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Economic Reform in Japan

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The most fitting word to describe the current situation of the Japanese economy is "hypochondria", and some of you may wish to contrast it with "American euphoria" and "European paranoia". Many Japanese people are worried that something is wrong with the Japanese economy but they cannot be sure that things are moving properly to correct it; and some in the Japanese media are drumming almost masochistic warnings that the Japanese economy will shrink into a feeble second-class player. Some in the foreign media are repeating "I told you so" type comments without concealing a sense of relief to have found that the 800-pound gorilla they dreaded ten years ago turned out to be a teddy bear.

Indeed, there are problems, some of which are quite difficult. However, before I discuss these, I want to state that the real economy is clearly improving. GDP growth in 1996 reached 3.6%, which was the highest among the G7 economies. In spite of the reduction of the fiscal stimulus package, the robust activities of the private sector are pushing up the overall economy. Reflecting the reasonable increase of nominal wages and zero inflation, disposable income is rising while household consumption advances solidly. The unemployment rate crept up to 3.5% in the second quarter of 1996, but peaked out and started to decline to a current 3.3%. The job opening ratio is also improving. The recent employment situation, as such, may prove that many corporations have managed to carry out the process of restructuring without creating too many jobless people on the street. Large corporations, particularly in the manufacturing sector, have improved their performance markedly thanks to restructuring efforts and the weaker yen. They are increasing investment and employment. Smaller-sized firms in the non-manufacturing sector are also enjoying better business, and innovative new companies are appearing in a broad range of services, information, and specialized manufacturing, although not in numbers and speed comparable to the U.S. The average annual productivity gain of Japanese industry during last five years was over 1%, which was more or less on a par with that of U.S. industry.

From April 1997, there will be a tax increase amounting to 7 trillion yen and a further cut of public works outlays is expected. The fiscal constraints of this magnitude will inevitably have a certain dampening impact on economic activity and slow down growth. However, it is the majority view now that the momentum of Japan's recovery will be strong enough to quickly absorb the fiscal drag. Therefore, it is my view that the growth rate in 1997 will remain somewhere between 2.0 and 2.5%, and accelerate again in 1998. All in all, the near-term prospects for the Japanese economy do not warrant pessimism.

Then why is there such widespread frustration? In my view there are two major factors. One is the sense of loss which was brought about by the collapse of the preeminence of the Japanese economy with the burst of the "bubble" in the early 1990's. During the bubble period of the late 1980's, the Japanese economy demonstrated a remarkable buoyancy compared with the other G7 economies. High growth, rapid rises in productivity, a large current account surplus (in spite of a strong yen), and stable prices have all contributed to create the image of a mighty economy. Supported by the strong yen and abundant liquidity, Japanese financial institutions wielded formidable clout in the global market. Supported by advanced technology and innovative managerial techniques, Japanese products such as autos and electronics became a daunting presence in the world marketplace. Not only Japanese, but many foreign observers as well, came to believe in the invincibility of the Japanese economy. What made the problem more complicated was the fact that many Japanese were convinced that the success of the Japanese economy vindicated the Japanese way of economic management and market operation. The concept of the Japanese model included, *inter alia*, a collusive triangle between politicians, bureaucrats, and business-men, a corporate governance in which the shareholders' role was minimal and the producer was predominant over the consumer. Japan was vanquished by an unwarranted euphoria.

The burst of the bubble, which was in fact a severe case of asset deflation, and the ensuing economic distress shattered the euphoria. The Japanese people had to recognize that the bubble and the mess which followed were created by policy mistakes and then aggravated by the peculiar features of the Japanese economic structure. The burst of the bubble left corporations, banks and households with deteriorated balance sheets, and economic growth became very stagnant. The government took a series of steps to solve the problems of financial institutions which were neither decisive enough nor transparent enough to convince the market. The property market and stock market remained anemic. The trauma intensified in early 1995, with the appreciation of the yen, devastating earthquake in Kobe, and social insecurity which was gruesomely demonstrated in the mass murder by a fanatic religious cult. Meanwhile, our main trading partners, i.e. the U.S. and East Asian countries, were making great strides in their respective processes of revitalization and development. Comparison with them made the Japanese economy look senile and unhealthy.

All in all, the Japanese themselves and foreign observers as well came to believe that the economic system of Japan had proven to be inoperative under a changed environment, and yet Japan was still not capable of coping with the tribulation.

Another cause for frustration is doubts about the health of the Japanese financial industry, as Japanese banks are still loaded with bad assets. According to the Ministry of Finance, of the 700 trillion yen in total loan assets held by all deposit-taking institutions in Japan, 30 trillion is classified as non-performing, and 7 trillion is deemed uncollectible. Though naturally the situation differs greatly between individual banks, there are concerns that some of the weaker ones will have to go under. Persisting doubts about the accuracy of data released by banks and the Ministry of Finance on the amount of banks' bad assets, slow pace of write-off, and low profitability have raised concerns about the viability of Japanese banks. There are also worries about the stock market, as the Nikkei average of stock prices collapsed from its peak of 39,000 in 1989 to 15,000 in 1995. The government introduced a variety of measures to support stock prices, including the purchase of stocks with public funds, but the effect, as such, did not last long and the Nikkei average is still hovering at around a 18,000 level. The more fundamental problem with the stock market is misgivings about its transparency and fairness. Recurring scandals, including the recent one in the largest brokerage house, have tarnished the clean image of the market. It cannot be denied that there is an impression that the Japanese stock market is still contaminated with insider trading and other types of misconduct.

It is true that the Japanese financial industry has long operated under tight control by the regulatory authorities. The philosophy behind such control was to prevent the failure of financial institutions and thereby to protect depositors and investors. The combined system of protection and control worked well as long as the market was kept separate from the outside world. However, the globalization of financial markets which advanced rapidly since 1980's has made the old system obsolete and inoperative. Cumbersome regulations diminished the attractiveness and efficiency of the market, and eventually players and businesses began to desert it. The phenomenon often called the "hollowing out" of the Tokyo market became a matter of serious concern and contributed to a loss of confidence in the future of the Japanese financial industry.

I have explained why Japan is now suffering from a severe case of hypochondria. The Japanese people realized that the way they managed the economy was not that flawless, and also recognized that because of the bonanza provided by the bubble economy, they wasted time in correcting flaws and thereby lost competitiveness. The awakening to a crisis came late, but it did come.

Since summer 1996, a driving force of national scale has been put in motion. The Prime Minister announced a plan to implement reforms in six broad areas, i.e. bureaucracy, national budget, economic structure, financial industry, social welfare, and education. The issue of reform was the focal point of the last Lower House general election, and the outcome demonstrated the broad public support for it. In November 1996, the government disclosed an extensive plan for the reform of the financial industry, which is based on three keywords: market principle, transparency, and international compatibility. The items included are: deregulation of the management of pension fund; liberalization of international financial transactions; removal of the demarcation between commercial banks and long-term credit banks; liberalization of the insurance premium; introduction of bank holding companies; lowering of the barriers between commercial banks, securities firms, and insurance companies; liberalization of securities transaction fees, introduction of mark-to-market accounting; liberalization of investment trust management; and several others. A11 these measures are expected to be implemented by the year 2001. Furthermore, the Reform Committee of the Liberal Democratic Party announced on March 14, 1997 its recommendation to front load several important measures, such as the abolition of securities transaction taxes and land price taxes, and the liberalization of securities transaction fees.

With regard to the restructuring of the financial industry and financial market, the strategy is to address the issue on two fronts. One is establishment of a legal, institutional and financial framework by which to expedite restructuring and at the same time prepare for any crisis which may occur in the course of the process. A Japanese version of the Resolution Trust Company was set up; the deposit insurance scheme was expanded; the financial supervisory capacity is to be separated from the Ministry of Finance, and a new agency will be created under the Prime Minister's direct control to carry it out; new rules and mechanisms for intervention and closure of troubled institutions were established; and the Bank of Japan will be restructured with greater independence from the government.

The other part of the strategy is

to provide financial institutions with greater freedom to develop and market new financial instruments and services so that those which are competent may thrive. I have just listed the proposed items of deregulation. It is obvious that it is entirely up to the financial institutions themselves to decide how to cope with the new environment and face the challenge .

For the sake of fairness, I should tell you that there are various criticisms and concerns expressed both at home and abroad about the reform plans announced so far. Some argue that plans are not comprehensive enough. They point out, for example, that the privatization of the postal service, which runs its own banking, insurance, and pension, is not included in spite of the strong criticism that the state-run business is engaging in unfair competition against private business. Some argue that the target date of 2001 is too late in view of the rapid development taking place in other major markets in the world. Also, there are some who are worried that the reform effort will be defeated after all by resistance and sabotage by the many special-interest groups and bureaucrats who are enjoying the benefit of regulation. There is also a voice of warning that the general public may become less enthusiastic when they have discovered that deregulation and increased competition will bring on a loss of stability and an increase of risk. Some foreign observers cynically ask how many times they have heard about Japanese reform.

I believe these criticisms and concerns should not be ignored. There is no question that the reform now contemplated is probably one of the most major in the modern history of the Japanese economy. When implemented it will have a far-reaching impact on the basic structure of the Japanese market and the Japanese way of economic management at the level of the government, the corporation, and the household. We should not underestimate the roughness of the road ahead.

However, having said that, I tend to believe that this time around reform will be carried out. There are three reasons to support my argument. First, the majority of the Japanese public today is seriously concerned about their standard of living. They know that the population is aging rapidly. They know the global competition is intensifying. They know the Japanese economy is vulnerable in many respects. On the whole, they are adequately cognizant that, without revitalizing the Japanese economy through reforms and deregulation as proposed, they have to accept a considerable deterioration of their living standard in future. For the first time a sense of urgency has gripped the nation.

Second, politicians came to realize that the current is clearly running in the direction of reform. For the first time, the majority of elected politicians are aware that, in order to survive as politicians, they have to support the broad agenda of reform. No doubt many politicians have groups of voters in their constituencies who will lose vested interest when reform progresses, but even those politicians have to accept that support of vested interests will inevitably ruin their popularity.

Last but not least, the ball has already started to roll down the hill. Bills to abolish foreign exchange controls, to allow holding companies, and to reform the Ministry of Finance and Bank of Japan have already been submitted to the Diet, and it is certain that it ill approve them in a matter of months. More reform bills, including tax laws, banking laws, and securities transaction laws, will be submitted to a special session of Diet in fall 1997. Once implemented, the reforms incorporated in these bills will cause cracks in the old system. It is possible that initial cracks may create a certain distortion in the market, in which money flow may change or some instability may occur. Nevertheless, this very distortion will make further reforms inevitable and indispensable.

Let me conclude by summarizing my argument. The Japanese economy is recovering. Although there will be a temporary slowdown in the near future, and although there will be certain pandemonium in the financial industry during the process of restructuring, the overall economy will remain resilient. The reform process has already started and will gain momentum as it progresses. The challenge for Japan in the early part of the twenty-first century will be to consolidate the new image of the Japanese economy which is internationally compatible, but at the same time original.

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