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Whither Japan's Economy?

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European Commission

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Abstract

The Japanese economy entered a long recession in spring 1997. Its economic growth has been much lower than in the US and the EU despite large fiscal stimulus packages, a monetary policy which has brought interest rates to zero since 1999, injections of public money to recapitalize banks, and programs of liberalization and deregulation. How could all these policies have failed to bring the Japanese economy back on a sustainable growth path? This paper argues that the failure of Japan's efforts to restore a sound economic environment is the result of having deliberately chosen inappropriate and inadequate monetary and fiscal instruments to tackle the macroeconomic and structural problems that have burdened the Japanese economy since the burst of the financial bubble at the beginning of the 90s. These choices were deliberate, since the "right" policies (*in primis* the resolution of the banking crisis) presented unbearable political costs, not only for the ruling parties, but also for the bureaucratic and business elites. The misfortunes of the Japanese economy during the long recession not only allow us to draw important economic policy lessons, but also stimulate reflections on the disruptive role on economic policies caused by powerful vested interests when an economy needs broad and deep structural changes. The final part of the paper focuses on ways to tackle Japan's banking crisis. In particular, it explores the Scandinavian solution, which, *mutatis mutandis*, might serve Japanese policy-makers well.

1. On a winter's night in 1997...

If, on a winter's night in 1997, a Japanese policy maker had taken some time to consider the economic situation of the country, he or she would have found some reasons for concern, but also some reasons for cautious optimism.

a. Reasons for concern

So far, the 90s had not been a particularly good decade. Economic growth in the last six years had been on average less than half of that of the previous decade (see table 1). The burst of the bubble in 1990-1991 produced large imbalances which were still negatively affecting private demand and constraining the government to run relatively large budget deficits (see table 2). The decline in land prices continued, affecting household wealth and worsening the value of collaterals held by banks. Corporate balance sheets were burdened by the excessive borrowing of the bubble period.

Deflationary pressures were mounting: the wholesale price index had started to decline in 1992 and GDP deflator became negative in mid-1994 (see table 3). On the other hand, this was not the case of the consumer price index: although consumer prices growth had decelerated significantly, it was still slightly positive (0.1% in 1996).

Another reason for concern was the health of the banking sector. Non-performing loans in the banking sector continued to grow, despite the resolution of the *jusen*[1] problem in early 1996. The 1995-1996 recovery had not been strong enough to repair the balance sheet of Japanese banks.

Last but not least, 1997 was expected to be a difficult year, since some important, but also unpopular, decisions would be implemented, *in primis* the rise of the consumption tax from 3% to 5%.

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[1] The *jusen*, private non-bank financial firms dedicated to mortgage and financial lending, were the first financial institutions to collapse under the burden of a worsening economic situation, the increase of bad loans, the rapid depreciation of collateral values, and the contraction of credit. Ministry of Finance inspectors discovered that in 1991 40% of the *jusen* outstanding loans were non-performing, but they opted for a soft solution and gave them 10 years to solve their problems. However, in 1995 the share of bad loans on total outstanding loans rose to 75% (Kuttner and Posen (2001), Cargill, Hutchison and Ito (1997)). Faced with the risk of having to deal with a systemic crisis, the government stopped its policy of forbearance, and intervened to liquidate the *jusen*. The liquidation costs of the *jusen* felt mostly on the banking sector, and the cost for the Japanese taxpayer was only 0.2% of GDP. However the political interference that affected the way in which the problem was resolved will haunt Japanese policy-makers in the years to come.

b. Reasons for hope

Despite the disappointing performance of the economy in the last few years, a recovery that began in the second half of 1995 seemed to have gathered strength. The most recent figures available at the beginning of 1997 indicated that in 1996 the Japanese economy, with 5% growth, might well have become the fastest growing G-7 economy.

The international environment remained favorable: after the 1991-1992 recession, the recovery had not given signs of weakening. In the US, the economy was buoyant. East Asian growth continued on its high speed path[2] and Europe, engaged in the process of Economic and Monetary Union, was performing relatively well (especially given that it was carrying out fiscal consolidation to fulfill the Maastricht criteria).

The strong economic performance of 1996 had also a positive effect on Japan's international economic relations: the current account surplus had declined significantly and was just above 1% of GDP, hardly a large imbalance. Given the strong performance of the US economy (partly financed by Japanese capital inflows), the confrontational approach adopted by the Clinton Administration between 1993 and 1995 was relaxed and demands for quantitative targets were *de facto* dropped[3]. This factor, together with monetary easing of 1995, did not put upward pressure on the yen, with positive repercussions on the contribution of Japanese exports on economic growth.

Some positive repercussions on investor and consumer confidence could also be expected by the recovery of the Tokyo stock exchange. After an almost uninterrupted decline since its 38.915 yen peak on 29 December 1989, in 1996 the Nikkei index jumped more than 30% year-on-year, ending the year above 21.000 yen. It was the first time since 1991 that the Nikkei started the new year above the 20.000 level.

Another reason for optimism was the return to a stable political situation, after the turmoil of the first half of the 1990s. The LDP victory in the Lower House elections of 1996 triggered realignment in the opposition camp: the main opposition party collapsed and many of its members rejoined the LDP, allowing it to take control of the Upper House as well. Furthermore the LDP returned to the helm of the government[4] not with the objective of undoing the (timid) process of deregulation and structural reform started by the anti-LDP coalition, but to strengthen it and to push it forward in bolder and more coherent terms. The new Prime Minister, Ryutaro Hashimoto, had distinguished himself as a reformer and a supporter of liberalization and deregulation, as well as a tough

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[2] Well informed policy-makers were aware that Thailand was facing challenges due to a big current account imbalance, a bubble in the real estate sector, and a fragile banking system. However, given the small size of the country's GDP, they believed that an eventual currency and/or banking crisis would not have been more than a blip in the performance of the huge East Asian economy.

[3] The high-profile US-Japan trade dispute of 1996 was Kodak's complaint of Fuji's anti-competitive practices on the Japanese film market. It was hardly an issue likely to trigger an all-out trade war.

[4] The LDP was already back in government at the end of 1994, when the anti-LDP coalition collapsed. However, in order to split the anti-LDP camp, it had to allow its 40-year long opponent and now unlikely ally, the Japanese Socialist Party, to name the Prime Minister.

negotiator vis-à-vis the US, during his tenure as MITI minister in the previous Murayama government.

Hashimoto had launched a number of important reforms. His financial services "Big Bang" was a program of deregulation and liberalization to be implemented over a time span of five years,[5] with the aim of making Tokyo the top financial center in Asia. He also passed a law to give independence to the Bank of Japan, to make it similar to the Federal Reserve or the incoming European Central Bank. The concession of independence to the Bank of Japan was also aimed at making clear that there was no monetary solution to the growing government deficit and that it was time to proceed to fiscal consolidation (Cargill, Hutchison, and Ito (1997) and (2000)). In this respect, PM Hashimoto was pressing the Diet to pass a law aimed at bringing the government deficit below 3% in 2003.[6] Hashimoto and his advisers also envisaged an ambitious reform of the taxation system. The increase of the consumption tax[7] was the first step in such a direction. It would be followed by a reduction in the marginal rates of the income tax as well as by the elimination of a number of loopholes creating significant distortions on economic activity. In addition, the Hashimoto government was seeking further deregulation; it wanted to reform the welfare system to control health insurance costs and limit the rapid growth of employers' and employees' contributions to retirement schemes; and it was working on a project aimed at streamlining the structure of the public administration and reducing the number of its employees. All these reforms should have generated important supply-side effects which in turn should have enhanced Japan's sagging potential growth.[8]

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[5] In this respect, it would have been more appropriate to call it "Long Bang" instead of "Big Bang".

[6] The 3% threshold was related to the European deficit threshold included in the Maastricht Treaty. For a discussion of the impact that the move towards Economic and Monetary Union in Europe had on Hashimoto's policies, see Sakakibara (1999), Bertoldi (2002a), and Bertoldi (2002b). Paradoxically the law on fiscal consolidation was approved in November 1997, when the economic situation was deteriorating so dramatically that it was already clear that there was no chance to have it implemented in the original timeframe.

[7] It is interesting to note that the increase of the consumption tax from 3% to 5% (as well as the repeal of the temporary tax cuts) was not a Hashimoto's decision. The consumption tax hike had been decided by PM Murayama two years before, but with a 2-year suspension clause. Given the short life of Japanese governments, this meant to pass the buck to his successor, as in fact happened.

[8] The Hashimoto's reforms were the most ambitious and coherent envisaged by a Japanese government since Nakasone in the mid-80s. It is important to stress that the Hashimoto's reforms did not try to transform the Japanese economy in a US-type variety of capitalism. The reforms did not touch the functioning of the labour market and, despite the financial Big Bang, they should not have undermined the main bank system, i.e. what was considered rightly or wrongly the backbone of Japan's horizontal keiretsu. They tried to increase the efficiency of the sheltered sectors of the economy, but they neither eliminated the informal barriers protecting these sectors (see Lincoln (2001)) nor cut drastically the direct and indirect transfers of public money to politically sensitive sectors such as agriculture or construction. But this was not really an issue that would have troubled our imaginary policy maker: Japanese authorities' views might have differed on the ways and instruments to use to return to a strong and sustainable growth, but in 1997 there was no doubt that the issue was not the replacement of Japan's post-war variety of capitalism, but its adaptation to a changing environment and to the challenges of globalization. In this respect, Hashimoto, as the Japanese reformers of the Meiji period, was trying to strike the right balance between the introduction of US and European best practices and their pragmatic adaptation to the Japanese original socio-economic and institutional frameworks. For a more in-depth discussion on virtues and limits of Hashimoto's reforms, see Bertoldi (2002a).

The economic recovery under way and the expected enhancement of Japan's growth potential due to the Hashimoto's structural reform program also boded well for a Japanese-style resolution of the banking problem. Instead of going through painful solutions like those triggered by the Saving and Loans crisis in the US in 1990 or the Scandinavian banking crisis of 1992-1993, which implied the closure and/or downsizing of a large number of banks, a large number of bankruptcies, and rising unemployment, Japan could envisage a softer approach, where growth would solve most of the problems, and downsizing could be administered in homeopathic doses. Banks would play a diminishing role in credit provision, in particular for Japan's large companies, but they would be able to retain the role of guardian of the ownership structure within the keiretsu. The relative inefficiency of the banking sector due to the (intentional) slow pace of restructuring would be offset by the higher efficiency (generated by the Big Bang) of other financial institutions, which would be able to provide low cost financing for companies engaged in global competition. The downside risks of financial liberalization (i.e. financial bubbles) would be avoided by an independent central bank and the new financial supervisory agency.

Even the worries about a weakening of the economic recovery due to the increase of the consumption tax from 3% to 5% and the end of some temporary tax cuts, although they would have affected negatively growth in the short term, could have been dismissed on the basis of a longer-term perspective. The increase of the imposable basis in Japan was an issue which was widely recognized and supported by international institutions like the IMF and the OECD (as well as by the US and the EU). If included in a broader project aimed at overhauling of the inefficient Japanese tax system (and Hashimoto, as we have seen, envisaged such an overhaul), the measure could have important supply-side effects which would be significantly more important than the short term demand effects.[9] Last but not least, the EPA economic model indicated that the recessive impact would have been concentrated in the second quarter of 1997, and from summer consumption would start to pick up again, allowing the 1995-1996 recovery to continue.

On the basis of such a thorough assessment, our imaginary policy maker might have returned home with more hope than fear about the prospects of the Japanese economy: after five years of political and economic uncertainty and growing doubts about the potential of the Japanese economic system, the end of the tunnel seemed at sight. With strong leadership and a bold reform program, Japan could hope to have left most of its economic woes behind.

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[9] At the time the concept of "expansionary fiscal contraction" was very fashionable among policy-makers. A 1990 paper by Francesco Giavazzi and Marco Pagano showed that in some economies severe fiscal contractions can be expansionary. Although the paper studied the case of two small open economies, its policy implications were rapidly widened to embrace large economies. At the time, in many advanced countries, policy-makers were frantically looking for good reasons to bring budget deficits under control, and the article by Giavazzi and Pagano provided excellent justifications for budget hawks. Discarding the caveats and nuances of the paper, these policy makers turned "expansionary fiscal contraction" into an important pillar of economic policy in the 1990s.

2. One year later

One year later, policy-makers were struggling desperately to avoid the collapse of the banking system and the Japanese economy entered into a deflationary spiral. They were wondering not only why everything went wrong, but also whether in the above assessment there were some critical flaws, which went unnoticed or were not sufficiently taken into account one year before.

a. Everything went wrong ...

On April 1st 1997, the Japanese government implemented the fateful decision to increase the consumption tax from 3% to 5% and, at the same time, repealed tax cuts introduced in 1994. Although widely expected, Japanese consumers reacted much more negatively than predicted by government and private sector econometric models, and domestic demand was strongly depressed in the second quarter of the new fiscal year.

Furthermore, GDP revisions indicated that earlier statistics had overstated the strength of the Japanese recovery of 1995-1996. GDP growth for 1996 was revised down to 3.4%, and was no longer viewed as the outcome of a new dynamic in the private components of demand.

The international environment also played against the Japanese economy. Three months after this domestic fiscal shock, the Asian financial crisis spread all around Asia, badly hurting financial markets and economic activity. In the midst of financial turmoil and economic recession, the Nikkei index crashed, ending 1997 just above the 18.000 yen level, and with a strong likelihood of the sell-off continuing in 1998. Although in summer there were some fragile signs of recovery in household consumption, these soon disappeared as consumers became much more weary and downbeat about economic prospects.[10] By the fourth quarter of 1997, private consumption and investment growth were weakening at a worrying pace.

Not surprisingly in a society that values certainty highly, the domestic collapse in demand, the worsening of the stock market and the domino effect of the financial crisis initiated in Thailand and spreading through East Asia, triggered consumer panic and, after the bankruptcies of Hokkaido Takushoku Bank (the 10th biggest Japanese Bank) and Yamaichi Securities (the 3rd biggest security house), there were signs of an incipient bank run.[11]

b. ... but there were also fundamental flaws

Even if everything that could have gone wrong in fact did go wrong (and the worst-case scenario seemed suddenly to materialize), the crisis of 1998 was also the outcome of fundamental flaws in the economic policy of the Japanese authorities. Some of these

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[10] A relatively cold summer, depressing the sale of consumer durables goods, such as air conditioners, also contributed to weakening consumption.

[11] For instance, the purchase of safes skyrocketed at the end of 1997.

flaws were due to an inadequate understanding of the post-bubble situation in Japan both by bureaucrats and policy-makers. However, some of the biggest flaws were also the outcome of "political sanctuaries" that impeded the adoption of the measures needed to address some of the major causes behind the deflationary pressures plaguing the economy.

The first fundamental flaw in the analysis made by policy-makers was to have misinterpreted the nature of the 1995-1996 recovery and to have supposed that Japan was in the process of working out its structural fragilities. In reality, Japan's recovery was almost entirely the result of the combined fiscal and monetary stimulus introduced in 1995 and had almost no endogenous dynamism (Kuttner and Posen (2001), Mankin (2001)). The postwar Japanese model relying on the main bank and its network of enterprises had not been able yet to restructure sufficiently after the burst of the bubble to serve as the microeconomic foundation for a renewed and viable growth regime (Boyer (2001) and (2002)).

The second fundamental flaw, related to the previous one, was the underestimation of the sheer size of the fiscal adjustment in the pipeline in an economy still very fragile and therefore extremely sensitive to abrupt changes in policy. In retrospect, it is surprising how little attention Japanese policy-makers paid to the huge deflationary effects of the fiscal shock they were introducing into the economy. The increase of the consumption tax from 3% to 5%, the rise in contribution rates in social security and the repeal of a special income tax cut all happened in one shot in April 1997 (the beginning of the fiscal year) and their negative impact was enormous: at least 2% of GDP, according to estimates by Kuttner and Posen (2001). On top of this, public consumption and investment declined in the April-June quarter (by 0.3% and 1.6%, respectively, on a quarter-on-quarter basis), pushing economic activity further down. With a fiscal squeeze of this size, there was no chance that the awaited non-Keynesian effects could work: the collapse of effective demand was simply too large to inspire new confidence in consumers and investors. Expansionary fiscal contraction requires a lot of favorable pre-conditions to be successful and must be carefully tuned: if too small, it will probably not be sufficient to boost confidence, if too large (as in Japan), it will reverse initial positive expectations, since too sharp a decline in aggregate demand has negative effects on personal income and corporate profits.

To make things worse, government attempts to justify this fiscal contraction were inadequate and probably contributed to depressing consumer and investor sentiments. By stressing the potentially unsustainable fiscal position of the government as well as the huge size of under-funded future pension liabilities without making clear distinctions between the short and the medium-long term, the government contributed to a feeling of generalized insecurity, which erupted into panic when a number of banks and financial institutions began to fail in the second half of 1997.

The third fundamental flaw was the orthodoxy of Japan's monetary authorities and their consequent passivity in the fight against deflation. The Bank of Japan did not see

deflation coming and, when it started to emerge,[12] it was neither perceived as a lasting phenomenon nor as a major threat for the economy. Japan's prices being the highest in the world, mild deflation could have been the outcome of structural reform and the opening of Japanese markets to competition. Unfortunately for Japan, what it was experiencing was not "good deflation" (if there has ever been such a thing), but deflation *tout court* due to the fact that monetary transmission mechanisms were not working properly as a consequence of the balance sheet problems of banks and the growing output gap generated by the incipient recession.

This prefaces the fourth fundamental flaw, which impeded (and still impedes) macro-economic solutions to Japan's economic woes: contrary to what most policymakers believed or wanted to believe, the banks did not have the resources to clean up their balance sheets and had become sources of both deflation and inefficiency in the allocation of resources. A small number of policy-makers were aware that situation in the banking sector was much worse than the picture provided by official data. However, the political cost[13] of attempting to resolve this problem in a timely fashion was deemed so high that policy-makers instead preferred an alternate but extremely risky strategy: betting on a strong rebound in the economy.

Of course, not all of these flaws had to appear at the same time. In the middle of 1997, Japan found itself in the middle of a "perfect storm" triggered in part by its own policy-makers, in part by structural weaknesses in the socio-economic system (Boyer and Yamada (2000)), and in part by imponderable events in the international environment.

3. The long recession

Japan experienced its worst postwar recession between October 1997 and December 1998. Although real GDP declined by 1.1% in 1998, this outcome would have been much worse had the government not introduced two huge fiscal stimulus packages (of the total size of about 5% of GDP) (Muhleisen (2000)). Economic policy authorities also injected a large amount of money into the banking system, while the central bank moved to ease

[12] In fact, neither Japanese policy makers nor the private sector correctly anticipated Japan's deflationary slump. By studying the evolution of forecasts for growth and inflation across the 1990s, Ahearne, Gagnon, Altmaier and Kamin (2002) conclude that "most observers were very slow to appreciate how deep and protracted Japan's economic slowdown would be. Similarly there was little in financial market indicators to suggest that market participants realized that Japan was facing a prolonged deflationary slump until late in the decade" (pp. 11-12).

[13] As already mentioned in note 1, the political costs of solving the *jusen* problem were very high. The ruling LDP intervened heavily to avoid having some of its rural constituencies (*in primis* agricultural credit cooperatives), which were badly exposed to the *jusen*, bear their share of burden in the clean-up of the financial mess. The uproar, in particular among urban voters, was particularly strong and the idea of further use of public money to tackle the problems of the banking sector became extremely unpopular, since it was associated with the possibility of further wasting money to protect powerful interest groups. As pointed out by Cargill, Hutchison and Ito (2000), "the intense public negative reaction to the small amount of taxpayer funding included in the plan gave the regulatory authorities the rationale to continue a policy of forgiveness and forbearance... As a result, the government became very reluctant to propose the use of public funds to resolve the financial distress. This reluctance to use public funds further delayed resolution of the non-performing loan problem and thereby substantially increased the ultimate resolution cost" (p.53).

monetary policy. The resilience of the EU and US economies as well as the rapid depreciation of the yen also helped to keep Japan's aggregate demand afloat. In 1999, the economy stabilized and started to grow again,[14] albeit at the price of running a high fiscal deficit.

Although the short term macro-economic response avoided a full deflationary spiral, it failed to produce the desired jump-start (Krugman (1998) and (1999)) necessary to generate a sustainable recovery. This disappointing outcome can be explained by the interaction of three factors:

3.1. Insufficiently expansionary monetary policy

The monetary easing in 1998 was useful, but not large enough to reintroduce inflationary expectations. In February 1999, the Bank of Japan cut the overnight call rate to zero and, having exhausted all conventional instruments at its disposal, stopped short of taking further new aggressive measures to fight deflation.[15]

The Bank of Japan's passivity has various explanations. On the one hand, the conservative monetary policy adopted was aimed at pushing the government to accelerate the process of structural reform (which had almost stopped after PM Hashimoto's resignation). Monetary authorities did not want monetary policy to be used by the ruling coalition to postpone key decisions concerning fiscal and structural policies. On the other hand, the Bank of Japan had to show that its newly acquired independence was real. This implied that it would neither easily accommodate the Ministry of Finance's requests nor accept MOF leadership in the coordination of macro-economic policy.

Although well intentioned, the Bank of Japan's monetary policy failed to focus all the instruments available in the fight against deflation, towards which, instead, the bank took an ambiguous position. When asked to intervene to stop the decline in prices, Bank of Japan officials pointed out that (a) not all deflation was negative; there could be "good deflation" as a result of a decline in prices due to technical progress; (b) Japan's deflation was mild and not comparable with the US deflationary spiral of the 1930s; and (c) the Bank of Japan had already exhausted all instruments available to restore positive growth in prices and it was up to the government to restore the economic dynamism needed to move from moderate deflation to moderate inflation.

It is clear that the three explanations are not necessarily compatible. The good deflation argument made a short appearance in 1999-2000, but it disappeared rapidly, crushed by

[14] The recovery started in June 1999 and continued through 2000, the best year in terms of growth since 1996 (+2.8%). Excess capacity provided the potential for the rebound; fiscal and monetary stimulus, as well as the worldwide IT investment boom, boosted economic activity. But the structural weaknesses of the economy and the burst of the technological bubble put an end to the recovery at the end of 2000. The important thing to note about the 1999-2000 recovery is that, although a weak banking sector does not necessarily prevent a cyclical rebound, it weakens and shortens it.

[15] The research department of the Bank of Japan worked hard to justify Japan's central bank passivity vis-à-vis deflation. See in particular Okina (1999), Okina and Alii (2001), Okina and Shiratsuka (2002).

the impact of deflation on the balance sheet of households, companies and banks.[16] It was true that Japan had not gone through a 1930s type of deflationary spiral (also thanks to BoJ monetary easing), but deflation's resilience hung like the sword of Damocles over the Japanese economy. Finally, the argument that the bank had exhausted all monetary instruments capable of fighting deflation has been challenged convincingly by many economists (Bergsten, Ito and Noland (2001), Svensson (2001) and (2002), Posen (1998), Posen and Mikitani (2001), Kuttner and Posen (2001)) and more recently by Fed Governor Bernanke (2002), who in the speech "Deflation: Making sure 'It' Doesn't Happen Here" pointed out that "a central bank whose accustomed policy rate has been forced down to zero has most definitively *not* run out of ammunition … [A] central bank, either alone or in cooperation with other parts of the government, retains considerable power to expand aggregate demand and economic activity even when its accustomed policy rate is at zero."[17]

It is difficult to explain the Bank of Japan's resistance to adopting a more aggressive deflationary policy in the absence of significant costs to do so. A possible explanation can be found in the convergence of objectives between its top economic staff and the Board of the Bank. The top monetary staff of the Bank of Japan seems to believe that the best way to assert its newly acquired independence is to stay within the limits prescribed by orthodox monetary policy. Once the overnight call rate is pushed down to zero, the Bank has more or less done everything in its power to support the economy. Inflation targeting could be considered once Japan returns to inflation, but it is not advisable in the current situation, since "orthodox" instruments are not powerful enough to move price dynamics from the current situation of deflation to a situation of inflation (Okina (1999), Oda and Okina (2001)). This theoretical stance has served well the "structural reform first" approach by Governor Hayami and the majority of BoJ Board. The "structural reform first" approach argues it is not up to the Bank of Japan to make the first move in the fight against Japan's long recession. The causes underlying the recession come from the real side of the economy, and activity is not picking up because the government and the ruling LDP are not sufficiently committed to the reforms necessary to bring the economy on a sustainable recovery track. Against this background, a non-orthodox monetary policy would only make things worse: it would be unable to fight inflation in the short term, it would alleviate the pressure on the government to carry out structural reform, and, in creating expectations for inflation in the long run, would push up long term real interest rates, further depressing economic activity.

[16] On this issue, see Bernanke (2002).

[17] This "ammunition" includes inflation targeting, aggressive monetary expansion, increases in the purchase of assets by the central bank (and/or expanding the menu of assets that it buys), and announcements by the central bank of explicit ceilings for yields on longer-maturity Treasury debt. If these measures still prove insufficient, a central bank might also buy private securities directly to lower their yield or buy more foreign government debt to depreciate the exchange rate. These measures would be even more effective if carried out in coordination with fiscal authorities. Bernanke (2002) points out that "a broad based tax cut … accommodated by a program of open-market purchases to alleviate any tendencies for interest rates to increase, would almost certainly be an effective stimulant to consumption and hence to prices" (p.7). If instead the government increases spending on current goods and services and issues debt to purchase them and then the Fed purchases an equal amount of Treasury debt, "the whole operation would be the economic equivalent of direct open-market operations in private assets" (p.8) and would have a significant anti-deflationary impact. See Bernanke (2000).

However, in following such a strategy, the Bank of Japan has found itself caught in an "independence trap" (Cargill, Hutchison and Ito (2000), Cargill (2001)), in which a too strong and rigid assertion of independence has made it unable to fight deflation effectively. In ruling out any *ex-ante* co-operation with fiscal authorities, the Bank of Japan has exacerbated and pushed to the limit the "game of chicken" (Posen 2003) played with the Ministry of Finance and financial regulators.[18] In addition, its intellectual refusal to consider non-orthodox alternatives and even not so un-orthodox solutions like inflation targeting, instead of building credibility, has backfired so badly that it has become almost impossible to find somebody outside the Bank willing to defend its policy. As a result, monetary policy is now an important part of the overall Japanese problem: without a brand new monetary strategy -and a new team to implement it- Japan cannot find a way out of its current woes.

3.2. Failed restructuring of the banking sector

To work properly, monetary policy transmission instruments need a functioning banking sector. This is particularly true in an economy, like Japan's, which has relied heavily on banks to finance its postwar capital accumulation. But, as we have seen, the banking system in Japan at the end of the 1990s was in dire straits. In late 1997, big banking and financial institutions were allowed to fail for the first time in Japan's postwar history. Households, fearing a systemic collapse, withdrew massively their deposits, while the premium for Japanese banks in international financial markets, which did not exist until 1997, grew rapidly. The distressed balance sheets of the banks, as well as self-fulfilling predictions by domestic and international agents, brought the Japanese banking sector close to collapse in 1998.

Despite (or because of) this dramatic situation, the management of Japanese banks continued to oppose both drastic restructuring and adequate re-capitalization through the injection of public funds between late 1997 and early 1998. However, facing a worsening situation and heavy political pressure to take action in the spring of 1998, eighteen out of the nineteen major Japanese banks accepted an injection of public funds. The interesting feature of this "re-capitalization" was that, in an arrogant display of confidence in the "convoy system", all banks applied for (and got) the same amount on money: 100 billion yen, an amount that was far too low to clean up the bad loan mess accumulated since the burst of the bubble economy. In exchange for this injection of capital, they made vague restructuring commitments that they did not even attempt to implement.

Such a public show of arrogance had disastrous effects: households accelerated their withdraws of savings; capital outflows pushed the yen down to a rate of 145 to the dollar; and the Japan premium went up to 100 basis points (a level unconceivable for the second largest economy in the world). Furthermore, with the economy sagging, the banks, while unable to clean up their own balance sheets, had to continue extending credit to corporate

[18] Of course, not all the blame should go to the Bank of Japan. As we will see below, politicians, the Ministry of Finance and financial regulators bear as much, if not more, responsibility for not encouraging a cooperative solution to develop.

clients that were *de facto* bankrupt and unable to repay these loans. This behavior has a double negative effect: it allocates credit to companies that are not viable while at the same time starving new and more promising enterprises seeking loans to develop and grow. This misallocation of resources thus aggravates both the recession and deflation.

The worsening of the situation during the summer of 1998, as well as the heavy defeat of the Liberal Democratic Party in the July Upper House elections, created new political momentum to tackle the bank re-capitalization issue. The opposition and LDP reformers pushed ahead a plan to restructure and downsize the banking sector in exchange for further injections of public funds. However, the LDP leadership succeeded in watering down the plan. Despite additional significant injections of public money and the acceptance of more credible restructuring commitments by bank management, the plan was still far from the downsizing and massive credit re-allocation needed to re-establish a sound banking system. Banks were merged (perhaps becoming "too big to fail"), but their organizational structures were only weakly integrated,[19] lay-offs were of the size of credit institutions restructuring in a sound banking sector, and credit reallocation was small and poor, as the worsening of the bad loan problem revealed in the years to come.

Therefore, the best opportunity to remove the biggest stumbling block to a sustainable recovery was unfortunately lost, and with it the possibility of finding a conventional or orthodox strategy to defeat deflation. In the absence of a functioning financial intermediation system, the zero interest rate policy of the Bank of Japan was unable to translate a substantial increase in high-powered money into an increase of M2 or M3 circulating in the economic system.

3.3. Inadequate fiscal stimulus

After the disastrous fiscal contraction of the first part of 1997, fiscal policy became expansionary and Keynesian to counter the collapse of effective demand. The stimulus packages of April and November 1998 played this role rather effectively and probably avoided a disastrous remake of the 1930s crisis. However, they were not able to trigger the jump-start for which the government was hoping.

Part of the reason behind this failure was related to the composition of the packages. The backbone of these packages was public works, mostly in infrastructure. The Economic Planning Agency indicated that this type of public expenditure had the highest multiplier effect, given their low import content.[20] Although these estimates were correct in terms of immediate impact, they failed to take into account the negative impact of the low quality of infrastructure investment on Japanese households. The infrastructure works included

[19] The lack of integration between mega-banks became evident to everybody when the new banking conglomerate Mizhuo, issued by the merger of Dai-Ichi Kangyo, Fuji Bank and Industrial Bank of Japan, started its operations in April 2002. The bungled integration of the computer systems of the three banks resulted in a dramatic system failure that disabled automated teller machines, delayed automatic transfers to pay utility bills, and caused mistaken withdrawals from customer accounts. See Nikkei Weekly, "Mizhuo's rocky start shackes public trust", 15 April 2002.

[20] Kuttner and Posen (2001) found that permanent tax cuts could have an even bigger multiplier and probably less side effects (see pp.124-140).

in the stimulus packages (motorways and high-speed railways in rural areas, a disproportionate amount of agricultural infrastructure) displayed, on the one hand, low contribution to productivity and, on the other hand, high maintenance costs. Therefore the real rate of return of such investments was very weak. Since such weakness will appear sooner or later in the balance sheet of the bond-holder institutions (*in primis* public pension funds and health care insurance companies), Japanese households have grown increasing uncomfortable with the content of the fiscal stimulus packages, with negative repercussions on consumer confidence. Furthermore, as pointed out by Melzer, "as public debt mounted, the risk increased that the government would have to renege partially on its pension and health care promises. The public responded by increasing saving relative to GDP, offsetting part of the effect of fiscal stimulus"[21] (Melzer (2001), p. 29).

Another reason behind the absence of the desired jump-start from expansionary fiscal policy was that the stimulus packages that followed the April and November 1998 packages did not play a significant stabilization role. In fact, their size and timing had little to do with macro-economic stabilization, and instead were closely linked with key electoral events, as well as with incentives to keep together the parties of the ruling coalition.[22] In this respect, it is worth mentioning that, contrary to the common wisdom, the fiscal stimulus injected into the economy during the long recession may well have been insufficient (Posen (1998) and Kuttner and Posen (2001)). More stimulus was likely necessary to avoid abrupt fluctuations in aggregate demand.

In a recession, fiscal policy should support aggregate demand initially through a significant demand shock and then by keeping its level steady until the economy shows that the cycle has turned around. This strategy aims both at boosting economic activity and at improving consumer and investor expectations by reducing uncertainty in the decision-making environment. If such a strategy cannot be implemented, the impact of fiscal stimulus risks being temporary and insufficient to restore the economy to a viable growth path.

Already in the past (e.g. in 1992 and 1995), fiscal packages were introduced a couple of months ahead of parliamentary elections to boost the victory chances of the parties in power.[23] However, before the end of the 1990s, the use of fiscal packages for political purposes was not systematic (Cargill, Hutchison and Ito (1997)) and took place in conjunction with cyclical slowdowns that needed to be addressed. On the contrary, the stimulus packages of 1999 and 2000 were not designed to make the economic environment more certain and stable. Had that been the case, the 1999 package would

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[21] Melzer continued: "Believing their pensions were threatened, households tried to restore personal wealth. The more they responded this way, the smaller the effect of fiscal expansion on GDP."

[22] In this respect, the November 1998 stimulus package already contained provisions (e.g. consumption coupons, a major failure) aimed not at stimulating aggregate demand, but at co-opting a small party in the ruling coalition.

[23] An *a contrario* proof of their political effectiveness is given by the fact that PM Hashimoto went to elections only with a small package introduced in March 1998 (too late to have any significant effect in the run- up to the vote) and the LDP suffered one of the worst defeats in its history.

have been frontloaded and approved before summer[24] (and not at the end of the year), while the 2000 package would have been smaller and postponed for a couple of months[25] (see table 4). Instead both packages were approved in the month of November, eight months ahead of key Lower House (in July 2000) and Upper House (in July 2001) elections.

Table 5 shows clearly that if the main purpose of Japan's public investment policy in 1999 and 2000 was to stabilize the economy, it failed miserably. Public investment fluctuations were huge and they generated by themselves very short and violent cycles around a very low growth trend. However, if the objective of the stimulus packages was to deliver good economic outcomes to be exploited in an electoral campaign, they succeeded quite well.

In the second half of the 1990s, once a stimulus package was approved in November, public works were frontloaded and most of the impact was felt in the first two quarters of the following year. Since the GDP figures for the first quarter of the year were released on 10 June (about 30-40 days before elections), the ruling parties were able to present themselves to the voters with a positive record, the economy showing signs of recovery .

However, the political-business cycle strategy put in place was even more sophisticated (and harmful for the economy). In the Japanese political system, the rural seats have a disproportionate weight (to be elected, representatives from urban areas need more than twice the number of votes required by representatives from rural areas. The voice of urban voters is therefore much weaker than that of rural voters). Since the stimulus packages targeted key electoral constituencies of the ruling parties, and since the LDP has a crushing majority in the rural districts, discretionary fiscal measures also end up in the creation of a dependency path in non-urban areas. This dependency path has two related (and perverse) effects. On the one hand, living in proximity to where the investment takes place, rural voters know well the possible negative economic and employment implications for their district of a stoppage of the flow of funds from the central government. They thus vote for the candidate supporting new fiscal largesse for their area. On the other hand, candidates from rural districts find it necessary to promise more of the same in order to avoid disastrous defeats.[26] Against this background, as soon as data concerning the third quarter GDP and public investment figures start to be released, Japanese politicians from rural districts loudly call for new stimulus. Without negative figures expected in the second half of the year, their case for big (and wasteful) stimulus

[24] It was clear already in spring 1999 that public investment in the second half of the year would have had a significant negative impact on the recovery.

[25] In October-November 2000 the evidence for the need of a new big stimulus package was mixed. The need for a new fiscal stimulus was more apparent later in the year.

[26] In the 2000 Lower House elections, the leader of the major opposition party, Mr. Hatoyama, run an effective electoral campaign against the wasteful use of public money. As a result, his party, the Democratic Party of Japan, scored very well in those elections, in particular in urban areas. However, Mr. Hatoyama himself was running in a rural constituency in Northern Hokkaido, heavily dependent on public expenditure. Because of the challenge mounted by his (unknown) LDP opponent on the issue of public spending, he had to stop short his national campaign and rush back to Hokkaido. Mr. Hatoyama won by a narrow margin and seriously risked defeat.

packages would be undermined.[27] Therefore, it is not surprising that the strategic use of public expenditure for political purposes has made Japan's fiscal policy more and more ineffective in moving from stabilization to recovery. This state of affairs has led many to conclude (erroneously as we have mentioned above) that the Japanese case clearly shows that fiscal measures are not appropriate for fighting a deflationary spiral in advanced countries (Friedman (2001), Utt (2001)).

Inevitably a fiscal policy so heavily dependent on the vagaries of the political cycle gives rise to large budgetary imbalances. These imbalances are further worsened by persistent deflation and weak economic activity. The outcome for Japan at the end of the 1990s is well-known: a fiscal deficit close to 10% a year, government debt well above 100% and, because of deflation, growing above 10% every year. It is therefore not surprising that, although accepted at the beginning as a necessary instrument to avoid the worse, the fiscal policy implemented at the end of the 1990s displayed rapidly decreasing political returns.

3.4. Political repercussions of the failed stabilization

Due to this worsening environment, it was very difficult for economic policy authorities to proceed with coherent plans of structural reform. Progress was made in a number of fields (e.g. financial liberalization, accounting standards, elimination of technical barriers to trade), but in other key areas, such as competition policy, improvements were merely cosmetic. After Hashimoto's fall, the momentum for reform inside the LDP declined dramatically. The opposition might (and should) have taken up the fallen banner of reform as part of a strategy to replace the ruling coalition. However, deeply divided in terms of leadership, programs and ideological background, the opposition was unable to offer a credible alternative to the LDP and its allies.

Nevertheless, the opposition could have won by default: PM Mori, who succeeded the deceased PM Obuchi in spring 2000, quickly became the most unpopular PM in Japan's history and the LDP seemed on the verge of a dramatic defeat. However, banking on a victory by default is never a good strategy. The LDP, understanding that with Mori all was lost, pushed him to step down and organized an internal process to choose his successor. The "old guard" of the LDP bet on former PM Hashimoto, at the condition that he would not push too hard for structural reform and would not revert to short term fiscal discipline. In fact, Hashimoto had to run his electoral campaign inside the LDP on the not-so-appealing slogan of "I'll not repeat my past mistakes." However, the old guard was not sufficiently united in its support of Hashimoto and two conservative wings of the party fielded competing candidates. This split enhanced the initially poor chances of the outsider LDP "reformer," Junichiro Koizumi, the second-in-command in the Mori

[27] It is interesting to note that neither the change in government, with the rise to power of the "reformist" Koizumi, nor the fact that major elections are scheduled in 2002 and 2003, have been able to break the dependency path mentioned above: in 2001, attempts at fiscal consolidation backfired badly and not one but two fiscal packages were introduced in the winter of that year. In 2002, Koizumi had to resort again to a stimulus package after a decline in public investment threatened again to undermine the recovery. The Japanese government does not seem to have learned from past mistakes yet.

faction, who had already run in the past for the top LDP post[28] on a vague but popular platform in which he attacked some LDP sacred cows, including the postal saving system. Since Hashimoto was still held as responsible for the crisis of 1997-1998 and was backed by those who preached the status quo over reform, LDP rank-and-file members started to fear that he had very few chances to win in the next general election. However, this in and of itself was not sufficient for Koizumi to win the race. Since he did not control the party apparatus, in order to win he had to run on a platform opposite to that of Hashimoto, appealing in the meantime to survival instincts of party members. Therefore he ran a campaign that can be summarized in the formula "I'll repeat Hashimoto's mistakes ... without telling you," and won.

4. Why has the Koizumi government not succeeded so far?

The answer to this question comes straight from the above discussion. Koizumi tried to keep (some of) his promises and, in so doing, repeated (some of) Hashimoto's mistakes. At the end of April 2001, Koizumi was elected Prime Minister and replaced Mori. In his first speech to the Diet he identified three priorities: structural reform (including a resolution of the bad loan problem), strengthening of competition policy, and fiscal consolidation. However, the program was short on details, had important flaws and did not indicate any viable sequence for reform measures.

Until the Upper House elections of 2001, government plans seemed to focus mostly on future fiscal consolidation, which was the most popular part of the program, in particular among urban voters. The consolidation plan was even more popular since its possible impact had yet to be felt. In fact, voters were still enjoying the effects of the stimulus package introduced by Mori in November 2000 to boost his election chances (see table 5).

Koizumi's fiscal rectitude paid out and he and the LDP won a landslide victory at the Upper House elections of July 2001. He personally won in the towns with his promise to bring public expenditure under control, and he and the LDP won in the countryside, mostly thanks to his predecessor, who, before being sacked, delivered the public works vital for the economy of rural areas. Victory in the rural districts was not a full endorsement of Koizumi's policy; it was rather a hedging exercise by voters of non-urban districts. Given the dependency path mentioned above, these voters have to vote for the likely winner, since the winner will take control of the distribution of public resources. However, should Koizumi become serious in his reform projects, the politicians elected form rural districts will likely act to moderate any radical proposals. Koizumi was (and is) extremely popular, but his power base is limited. He still needs to compromise with the party's leadership in general and the old guard in particular.

To make things worse, Koizumi got his priorities wrong in the aftermath of the election. Having been an outsider with little chance of winning the power struggle within the LDP until shortly before his selection as party leader, he had not seen the need to work out a

[28] The President of the LDP becomes almost automatically the new Prime Minister when the LDP is in government.

coherent and detailed policy program. Thus, in going ahead with his idea of rapid fiscal consolidation in the short term, he missed the fact that by the end of 2000 the economy had started to slow down due to the bursting of the worldwide technological bubble that and the first quarter good performance in terms of GDP was mostly the result of expansionary fiscal policy. Moreover, the US economy had entered into recession, weakening another important source of aggregate demand for Japan. The initial macro-economic policy of the Koizumi government was therefore pro-cyclical (see tables 4 and 5), adding to the contraction under way in the GDP. In short, it began to look like 1997-1998 would not be the lowest point in postwar Japan's postwar economic history.

However, during summer 2001, when it became clear that the government was on the track to go down the Hashimoto way, corrective measures were taken and two fiscal stimulus packages (one in November and one in December) were hurriedly prepared to counter the oncoming recession. At least six months were lost in a vain and wasteful effort to consolidate the budgetary situation independently from the evolution of the business cycle. In those six months a lot of talks on structural reform took place, but not much was delivered. At the end of the year, almost none of the big reforms envisaged, such as privatization of the postal service, the strengthening of competition policies, the liquidation and/or privatization of inefficient and wasteful public companies, and tax reform, had made significant progress. Last but not least, in imposing the 30 trillion yen cap to the government bond issuance for FY 2002, implicitly also supposed to cover FY 2001, Koizumi *de facto* ruled out the possibility of cleaning up the banking sector with a drastic and swift intervention. The alternative offered was a cat-and-mouse game between the Financial Services Agency (FSA) and the banks: FSA would conduct more severe inspections, pushing the banks to disclose more (but not too many) bad loans, and banks would increase their bad loan provisions and announced more aggressive plans to dispose non-performing loans (which however continued to grow despite these reassuring statements). Needless to say, this mild step-by-step approach did not work. Banks disclosed more (but far from all) non-performing loans, but did not take action to tackle the problem decisively because they knew that the government was not ready to take extreme remedies. Once again the opportunity to deal once and for all with the crisis in the banking sector, based this time on the strong popular support enjoyed by Koizumi and his plea for in-depth reforms, was lost.

Given the absence of a coherent set of measures, not surprisingly, 2002 was again a year of half-reforms, with no breakthrough in any key area. Since the first half of the year, a cyclical recovery has been under way, but deflation has not been subdued, and the self-inflicted cap on government bond issuance has been broken. The blame game between the Bank of Japan and the government on the most appropriate policy mix to end deflation and to accelerate recovery went on until September, when the Bank of Japan, with a surprise move (i.e. the announcement that it would purchase corporate stocks from the portfolios of private commercial banks), hinted at systemic weaknesses in the banking sector. This triggered the eviction of Mr. Yanagisawa[29] as head of the Financial Services

[29] Mr. Yanagisawa was the first minister in charge of the Financial Supervisory Agency when it was created in 1998. At that time he was considered a top reformer, determined to be tough with the Bank management. However, after having injected public money in the banks in 1999, he took the commitment

Agency and his replacement with Mr. Takenaka, who also kept his previous post as minister for economic and fiscal policy.

5. Takenaka's plans for the banking sector

5.1. Plan A

Takenaka, who in the past argued for a radical clean-up of the banking sector, came up with a radical policy platform at the end of October 2002.[30] The plan aimed to force the major banks to admit that they were undercapitalized, and hence pave the way for the compulsory injection of public funds in order to raise their capital adequacy ratio. As noted in the country report of The Economist Intelligence Unit (December 2002), "in exchange for this re-capitalization, the banks would be required to give equity to government, which would then use its shares to force changes in operational behavior. Mr. Takenaka could then close several of the weakest banks, remove incompetent or venal managers, and insist that the surviving lenders supply credit only to corporations with some prospect of repaying those debts." Non-performing loans would be transferred to the Resolution and Collection Corporation (RCC), which would sell them off in the secondary market. The result, the EIU noted, would be "a smaller, more efficient, and more stable banking system." However, in a matter of hours PM Koizumi withdrew his political support to the Takenaka plan because of the stern opposition of conservative politicians in the Liberal Democratic Party and banking management. It is unclear how determined Takenaka was when he put forward his plan: it might well have been a *ballon d'essai* aimed at attracting the fire of conservative LDP members and the management of banks against a straw man, thereby allowing him to obtain (as he did) the approval of new laws and regulations tightening his grip on individual banks with significant weaknesses. Furthermore, the initial plan remained vague on some key issues: Would the Bank of Japan proceed speedily to further monetary easing? Would the 30 trillion yen cap to the budget deficit be lifted? Which measures would be taken to strengthen social safety nets? To suppose that Takenaka and possibly Koizumi made the hypothesis that *"l'intendance suivra"* is both too bold, and too Napoleonic, for Japan's politics. This, as well as the fact that Takenaka did not resign despite Koizumi's disavowal of the plan, casts further doubt on whether the October radical reform plan was really part of Takenaka's master plan.

5.2. Plan B

Whatever his initial strategy Takenaka was able to present, and have approved by the Cabinet, a less ambitious version of the initial plan. The new plan creates the framework

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of avoiding to have to do it again. Because of his tough stance, he was replaced few months later by more malleable LDP politicians. When recalled by Koizumi in the government, he was constrained by his previous commitment and, paradoxically, he was seen as increasingly leaning to the conservative camp, replaced among the reformers by Mr. Takenaka, a university professor with no LDP political background.

[30] The most important measure in the platform was the revision of the deferred tax accounting rules. Deferred tax assets totaled 8 trillion yen as of the end of March 2002, accounting for roughly half of the Tier 1 capital of major banks. The tighter standards would reduce the capital adequacy ratio of all the major banks below the 8% line, which is the regulatory minimum for banks with international operations.

for the injection of public money into troubled banks, as well for their nationalization if necessary. Moreover, it harmonizes loan assessments and aims to develop a loan market, which would transfer loans from the Resolution and Collection Corporation back to the markets.

The timetable unveiled by Takenaka at the end of November 2002 turns up the heat on the banks by creating a financial issues staff office which could impose "special assistance" (including the injection of public money on undercapitalized banks), introduce a new approach in evaluating loans, and launch a new round of special regulatory examinations designed to assess the accuracy of banks' internal assessments of debt-ridden companies. Further, Takenaka intends to revise the accounting rules on banks' deferred assets in the next fiscal year (starting in March), which could be a lethal threat to banks given their current status.

When first introduced, Takenaka's Plan B looked uncomfortably like a withdrawal to a step-by-step approach, which has failed badly in the past as tough measures have been dropped when the banking sector started to feel pain. However, Takenaka is showing signs of determination, and seems to want to achieve the original objectives of Plan A, although with different means and a longer time frame. His Plan B deserves the benefit of the doubt for now.

Further, the fear amongst banks that Takenaka's Plan B might be almost as dangerous as Plan A for management and shareholders is forcing them to take action. The banks have started to understand that the defeat of the initial Takenaka plan might not have been sufficient to buy more years of status quo. In response to Takenaka's timetable, and the new wave of announced inspections, a number of banks have put together plans to raise new capital in order to pre-empt government takeover.

In cases such as the Bank of Mitsubishi Tokyo, this has been done according to market rules, with fresh capital raised from the financial markets. This dilutes the control of current shareholders, but should reflect positively on the balance sheet of the bank, as well as strengthen the resolution process for non-performing loans. In other, more controversial cases, such as Mizuho Bank, major (and weak) shareholders, such as the insurance companies, have been asked to subscribe to new equity issuance. As noted by Robert Madsen, since these companies would collapse if their loans were called in, several of them have agreed to provide more capital to the embattled banks. This means that bank money will be flowing to insurance companies which then lend it back to the banks. As Kashyap (2002) points out, this "double gearing makes the banks and the insurance companies each look better capitalized than in reality they are." (p.7)

In these cases, it is unclear whether the banks can avoid government intervention. It will be up to the government to decide whether to continue playing cat-and-mouse, or to move decisively for a bank re-capitalization with public funds. Finally, banks have turned to overseas institutions to obtain capital, but on very onerous terms. An example is the the deal between Goldman Sachs and Sumitomo Mitsui Financial Group (SMFG), where Goldman Sachs agreed to invest 150.3 billion yen into the group, thereby lifting its

capital adequacy by half a percentage point. The terms of the agreement however, weighed heavily in favor of Goldman Sachs, with the shares carrying an annual 4.5% cash dividend after tax, or roughly 7% before tax. Goldman Sachs is also indemnified by SMFG for losses up to US$2.1 billion (about 250 billion yen) in its own lending activities. It will also gain access to SMFG's huge portfolio of distressed assets. The deal is so onerous and imbalanced that it looks like a desperate bet.[31]

Against this background, and despite the weaknesses and lack of personnel at the Financial Services Agency, Takenaka might well have identified a critical date when, in unveiling his timetable on 29 November 2002, he said "we will strive to resolve the bad loan problem by fiscal year 2004." Although it is very much unclear whether the Koizumi government and/or the banks will be able to find the political and economic resources to solve the banking crisis by 2004, things have clearly started to move again.

If a real resolution of the non-performing loans problem does not begin being implemented however, a crisis might become inevitable because of the very measures that the government has introduced. Some more time might still be bought by the authorities and the banking management, but, as the SMFG case shows, at such prohibitive a cost that an earlier meltdown would probably appear a more attractive alternative.

6. Japan's impossible trinity

On various occasions in the last six years, the Japanese authorities have tried to anchor their economic policy to three pillars following economic crisis: (1) an "expansionary" monetary policy within the limits of orthodoxy,[32] (2) the regain of control over the fiscal deficit, with the aim of short to medium term fiscal consolidation, (3) a step-by-step, non-traumatic, resolution of banks' non-performing loan problem. This is the economic policy that the Bank of Japan, on the monetary side, and the Japanese government, on the fiscal and banking sides, have pursued under Koizumi until the replacement of Yanagizawa with Takenaka. Since then it is unclear whether there has been a radical change in (3). The dismal economic performance of the last six years indicates that the policy-mix determined by this trinity is inadequate. It has only succeeded in producing low growth, frequent recessions, deflation, dramatic switches in Japan's fiscal policy, high government deficits, a huge and growing debt/GDP ratio, and a further accumulation of non-performing loans.

Japan's economy can still avoid a deflationary spiral and a major economic and financial crisis, but an increasing number of people are wondering how much longer it has. On the one hand, when Japan tries to accelerate the process of fiscal consolidation the weakening

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[31] SMFG decided, after the deal with Goldman Sachs, to issue yet another tranche of preferred shares. This seems to confirm that the bank is still under-capitalized and the chances (and fears) of partial or total nationalization been have raised again.

[32] The *ex-post* outcome of such an approach is not necessarily expansionary. As pointed out by Cargill, Hutchison and Ito (2000), policies that in normal circumstances may have worked have become "too restrictive for the situation faced by Japan." (p.173) See also Kuttner and Posen (2001) and Posen (2003).

of aggregate demand puts strong pressure on the ailing banking sector, increasing the level of bad loans and risking a deep recession. Since the government does not want to go through a major banking crisis it has been forced to reverse its fiscal policy and produce even higher deficits. On the other hand, a gradual resolution of the non-performing loan problem takes a very long time. In Japan's case it might go on forever, since the approach that was adopted in 1999, instead of decreasing the amount of non-performing loans, has led to their steadily increase.[33] Furthermore, the injection of public funds in the banking sector, even if only on an *ad hoc* basis, would imply a further short term worsening of the deficit and the debt/GDP ratio, undermining the three pillars of the current economic policy framework. Finally, a conventional expansionary monetary policy avoids a downward price spiral, but in the absence of a functioning financial intermediation system even the continued injection of high-powered money into the system is not sufficient to stop nominal GDP from shrinking and the debt/GDP ratio from climbing, making the government debt situation increasingly unsustainable.

The three pillars anchoring Japan's current economic policy are in fact an impossible trinity. The Japanese authorities might still have sufficient resources to buy some time, but, as rightly pointed out by Robert Madsen (2002), the end of the game is fast approaching for Japan.

7. Can the Scandinavian solution work for Japan?

Given that Japan's impossible trinity is not only unsustainable in the long term, but also presents increasing costs and rapidly decreasing returns in the short term, a new framework needs to be developed. Takenaka's radical plan of October 2002 did this, but it was stopped short by opposition from politicians and bank management. Takenaka's Plan B can still deliver, despite skepticism surrounding the way it was introduced. To assess what policy mix might be best for Japan, it is worth considering how other advanced countries were able to solve banking crises.

Japan was not the only place where a financial and real estate bubble inflated at the end of the 1980s. The US, UK and Scandinavian countries went through the boom and bust of the bubble more or less at the same time as Japan, although not to the same degree. The biggest difference is that all these countries took appropriate measures to clean-up the balance sheet of their respective banking sectors in the first half of the 1990s.

The case of the Scandinavian countries in general, and Sweden in particular, may be more informative than the S&L resolution in the US, since the S&L resolution had much smaller macro-economic implications than the resolution of the banking crisis in Sweden (Ingves (2002), Bertoldi (2002b)). Furthermore, the US style of resolution seen in S&L

[33] And more bad news might be in the pipeline. Recent studies (for instance Kashyap (2002)) have shown that the real amount of bad loans could be a multiple of the official figure. Should US-type standards be adopted for Japanese banks, *de facto* all banks would be below BIS capital requirement ratios.

might raise political and business opposition in Japan against US and foreign vulture capital.[34]

7.1. The Swedish Banking crisis.

By the end of 1991 the Swedish banking sector was in big trouble. Some of the problems were similar to those encountered by Japanese banks, including excessive lending to the real estate sector, an accumulation of non-performing loans much larger than the banking sector's total equity capital, and an excessive tightening of monetary policy which heavily damaged the balance sheets of companies and banks (Aglietta (2001), Backstrom (1999)). Some of the problems however, were different. For example, in Sweden the crisis was triggered by difficulties in obtaining international finance (Backstrom (1999)),[35] which is not a significant factor in Japan's case.

Of particular interest to Japan in the resolution of the Swedish banking crisis is the effective division of labor between institutions in achieving a rapid stabilization and return to a sustainable growth path.

At the political level, the crisis was recognized as sufficiently severe for government and opposition to develop a bi-partisan solution. This allowed the legislation to be put in place quickly. In September 1992 the government and the opposition jointly announced a general guarantee for the whole of the banking system. By December, the Swedish Parliament formally approved the guarantee. As noted by Backstrom (1999) "this broad political consensus was ... of vital importance and made the prompt handling of the financial crisis possible" (p.134).

Establishing a political consensus however, although an important condition for tackling the crisis, was not without peril. In order to accommodate powerful lobbying groups in both the majority and the opposition, the government may have been forced to opt for a high-cost solution for the public sector (and therefore the taxpayer), with problems of moral hazard also present.

To avoid this risk, a clear separation of roles was established between the political level and the authorities, as well as between different authorities. A separate authority was set up to administer the bank guarantee, as well as to manage banks facing problems with solvency. The crucial decision concerning the provision of support however, was ultimately a matter for the government (Backstrom (1999)).

[34] This bias against "vulture" capital remains quite strong, despite the fact that the economic impact of vulture capital has been quite positive both in the restructuring process of failed Japanese companies, and in introducing management innovations in the restructured companies. See Michyo Nakamoto, "Locals seek to ward off foreign vultures" Financial Times, 15 November 2002.

[35] In this respect, Sweden was luckier than Japan. Had such difficulties significantly affected the Japanese banking sector in the early 1990s, appropriate measures would have been taken much earlier and Japan's long recession would have been much shorter and less costly.

Banks applying for support firstly had their assets valued by the supervisory authorities using uniform data.[36] The banks were then divided according to whether they were judged to have only temporary problems, or had no prospect of becoming viable. To make such an assessment the Swedish authorities opted for "the disclosure of expected loan losses and assignment of realistic values to real estate and other assets," a method which may be of interest to the Japanese authorities.

This assessment led to capital injections by the government into two large commercial banks, while non-commercial bank-affiliated companies were left to go bankrupt (Goodhart and alii (1998)). In the meantime the government ensured that banks could maintain their commitments to all liability holders (to avoid disruptive legal actions during restructuring), and meet demand for new credit. To limit moral hazard, the authorities engaged in tough negotiations with the banks that needed support. Shareholders had to cover the losses in the first instance, and in many cases they lost control (the insolvent banks were *de facto* nationalized), and the management was fired.

The restructuring and downsizing of the Swedish banking sector proved effective. In two years their health was restored and financial intermediation was back to normal. The bank guarantee was terminated in 1996 and replaced by a deposit guarantee that is financed entirely by the banks. However, the successful resolution of the Swedish banking crisis would not have been possible without the close co-operation between monetary, fiscal and financial supervisory authorities.

The central bank of Sweden was partly responsible of the worsening of the financial situation, due to the policy of monetary tightening it introduced to defend the Swedish Krona in the fall of 1992. It changed its policy in November, abandoning its fixed exchange rate policy in order to support the effort to clean up the banking mess. Monetary policy became expansionary, interest rates declined dramatically (from 13.5% in 1992 to 8.8% in 1993) and the Krona depreciated significantly (see table 6). The banking system was freed to obtain unlimited liquidity by drawing on its accounts with the central bank, without needing to provide collateral.

On the fiscal policy side, automatic stabilizers also helped to lessen the contraction in GDP (see table 6).[37] This meant that company profits and household disposable incomes were sustained. Over 4% of GDP was injected in the banking sector to re-capitalize it. This worsened the fiscal situation of the country in the short term, but avoided a debt-deflation crisis. The government deficit skyrocketed above 10% in order to finance the bank re-capitalization (11.9% in 1993; 10.8% in 1994), but two years later it had returned to 3.1%. Since 1998 the budget has been in surplus. The debt/GDP ratio peaked in 1994 at 77.7% but has declined since then, falling to 52.6% in 2002.

[36] Takenaka's plan, passed in November, has finally introduced such a rule in the Japanese system.

[37] In Sweden social safety nets are particularly strong, meaning that automatic stabilizers are much bigger than in the US or Japan. European Commission calculations indicate that they are at least twice as big as in the US. The fiscal stimulus they provide is therefore quite large even in the absence of discretionary fiscal stimulus. Furthermore, it is less likely that this type of stimulus is pro-cyclical or distorted to accommodate political-business cycle concerns.

In 1994 there were signs that the recovery was well under way. Inflationary pressures started to mount in response to further monetary expansion, which was a good indication that financial intermediation had started to work properly. The Krona weakened further (in two years it depreciated more than 20%), going far below its real equilibrium rate and contributing to further inflation. By 1994 the debt-deflation risk was eliminated, and by the end of 1994 both monetary and fiscal authorities started to bring government deficit and debt under control and show that the Swedish central bank commitment to 2% inflation target was real. Sweden began to adjust its macro-economic policy to restore a sustainable growth path, backed by strong fundamentals. While in the 1990-1995 period Swedish growth was almost negative (on average +0.2%), it moved up to an average of 3.1% from 1996-2000, a level significantly higher than the EU average of 2.6%.

The direct and indirect costs to the Swedish taxpayer have been estimated between 6% (Backstrom (1997)) and 8% (Aglietta (2001)) of GDP.[38] However, as pointed out by Backstrom, at the beginning of the crisis in the early 1990s the situation looked worse than the Swedish banking crisis of the early 1920s, when GDP fell 18%. Had the course of action been different, the losses might have been much worse.

Despite the positive outcome of the crisis, was the Swedish way the best approach to take? Goodhart and alii (1998) have argued that "in no case was an effort made to auction off failed banks to private investors, primarily because domestic markets were too small to find investors for large banks. However, the question still remains why a bidding process open to foreigners was not initiated. The absence of bidding for the franchise value of failed institutions constrained the ability of authorities to minimize the immediate payout costs of the banking crisis." (pp.126-127) Goodhart and alii come to the conclusion that the Swedish authorities "could have done more to ensure that private investors, who were not depositors, lost wealth." However, they admit that the Swedish government managed the take-over of domestic banks "in a professional manner, ensuring that efficiency and profitability requirements were established." Furthermore, if taxpayers had to bear a slightly higher burden in order to buy the shares of private shareholders in now majority-owned government banks, this was probably a reflection of a social preference to avoid a complete loss for shareholders.[39] Maybe the approach taken by the Swedish authorities was not the optimal textbook solution, but there is no doubt that its benefits outweighed the inevitable shortcomings.

[38] The cost might have been even lower, since, as Ingves (2002) pointed out: "Nordic banking crises, except in Finland, ultimately generated a profit for the governments, especially when the revenue impact of all the efficiency gains are included." (p.9)

[39] As noted by Backstrom (1997), "the banking problems arouse a lively debate in Swedish society, but the work could still be done by political consensus, which was a great advantage." (p.137) Had the Swedish citizens considered the burden sharing unfair, the solution adopted would have been different. The solution adopted, although not "economically optimal," was probably considered more social welfare enhancing by the majority of the Swedish population.

7.2. Should Japan look at Sweden?

Mutatis mutandis, can Japan find inspiration from the approach that Sweden adopted more than ten years ago? In theory, the answer is yes. It is not by chance that Takenaka's plan of October 2002 had so many similarities with the decisions taken in early 1990s in the Scandinavian countries in general, and Sweden in particular. Sweden succeeded in ensuring that its central bank, fiscal authorities, and regulators, worked together in order to provide a policy mix capable of reaching a rapid resolution of the crisis. Furthermore, Sweden worked out an effective division of labor and responsibilities between the political and the technical/administrative levels. This avoided having politicians micro-managing restructuring (and the inevitable moral hazard problems implied by this), although the key decisions were taken, as it should be, at the political level.[40] The bank restructuring produced the desired changes in the corporate governance of the banks: savings were now channeled not to finance summer houses on Swedish coast, but to provide credits to sound companies with profitable investment plans, and to high-tech and fast growing new firms.

Another interesting effect of the resolution of the banking crisis was that it created the appetite for new changes, accelerating the process of structural reform. In 1996 major pension reform was introduced, making Sweden one of the few countries with an almost sustainable pension regime. Thanks to all these reforms, together with Finland, Sweden was able to produce "new economy" performances in the second half of the 1990s. Despite the burst of the technological bubble, Sweden's economic fundamentals are now sound, and it has become one of the fastest growing countries in the European Union. A European Commission report published in January 2003 ranks Sweden first in term of structural indicators that reflect the performance of Member States across six areas (general economic performance, employment, research and innovation, economic reform, social cohesion, and the environment).[41]

As mentioned, the Swedish approach may also be more politically and socially acceptable than a pure market solution to the problem. On the one hand, in a country concerned by vulture capital and the possibility of having to go through a fire-sale of its assets, a government-led restructuring of the banking sector might be more acceptable to politicians and the general public. As pointed out by Ingves (2002), "the Nordic banking crises taught the world powerful lessons of the need for prominent state involvement in the resolution process: it was the state rather than the private sector that had to lead the systemic restructuring exercise seeking to bring in private sector owners and investors as much as possible. The Nordic crises also showed a role for the state in the protection of asset values of banks, in situations where private asset markets collapse; the use of special asset management companies and loan workout units, that have to be government owned, if no private investors were available-as they seldom are in a systemic crisis.

[40] Considering the costs to be paid by the Japanese taxpayer for having politicians micro-manage fiscal policy, the need for a clear division of labor at the various level of government is almost a necessary condition for a successful restructuring of the Japanese banking sector.

[41] Cfr. European Commission, "Choosing to grow: Knowledge, innovation and jobs in a cohesive society," Brussels, SEC (2003) 25, 14 January 2003, p. 24.

Such bodies can protect values through careful management rather than destroy values through rapid fire sales. The Nordic experience also highlighted the importance of operational restructuring of corporations as the underpinning of bank restructuring" (p.9). However, this should not mean that the government tries to manage the process of re-capitalization or re-privatization of banks by forcing the set-up of consortia, imposing national preference, or other politically tempting but economically unsound arrangements. In this respect a clear division of labor is essential to the long term success of the operation. Should "political arrangements" be introduced in the public or private re-capitalization process, their hidden costs in terms of loss of efficiency and lower profitability would make the Swedish solution much less attractive, and the "market-led solution" might become more appropriate.

A final note of interest, which should be of comfort for Japan, is that the restructuring of the Swedish banking sector, although has generated many changes in the entire Swedish economy, has not put an end to the Swedish variety of capitalism. Today, the Swedish model is no longer the model of the 1950s and 1960s, but it maintains an original character and has not been transformed into the US model, or to what the *theorie de la regulation* (Boyer (2002)) and Hall and Soskice (2001) have defined as the "liberal market economy." In this respect, Sweden has become a reformed coordinated-market economy, which is still able to produce high levels of wealth and welfare for its citizens.

7.3. Problems with the Swedish solution

It would be a mistake to play down the risks involved in a Scandinavian solution for Japan. On the one hand, the redistribution costs will be much higher than in Sweden. Japan's households and investors have adapted to almost a decade of deflation. Many of them they have made financial investments under the premise of a continuation of moderate deflation. A jump from moderate deflation to moderate inflation would have major consequences, making many people and companies worse-off. Pressure on politicians would rapidly intensify, and, judging from the past (Lincoln (2001), Curtis (1999)), the Japanese political system would make it very difficult to stop the process derailing. As pointed out by Lincoln, until now a majority of people have not been deeply affected by Japan's economic woes. Judging by the Swedish experience, the clean-up of the banking mess would have a strong short term negative impact on the economy, and the question of whether politicians would put their careers at risk with no certainty of success is debatable. To complicate things further, it will be difficult to find support across the political spectrum for swift and drastic bank reform. As mentioned, a "bipartisan" solution to Japan's banking woes was tried in 1998. However, when the injection of public money was finalized, the ruling coalition dropped the opposition's requests and imposed much milder conditionality on banks. Politically, the opposition suffered a major setback, and it seems therefore unlikely that it will cooperate again with the ruling parties unless it is offered strong incentives. This is quite different from the co-operative approach taken the social-democratic opposition during the resolution of the Swedish banking crisis.[42]

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[42] The Swedish Social-Democrats had a strong incentive to be constructive: the crisis developed when they were the ruling party, and a non-cooperative stance would not have won the appreciation of Swedish

Another major problem is that Japan, in contrast to the Scandinavian countries, has not developed a social safety net to cope with the growing unemployment and social disruptions that bank restructuring will cause. Therefore it could be exposed to a major social backlash, which again might stop the process mid-way.

Also, unlike Sweden, the global and regional impact of wide exchange rate fluctuations will be much greater if the yen slides in response to the restructuring of the banking sector (see Madsen (2002)). The uncertainty created before and during the nationalization of part of the banking sector would risk creating high yen volatility, coupled with a substantial depreciation. A significant devaluation by Sweden, which is a small open economy, is not particularly disruptive. A massive Japanese devaluation would have a impact on its main trading partners, starting with the US, which is already running a huge current account deficit. Bad timing in the implementation of banking reforms might weaken the US and the EU recovery, and increase trade tensions. In a way or another, Japan will have to coordinate with its major partners. It will have to convince them that the short term flood of Japanese goods and services into their economies will have important rewards in the medium to long term, not only in terms of exports, but also in terms of a more friendly and open environment for foreign investors. And it will need their full political support in the reform process, since domestic political resources will rapidly run short.

The major difference with the Scandinavian solution however, is the size of the non-performing loans problem in Japan. A paper by Kashyap (2002) estimates the "current taxpayer liability for losses incurred by yet to be recognized in the financial sector" (which, apart from banks, includes insurance companies and the Fiscal Investment and Loan Program[43] (FILP)), at 24% of Japan's GDP. The risk of sending the Japanese economy in a tailspin is therefore much larger than in the case of the Scandinavian countries (which incurred losses below 10% of GDP). To succeed, the Japanese government is obliged to make a *parcours sans faute*, which in politics is almost an impossible task. To make things more difficult, it can not rely entirely on past Scandinavian and US best practice. For instance, in the technical field of guarantees offered in the sale of failed banks, as Spiegel (2002) has recently shown, the methods that worked well in the resolution of the Saving and Loan crisis (i.e. "loss-sharing arrangements" and "put guarantees"), might instead produce ambiguous outcomes in the presence of deteriorating economic conditions. The task that will fall to the Financial Supervisory Agency will be daunting, and it is far from clear whether it has the manpower and the political resources to successfully manage such a difficult transition.

Finally, it is clear that bank management will not go without a fight, and they will use all the political backing they have to obstruct and reverse any Scandinavian-type solution. If

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citizens. In the case of Japan, the opposition has a much stronger exit option than the Swedish opposition had back in 1992-1993.

[43] Doi and Hoshi (2002) in their paper "Paying for the FILP" find that 75% of FILP loans are bad and the estimated losses are about 15% of GDP.

past experience is any guide, there is not much room for optimism regarding the capacity of the government to fend off such a determined and powerful opposition.

8. A window of opportunity?

Against this background, the chances of achieving a "non-crash" landing[44] with a Scandinavian/Swedish solution are not high. But the current choice of continuing to fly until the economy runs out of gas, and hope for a miraculous recovery, is even less palatable.

The Japanese government has a small window of opportunity to put all the pieces of the puzzle together at the end of 2003 and first half of 2004.[45] At that time, economic activity is expected to pick up moderately in Japan, and economic recovery should have strengthened both in the US and the EU, making them more willing, if need be, to accept a short term devaluation of the yen.[46] Furthermore the FSA would have had the time to prove that part of the banking system is de-facto bankrupt and needs to be restructured, downsized and possibly nationalized. It would also have time to draw-up coherent plans for cleaning-up the balance sheets of the banks, and disposing of non-performing loans without excessive disruption to economic activity. Although time is running short, some social safety net schemes could still be introduced in the months to come to absorb the clean-up shock. Given the weakness of Japan's welfare system however, a discretionary fiscal policy (in the form of a well-thought stimulus package containing both investment in projects with high economic and social returns and tax cuts) would also be necessary. As mentioned above, the world recovery would help support aggregate demand, allowing the size of the stimulus package to be contained. Last, but not least, the new Governor of the Bank of Japan, who would still be in the middle of a grace period following nomination, would have his/her greatest opportunity to make a fresh start, enjoying wide domestic and international support for a turn-around in monetary policy. Therefore the adoption of bold, unorthodox monetary policies aimed at defeating deflation and supporting the reform and restructuring of the banking sector, would have more chance of success than if adopted at a later stage.

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[44] It is unfortunately too late to hope for a soft landing.

[45] Of course, an early coordinated resolution of the debt-deflation problem would be very much welcome. However uncertainty and downside risks linked to geopolitical tensions, as well as the leadership change at the Bank of Japan, make such coordinated intervention rather difficult. Another possible window of opportunity could be find at the end of the elections period in Japan (summer 2004) and the US (November 2004). However, postponing *de facto* action until 2005 would be very damaging for the credibility of the Bank of Japan and its new management (almost two years of inaction would be very damaging to the credibility of the new leadership). It would also be risky for fiscal authorities, who are increasingly caught in a deficit and debt trap, which narrows their margin for maneuver. Furthermore, the Upper House elections in 2004 might bring back political instability, particularly if the current government fails to translate its reform plans into positive action.

[46] The US might have some problems in seeing the yen slide and the trade deficit increase, ahead of presidential elections. Japan was an issue in the campaign of 1992, and did not play well for the incumbent, President George Bush. However, if there are clear signs that Japan is going to fix its problems, and in so doing creating new opportunities for US exports and investment, the risks of a major rift could be limited.

The window of opportunity for a coordinated attempt to tackle Japan's economic woes might be short. Will it be grasped?

9. On a winter night in 2003...

Six years later our Japanese policy-makers are in a much more somber and downbeat mood than that winter night in 1997. Macro-economic and structural problems have grown to worrying dimensions. Government debt (now close to 150% of GDP) and non-performing loans break new negative records every year, dangerously testing how far the Japanese economy can fall without entering into an unmanageable downwards spiral.

The international economic situation in the winter of 2003 is not brilliant. The US recovery is slower than expected and, because of geopolitical uncertainties, the dollar is slowly depreciating. Europe's growth is very weak and a relatively strong pick-up is not expected until the end of the year. Risks of war and the fear of terrorist activities, as well as doubts about the US and EU recoveries, are pushing companies to postpone or delay new investment. Oil prices are at their highest level since 2000, and not far from the levels reached before the beginning of the first Iraqi war. China's dynamism is only partly good news for Japan, given the strength of Chinese exports (which would be strengthened by a further weakening of the dollar).[47] Contrary to winter 1997, the world seems in much worse shape, and this makes the possibility of solving the problem through exports and net external demand much more difficult to implement.

On the political front, reformers' attempts to fix Japan's problems are thwarted by an inter-party and intra-party majority opposing them. Reforms do not proceed or are significantly watered down because of the already strong opposition inside the ruling coalition. The general public is confused by the absence of a clear political agenda and the continual change in priorities of the reformist camp, which is far from homogeneous and much more divided than the *status quo* camp. Voters maintain a passive and increasingly agnostic stance, providing only unenthusiastic support for a reform process which is unclear in its priorities and poor in its economic and social implications.

It is difficult to see a bright horizon in the current situation, or in the future. Our policy-maker might even wonder whether Japan has not entered into long term decline, exacerbated by the rapid ageing of the population and the huge liabilities created during the lost decade.

But maybe, as our Japanese policy-maker of winter 1997 was over-optimistic about the prospects of the economy, the Japanese policy-maker of winter 2003 might be too pessimistic about the possibility of the country restoring itself to economic health. What needs to be done is now well known, although a lot of details still need to be worked out. The real question is whether there is the political will and the ability to mobilize sufficient political and economic resources to go after the problems and solve them.

[47] Although it only affects some low-tech segments of Japan's production, it raises protectionist reflexes among Japanese politicians, not least because these sectors are labor intensive and mostly located in rural areas with unemployment problems.

Whether there is in Japan's political leadership the "Rooseveltian resolve" (Bernanke (2000)) needed to introduce innovative solutions, without which the country will continue to be trapped in its long recession.[48]

The Japanese policy-maker should be more aware, and less afraid, that economic and structural changes do not mean that Japan will have to adopt the Anglo-Saxon model. Like Sweden, Japan will still keep some of its original characteristics, although it is inevitable that during the reform process it will also develop new ones.[49] The issue is whether Japanese policy-makers will be able to create the institutional arrangements able to give internal coherence to the new model, so that it does not become unstable and threaten the success of the reforms introduced.

There is no doubt that because of the sheer size of the current problems, the transition to a viable growth regime will be messy, and a huge transfer of income among various social groups will be required. Unemployment could go up significantly and the consequential social shock might be considerable. In the short term it will be a negative sum game. However, this was already known at the end of the 1990s. The real trade-off is between paying the price immediately, or to paying a higher price later. Since many years have been wasted without deciding when and how to tackle the crisis the price to be paid by Japanese society is much higher today, and it is difficult to imagine that it will not generate a major political changes.[50]

But, as shown by the experiences of other economies which found themselves trapped in more dramatic situations than Japan, a country almost always has at least one opportunity left to fix its major problems. It is up to policy-makers to seize and make the best of that chance. In this respect the game is not over yet, and Japan has still many strengths (e.g. technology, high quality of its human capital, ability to innovate) on which to rely. What is needed is political determination; a bold, innovative economic policy; and, as Rudiger Dornbush would have said, a bit of luck... Only a bit? Under the current circumstances, a lot of it would be much more reassuring.

[48] As pointed out by Bernanke (2000), "Franklin D. Roosevelt was elected President of the United States in 1932 with the mandate to get the country out of the Depression. In the end, his most effective actions were the same ones that Japan needs to take – namely, rehabilitation of the banking system and devaluation of the currency. But Roosevelt's specific policy actions were, I think, less important than his willingness to be aggressive and experiment – in short, to do whatever it took to get the country moving again. Many of his policies did not work as intended, but in the end FDR deserves great credit for having the courage to abandon failed paradigms and to do what needed to be done" (p.165).
[49] See Bertoldi (2001).
[50] With regard to Japan's political prospects, both Samuels (2003) and Katz (2003) make interesting parallels between the current Japanese situation and the Italian situation of the early 1990s.

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Tables

Table 1: Japan's Real GDP Growth

(at constant prices)

Year	Real GDP Growth
1981-1990	4.4%
1991-1996	1.8%
1997-2002	0.7%
1997	1.8%
1998	- 1.1%
1999	0.1%
2000	2.8%
2001	0.4%
2002	0.3%

For comparison:

Year	US	EU
1981-1990	3.2%	2.4%
1991-1996	2.6%	1.5%
1997-2002	3.3%	2.3%

Sources: Cabinet Office, European Commission.

Table 2: Japan's Government Deficit

(% of GDP at market prices)

Year	Deficit/GDP
1994	2.8%
1995	4.2%
1996	4.9%
1997	3.7%
1998	10.7%
1999	7.1%
2000	7.4%
2001	7.2%
2002	8.0% (*)

(*) Estimate

Source: European Commission.

Table 3: GDP deflator, Consumer Price Index (CPI) and Domestic Corporate Goods Price Index (DCGPI)

Year	Deflator	CPI	DCGPI
1991	3.0%	3.3%	1.0%
1992	1.7%	1.7%	- 0.9%
1993	0.6%	1.2%	- 1.6%
1994	0.1%	0.7%	- 1.7%
1995	- 0.5%	- 0.1%	- 0.8%
1996	- 0.8%	0.1%	- 1.6%
1997	0.3%	1.8%	0.6%
1998	- 0.1%	0.7%	- 1.5%
1999	- 1.5%	- 0.4%	- 1.5%
2000	- 1.9%	- 0.7%	0.0%
2001	- 1.6%	- 0.7%	- 2.3%
2002	- 1.6%	- 1.0%	- 1.9%

Sources: Cabinet Office, Bank of Japan.

Table 4: GDP growth and public investment growth (quarter-on-quarter)

(Annualized rate of change from the previous quarter, at constant prices, seasonally adjusted series)

	GDP growth	Public Investment Growth
Q1-1997	+ 9.1%	- 15.8%
Q2-1997	- 13.5%	- 5.5%
Q3-1997	+ 6.3%	+ 27.5%
Q4-1997	+ 1.0%	- 14.7%
Q1-1998	- 2.1%	- 11.7%
Q2-1998	- 2.3%	- 8.7%
Q3-1998	- 2.8%	+ 3.4%
Q4-1998	+ 2.2%	+ 45.7%
Q1-1999	+ 1.1%	+ 19.3%
Q2-1999	+ 1.6%	- 7.6%
Q3-1999	- 0.7%	- 22.5%
Q4-1999	- 3.8%	- 11.9%
Q1-2000	+ 4.0%	- 15.8%
Q2-2000	+ 3.9%	+ 7.5%
Q3-2000	+ 2.6%	- 16.5%
Q4-2000	+ 5.5%	- 17.4%
Q1-2001	+ 2.0%	+ 24.5%
Q2-2001	- 5.3%	- 19.2%
Q3-2001	- 4.4%	- 0.7%
Q4-2001	- 1.7%	- 3.0%
Q1-2002	+ 0.2%	+ 0.2%
Q2-2002	+ 5.3%	- 8.1%
Q3-2002	+ 2.9%	- 6.6%
Q4-2002	+ 2.0%	- 1.8%

Source: Cabinet Office

Table 5: Contribution of public investment to growth during Japan's recessions.

(Contributions to changes in GDP, at constant prices, seasonally adjusted series)

	GDP Growth	Contribution of Public Investment to Growth
Q2-1997	- 3.6%	- 0.1%
1. 1998 Recession		
Q1-1998	- 0.5%	- 0.2%
Q2-1998	- 0.6%	- 0.2%
Q3-1998	- 0.7%	+ 0.1%
2. 1999 Recession		
Q3-1999	- 0.2%	- 0.5%
Q4-1999	- 1.0%	- 0.2%
3. 2001 Recession		
Q2-2001	- 1.4%	- 0.4%
Q3-2001	- 1.1%	- 0.0%
Q4-2001	- 0.4%	- 0.1%

Source: Cabinet Office.

Table 6: Sweden's Economic Performance during the Banking Crisis and After

Year	GDP	C	I	Deficit/ Surplus	Inflation	Exchange Rate	Unemployment Rate
1991	-1.1%	1.0%	- 8.6%	- 1.1%	7.3%	100.0	3.1%
1992	-1.7%	-1.3%	-11.6%	- 7.5%	1.0%	101.2	5.6%
1993	-1.8%	-3.0%	-15.0%	-11.9%	2.7%	82.3	9.1%
1994	4.1%	1.8%	6.1%	-10.8%	2.4%	81.4	9.4%
1995	3.7%	0.6%	9.4%	- 7.7%	3.5%	81.4	8.8%
1996	1.1%	1.4%	5.0%	- 3.1%	1.4%	89.4	9.9%
1981-1990	2.2%	1.7%	3.8%	- 0.8%	7.6%	---	2.6%
1991-1996	0.7%	0.1%	-2.5%	- 7.0%	3.0%	---	7.7%
1997-2002	2.8%	2.4%	3.6%	+ 2.0%	1.4%	---	7.1%

GDP: Gross Domestic Product at 1995 market prices.
C: Private Final Consumption Expenditure at 1995 prices.
I: Gross Fixed Capital Formation at 1995 prices; total economy.
Deficit/Surplus: General Government Balance.
Inflation: Price Deflator GDP at market prices.
Exchange Rate: Nominal effective exchange rates. Performance relative to the rest of 22 industrial countries; double exports weights. 1991=100.
Unemployment Rate: Percentage of civilian labor force.

Source: European Commission