative reform is certainly the way to sustained economic growth led by domestic private-sector demand. But it will be several years, at least, before such reforms take effect and start to strengthen the macro economy as a whole. The Koizumi Administration is to be praised for the reforms it has implemented with a view to the reform of the public highway corporations and the privatization of the postal businesses, but must realize that it will take time for such systemic reforms to help rationalize the government sector and contribute to the revitalization of the private sector.

The highroad to economic revitalization is to pursue structural reform and promote the metabolism of industries and enterprises according to the principles of market economics, and this is the basic means of halting the deterioration of the assets held by banks. The problem, however, is that although the government may wish to pursue structural reforms, the weakness of the financial system - perturbed, for example, by the fall in share prices - prevents it from taking a bolder approach to the task. The only way to ensure that structural reforms lead to economic revitalization is to break the connection between share prices, bank management and the financial system. It must, therefore, be concluded that the BOJ's unprecedented experiment is still not enough.

The most important thing for the government to realize is that if, in its eagerness for a quick solution to the problem of non-performing loans, it focuses on banks alone, ordinary companies may adopt defensive measures out of anxiety over their future cashflow. The resulting fall in

the volume of business-to-business transactions and shrinkage in the inter-company credit may well exert pressure on the real economy, forcing it into a diminishing equilibrium.

3. Assumptions for Effective Policy Management

The effective management of policies aiming to overcome this trilemma must be based on the following three assumptions.

Assumption 1: The fight against deflation will be protracted

No matter what economic stimulus measures (fiscal or monetary) or structural reforms the government implements, it cannot hope to overcome the problem of deflation within a short time frame. Those who believe that implementing economic stimulus measures is enough to lead Japan out of deflation are dreaming, and, as stated earlier, it is likely to be some time before the benefits of structural reforms emerge.

Some critics point out that slowness in the bad loan cleanup has led to a decline in financial intermediation functions, or maintain that asset intermediation functions will recover if only the fears over possible bank failures can be alleviated. However, it is important not to overlook the dilemma that positive demand for funds from the business sector is falling against the background of a decline in the expected economic growth rate, and that if banks deliberately accept high risk by lending more in a climate of deflation, the volume of non-performing loans is certain to increase.

With the economy overshadowed on the domestic front by a strong sentiment of stall due to the fall in the expected growth rate, and exposed to competition on the international front, achieving a return to stable, positive growth on both real and nominal terms within a short time frame will, by no means, be an easy task. It is likely to take a number of years, at least. Needless to say, if the Koizumi Administration is successful in improving confidence among economic entities and eliciting a positive response from companies and individuals through the expression of a strong resolve to overcome deflation and the implementation of concrete measures, it is possible that Japan may escape the clutches of deflation at an earlier date.

In other words, there are limits to the efficacy of macro policies alone as a means of preventing the generation of fresh non-performing loans and offsetting the deflationary effect of the disposal of existing non-performing loans. On the assumption that overcoming deflation will take some time, the government should simultaneously implement micro-level measures, specifically a strengthening of measures for the revitalization of the business sector.

Assumption 2: Structural reforms can make no progress without the stabilization of the financial system

While the economy remains prey to fears of bank failures and a subsequent crunch in business finance, the government will be unable to embark on the necessary reforms. If the government plans to speed up the disposal of non-performing loans, it must build in measures to prevent massive losses on the shares held by banks and protect the stability of the financial system as a whole.

Under the Obuchi Administration of 1998-1999, an attempt was made to stabilize the financial system by the simultaneous injection of public funds into a number of private financial institutions, including major banks, but subsequent experience shows that when deflation continues to accelerate and the economy continues to deteriorate, the effects of a direct injection of public capital will be temporary. The government may strengthen asset assessment, encourage banks to write off non-performing loans and increase their reserves and inject public funds as a preventive measure, but as long as the vicious circle of economic deterioration and fresh non-performing loans remains unbroken, the only effect of such measures will be a temporary improvement in bank balance sheets. Eventually, the government will have to repeat the assessment process to reflect the deteriorating value of assets and inject more public funds. Moreover, the injection of public funds as a preventive measure presents a moral hazard to banks and may prolong the life of non-viable institutions.

Assumption 3: The injection of public funds must allow for the need to overcome deflation

The root cause of the non-performing loan problem is the decline of economic vitality. In the past, amidst continuing deflation and economic deterioration, the average volume of fresh non-performing loans generated each year has been in excess of ¥10 trillion, well in excess of the net business profit made by banks (¥4-5 trillion a year). While shares held a latent profit, it was

possible to dispose of a volume of non-performing loans comparable to the amount of fresh non-performing loans being generated. However, as deflation has become more severe while the structural deterioration of the balance of supply and demand due to the discontinuation of the practice of mutual shareholding has come into play, a fall in share prices that deviates from the economic fundamentals has occurred. Moreover, under the present system of market value accounting and depletion accounting, this has exacerbated fears over the stability of the financial system and increased the severity of economic deterioration. It is truly a fallacy of composition. The problem is now too great to be solved by the efforts of individual banks alone, and the government is under pressure to take a wider view and come up with policies that will break this vicious circle.

For this reason, an injection of public funds, in some form or other, will, sooner or later, become an unavoidable necessity. Even then, the government should make every effort to (i) minimize the burden on the people, and (ii) ensure that the public funds injected are used in an efficient manner to help revitalize the economy, industries and individual companies. Needless to say, the business sector and financial institutions must also make every effort to assist in the revitalization of industries and companies. Government policy should be geared to supporting the efforts of the private sector.

The use of public funds to strengthen the equity capital of banks is a remedial treatment and will do nothing to prevent the generation of fresh non-performing loans. If anything, public funds should be used (i) to help in the winding up of non-viable banks and to protect depositors, and (ii) to help in the revitalization of industries and companies. Injections of public funds should be clearly positioned as a cost attendant on the revitalization of industries and companies, and used as the trump card in the fight against deflation. Given that overcoming deflation will take time, the government should resign itself to the fact that the amount of injections of public funds required over the years will be sizable.

4. The Need for Comprehensive and Compatible Policies and Moratorium Measures that Brook no Taboos

Following the recent Cabinet reshuffle, the Koizumi Administration declared that it aims to solve the problem of non-performing loans by the end of fiscal 2004. Under the present

conditions, this goal is likely to be quite difficult to achieve, but in order to do so, the government will have to draw up and implement a package of compatible measures for the stabilization of the financial system, for the revitalization of the economy and for medium-term fiscal management. At the same time, with regard to the issues of financial system stability and non-performing loans, the government should eliminate all the taboos that have prevailed to date and implement moratorium measures with an initial time limit of two years. Rather than implementing measures designed to temporarily bring the balance of non-performing loans back to zero, it is more urgent for the government to draw up a clear timetable for achieving its goals and a broad plan for the resolution of the problem of non-performing loans. Meanwhile, it should also set about encouraging a fall in the value of the yen against foreign currencies with a view to supporting its economic stimulus measures.

(1) Addressing the Financial System and Non-Performing Loan Problems

To ensure the stabilization and revitalization of the financial system, the government must recognize that the present situation is abnormal and set about dealing with the problem of non-performing loans according to the following principles.

- (i) The connection between share price fluctuation and the equity capital of banks should be broken.
- (ii) The RCC should be used to help in the final disposal of non-performing loans classed as "uncoverable or valueless".
- (iii) The incidence of fresh non-performing loans should be reduced through a revitalization of the macro economy.
- (iv) Banks should identify borrowers "requiring special attention" and seek to support industrial and macroeconomic revitalization by supporting their rehabilitation.
- (v) Public funds should be used to help prevent the generation of fresh non-performing loans and help revitalize industries and companies, being positioned as a necessary cost attendant on finding a way out of deflation. However, where it is necessary to promote the restructuring of banks, or mergers between banks and where bankruptcy procedures are required, public funds should, afterwards, be used to protect depositors.
- (vi) The scope of the activities of the postal savings system and government financial institutions should be reduced and rationalized through the adoption of market principles.

As a follow-up, the government should position the next two years as a period during which to restore the soundness of the financial system, and implement the following measures.

(i) The BOJ should go ahead with buying up shares held by private banks without delay and ensure a smooth supply of the funds that will be required in reforming the financial system to the RCC, the Banks Shareholdings Purchase Corp., etc.

(ii) To encourage banks to use the Banks Shareholdings Purchase Corp., the 8% contributions required for banks should be abolished and the requirement of a BBB rating or above should be relaxed so as to expand the range of shares that can be bought up.

(iii) Market price accounting, depletion accounting and the lifting of the ban on payoffs should be fully frozen for a period of two years.

(iv) The government should draw up and implement a plan for the disposal of non-performing loans that is consistent with its forecasts of macroeconomic trends. The Financial Services Agency should inspect and supervise the execution of this plan, remaining sensitive to changes in macroeconomic and market conditions.

(v) For non-performing loans classed as "uncoverable or valueless", purchases at effective book price by the RCC should be promoted. To provide for cases where a secondary loss arises, a system of indemnification using public funds should be established. Some will criticize this use of public funds as constituting a subsidy, but it should really be regarded as a cost of the failure of macro policy management and an infrastructure cost relating to the establishment of a market for the distribution of non-performing loans. Naturally, to avoid any moral hazard to banks, banks must be subject to strict requirements on the holding of reserves.

(vi) To enable banks to use public capital as risk capital, the preferred shares of banks held by the RCC should be converted to common shares to allow them to be sold on the markets.

(vii) A "Corporate Rehabilitation Fund" should be established to deal with non-performing loans to borrowers classed as "requiring supervision". This fund should unite multiple debts under the supervision of an "Industrial and Corporate Revitalization Committee", to be described later in this article. This fund should be used to acquire common shares of debtor companies and to purchase shares acquired by banks through DES (dead equity swaps). The fund should be supported by public funds (government expenditure) but also gather private-sector money, including foreign capital, and work to rehabilitate companies with the full support of the companies which have invested in it. Banks should cooperate in every way possible with the

rehabilitation of small and medium-sized businesses classed as “requiring supervision”, with the support of government guarantees.

(2) A Change in Fiscal Management

The Koizumi Administration has set itself the goal of restoring a primary balance within the next 10 years, and has pursued a style of fiscal management that places considerable emphasis on the restoration of soundness to public finance in the medium term. However, it has already been forced to abandon the target of keeping annual issuance of government bonds to below ¥30 trillion owing to a fall in tax revenues due to the slowing of the economy, and the negative targets for ordinary expenditure under next year's budget will have a considerable deflationary impact. If the Koizumi Administration aims to resolve the problem of non-performing loans by fiscal 2004, it must at the very least effect a number of basic changes in fiscal management with a view to canceling out the effect of deflation.

(i) The next two years should be excluded from the timetable for the restoration of a primary balance and should be positioned as a period during which to implement a radical reform of the various systems that have led to inefficiency in the distribution of resources (the fiscal investment and loans program, subsidies, allocations, etc.).

(ii) During this period, generous funding should be allocated to the strategic sectors which are set to shape the future of the Japanese economy (IT, biotechnology, nanotechnology, etc.) and the geographical areas designated as "special zones for structural reform", and the government should abandon the restrictive approach of seeking to achieve a fiscal balance in each fiscal year.

(iii) The scale of the net tax reduction over the next two years should be increased from ¥2.5 trillion to ¥5 trillion. Thereafter, the government should publish a basic schedule for the achievement of tax neutrality, to be achieved without strain over the next decade or so, through a combination of expenditure cuts and tax increases. The government should also implement a radical review of the content of public investment, the total amount of which should maintain economic neutrality (no change in ratio to GDP) over the next two years.

Over these two years, during which the disposal of non-performing loans should be accelerated while maintaining discipline with a view to restoring soundness to public finance in

the medium term, it will be important to use fiscal measures to support the economy, within reasonable limits.

(3) The Need for an Integrated Policy Package for Economic Revitalization

The linkage between the Koizumi Administration's plan for the revitalization of the economy and the real-life budget and tax system are weak, and its effects can only be described as extremely unclear. The Administration should effect a turnaround in fiscal management with a view to opening up new growth sectors within the Japanese economy, without being too greatly confined by the objectives of achieving a fiscal balance in any one fiscal year, or of maintaining tax neutrality in the medium term. At the same time, it should implement an "integrated policy package for economic revitalization" involving budgets, deregulation and tax system reforms, with a view to supporting the efforts of companies to improve productivity and make structural adjustments with a view to enhancing their profitability.

- 1) The drafting and implementation of a medium-term program to stimulate innovation, comprising investment tax credit, deregulation and an emphasis on research and development. Specifically, the government should reduce the investment tax in such a way as to stimulate corporate productivity and competitiveness, by expanding the range of tax systems to promote research & development, offering more tax allowances against investment in IT, and shortening the period of depreciation for manufacturing equipment, which is the basis of Japan's international competitiveness. As the investment tax credit will lead to a fall in tax revenue only when the amount of investment rises, it should be excluded from the medium-term calculations of tax neutrality.

- 2) The drafting and implementation of an integrated plan for the expansion of business frontiers. Specifically, in special areas for urban renewal and special zones for structural reform, the government should implement a 3-piece set of policy measures consisting of bold deregulation, special budget frameworks for the creation and expansion of basic infrastructure, and reductions and exemptions under real estate-related tax systems (real estate acquisition tax, property registration tax, tax for capital gains through land transfers) as well as preferential tax measures (special depreciation allowances on buildings such as

high-rise housing and commercial facilities, reductions and exemptions on fixed assets, etc.).

3) The drafting and implementation of an integrated plan to promote the development of new industries and revitalization of existing industries. The government should establish an "Industrial and Corporate Revitalization Committee", consisting of representatives of industry, officials from the government agencies with supervisory responsibility and experts from academia. The committee should draw up a "vision for industrial revitalization " for each industry that includes a large number of ailing companies (considering industry growth rates, the viability of new business areas, etc.) and a "vision for the creation of new industries" for each promising new industrial sector. On the basis of these visions, the government and private sectors should work together for the rehabilitation of individual companies, the restructuring of entire industries and the development of new industrial sectors. By way of policy support measures, tax systems to support ventures and the establishment of new businesses, and thereby the creation of new industries should be expanded (an expansion and strengthening of the "angel" tax system, the creation of a tax credit system for venture investment, etc.), and an "Industrial Creation Fund" packaging loans to venture companies and small and medium-sized businesses with strong technological capabilities and a "Corporate Rehabilitation Fund" packaging non-performing loans held by the RCC and the private banks, etc. mentioned earlier should be established. A range of tax incentives (tax break for capital gains from the transfer of property, deductions against losses carried over, investment tax credit, etc.) should be implemented.

4) The drafting of a "scenario for job creation" and preparation of an "employment safety net without holes".

A "scenario for job creation " for each industry (forecasts of the number of persons changing jobs within the industry, the number of persons moving to jobs in other industries, etc.), based on the "Vision for Industrial Revitalization" should be drawn up by the "Industrial and Corporate Revitalization Committee" in collaboration with labor representatives. To facilitate the implementation of this scenario, an "employment safety net without holes", that will support the efforts of unemployed workers seeking new employment and help to stabilize employment, should be created.

(i) Livelihood support measures should be implemented to help workers who are excluded from or not adequately covered by the employment insurance system. At present, the self-

employed are not covered, the coverage for day workers is inadequate and payments to non-regular employees are inferior to those provided for regular employees.

- (ii) A painstaking "one-stop service" system that puts the interest of the unemployed worker first should be created to support the efforts of those seeking new employment. The operation of this system should basically be entrusted to the private sector and counseling functions should be strengthened. Job introduction services, occupational training services and livelihood support services should be provided as a unit.

The Koizumi Administration should recognize that without bold economic stimulus measures with a view to overcoming deflation, it will be difficult to achieve a fundamental solution to the problem of non-performing loans. Now is the time to adopt a "bold and flexible approach" that is not slave to past approaches to policy management, and to show, by word and deed, its determination to overcome Japan's present problems.