JAPAN'S ECONOMIC AND FINANCIAL STAGNATION AND THE POSSIBILITY OF A SECOND LOST DECADE

by
Thomas F. Cargill
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Postal address: P.O. Box 6501, S-113 83 Stockholm, Sweden. Office address: Sveavägen 65
Telephone: +46 8 736 93 60 Telefax: +46 8 31 30 17 E-mail: japan@hhs.se Internet:
http://www.hhs.se/eijs

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Thomas F. Cargill*

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1.0 Introduction

Japan's postwar economic performance is remarkable[1]. In fact, with the exception of World War II and its immediate aftermath, the overall economic development of Japan starting with the Meiji Restoration in 1868 is remarkable. Raising from the ashes of defeat in World War II and achieving "Asian Miracle" status by the late 1980s, Japan fell into an economic, financial, and political malaise in the 1990s that continues to the present. The 1990s are now referred to as Japan's "lost decade" and many wonder whether Japan has commenced a second "lost decade." Economic, financial, and political developments in Japan since the century started appear to support the pessimistic second "lost decade" scenario.

The economy again shifted into recession in the fourth quarter of 2000 and began a weak recovery in the first quarter of 2002. Real GDP increased only slightly in 2001 and 2002 (Table 1). The unemployment rate in 2002 was 5.7 percent and had steadily increased since 1990 when the unemployment rate was 2.1 percent[2]. Most distressing and rekindling memories of the 1930s, Japan has experienced a persistent deflationary process since the mid 1990s. The GDP Deflator declined in every year since 1994 to 2002 with the exception of a slight increase in 1997 (0.3 percent). Prices measured by

the GDP Deflator declined 1.56 and 1.70 percent in 2001 and 2002, respectively. While not approaching the price declines experienced in the 1930s, the adverse impacts of even mild deflation on the economy render the macroeconomic situation in Japan serious.

Financial distress has continued. Nonperforming loans are higher than at any time since 1990. The percentage of bank loans classified as nonperforming ranges from 7 to 10 percent depending on how nonperforming loans are defined. Nonperforming loans for all depository institutions combined represent about 30 percent of GDP. There is evidence the nonperforming loan problem is far more serious than previously estimated. Past estimates have ignored the nonperforming loan problem embedded in the Fiscal Investment and Loan Program (FILP). The eight government banks, for example, have only recently begun to release information on nonperforming loans and the most rapid areas of government bank lending in the past decade has been for housing and business loans. Recent work by Doi and Hoshi (2003) suggest that the nonperforming loan problem embedded in the FILP system might be as much as 16 percent of GDP.

The economic and financial distress since 1990 stands in sharp contrast to the overall economic and financial stability of Japan in the previous four decades. Likewise, the political instability since 1990 stands in sharp contrast to the political stability provided by the dominance of the Liberal Democratic Party (LDP) from 1955 to 1993. Japan experienced about one new Prime Minster each year since 1990 until Junichiro Koizumi assumed power April 2001. Koizumi, even though a product of the LDP, proposed far more aggressive reforms than previously enacted, including privatization of the Postal Saving System (PSS). Public confidence in Koizumi has declined somewhat during his tenure as Prime Minister because of the continuing economic and financial

distress, though he remains a strong political force capable of initiating significant reform. Koizumi has, however, encountered intense opposition to his reform program with regard to resolving the nonperforming loan problem in the private banking system and reforming the FILP and the PSS. There continues to be an entrenched political establishment wedded to the old mutual support regime based on forgiveness and forbearance of troubled firms and industry as the preferred policy instead of making the type of major structural reforms needed in Japan.

The current level of economic and financial distress and political uncertainty is all the more remarkable considering the extensive efforts made to deal with the problems, especially since 1995. There have been a series of fiscal stimulus packages of increasing size and the Bank of Japan has implemented a zero interest rate policy since February 1999 except for a few months following August 2000 when the Bank of Japan tightened policy. Major institutional redesign has taken place throughout the financial system. The Financial Services Agency (formally, the Financial Supervisory Agency) was established April 1, 1998 to assume the financial regulatory and supervisory responsibilities previously held by the Ministry of Finance. The Bank of Japan's independence was significantly enhanced as of April 1, 1998. Deposit insurance was reorganized to provide the primary safety net for the financial system and Prompt Corrective Action was accepted as the proper approach in dealing with troubled institutions. The FILP system was reformed April 1, 2001 to make it more transparent and market sensitive. In addition to institutional redesign, major attitudinal changes have taken place. Many policy makers now recognize that the economic and financial regime that served Japan so well during much of the postwar period is no longer compatible with the new economic,

technological, and political environment facing Japan. Policy makers have also come to accept that moral hazard is not a problem unique to market-oriented financial regimes and that forgiveness and forbearance ultimately increase the economic and political costs of resolving the nonperforming loan and nonperforming borrower problems.

The juxtaposition of efforts to stimulate the economy and redesign the financial system and the continued economic and financial distress raises two questions. Why has recovery not yet occurred, and is Japan in a second lost decade in terms of economic and financial development? This paper offers some perspectives on the resistance to change and the difficulty Japan has experienced in returning to sustained growth. The remainder of the paper is composed of seven sections.

In Section 2, a general framework or taxonomy of financial reform applicable to any reform process is outlined as a background for discussing the failures of financial redesign in Japan. The outline is based on a sequence of events that describe the financial reform process in terms of factors that initiate the shift from an "old" to a "new" financial regime, the internal resistance to the transition, and the feedback relationships between the public and private sectors that occur during the transition. In particular, the basic theme of the outline is that resistance to institutional redesign is normal and that one can reasonably identify those factors responsible for differing policy outcomes across countries.

Section 3 discusses a number of restraints embedded in the Japanese financial system that help understand why reform has been so slow and incomplete. These restraint factors are referred to as *country-specific* restraint factors because they reflect the basic foundation of the old Japanese financial regime. In other words, these restraint

factors are special to the Japanese financial regime as it developed over the postwar period. In contrast, Section 4 discusses resistance factors not fundamental to the financial regime and hence are not country specific; that is, these factors are potential problems for any country. These factors are referred to as *general* or *global* restraints. In the case of Japan, policy failures on the part of the Bank of Japan represent the major general restraint on recovery.

In Section 5, the paper discusses the FILP and PSS as examples of the difficulty of change in Japan's financial system. The FILP and PSS have resisted meaningful reform until only recently despite an official policy of liberalization and more than any other financial institution reflect key elements of the old regime. Reform has commenced, but it is too early to determine whether Japan can reduce the role of government financial intermediation. Koizumi was unsuccessful in generating support to privatize the PSS and has met resistance to eliminating a number of the FILP-entities.

Section 6 raises the issue of whether the Japanese financial regime was sustainable even in the absence of the economic and financial distress of the 1990s. That is, would other events have eventually generated economic and financial distress in Japan. Two factors are identified that suggest the regime was not sustainable.

Section 7 focuses on demographic factors that are rapidly reducing Japan's window of opportunity to resolve the economic and financial distress. A short concluding section ends the paper.

2.0: Common Sequence of Financial Reform but Different Policy Outcomes

Financial liberalization has been an ongoing process in a wide range of developed and developing countries since the 1970s. Despite different economic and political institutions, history, and culture, the financial reform process in virtually every country follows a common sequence that can be described by the following points:

There is a given pre-reform institutional design of the financial regime consisting of private financial institutions, markets, government regulatory authorities, and central banking institutions.
↓
The given institutional design conflicts with new economic, political, and/or technological environment.
↓
The conflicts interfere with the ability of the given financial regime to meet basic responsibilities. The conflicts can be manifested in a variety of ways ranging from failures of financial institutions to sharp shifts in the allocation of funds among financial institutions.
↓
The resulting financial disruptions and inefficiency stimulate market and regulatory innovations
↓
Market and regulatory innovations are resisted by various regulatory authorities unwilling to depart from the old regime because they view the transition as a potential loss of regulatory power.
↓
Market and regulatory innovations are also resisted by various private sectors unwilling to depart from the old regime because they view the transition as a potential loss of property rights and rents enjoyed under the old regime.
↓
The degree of the resistance from the public and private sector determines the timing, the completeness, and the stability of the transition from the old to the new regime.
↓
Financial reform becomes a two-way feedback process between the public and private sectors in that reform requires institutional redesign of both private and public institutions.
↓
The financial reform process is stable or unstable depending not only on the degree of resistance to redesign from the private and public sector, but also depends on central bank policy, existence and extent of money and capital markets, degree of interface between domestic and international finance, etc.

The specific characteristics of a country's financial design reflect the country's culture, history, and national economic policy goals. However, the basic function of providing an orderly and stable flow of funds and platform for monetary policy remains country invariant. Institutional redesign occurs when the financial regime's basic responsibilities are not achieved. This frequently occurs when the existing regime encounters a new environment that conflicts with one or more key elements of the existing financial structure. The new environment may consists of economic, political and/or technological forces. The reform process itself is a complex interplay between market innovations and government or regulatory innovations. This process is seldom smooth, however.

There is considerable resistance to financial reform and conflict between the various participants in the reform process[3]. There is resistance from established groups possessing long-held property rights to regulatory rents embedded in the pre-reform financial regime. Private banks and depositors regard deposit guarantees as entitlements and hence resist any effort to reduce them and/or make them more market sensitive. Regulatory authorities resist reform if they perceive reform as a rejection of past regulatory policies and more importantly, if they perceive reform reducing their role or prestige in the new regulatory framework. No country is immune.

Once financial reform becomes an ongoing process, it frequently requires redesign of all of the major components of the financial structure including government regulatory institutions as well as nonfinancial components such as corporate governance and industrial organization.

Financial liberalization in the 1970s and 1980s commenced as a worldwide process when a new set of economic, political, and technological forces emerged. The process has not, however, been smooth in any country. Explanations for the lack of a smooth transition fall into one of three explanations.

The first view emphasizes the inherent instability in markets caused by rent seeking activity in a less regulated environment and hence, places the blame on liberalization. That is, providing markets with enhanced portfolio diversification powers allows market participants to assume imprudent levels of risk and increase the market's systemic risk as market participants seek to maximize their own profit. This view emphasizes market failure as the explanation for the lack of a smooth financial transition. The policy implication of this view ranges from return to the old-style of controls to a much slower pace of liberalization.

The second view does not regard liberalization as the problem and regards liberalization as inevitable, but rather, finds fault with the process of liberalization as carried out by government. The process has been uneven and sometimes disruptive because of government resistance to reform and willingness to pursue unbalanced reform in the context of government's unwillingness to impose bankruptcy on insolvent financial institutions and reduce government deposit guarantees. Regulatory authorities resist reform, either because they perceive a loss of regulatory influence or perceive adverse effects on the sector they regulate. As a result, reform tends to be unbalanced and incomplete. Regulatory authorities resist lowering deposit guarantees because they have come to be viewed as entitlements by the public. As a result, moral hazard induces imprudent portfolio behavior on the part of financial institutions. Regulatory authorities

are reluctant to close insolvent financial institutions. Instead, they adopt forgiveness and forbearance in dealing with troubled institutions and hence, further increase moral hazard and increase the economic and political cost of resolving nonperforming loan and borrower problems. The degree of resistance to the process largely determines the economic cost of the transition. This view thus emphasizes government failure, rather than market failure, as the major contributing factor to an unstable transition process.

The third view combines the market failure and government failure views. The uneven financial liberalization process reflects elements of both that reinforce each other. The problem with the third view, however, is that it is more useful for understanding the uneven process of liberalization once in place, but does not provide much insight into the takeoff conditions that determine whether liberalization will be a stable or unstable process. In this regard, the first two explanations are the most useful.

Korea, Japan, and the United States illustrate the differing policy outcomes and the effect of the differing degrees of resistance on the policy outcomes. A brief comparative consideration of financial liberalization since the 1970s in Korea, Japan, and the United States is instructive for three reasons[4]. First, the pre-liberalization financial regimes represented by the three countries represent the two ends of the financial spectrum with state-directed and market-directed financial regimes at the opposite ends of the spectrum. Second, despite differing approaches to the liberalization process in each country, the accomplishments to date have reduced the role of state-directed elements and enhanced the role of market-directed elements in the allocation of credit and the conduct of monetary policy. Third, the policy outcomes of the liberalization process, however, have been dissimilar. The United States achieved a reasonable transition to a more open

and competitive financial design by the early 1990s, though only after considerable instability and hesitation (Benston and Kaufman, 1997). Korea, whose financial institutions are more closely modeled on the Japanese system than any other Asian country (Cargill, 1998), was able to rebound early from the sharp decline in macroeconomic activity in late 1997 and 1998 (Korea Economic Institute, 2002). While more successful than Japan in resolving economic and financial stress, Korea's ultimate success remains uncertain. Japan's performance has been the least successful, not only among the three countries, but by almost any comparison with other countries that have attempted financial liberalization.

The differing policy outcomes can be attributed to a combination of cultural, philosophical, attitudinal, structural, and macroeconomic factors, especially monetary policy. It is somewhat arbitrary to attempt a classification scheme for the resisting factors; however, two broad classifications seem appropriate. First, there are country-specific resistance factors that reflect different organization and objectives of a financial regime, different attitudes over the role of government in the economy, and different approaches to the organization of the nonfinancial sector. The reference frequently made to structural resistance to reform is what is meant by country-specific resistance factors. Second, there are general or global factors that can be potential problems for any country that resist reform. These are referred to as general or global because they are not directly tied to the fundamental elements of the financial regime. The reference frequently made to macroeconomic policy errors is an example of a general or global resistance factor.

The distinction between country-specific and global factors may appear arbitrary since macroeconomic factors such as monetary policy reflect the fundamental structure of

the financial regime and the structure of the financial system is dependent on how monetary policy is conducted. Despite the ambiguity, the two-part classification may be a useful way to disentangle factors that are special to Japan and those that are independent of Japan.

3.0: County-Specific Factors that Resist Reform in Japan

Japan's financial institutions first evolved during the Meiji Restoration in 1868, reached maturity in the early 1950s, and manifested the following core elements: (1) The financial system was an instrument of industrial policy to ensure that financial resources were directed to support domestic investment and export industries; (2) the financial system was based on a bank finance model with close bank-firm relationships designed to evaluate and monitor credit to the large business sector: to ensure that large corporations had first access to credit, and minimize bankruptcies; (3) the financial system was designed to encourage household saving while at the same time, limit household access to consumer and mortgage credit; (4) government financial intermediation provided funds to those sectors with limited access to private bank credit; (5) a policy of "no failures of financial institutions and markets" and pervasive deposit guarantees supported by government regulation, nontransparency, and central bank lender of last resort powers was designed to provide a low-risk and low-bankruptcy environment for investment; and (6), market forces played a minor role while, overall, the flow of funds was constrained by government regulation and international isolation.

WW II and the Allied Occupation were only marginal influences on the evolution of the Japanese financial regime, as the postwar regime was a continuation of the prewar

regime. The financial regime from the start of industrialization in 1868 to the 1980s was successful by any reasonable standard. The prewar growth record, the rapid reindustrialization after WW II, the high growth period from 1950 to 1973, and the emergence of Japan as the second largest and one of the most stable economies in the world from 1975 to the late 1980s, were all importantly dependent on Japan's financial institutions. As a result, Japan served as a model for other Asian countries.

This regime came under pressure to change in the second half of the 1970s and on the surface, appeared to have achieved by the second half of the 1980s the world's smoothest transition toward open and competitive markets[5]. It was also making process toward internationalization of the domestic economy while at the same time, adjusting to the second oil price shock in 1979/1980 without the inflation-disinflation cycle common to almost every other industrialized economy. In hindsight however, Japan's accomplishments were not sustainable and the "burst of the bubble" economy in the early 1990s and the subsequent economic, financial, and political distress were natural outcomes of the flawed and incomplete liberalization process started in the 1970s. This has become a well-known story, documented elsewhere[6]. The objective here, however, is to identify those characteristics specific to the Japanese financial regime that have resisted reform and made recovery elusive to date. The following discussion brings together the most important country-specific problems facing Japan while the next section focuses on problems facing Japan not dependent on the Japanese financial regime..

Financial Liberalization Was More Rhetoric Than Substance Financial liberalization in Japan did not emerge from a renewed faith in market principles and

reevaluation of the role of government in the economy. While important for the liberalization process in the United States, they were relatively unimportant in Japan (Lee, 1992 and 2003). Japan's liberalization process was a reaction to pressure from well-organized internal and external interest groups that demanded liberalization for reasons of self interest.

Banks and securities companies demanded liberalization to restore lost market share in a slower-growth environment and to expand market share, respectively. Corporations became advocates of liberalization since increased portfolio flexibility would allow them to earn higher returns on liquidity freed up from reduced reliance on bank credit and the need to maintain compensating bank balances. The Ministry of Finance was willing to supply liberalization to finance the large central government deficits that emerged after 1973.

External pressure to liberalize came from the United States in the early 1980s from the Reagan administration. While the U.S. liberalization process was more firmly rooted in market principles than in Japan, the U.S. was not above using liberalization as a component of trade policy. The U.S. Treasury in 1984 argued that Japan's favorable current account balance was the result of an artificially undervalued yen. The yen was artificially undervalued because the financial system was rigidly regulated and controlled and as a result, the yen had little international investment or reserve asset value. That is, given Japan's large current account surplus and status as the second largest economy in the world, the yen should have been a more widely used investment and reserve asset. The problem was Japan's financial regime; hence, financial liberalization was viewed by the United States as a solution to a trade-imbalance problem.

The Ministry of Finance responded to these various pressures by first officially recognizing the *gensaki* market[7] in 1976; relaxing constraints on the inflow and outflow of capital; enhancing portfolio diversification powers for banks, securities companies, and nonfinancial firms; removing interest rate ceilings on loans and deposits; and, establishing money and capital markets. These were significant structural changes; however, they paled in comparison to the elements of the old regime left in place. Nontransparency, pervasive deposit guarantees, government financial intermediation, mutual support, and a general unwillingness to permit bankruptcy to play a role in the allocation of credit continued to define the Japanese "liberalized" financial system. Thus, official liberalization was more rhetoric and response to specific interest groups than a commitment to redesign the financial regime. One observer[8] at the time (early 1980s) referred to Japanese liberalization as "*bonsai*" liberalization meaning that open and competitive markets were acceptable as long as they progressed in the way the Japanese government wished them to progress.

The view that financial liberalization in Japan in the late 1970s and 1980s was more rhetoric than substance needs to be qualified. Japan saw little need to overhaul the entire financial system given it's successful performance in terms of financial stability and supporting impressive economic growth. Hence, it is understandable way Japanese regulatory authorities were not willing to change the basic structure of the system, but instead, only respond to those interest growths as long as the changes left intact the essential elements of the old regime. This explains why government financial intermediation (PSS and FILP), deposit guarantees, transparency, and the role of bankruptcy were not major concerns among regulatory authorities. While such a partial

equilibrium approach was not sustainable in the long run, Japanese regulatory authorities believed they could achieve a successful *bonsai* liberalization process.

This partial approach in the context of remaining committed to the key elements of the old regime, however, generated three consequences that contributed to Japan's current economic and financial distress. First, Japan's unbalanced and incomplete liberalization process in the presence of pervasive deposit guarantees exposed the system to moral hazard. Permitting enhanced portfolio diversification in the absence of financial disclosure and a weak monitoring system encouraged imprudent risk taking and weakened the quality of bank and borrower balance sheets. This in turn rendered the economy more susceptible to any type of shock such as fiscal/monetary policy errors or a collapse of asset prices. Second, the expectation that policy makers could manage the financial system through administrative guidance made them less concerned about potential shocks and/or problems with the liberalization process. This expectation supported an overoptimistic assessment of the stability and soundness of the financial system and the ability to manage financial distress. There was the expectation that any serious problem could be handled, like in the past, through nontransparency, administrative guidance, and Bank of Japan lender of last resort services. Third, the adherence to key elements of the old regime made it more likely that the policy response to any type of shock would first be denial, followed by understatement, and then followed by a policy of forgiveness and forbearance. Japanese regulatory authorities are not unique in this regard; for example, U.S. regulatory authorities responsible for the S&L industry exhibited the same response. However, adherence to the old regime made it

more likely that denial, understatement, forgiveness and forbearance would be resorted to in the face of finance distress and would like be pursued longer.

Japan is Special and Not Susceptible to Moral Hazard and the Regulatory-Market Dialectic Japanese writers sometimes bristle when references are made to the special or unique characteristics of Japanese economic institutions. But at the same time, Japanese policy makers perceived their economic and financial institutions immune to the type of financial disruptions that characterized the United States in the 1970s and 1980s. This view was based on the historical performance of the Japanese financial system and the expectation that administrative guidance in the context of an extensive mutual support system between the government and the private sector would ensure that Japan would not experience the type of S&L and banking problems experienced by the United States in the 1970s and 1980s or the type of banking problems experienced in the Scandinavian countries in the late 1980s. The view that Japan was special was manifested by the large number of articles and books published in Japan, the United States, and elsewhere during the 1980s praising "Japanese management," "Japanese industrial policy," and "Japanese financial and monetary policy." The rapid growth of other Asian economies in the 1980s and the attention devoted by the World Bank (1993) to the special features of Asian economic institutions further supported the view that Japan was special.

Differing macroeconomic policy outcomes, accounted for much of the difference in the process of financial reform across countries, especially with regard to Japan and the United States. The Federal Reserve failed to achieve price stability during the 1970s and early 1980s while the Bank of Japan achieved an impressive record of price stability for most of the period from the early 1950s. The Bank of Japan's policy outcomes,

especially after 1973 attracted world-wide attention because the Bank of Japan was ranked as one of the world's most dependent central banks. As a result, the transition of finance was smoother in Japan than in the United States because of better central bank policy outcomes that narrowed the gap between regulated and unregulated interest rates. This in turn, reduced incentives to innovate and generate regulatory-market conflicts (Kane, 1981) that led to the financial disruptions in the United States.

Japanese policy makers regarded moral hazard issues that played a major role in the U.S. as relevant for individual-based/western-type economic systems. Moral hazard had little relevance for a financial system based on social relationships in which mutual support and limiting risk were primary objectives. Japanese policy makers regarded the type of regulatory-market dialectic common in the United States as appropriate only for a formal codified legal system which permitted "loop-hole mining." In a system dominated by administrative guidance and informality, market participants were more likely to refrain from actions that were not expressly permitted by the regulatory authorities whereas in the United States, market participants would only refrain from actions that were expressly prohibited.

In hindsight, Japanese policy makers understated the contribution that the Bank of Japan made to the reform process and overstated the special nature of Japanese economic institutions. Disintermediation and moral hazard that characterized the U.S. reform process were absent in Japan because of better central bank policy outcomes and fewer opportunities for disintermediation.

Japanese Financial Institutions Have Been Successful so Why Should Japan Change: Japan's financial institutions commencing with the start of industrialization in

the 1870s were strong contributors to Japan's rapid growth. In a country lacking a tradition of markets, risk-taking, and individual as opposed to authoritative decision making, bank finance in the context of nontransparency and mutual support was well suited for transferring household savings to the industrial sector. While government credit allocation was not nearly as extensive as sometimes claimed by those who viewed Japan as "Japan, Inc.", the government did play an important role in maintaining a "no failure policy of financial institutions" as well as providing credit through the PSS and FILP to those sectors denied access to private bank finance.

Private and public institutions evolved to support export-led economic growth, provide for a high level of household saving, ensure that financial resources were used to support industrialization as opposed to consumption, and ensure international isolation. Japan's comparative economic growth has been well documented (Ito, 1992) and emulated throughout Asia to varying degrees (World Bank, 1993). The attraction to Japanese financial institutions among many Asia countries, formally under Japanese military control, in the postwar period attests to their acceptance as an important part of the most prominent examples of the "Asian Miracle" identified in the well-know World Bank (1993) report on Asia.

Thus, economic and financial distress in the 1990s, at least up to late 1997, appeared as an outlier to many Japanese policy makers, and hence, they found it difficult to depart from a set of institutions that had served Japan so well for so long. This view rejects the notion that Japanese and Asian economic growth in general resulted from a special set of circumstances that could not be sustained (Cargill and Parker, 2002 and Krugman, 1994).

Liberalized Financial Markets and Institutions Are Incompatible with Japanese Culture and Belief Systems Lee (1992 and 2002) and Lincoln (2001) have argued that characteristics of Japanese culture and belief systems make it difficult to adopt market-oriented financial institutions. According to Lincoln, for example, the matrix of social relationships, cultural characteristics, and economic institutions in Japan - especially the financial system - create binding constraints on reform.

The essence of Lincoln's argument is as follows. Markets require formality whereas informality is a chief characteristic of Japanese society. Markets require a focus on short run (profit maximization) and limited dimensional transactions (price and quantity) whereas Japanese financial institutions focus more on long run (maintaining market share) and multidimensional transactions (complex customer relationships that go far beyond price and quantity to include management services, arranging connections with other firms, etc.). Markets require specialization and division of labor independent of social relationships whereas Japanese economic and financial institutions directly incorporate social relationship characteristics such as long-term relationships, mutual support, and limiting risk. Markets require bankruptcy as a penalty function whereas Japanese economic institutions are designed to limit market risk and, consequently, bankruptcy. Markets require transparency whereas Japanese institutions emphasize nontransparency and facades.

Relying on cultural characteristics to explain economic institutions is generally played down among economists. However, the dichotomy between Japanese culture and markets is large, and hence, financial liberalization is at best a difficult process. Financial liberalization was a much easier process in the United States and other western-

oriented economies because their historical and cultural backgrounds were compatible with relaxing constraints on the flow of funds.

Bank Capital and BIS Capital-Asset Requirements Japanese banks hold equity in nonfinancial firms - up to 5 percent of outstanding shares - to establish a long-term relationship with corporations as part of the *keritsu* system of industrial organization. This was an important component of the main bank system in which a financial institution, usually a city bank, played a leadership role in the company group. In the 1980s the main bank system declined in importance as firms found alternative sources of funding and developed other methods to inform potential lenders of their credit worthiness. However, banks continued to hold large amounts of corporate equities, and the capital gain accumulated on these securities over the years was referred to as "latent" or "hidden" capital.

Japanese banks sought to have the latent capital counted toward the new BIS capital-asset requirements established in 1988 for banks that engaged in international activities. As a result of intense lobbying, they were permitted to count 45 percent of their latent capital as part of tier II capital requirements. This greatly enhanced bank capital in the bubble phase of the economy and contributed to the run up in real estate prices as banks expanded into the real estate sector either directly or indirectly through their *jusen* subsidiaries.

Unfortunately, the process also worked well for latent capital losses. The collapse of equity prices made it difficult for banks to meet capital-asset requirements and in order to maintain adequate capital-asset ratios, banks slowed the growth of assets (loans and investments) and generated a bank credit crunch. This was the only way banks could

meet their capital-asset requirements since banks were unable to raise capital through bank equity and/or subordinate debt.

The Role of the PSS and FILP The PSS and FILP are major components of the Japanese economy measured by their size relative to both the economy and the financial system. Postal deposits held in about 25,000 post offices throughout the country represent 35 percent of total deposits. The PSS also sells life insurance and postal life insurance represents 30 percent of the life insurance market. The PSS continued to expand after 1976 despite an official policy of liberalization. The FILP system obtains the majority of its funds from the PSS. The FILP is a flow of funds budget developed along with the government's general budget designed to collect funds from the private sector through postal deposits, life insurance premiums, and other sources and then transfer those funds to a large number of government banks, government enterprises, and government corporations referred to as FILP entities. Prior to April 1, 2001, postal deposits and postal life insurance premiums, together with other sources of funds, were transferred directly to the Trust Fund Bureau of the Ministry of Finance, which were then distributed through the FILP budget to the FILP entities.

The PSS and FILP have only recently been the focus of institutional redesign. Starting April 1, 2001, postal deposits and life insurance premiums are no longer transferred to the Trust Fund Bureau, but are now managed by the PSS which as of April 1, 2003 became a public corporation. The FILP-entities either sell their own agency securities or participate in FILP bonds issued by the Ministry of Finance in the open market. While these reforms may set in motion changes that will fundamentally affect the PSS and FILP it is far too early to be optimistic. The PSS and FILP embody the key

elements of the old financial regime and as such, have been resistant to reform[9] and in turn because of their size, have contributed to the overall inefficient of Japan's economy.

These institutions are important aspects to understanding Japan's resistance to reform. First, their size, their interactions with almost every sector of the Japanese economy, and their importance in supporting the LDP constitute critical resistance factors to reform and recovery. Japan cannot return to sustained economic growth without redesigning its financial institutions to raise the return on the high saving rate: however, the fact that a large part of the public's savings are absorbed by the PSS and FILP and allocated to low return and sometimes negative return projects is a serious restraint on recovery. Second, the expanding influence of these institutions during the past three decades attests to the view that Japan's financial liberalization was more rhetoric than substance and to the difficulty of shifting from the old to the new financial regime.

Japan Does Not Perceive a Crisis There is an interesting comparison between Korea and Japan that suggests another country-specific restraint on reform. Prior to the Asian Financial Crisis Korea had long been criticized for its inefficient financial institutions, irrational allocation of credit, and large nonperforming loan problem that had emerged in the 1970s. Korea devoted some attention to these concerns and officially adopted numerous financial liberalization measures in the 1980s. Despite some progress, the general assessment up to 1997 was that financial liberalization was even more rhetoric than substance compared to Japan. Korea's efforts were designed to be just sufficient to secure acceptance into the OECD, which Korea achieved in 1995, but not critical enough to change the basic structure of the financial system. Korea, like Japan, found it difficult to accept the necessity to make fundamental changes when their

economy has achieved so much success in such a short period of time. Korea's financial institutions more than any other Asian country were closest to the pre-war Japanese financial institutions organized around the *zaibatsu*.

In late 1997 when Korea's economy and financial system collapsed, policy makers correctly perceived a crisis situation and one that required decisive action. As such, Korea in 1998 and 1999 moved swiftly to bail out private banks, permit foreign investment in banks, and reform corporate governance. Central bank policy was constrained to prevent both inflation and deflation by adopting a formal inflation-target framework. The economy recovered rapidly and by 2000 Korea had appeared to return to sustained economic growth. Thus, the crisis environment provided an incentive to initiate fundamental institutional redesign. It should be noted in passing, that the United States also allowed inefficiencies to accumulate in the financial system for almost 15 years from 1965 to 1980 until a crisis environment in 1980 induced fundamental institutional redesign (Cargill and Garcia, 1985).

Japan does not perceive itself in a crisis situation, with the possible exception of the turbulent period from the fourth quarter of 1997 to early 1999. Japan's lost decade is more one of lost potential, than of actual decline. Income per capita is now higher than in 1990. Japanese homeownership is broad based and while real estate prices have declined as much as 60 percent, the turnover rate of homeownership is low. Despite a Nikkei Index at about 8,500 as of early 2003 compared to almost 40,000 in December 1989, household financial wealth is large with much of it held in the form of risk-free postal deposits that even though they pay a low nominal rate (less than 0.5 percent), they provide a real rate of return of 1 to 2 percent because of deflation. The large corporations

have shielded themselves from Japan's inefficient financial institutions shifting much of their production and financial operations outside of Japan; that is, they have "opted out" (Schoppa, 2001) of providing political pressure to reform the system. The LDP, for the time being, continues to benefit politically from the support by banks that do not wish to see a more aggressive resolution of the nonperforming loan problem, from the support of corporations and business firms that do not wish to see a more aggressive resolution of the nonperforming borrower problem, and from the PSS and FILP that do not wish to see a reduction of government financial intermediation. At the same time, the deadweight loss has not yet been perceived by the public to be serious enough to demand change. Japan is not in danger of a currency crisis since it has virtually no external debt, international reserve assets are large, and the world continues to purchase Japanese goods. Thus, in many respects, the household, business, and political sectors do not see the current situation in crisis terms and that in of itself is a constraint on reform. There is one possible exception to this observation. The economic and financial turbulence following the failures of Hokkaido Takushoku Bank and Yamaichi Securities Company in November 1997 and the sharp decline in real GDP in 1998 led to a LDP defeat in July 1998 Upper House elections, which forced Prime Minister Hashimoto to resign and the government to take more aggressive action.

4.0: General or Global Factors that Provide Resistance to Reform

Much resistance to reform stems from country invariant factors and in this regard, attention needs to be directed to central bank policy[10]. Bank of Japan policy outcomes in the 1990s represent a major restraint on reform and recovery. To understand the role of

the Bank of Japan as a restraint fact, the following five issues are considered: first, the overemphasizes on external considerations that led to the two major policy errors prior to 1989; second, tight monetary policy in the 1990s; third, explanations of why the Bank of Japan has not been sufficiently expansionary in the 1990s, especially the second half of the 1990s; fourth, why deflation is a serious problem and the feedback between central bank policy and deflation that make reversing the deflationary process more difficult over time; and fifth, recent developments through mid-2003 in Bank of Japan policy

Policy Errors Prior to 1989 The performance of the Bank of Japan during the past decade stands in contrast to an impressive record of monetary policy in the postwar period marked by only two identifiable policy errors: expansionary monetary policy in the early 1970s and in the second half of the 1980s. Both policy errors were rooted in an attempt to limit yen appreciation and both can be accounted for without placing extensive blame on the Bank of Japan.

In the first instance, the Bank of Japan was directly under the influence of the Ministry of Finance, which delayed shifting to tighter monetary policy to slow inflation in 1972 and 1973 as a result of past easy monetary policy. The Bank of Japan expanded the money supply in the late 1960s and early 1970s to maintain high economic growth into the 1970s. After 1970, the Bank of Japan also expanded the money supply to limit yen appreciation as the fixed exchange rate system was collapsing. The result was rapid inflation and while the Bank of Japan had been willing to expand the money supply in the past, the Bank in late 1972 wanted to shift to tight monetary policy to combat inflation. The Bank of Japan, however, was prevented by the Ministry from shifting to tight

monetary policy and as a result, inflation increased rapidly before the Bank shifted to tight monetary policy in late 1973.

In the second instance, the Bank of Japan pursued intervention in the foreign exchange market to limit yen appreciation or equivalently, support the dollar in the context of an expanding and low inflation economy. The Bank of Japan's mistake was to believe it could have a "free lunch" – limit yen appreciation with no adverse effect on the domestic economy, the same error made in the early 1970s. Increasing concern with consumer prices in 1989 as well as asset inflation in equity and real estate prompted the Bank of Japan in May 1989 to shift to tight monetary policy. As an indication of the degree of political independence achieved by the Bank of Japan, the increase in the discount rate was openly opposed by the Ministry of Finance. In the early 1970s, the Bank of Japan was more accommodative to the wishes the Ministry.

Policy Errors in the 1990s Bank of Japan policy after 1989, however, cannot be so easily defended. It became a serious constraint on reform and recovery in two ways: first, by pursing tight monetary policy after 1989 for too long a period; and second, not pursuing easy monetary policy after 1994 aggressively enough and allowing the price level to decline. There is general agreement outside of the Bank of Japan that monetary policy in the 1990s was tight (McCallum, 2003).

The Bank of Japan continued tight monetary policy until 1994, well after it became obvious the decline in economic activity was more serious than previously experienced since re-industrialization commenced in 1950. This period deepened the economic and financial distress in Japan and exacerbated the effects of the collapse of asset prices on balance sheets. Better monetary policy during the first part of the 1990s,

however, would not likely have made much difference in Japan's willingness to redesign the financial system and aggressively deal with the nonperforming loan problem.

First, the majority of policy makers did not view the economic and financial problems as very serious. In fact, the economy began to recover in 1995 and 1996 and appeared to justify the forgiveness and forbearance policy adopted in the early 1990s. Second, in 1995 major institutional change was in progress – the official closing of a number of small depository institutions, the redesign of the Deposit Insurance Corporation (DIC), the closing of the *jusen* industry, and the establishment of two agencies to dispose of nonperforming loans of the *jusen* industry (Housing Loan Administration Corporation) and banks and credit cooperatives (Collection and Resolution Bank). As far as policy makers were concerned, these policies were sufficient to deal with the financial distress.

The reluctance to make more fundamental changes appeared justified with events in late 1995 and 1996. Monetary policy shifted to ease, the economy improved, equity prices began to recover, and the growth of the nonperforming loan problem slowed. In fact, there was sufficient confidence about resolving the economic and financial distress that the newly elected Hashimoto government launched the Big Bang approach to financial redesign in November 1996. Thus, while Bank of Japan policy could have pursued a less restrictive policy in the first half of the 1990s, better policy outcomes would not have made much difference in Japan's willingness to reform. In fact, it probably would have provided even more resistance to reform since economic recovery would have likely occurred earlier.

The second part of the restraint period with regard to Bank of Japan policy, however, is more fundamental and serious. After 1997, there were few in Japan who argued that the old regime could continue for much longer. Japan could no longer argue that financial distress had not reached the center of the financial system. The failures of Hokkaido Takushoku Bank and Yamaichi Securities in late 1997 and the nationalization of the Long Term Credit Bank of Japan and the Nippon Credit Bank in late 1998 were clear manifestations of the old regime's failure.

By any reasonable standard Japanese monetary policy in the second half of the 1990s has been excessively tight despite arguments to the contrary by the Bank of Japan. The decline in prices and increase in real interest rates are clear indications of tight monetary policy. While nominal interest rates were at historical lows in early 2003, the real rate of interest had exhibited an upward trend since 1996.

Why Has the Bank of Japan Permitted Deflation? It is difficult to account for the Bank of Japan's behavior, especially given the lessons learned from the history of central bank policy during the 1930s. Cargill (2001b) argued the Bank of Japan was making the same mistake made by the U.S. Federal Reserve in the early 1930s and was using similar rationalizations employed by the 1930s Federal Reserve as to why more aggressive monetary policy could not be pursued. Five explanations offer some insight into the Bank of Japan's position.

First, the Bank of Japan has argued deflation was not an outcome of monetary policy and that the zero-interest rate policy was as much as the Bank of Japan could contribute to reversing the decline in prices. The Bank of Japan has attributed declining prices to structural factors such as the increased role of foreign competition in Japan,

Chinese imports (Noland and Posen, 2002), and the failure to resolve the nonperforming loan and borrower problems. These explanations, however, stand in contrast to an extensive literature linking monetary policy to long-term price movements and as such, have found little support outside of a few circles in Japan.

Second, Cargill, Hutchison, and Ito (2000) argue that the Bank of Japan is caught in an "independence" trap and became overly conservative. Central bank independence in 1998 was an unexpected event, despite lobbying by the Bank of Japan to have the 1942 Bank of Japan law revised. Perhaps the Bank of Japan became overly conservative and timid in conducting monetary policy so as not to inflate the economy as it had done in the second half of the 1980s. Another policy error might result in the loss of the newly achieved independence.

Third, the Bank of Japan resisted calls for more aggressive policy, at least up to mid-2002 when the Bank shifted toward more ease. This was not so much because the Bank of Japan did not believe more aggressive policy was needed, but because to give into outside pressure would appear to be acting less than independent. To borrow a phrase attributed to Paul Samuelson[11], the Bank of Japan has become a "prisoner of its own independence." That is, the Bank of Japan is more concerned with maintaining a perception of independence and thus rejects outside criticism and suggestions, especially if they come from the Ministry of Finance. To pay serious attention to outsiders, even if they offer good advice, is seen as giving in to an outside "mob" and thus, the existing policy becomes even more entranced. This is another manifestation of the independence trap argument.

Fourth, Cargill and Parker (2003a) argue there is a "war of attrition" between the Bank of Japan and the rest of government, especially the Ministry of Finance, has provided an incentive for the Bank of Japan to resist more aggressive monetary policy. Japan's government has generally been reluctant to impose the type of penalty function on the banking system and the nonfinancial sector required to resolve the nonperforming loan and borrower problem. The Ministry would rather have the Bank of Japan, through monetary growth, support the banking system and economy as part of a forgiveness and forbearance strategy. The Ministry supports the banking system through the budget, which in turn, can be more easily financed with easy monetary policy. The Bank of Japan resists using monetary policy to support a continued policy of forgiveness and forbearance and is reluctant to pursue nontraditional policies until it is convinced the government is serious about resolving the nonperforming loan problem. Thus, the tight monetary policy might be the outcome of the Bank of Japan's view that until serious structural changes are made, aggressively easy monetary policy will only postpone resolution of the nonperforming loan problem and increase its ultimate economic and political cost.

Fifth, the Bank of Japan is concerned that more aggressive monetary policy will be used to support an already high level of government debt independent of its concerns over structural reform of the financial system. The Bank has a long memory and does not wish to repeat the events of the 1930s when monetary policy was used to support large government deficits and high inflation resulted.

Why Deflation is a Problem and the Potential for a Central Bank Discontinuity or Liquidity Trap Deflation has recently come to be recognized as a

serious macroeconomic problem beyond the experiences of Japan[12]. The Federal Reserve and European Central Bank in May 2003 expressed concern about the potential for deflation. Krugman (1999) reintroduced the concept of the liquidity trap to account for what is happening in Japan and what is likely to become a more general problem of "depression economics" elsewhere (Krugman, 2000).

Parker and Cargill (2003b, 2003c, and 2003d) discuss the sources of deflation, the effects of deflation, and the relationship between deflation and monetary policy from an institutional, theoretical, and econometric perspective. Their discussion can be summarized in the following steps.

First, since deflation has been a rare event in the postwar period, contracts are likely to be adjusted much more slowly in response to a deflation of x percent than an inflation of x percent. Second, the nominal rate of interest is bounded from below by zero; hence, deflation increases the real rate of interest and reduces investment spending. Third, deflation increases the cost of servicing debt and increases bankruptcy further reducing spending and weakening balance sheets of financial institutions. This is a variation of Fisher's (1933) "debt-deflation" process described 70 years ago in the context of the decline in economic and financial activity in the United States from 1929 to 1933. The increased bankruptcy rate reduces the money multiplier as banks become less willing to lend. Fourth, even perfectly-expected deflation may reduce current consumption due to the asymmetric effect on future prices and the real interest rate, as consumers wait for cheaper prices in the future. Specifically, since the nominal interested is bounded from below by zero, deflation increases the real interest rate and provides incentives to save. Fifth, deflation changes the relative prices between money

and commodities and tends to increase the demand for money making it more difficult to restore expectations of price increases by monetary policy.

Deflation generates a discontinuity for monetary policy or liquidity trap in the sense that deflation shifts the demand for money upwards (velocity declines), reduces consumption, reduces investment, and reduces the money multiplier, thereby reducing the ability of the central bank to reverse course. This is a different type of liquidity trap than the standard textbook Keynesian case. In this case, the central bank is responsible for the upward shift in money demand and in turn, the central bank has the ability to reverse the liquidity trap by aggressive monetary ease. Hence, the phrase "discontinuity in monetary policy" might be more appropriate than liquidity trap. Estimates of the demand function for money in Japan using quarterly data find a significant (at conventional levels of confidence) upward shift in money demand and downward shift in the consumption function (annual data) in the 1990s that can be statistically related to the decline in prices. Cargill and Parker also present evidence that the money multiplier has declined along with the price leve.

Recent Policy Changes In the later part of 2001 the Bank of Japan shifted to a more aggressive monetary policy by adopting quantitative targets for reserves instead of focusing on the call rate target. The call rate was already close to zero. The impact on the monetary base was immediate. The monetary base increased 7.6 percent in 2000; however, starting in July 2001, the monetary base increased at an annual rate of 10 percent and since the end of 2001, the monetary base was increasing at an annual rate of between 25 and 30 percent. This shift in policy was a direct result of increasing criticism from the LDP and Koizumi, and the realization by the Bank of Japan that it would be

forced to accept an explicit inflation target and hence loose its newly found legal independence unless it showed more willingness to increase liquidity.

In order to maintain its legal independence, the Bank of Japan may have been willing to give up some of its substantive independence in other areas. News reports (*Business Times*, March 29, 2003) indicate that early in 2003 before the final decision was made on its new Governor, the Bank of Japan, promised a more cooperative attitude on dealing with troubled financial institutions. This may also account for why Koizumi, instead of appointing a "deflation fighter" as promised, appointed Toshihiko Fukui (a former deputy governor of the Bank of Japan) to replace outgoing Governor Masaru Hayami.

There is a dynamic in process between the Bank of Japan and the government, in which the Bank of Japan might be more aggressive with monetary policy; however, in an effort to protect its new-found independence, the Bank of Japan may become a more active partner in forgiveness and forbearance so that a more aggressive policy will compound Japan's problems. It is not yet clear this is the outcome and as of mid-2003, there is some reason to be optimistic. Governor Fukui made it clear the Bank of Japan will not purchase bank equities to provide support for the banking system as advocated by some Diet members.

5.0: The Difficulty of Institutional Change: The PSS and FILP[13]

Until Koizumi became prime minister April 2001, the PSS and FILP were not widely know institutions outside of Japan. Koizumi attracted attention to these institutions because he had been a long-time critic and advocated privatization of the

PSS. The PSS and FILP were an important and large part of the old financial regime. Despite two decades of financial liberalization, these institutions became more prominent and were not reformed. Postal deposits now represent the largest component of total deposits at any time in the postwar period and the FILP budget now represents about 10 of GDP (Cargill and Yoshino, 2003a).

The PSS and FILP avoided reform because they were supported by the household sector, small businesses, local and central government, and politicians - especially the LDP. Despite overwhelming evidence that the lack of reform of the PSS and FILP limited the liberalization process, there was little official attention directed toward institutional redesign of these institutions. These institutions were not even mentioned in the 1996 Big Bang announcement and subsequent legislation in 1997 with the minor exception of some changes in government corporation accounting. The PSS complicated Japan's government deposit guarantee system, provided incentives to transfer private bank deposits to the PSS whenever the public became concerned about the condition of the banking system, and in general made it difficult for banks and life insurance companies to compete in the household market. In fact, the PSS in the early part of the 1990s encouraged disintermediation by advertising the safety of postal deposits over private bank deposits[14]. There has been little discpline or monitoring of the funds distributed to various sectors in the economy through the FILP entities. Doi and Hoshi (2003) examined the extent of the nonperforming loan problem embedded in the FILP system and conclude that nonperforming loans represent 16 percent of GDP.

Major reform was initiated in 2001 when the PSS was no longer required to transfer funds directly to the Ministry of Finance and for all practical purposes became a

stand-alone government bank managing its own funds, and the FILP-entities were required to obtain funding by selling agency securities and/or participating in government debt. The PSS remained an important source of funds to the FILP, however, since at least 80 percent of its assets are to be allocated to safe assets such as government bonds.

As of April 1, 2003 the PSS became a public corporation; however, for all practical purposes it remains a government bank. The PSS as a government bank complicates Japan's deposit insurance reform in two ways. First, it encourages disintermediation of funds from private bank deposits to postal deposits in times of financial distress; second, in the absence of financial stress, the PSS will likely establish a dual system of deposit guarantees in Japan.

Disintermediation During periods in the 1990s, when people were concerned about the financial stability of the private banking system, they transferred funds from private depository institutions into the PSS. Why did this happen, considering that private bank deposits were insured up to 10 million yen and postal deposits were limited to 10 million yen? Because postal deposits were perceived by the public as direct government debt, and therefore fully guaranteed, while the DIC was perceived to be incapable of providing the 10 million yen guarantee beyond only a small number of depository institutions. It should not go unnoticed that disintermediation of funds from bank to postal deposits after 1996 occurred in the context of a temporary complete deposit guarantee that had been in place since late 1995 and set to expire April 1, 2001. Thus, even with a complete guarantee, the PSS induced disintermediation.

U.S. history has a similar episode when a postal saving system led to disintermediation. This happened in the early 1930s, when the financial system was in

distress. O'Hara and Easley (1979) and Kuwayama (2000) document how bank failures encouraged disintermediation of funds from private banks to the U.S. postal system, which increased the stress on private banks and contributed to the collapse of the U.S. banking system. Deposit insurance did not exist prior to 1934 and as a result, postal deposits were viewed as less risky than bank deposits in the context of about 10,000 bank failures from 1929 to 1933 in the United States.

While the U.S. version of the PSS has long since disappeared, Japan's PSS remains a large part of the country's flow of funds. Hence, its role as a government bank remains a potential problem as Japan moves toward a U.S.-style deposit insurance system. Any sign of financial distress in the banking system, especially among the smaller banks and cooperatives, is likely to induce disintermediation from bank deposits to postal deposits.

Dual system of government deposit guarantees Even in a more stable economic and financial environment, Japan will find it difficult to establish a meaningful deposit insurance system as long as the PSS remains a government bank. In terms of perceived deposit guarantees by the public, the PSS and large banks stand at one end of the financial system. Postal deposits are regarded as government debt, so holders of those deposits are not concerned about the underlying financial condition of the DIC or of any separate government insurance agency to fulfill the deposit insurance limit. Though postal deposits are limited to 10 million yen, the same level as the insurance limit on private deposits, the two types of deposits are not likely to be viewed as equivalent by the typical Japanese deposit holder, especially bank deposits at smaller institutions. The large Japanese banks operate with a complete deposit guarantee, irrespective of deposit

insurance. This feature of Japanese finance is known as "Too Big to Fail," and while the government may declare large banks insolvent (like Japan Long Term Credit Bank, and Nippon Credit Bank in late 1998), depositors anticipate their deposits will be protected beyond the deposit insurance limit.

At the other end of the financial system stand the large number of relatively small credit cooperatives and banks, whose deposit guarantee status is less certain. In the view of the typical deposit holder, postal deposits will likely be considered safer than the deposits of the smaller depository institutions. This complicates the government deposit guarantee system and puts smaller private depository institutions at a competitive disadvantage compared to the large private banks and the PSS.

Hence, the PSS complicates Japan's deposit guarantee system by supporting a dual system. Postal deposits and deposits at the large private banks may be considered equivalent, but postal deposits and deposits at smaller depository institutions may be viewed differently by the public to the disadvantage of the smaller depositories.

There are many arguments for privatizing the PSS. Few have recognized so far, however, that one of the most important arguments is that privatizing the PSS is a critical prerequisite in reforming deposit insurance, which in turn, is a necessary part of financial redesign in general.

Progress toward deposit insurance reform has been slow and less than promised. When the complete deposit guarantee was announced by the Ministry of Finance in late 1995, it was set to expire April 1, 2001 when the 10 million yen deposit insurance limit would become effective again for all deposits. The expiration date was extended twice, once to April 1, 2002, and then to April 1, 2003. In December 2002, the new deposit

insurance system was announced. Effective April 1, 2003, the 10 million yen limit was re-imposed on time and savings deposits, the complete guarantee remains in place on all ordinary (transactions deposits) until March 31, 2005, and non-interest bearing deposits (settlement or demand deposits) will continue to be subject to a complete deposit guarantee. This falls short of reducing government deposit guarantees in Japan.

6.0: Was the Japanese Financial System Sustainable?

It is important for Japanese policy makers not only to recognize the restraints to institutional redesign, but to recognize the weak foundation of the postwar success on the old financial regime. That is, the old regime was not sustainable because it functioned in an environment that could not be maintained despite Japan's impressive growth record. This is an important part of the attitudinal change needed to more aggressively pursue institutional redesign. Krugman (1994) was one of the first to discuss this issue in his controversial paper on the sustainability of economic growth in Asia or the sustainability of the so-called "Asian miracle." Krugman's argument focused on the diminishing returns resulting from large applications of capital and labor in the absence of significant technological advances. Two additional considerations can be identified that further suggest the Japanese regime was unsustainable.

First, the financial system of Japan required a special set of circumstances to function: limited number of channels of finance, an ability to administer and control financial transactions, consensus on national goals, international isolation, and rapid rates of economic growth. Rapid growth was required to mask inherent inefficiencies in the system and to placate those groups (households and small businesses) with limited access to the

private financial system. These conditions were not sustainable. At a minimum, the success of the state-directed financial regime in achieving high rates of economic growth ensured the country would increasingly come into contact with world markets and political forces and thus, would be forced to liberalize.

Second, the Japanese financial system possessed an inherent flaw that limited technological innovation and at some point, would be unable to support sustained economic growth. The emphasizes on mutual support, minimization of risk, and limiting bankruptcy ensured that inefficient firms were not eliminated and over time, inefficient capital would accumulate and increasingly become a dead weight on future economic growth. Cargill and Parker (2002) present a development model to illustrate how state-directed financial regimes with an emphasize on limiting bankruptcy may generate rapid growth for a period of time, but ultimately generate lower growth rates as the deadweight loss from inefficient capital accumulates. The model also illustrates the high transactions cost required to shift from a state-directed to a market-directed financial regime.

7.0: Demographic Changes – The Trump Card

Japan does not see itself in crisis nor are there sufficient sectors of the economy that see institutional redesign as worth the transition costs. Political leadership as of mid-2003 has failed to generate the support for the costly process of resolving the nonperforming loan and nonperforming borrower problems. Koizumi, more than any other Prime Minister since 1990, has attempted to move more aggressively forward. The year 2003 will be a critical period for the economy. The FSA has promised a far more aggressive and painful resolution of the financial distress under new leadership as of late

2002. The Bank of Japan has shifted to a more aggressive monetary policy and with a new Governor, may be able to reverse deflationary expectations and reestablish central bank credibility in Japan.

The ultimate trump card for Japan will be a radical change in demographics. Population is projected to commence declining about 2008 and the dependency ratio (non-working aged population to working-aged population) is projected to be the largest among the industrialized countries. Simple national income arithmetic suggests that unless Japan is able to offset these demographic changes with higher labor productivity, the standard of living in Japan will decline significantly.

It is widely recognized in Japan that labor efficiency is directly related to the efficiency with which Japan allocates its saving. The issue for Japan is not a lack of savings, but rather an inefficient distribution system for allocating savings. The demographic changes may be what is finally needed to convince Japan that a real crisis is present.

8.0: Concluding Comment

Japan has completed one lost decade in terms of foregone economic and financial development. The first three and a half years of the second decade are not optimistic and suggest that Japan may be on its way to a second lost decade. The economic and financial distress in Japan continues because of a reluctance to depart from the old system and because Japan does not perceive itself in a crisis. This is where more aggressive political leadership can play a role. Koizumi, however, does not have much of a window of opportunity remaining before new Lower House Elections will have to be called in

2004 and more importantly, demographic factors may soon eliminate any window of opportunity.

The issue now is not one of lack of understanding or lack of resources. Japanese policy makers have a clear understanding on what happened and the institutional redesigns needed to return the economy and financial system back to sustained growth and stability. It is also clear Japan has the intellectual and financial resources to implement the needed policies.

Ultimately, institutional redesign is a matter of will and political leadership. To date, Japan has not shown a willingness to accept the cost of reform and continues to engage in forgiveness and forbearance. Japan need not adopt the western-type of financial system to the same degree as in the United States or England, but it needs to find a way to depart from the mutual support and low-risk orientation of the current regime.

Table 1: Economic Indicators for Japan

	Change in Real GDP	Unemployment Rate	Change in GDP Deflator	Change in CPI
1986	2.92	2.77	1.64	0.60
1987	4.38	2.84	-0.09	0.10
1988	6.55	2.52	0.68	0.70
1989	5.25	2.26	1.97	2.30
1990	5.19	2.10	2.38	3.10
1991	3.26	2.09	2.95	3.20
1992	1.00	2.16	1.63	1.70
1993	0.30	2.50	0.53	1.30
1994	1.01	2.89	0.11	0.70
1995	1.93	3.15	-0.49	-0.10
1996	3.43	3.36	-0.78	0.10
1997	1.83	3.40	0.33	1.70
1998	-1.13	4.11	-0.11	0.70
1999	0.10	4.68	-1.54	-0.30
2000	2.84	4.73	-1.89	-0.70
2001	0.37	5.03	-1.56	-0.70
2002	0.34	5.36	-1.70	-0.90
2003	1.01	5.70	-2.15	-0.90
2004	1.11	5.70	-1.84	-1.00

Note: 2003-2004 are projected values. Unemployment rates are not standardized.
Source: OECD Economic Outlook, No. 73, June 2003:http://www.oced.org

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End Notes

* Professor of Economics, University of Nevada, Reno. The author expresses appreciation to the participants of the January 5-6, 2003 Conference on "Institutional Change in Japan: Why it Happens, and Why it Doesn't" and especially, Jack P. Suyerhond, for helpful comments on an earlier draft. All remaining errors are the responsibility of the author.

This paper extends Cargill (2001a) which reviewed the evolution of private and public financial institutions in postwar Japan. This paper focuses on why economic and financial distress continues in Japan and like the earlier paper, draws on previous work, but places the discussion in the context of a taxonomy of financial reform and bifurcates resistance factors into country-specific and general categories.

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[1] Cargill, Hutchison, and Ito (1997 and 2000) review the postwar financial and monetary developments in Japan, with emphasis placed on the past two decades. Other reviews of Japan's recent economic and financial performance include: Blomstrom, Gangnes, and La Croix (2001); Freedman (1999 and 2001); Hoshi and Patrick (2000): and, Mikitani and Posen (2000).

[2] Ono and Rebick (2003) analyze the variety of personnel practices, laws and regulation that lower the labor supply so that any given level of unemployment understates the inefficiency of the labor market and its effect on economic growth.

[3] The process of institutional change has been discussed much in the literature and the views in this paper are similar to those in Becker (1983), which provides a theoretical model of how competition among different groups influences the political process generating institutional change. These views are also similar to the "public choice" literature that models public decision making as a utility maximization process that may generate an equilibrium for the decision making authority inconsistent with the general welfare of the society. Additional references on the process of institutional change are found in Kawaura and La Croix (2003).

[4] Other reasons could be offered such as each country's importance in the world economy, each country's importance in the Pacific Basin region, and the special cultural and historical relationship that exists between the three countries.

[5] This was the major theme of Cargill and Royama (1988), which subsequent events proved to be overly optimistic.

[6] Feldman (1986), Cargill and Royama (1988), and Cargill, Hutchison, and Ito (1997 and 2000) and the extensive list of references in each of these works.

[7] Repurchase market in government securities that unofficially existed from about 1965 to 1976 and became an official market in 1976. The Ministry of Finance had permitted the

unofficial market for over a decade as part of a quid pro quo between the Ministry and the securities industry to absorb government debt at above market prices.

[8] This comment was made by Joseph Bisignano, Bank for International Settlements.

[9] Cargill and Yoshino (2003a) provide a comprehensive overview of the PSS and FILP in postwar Japan. An update on developments as of mid-2003 is provided in Cargill and Yoshino (2003b).

[10] Fiscal policy in Japan could also be signaled out as a general problem. The numerous fiscal stimulus packages have done little to resolve the economic and financial distress. Much of the spending has been wasted on pork barrel projects and much of the stimulus has been in the form of loan guarantees. The only real impact of fiscal policy has been to leave Japan with a large central government deficit and government debt. Despite the problems created by poorly designed fiscal policy, monetary policy remains the most serious problem.

[11] See Cargill (2001c) for more detail on central bank independence as well as more discussion regarding Samuelson's comment.

[12] Burdekin and Siklos (2003) provide an overview of the deflation issue.

[13] The material in this section is drawn directly from two research reports published by the Federal Reserve Bank of San Francisco (Cargill and Yoshino, 2001 and Cargill, 2002).

[14] Cargill and Yoshino (2003a) and Okina (2000) provide evidence of the disintermediation problem.