CHAPTER 3

JAPAN—ON THE THRESHOLD OF A NEW MILLENIUM

> Japan now faces the greatest national crisis in its post-war history.
>
> Taichi Sakaiya, December 1998[1]

Postwar Japan

3.1 In this chapter, the Committee traces the course of events that led to Japan's economic boom in the late 1980s, its collapse in the early 1990s and then the country's struggle through the remaining years of the decade to find the direction and drive that would take it into the 21st century.

3.2 The unconditional surrender of Japan in World War II left it a devastated country occupied by foreign forces determined to redefine and shape its society and economy. After two years of 'democratisation' and the dismantling of Japan's prewar economy, America's policy toward Japan softened and the bureaucratic managers of Japan's 1940s controlled economy were allowed to regroup and once again take charge of Japan's economic destiny.

3.3 Under their guidance, the Japanese people faced the daunting task of rebuilding their nation from the ruins of war. With renewed vigour and strength of purpose, they began the process of reconstruction. Led by stable government and nestling under the American security blanket, the Japanese people concentrated their energies on, and devoted their resources to, economic growth. Over the next forty years, Japan not only attained its goal of catching up with the West but, by adding economic success to economic success, earned its place in the world as the second largest economy.

3.4 The engine driving this transformation relied on a highly regulated society characterised by firm bureaucratic intervention 'in all facets of corporate and consumer activity'.[2] The extent of discretion allowed to the bureaucracy with its strong grip on economic development was indeed one of the defining features of the Japanese system of administration. According to economist, Mr Nukazawa Kazuo:

> Public servants in postwar Japan acted as protectors of egalitarianism. In areas ranging from the establishment of bank branches to the siting of oil

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1 Taichi Sakaiya, 'Japan is Changing', *Japan Echo*, vol. 25, no. 6, December 1998, p. 34.

2 See Isao Nakauchi, 'Corporate Efforts to Promote Deregulation', Text of Speech given by Mr Isao Nakauchi, Vice Chairman of Keidanren, at the Foreign Correspondents' Club of Japan, 19 September 1994. Dr Aurelia George Mulgan, submission no. 20, p. 10.

> refineries, the bureaucracy took over planning and adjustment functions instead of leaving them to the market. Basically the public supported this.[3]

3.5 This tightly managed economic system, known as the 'catch-up' model, combined with a well-disciplined and highly motivated workforce to promote economic development. Moreover, the ready supply of investment funds available at artificially low interest rates, due to the country's high savings rate and a regulated interest rate regime, provided generous support for industry.

3.6 The Japanese people willingly accepted government intervention in the financial system which offered them both stability and economic security. Although Japanese savers bore most of the costs because of the low returns on their deposits and the lack of alternative financial institutions, they could see their savings contributing to the rapid economic development of the country. Their 'reward was in wage increases, not interest yields on savings'.[4]

3.7 Also, from the 1960s, large industrial conglomerates known as 'keiretsu' formed in Japan. They tended to centre on leading banks and each fostered the development of its own general trading companies and general contractors and, over time, built up a large nexus of affiliated firms. Thus, according to Minister Taichi Sakaiya:

> Japan's industrial organization became characterized by the cooperative horizontal linkages in coodination of industries formed under bureaucratic guidance, and vertical 'keiretsu' linkages with financial institutions or large enterprises at the core.[5]

1980s—Bubble economy

3.8 Throughout the 1970s and 1980s, the Japanese economy grew steadily despite the negative impact of the two oil-price shocks in the 1970s when Japan's real GDP growth averaged 4.4%.[6] By the middle of the 1980s, Japan's economy started to boom, asset prices rose dramatically with equity and land prices increasing threefold.[7] Although improved economic fundamentals contributed to this increase in equity prices, the combination of financial liberalisation, an inadequate prudential regulatory

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3 Nukazawa Kazuo, 'The Japanese Economy: From World War II to the New Century, *Japan Echo,* vol. 25, no. 2, April 1998.

4 Hugh Patrick, 'The Causes of Japan's Financial Crisis', *Pacific Economic Paper, no. 288,* Australia-Japan Research Centre, February 1999, p. 1.7.

5 Taichi Sakaiya, Minister of State Economic Planning Agency, 'The Present and Future of the Japanese Economy', Speech at Yale University, May 2000, http://www,epa.jp/2000/b/0505b-daijinkouen-e.html (5 July 2000).

6 DFAT, submission no. 32, pp. 7–8.

7 IMF, *World Economic Outlook,* Chapter IV, 'Japan's Economic Crisis and Policy Options', IMF, 1998, p. 108.

regime and relaxed monetary policy also had a key role in the sharp increase in asset prices.[8]

3.9 Thus banks and other finance institutions, operating under lax lending rules and without adequate accounting procedures in place, provided imprudent levels of credit to real estate and equity markets to compensate for falling profit margins and shrinking market shares.[9] This increased lending to the property sector fuelled the boom in commercial and residential property prices.[10] Monetary policy, notably low interest rates, at this time further encouraged the rise in asset prices. Speculative money poured into the property market and the banks continued to lend assuming that economic growth and asset-price rises would continue.[11] According to Mr Thomas Cargill et al:

> …at some point, probably in late 1986 or 1987, the asset inflation process appeared to become a speculative bubble with little restraint either from financial institutions or the regulatory authorities. Expectations of asset price increases fed upon themselves and price/dividend and price/rent ratios increasingly deviated from fundamental values until the crash in the early 1990s. Speculators during the asset inflation typically thought that even though the 'levels' of stock and land prices were abnormally high and would eventually fall, further investment was warranted as long as other investors thought prices would continue to rise. Many felt that they would be among the first to sell their asset holdings, realizing large capital gains, when the market started to fall. [12]

1990—collapse of the bubble economy

3.10 By the close of the decade, the bubble economy was showing signs of distress and there were worrying indications that it was in serious difficulties. The speculative bubble, built on shallow foundations and inflated hopes, was about to collapse.

3.11 Japanese authorities, aware of the overheated economy and the rising asset prices, had begun to tighten monetary policy. Some analysts have argued that the Bank of Japan should have stepped in much earlier to tighten the money supply.[13] The

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8 IMF, *World Economic Outlook,* Chapter IV, 'Japan's Economic Crisis and Policy Options', IMF, 1998; pp. 108–9; Hugh Patrick, 'The Causes of Japan's Financial Crises', *Pacific Economic Paper no. 288, Japan's Financial Reform,* Australia-Japan Research Centre, February, 1999, p. 1.11.

9 Thomas Cargill, Michael Hutchison and Takatoshi Ito, 'Japanese Deregulation: What you should know, Japan Information Access Project, http://www.nmjc.org/jiap/deregulate/papers/deregcon/hutchison.html (1 March 1999).

10 IMF, *World Economic Outlook*, Chapter IV, 'Japan's Economic Crisis and Policy Options', IMF, 1998, p. 109.

11 See Mr Charles Wensley, Hamersley Iron Pty Ltd, *Committee Hansard*, 24 February 1999, p. 96.

12 Thomas Cargill, Michael Hutchison and Takatoshi Ito, 'Japanese Deregulation: What you should know', Japan Information Access Project.

13 Hugh Patrick; 'The Causes of Japan's Financial Crisis, *Pacific economic Papers no. 288¸* February 1999, p. 1.13; Ogata Shijuro, 'Three Proposals for Japan's Troubled Central Bank', *Japan Echo,* June 1998, p.

official discount rate rose 3.5 percentage points in just over 12 months until it reached 6% in August 1990.[14] Equity prices began to tumble and by the time they had flattened out in mid-1992, the Nikkei index had fallen by over 60% from its height at the end of 1989.[15] Land prices followed in early 1991 and have continued to fall steadily. According to the IMF, the average price of land in the six largest Japanese cities at the end of 1997 stood at about 40% of peak values in 1990.[16]

3.12 Investment, which had also grown significantly during the boom period, fell markedly as asset prices plunged and firms found themselves 'saddled with investment overhang from the late 1980s and returns to capital dropped'.[17]

3.13 Businesses that had borrowed heavily saw the value of their assets depreciate sharply while debts such as bank loans still carried their original value producing a widening gap between assets and liabilities. Financial institutions found a similar imbalance as parts of their corporate lendings became non-performing. Thus, firms and financial institutions suffered a substantial deterioration in their real capital base.[18] Economist, Mr Richard C. Koo, termed this the 'balance sheet recession'.[19]

3.14 Minister Taichi Sakaiya underlined the magnitude of the problem when he pointed out that in 1980 the total outstanding loans of all Japanese financial institutions amounted to 56.8% of GDP, whereas ten years later this ratio had risen to 103.1% of GDP—over a 45 percentage point increase in the relative size of lending.[20] Overall, the fall in asset values seriously undermined the profitability of Japan's financial institutions, generated uncertainty in the market, weakened consumer demand, lowered sales and profits for the corporate sector, tightened the availability of credit and precipitated a protracted economic slowdown.

3.15 With the economy now struggling to climb out of trouble and consumer confidence crumbling, the economic outlook during the early 1990s was turning increasingly bleak. The growth rate of GDP for fiscal 1993 was 0.0% (-0.1% for

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27; Adam S. Posen, *Restoring Japan's Economic Growth*, Institute for International Economics, Washington, 1998.

14 IMF, *World Economic Outlook*, October 1998, Chapter IV 'Japan's Economic Crisis and Policy Options', IMF, 1998, p. 110.

15 IMF, *World Economic Outlook*, October 1998, Chapter IV 'Japan's Economic Crisis and Policy Options', IMF, 1998, p. 110.

16 IMF, *World Economic Outlook*, October 1998, Chapter IV 'Japan's Economic Crisis and Policy Options', IMF, 1998, p. 110.

17 IMF, *World Economic Outlook*, October 1998, Chapter IV 'Japan's Economic Crisis and Policy Options', IMF 1998, p. 111.

18 Masaru Hayami, Governor of the Bank of Japan, Speech to the Yomiuri International Economic Society in Tokyo, 29 July 1998.

19 Richard C. Koo, 'Is Japan Misunderstood', Remarks of Richard C. Koo, Chief Economist, Nomura Research Institute at the Economic Strategy Institute, 13 July 1998.

20 Speech by Minister Taichi Sakaiya, Sorbonne University, Paris, 7 January 1999, http://www.epa.go.jp/99/b/19990107b-daijinkouen-e.html (24 April 1999).

GNP) which fell short of forecasts; the initial government prediction, measured on a GNP basis, was 3.3% and the average forecast by private research institutions was in the 'latter half of 2%'.[21]

Response to economic downturn

3.16 The Japanese Government took a number of steps to resuscitate the economy. On four separate occasions between August 1992 and mid-1995, it put in place packages of fiscal stimulation measures valued at a total of 45 trillion yen to bolster the growth rate. It also adopted two supplementary budget packages involving the disbursement of 2.3 trillion yen in FY 1994, and reduced income taxes by 6 trillion yen for FY 1995.[22] But the trillions of yen used to boost economic activity, especially the funds poured into public works, failed to return the Japanese economy to robust health.

3.17 The government also hoped that reform of the economic system would revive Japan's economy and set it on a growth path. For almost two decades Japan, in keeping with global trends, had been moving toward administrative and economic reform but the process had been piecemeal and faltering. During the early 1990s, the Japanese Government implemented a number of reform initiatives especially in the area of deregulation. During 1993 and 1994, three cabinet decisions led to agreement to act on over 1,100 individual deregulatory measures and administrative tools.[23]

3.18 But as the economy showed no signs of rallying, attention focused more intently on the long-term and structural issues in the Japanese economy. At first, the collapse of the bubble economy was attributed to the economic cycle but as the economy failed stubbornly to rebound analysts raised doubts about the structure of the economy which increasingly came under close and searching scrutiny. According to the Japanese Economic Planning Agency '…the sluggish economy has made the structural issues, which were masked by the domestic-oriented high growth during the bubble era, stand out more sharply'.[24]

3.19 Some commentators argued that serious and comprehensive reform was crucial to economic recovery. They saw Japan's economic system as outmoded: that the regulations, rules and practices that had become such a fixed and positive feature of the system were now obsolete. For them the system had outlived its usefulness:

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21 Economic Survey of Japan (1993–1994), 'A Challenge to New Frontiers Beyond the Severe Adjustment Process', Economic Planning Agency, Government of Japan, 26 July 1994.

22 An Outline of Emergency Measures for Yen Appreciation and the Economy, http://www.epa.go.jp/taisaku/taisaku-eng-summary.html (19 May 1999).

23 APEC, Deregulation Report 1997, Japan, http://www.apecsec.org.sg/deregulation/Japan.html (18 October 1999); Summary of the 1996 Annual Report of Management and Coordination Agency, 1996.

24 Economic Survey of Japan, 1993–1994, 'A Challenge to New Frontiers Beyond the Severe Adjustment Process', Summary, 26 July 1994, Economic Planning Agency, The Government of Japan.

> Like machines, however, systems have finite lives, and the present one seems to be terminally fatigued, making fundamental reform essential.[25]

3.20 The call for Japan to overhaul its 50-year old economic system grew louder. The 1940 financial system or the ‘catch-up’ model, the bedrock of Japan’s postwar recovery and economic prosperity, seemed unable to meet the challenges of the 1990s. Previously, it had been able to gather savings efficiently from the Japanese people and to direct their funds into a controlled system; it had kept interest rates artificially low; and it had channelled these savings into selected priority industries particularly the heavy and manufacturing goods sector such as steel, machine tools, automotives, shipbuilding and electronics. These strategic industries with easy access to a substantial pool of cheap money enjoyed a distinct competitive edge. A favourable exchange rate further helped exporters.

3.21 According to Mr Peter Hartcher, an economic journalist, ‘A virtuous cycle took hold. The workers continued to bank their money at low interest rates, the system continued to funnel their money into chosen industries and these priority industries continued to add more and more productive capacity.’[26]

3.22 This phenomenon of massive saving and investment in the private sector had a parallel in the public sector. Japanese households, with their propensity to save a large proportion of their earnings, placed these savings in postal savings accounts. The postal savings system, regulated by the Ministry of Posts and Telecommunications, directed vast volumes of low-cost capital into the so-called ‘zaito’ system, the government’s fiscal investment and loan program, often referred to as Japan’s ‘second budget’. This program, drawing on the post-office savings as a source of cheap loans, ploughed these funds into targeted industries.[27]

3.23 This policy of favouring savings and investment over consumption—where the producer-supplier took priority at the expense of the consumer—created an environment that enabled Japan to emerge as a leading manufacturing nation. History documents the outstanding successes of this model.[28] The ‘production first’ and anti-competition principles embodied in this system grew stronger during the postwar

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25 Fujiwara Sakuya, ‘Japan’s Financial Woes and the Hopes for Big Bang’, in *Japan Echo,* February 1998, p. 7.

26 Peter Hartcher, ‘Can Japan Come Back?’ in the *National Interest*, Winter 1998/99, pp. 32–9 in Peter Hartcher, submission no. 36, p. 36.

27 Ms Tessa Morris-Suzuki, submission no. 3, p. 2; Takatoshi Ito, ‘Japan’s Financial Crisis: Resemblances with East Asia’, *Pacific Economic Papers no. 288,* vol I, Australia-Japan Research Centre, February 1999, p. 2.15; The Economist Intelligence Unit Ltd, *EIU Report,* 1st Quarter 1996, pp. 19–20; Professor Noriyasu Watanabe, ‘Occupational Pension Systems in Japan’, *Japan Labor Bulletin*, vol. 37, no. 8, August 1998.

28 See Peter Hartcher, *Committee Hansard*, 15 April 1999, pp. 325–6; Noguchi Yukio, ‘The Persistence of the 1940 Setup’, *Japan Echo*, vol. 24, Special Issue, 1997.

period of dynamic economic growth, eventually 'achieving the status of values in their own right'.[29] But times were changing as Minister Taichi Sakaiya surmised:

> As compared to the American and European experience, perhaps Japan was simply too successful in industralization. We had erected a meticulously ordered industrial society, and there was little reason to doubt the wisdom of continued dependence on manufacturing industries based on standarized mass-production approaches. So, you can imagine our disappointment when we saw the world moving away from the industrialised society and toward the new paradigm of knowledge-value society?[30]

3.24 As the 1990s progressed, there was a growing recognition, especially among the more competitive export sectors of the business community in Japan, that public regulations frustrated economic progress; that they made the economy less flexible, less able to adapt to a changing economic environment and, overall, stymied future development.[31] The government was beginning to realise that the reform measures initiated so far were inadequate to accommodate the changing economic environment and that a greater effort was required to push ahead with reform especially deregulation.

3.25 In July 1994, the then Prime Minister Tomiichi Murayama told the Diet that it was imperative that Japan take a long, hard look at its various regulations and determine whether they were effective or not. He stated his resolve to go beyond measures already planned and to draw up a five-year deregulation action plan. This initiative would introduce further deregulation that would, for example, encourage the entry of business into new fields of enterprise and enhance Japanese purchasing power by reducing the price differentials between Japan and overseas.[32]

3.26 Nine months later, on 31 March 1995, the government decided on a 'Deregulation Action Programme' covering a five year period from 1995 to 1999. In formulating this program, the government identified 1,091 items for attention in 11 areas. The package was to be reviewed and updated every year. [33]

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29 Noguchi Yukio, 'The Persistence of the 1940 Setup', *Japan Echo*, vol. 24, Special Issue, 1997.

30 Speech by Minister Taichi Sakaiya, Sorbonne University, Paris, 7 January 1999. See also Ms Tessa Morris-Suzuki, submission no. 3, p. 2.

31 Economic Survey of Japan, 1993–1994, A Challenge to New Frontiers Beyond the Severe Adjustment Process, Summary, 26 July 1994, Economic Planning Agency. See also Dr Aurelia George Mulgan, submission no. 20.

32 Policy Speech by Prime Minister Tomiichi Murayama to the 130th Session of the Diet, 18 July 1994, http://www.kantei.go.jp/foreign/130.html.

33 Ryutaro Hashimoto, Minister of International Trade and Industry, 'Challenges for the World Economy in a Transitional Period and Development in the Asia-Pacific Region', Vancouver, 2 May 1995, http://www.jef.or.jp/news/challenge.html (19 October 1998). WTO Trade Policy Review of Japan (1998), 20 November 1998; JETRO, *The Changing Service Industries of Japan*, Tokyo, 2000, p. iii.

Emergency measures for yen appreciation and the economy—April 1995

3.27 As the economy limped toward the summer of 1995, the government became increasingly worried that the rapid appreciation of the yen from the beginning of March 1995 together with the depreciation of the United States dollar would hurt the Japanese economy over the short as well as the medium term.[34] Indeed, there were fears that the economy would slide into recession. In light of this mounting concern about the changes in the exchange rate and the emerging sense of uncertainty about the state of the Japanese economy, the government, in April 1995, decided upon a rescue package—the 'Emergency Measures for Yen Appreciation and the Economy'. Under this initiative, it again resorted to injecting large sums of money into the economy in the hope that it would reignite activity.[35]

3.28 The government reasoned that a drastic impetus to domestic demand would 'steer the economy on a steady recovery path through dispelling feelings of uncertainty concerning the economy, enhancing the sentiment of consumers and entrepreneurs, and inspiring consumption and investment'. To this end, the government explained that 'the largest amounts of public investment has been secured, and is planned to be implemented effectively; priority investment will be carried out to cope with the current economic and social situations'.[36]

3.29 The Emergency Measures for Yen Appreciation and the Economy, worth over 14 trillion yen, included among its government expenditure program 3,900 billion yen to be spent on general public works and 700 billion yen on reconstruction projects in disaster areas. Public works that had already been decided upon would be actively implemented. In their expanded public works program, the government was to give priority to science and technology, information and communication and efficient land use.[37] Measures were also included to improve educational and welfare programs.[38]

3.30 The Emergency Measures looked not only to fiscal policy but to accelerated structural reform to lift the economy out of the doldrums. Despite the reform measures already in place, the call for decisive reform was growing stronger. Mr Ryutaro

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34 An Outline of Emergency Measures for Yen Appreciation and the Economy, http://www.epa.go.jp/taisaku/taisaku-eng-summary.html (19 May 1999).

35 Economic Measures: toward steady economic recovery' (provisional translation), Ministerial Conference for Economic Measures, Government of Japan, 20 September 1995, http://www.epa.go.jp/taisaku/measures95_9 (30 March 1999).

36 Economic Measures: toward steady economic recovery' (provisional translation), Ministerial Conference for Economic Measures, Government of Japan, 20 September 1995, http://www.epa.go.jp/taisaku/measures95_9 (30 March 1999).

37 MITI, 'Economic Measures: (toward steady economic recovery)', Government of Japan, 20 September 1995.

38 MITI, 'Economic Measures: (toward steady economic recovery)', Government of Japan, 20 September 1995; Emergency Measures for Yen Appreciation and the Economy, 14 April 1995, Ministerial Conference on Economic Measures.

Hashimoto, Minister of MITI, in a now familiar refrain, urged Japan to cast off its weary and moribund structures and practices of the past. He noted:

> The social and economic system that has enabled Japan to catch up with the advanced nations of the West since the end of the Second World War has now reached a state of what may be called institutional fatigue. It has failed to adjust itself to the realities of the new global economy where corporations compete in a single global market. In consequence, there is a sense of slow suffocation, a sense of marked loss of vitality, throughout the domestic economy.[39]

3.31 In underlining the need for prompt and decisive action, Mr Hashimoto stressed that it was 'a matter of immediate and crucial importance for Japan to carry out domestic regulatory reform designed to turn Japan into an attractive business environment'.[40] For him, deregulation held the key to the rejuvenation of his country's economic system. It would, he reasoned, create new markets and employment opportunities and expand the range of options available for the consumer.[41]

3.32 Overall, the Emergency Measures, were to put in place structural reforms to promote the mid-term and long-term development of the economy. These measures, were designed to expand the economic frontiers, promote research and development (R&D), improve the information system and, through deregulation, facilitate imports and inward investment. They would pave the way for economic growth.[42] One aspect singled out for particular attention was the need to work toward the international harmonization of the business environment.

3.33 Under these Emergency Measures the scope of reform was not only broadened but also the process of deregulation was to be hastened. The five-year deregulation program, agreed to 12 months earlier, was to be advanced and implemented as a three-year program.[43]

3.34 Keidanren (Federation of Economic Organizations), one of the most influential peak business associations in Japan, estimated that deregulation would increase Japan's real GDP by 177 trillion yen over the next ten years, creating 740,000 additional jobs. In addition, it would correct the price differential that existed between Japan and the international community, expand Japan's range of products and

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39 Ryutaro Hashimoto, 'Challenges for the World Economy in Transitional Period and Development in the Asia-Pacific Region', Vancouver, 2 May 1995.

40 Ryutaro Hashimoto, 'Challenges for the World Economy in Transitional Period and Development in the Asia-Pacific Region', Vancouver, 2 May 1995.

41 Ryutaro Hashimoto, 'Challenges for the World Economy in Transitional Period and Development in the Asia-Pacific Region', Vancouver, 2 May 1995.

42 Economic Measures toward steady economic recovery, 20 September 1995, Ministerial Conference for Economic Measures, Government of Japan.

43 Emergency Measures for Yen Appreciation and the Economy, Ministerial (Provisional Translation) Ministerial Conference on Economic Measures, 14 April 1995.

services, and raise the national standard of living. It would also increase international access to Japan's market, make the market more transparent and encourage new foreign investment.[44]

The reform packages of 1996—economic, financial and fiscal

3.35 The emergency package was also designed to overcome pressing problems, such as the decline in asset prices by promoting efficient land use and revitalising the security market. The government was looking to financial institutions to dispose swiftly of their non-performing assets and was seeking to strengthen discipline in the management of such institutions and to formulate highly transparent financial markets. Finally, the government recognised the need to address the issue of mounting unemployment, which had climbed over the 3% mark, and the difficulties facing smaller enterprises.[45]

3.36 In the face of continuing economic stagnation and the growing realisation that Japan needed to change to meet the challenges of the time, reform remained firmly on the political agenda. Organisations such as Keidanren announced their intention to 'keep a close watch on how the government proceeds, to what extent the 1,091 items targeted in the Plan are deregulated, and to ensure that the Plan is implemented'.[46]

3.37 On 11 January 1996, Mr Ryutaro Hashimoto, a strong advocate of reform, became Prime Minister and, building on initiatives already in place, gave the reform process a firm nudge forward. During the year, he unveiled his plan to implement and promote six reform packages with the purpose of 'creating an overall economic and social system, which can stay in the forefront of global trends'. Three fundamental principles underpinned the reforms—capacity to respond to crises; freedom of choice; and co-existence which would encourage local communities to work together constructively and for the nation to move forward as a whole and in harmony with the international community. The six packages were to cover:

- administrative reform
- fiscal structural reform
- social security structural reform
- structural reform for the Japanese economy
- financial system reform

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44 Address of Shoichiro Toyoda, Chairman of Keidanren, before the 57th Keidanren General Assembly, 26 May 1995.

45 'Economic Measures: toward steady economic recovery', Ministerial Conference for Economic Measures, Government of Japan, 20 September 1995.

46 Address of Shoichiro Toyoda, Chairman of Keidanren, before the 57th Keidanren General Assembly, 26 May 1995. For information on Keidanren, see Hidetaka Yoshimatsu, 'Japan's Keidanren and Political Influence on Market Liberalization', *Asian Survey,* vol. XXXVIII, no. 3, March 1998. He describes Keidanren as 'the principal power center of business'.

- educational reform.[47]

3.38 The government accepted that the six packages were closely 'interrelated and intertwined'. But clearly, at the forefront of its mind was the need to find solutions to the economic and financial difficulties plaguing the nation. In particular, it saw the urgent need to promote the rejuvenation of Japan's economic structure as part of the six-area reform program. Three of the six packages had a direct bearing on the economy—economic, financial and fiscal structural reform.

Economic structural reform

3.39 As noted earlier, economic reform had long been a matter for debate in Japan and the announcement of the government's reform packages in 1996 marked yet another development in this long process. The Deregulation Program adopted in 1995 was revised and approved by Cabinet in March 1996 and now covered 1,797 items.[48] At its very core, the reform program recognised that many of the systems and practices that had functioned well up to the present in Japan were now stifling the future development of the economy. The reforms were primarily designed to eliminate the high-cost structure in Japan and thereby create an environment that would encourage new business ventures to attract Japanese as well as foreign companies.[49]

3.40 In Japan, a two-tiered economic system, known as a dual economic structure, had developed over the years. It comprised a highly productive, hypercompetitive, world renowned, cutting edge manufacturing export sector and a highly protected, non-competitive, inefficient domestic sector with costs higher than comparable industries throughout the world.[50] Companies such as Sony, Toyota and Toshiba are among the world's most successful exporters and form part of the highly competitive sector of this dual structure. On the other hand, electricity suppliers, the transport industry and a plethora of small, often family-owned, businesses, belong to the rest, 'the rump of the Japanese economy', which is a drain on the national economy. Mr Peter Hartcher described this dual economic system as:

> …a remittance economy where the profits and growth prospects generated overseas by the successful sector of the economy are then transferred or expropriated back home through taxes, through jobs, and through economic growth, to the rump…sector of the economy.[51]

47 Reforms and the Creation of a New Era Society—the six reform packages of the Hashimoto Administration, The Ministry of Foreign Affairs.

48 APEC, Deregulation Report 1997: Japan, http://.apecsec.org.sg/deregulation/jap.html (20 October 1999).

49 See for example Shinji Sato, English translation of Minister Sato's Speech at the Foreign correspondents' Club of Japan, 16 June 1997, http://www.miti.go.jp/press-e/f300001e.html (10 November 1999).

50 Peter Hartcher, *Committee Hansard*, 15 April 1999, p. 325. See also, The Department of the Treasury, submission no. 63, p. 4; *The Economist Intelligence Unit's Country Analysis, Japan, 2000*, p. 23.

51 Peter Hartcher, *Committee Hansard*, 15 April 1999, p. 325.

3.41 This protected sector for example resulted in extremely high electricity costs in Japan and transport costs five times those in the US.[52] In underlining the burden that these domestic distribution and energy costs place on producers, Professor Kosai Yutaka cited domestic marine freight charges, which he wrote:

> …are so high that the cost of transporting goods between Yokohama and Kobe is almost the same as that between Japan and Europe. Thus, even the production of quality products that have price competitiveness on shipment from the factory does not pay off if transportation costs are added…[53]

3.42 Indeed, Mr Ian McLean, a witness before the Committee, explained that his business spent $6,000 to move a display home from Australia to Japan but a further $24,000 to get it from the wharf in Tokyo to a site 24 kilometres away.[54]

3.43 Clearly, the protected home industries, which enjoy a huge array of rules and policies that shelter them from competition, are holding back economic progress. Regulations block the system with inefficient practices, drive up business costs, undermine the competitiveness of the export industries and inhibit the formation of internationally competitive industries in significant sectors of the economy.[55] Sectors whose competitiveness was suffering were pushing hard for change.

3.44 In December 1996 with a growing sense of urgency and in an attempt to accelerate the restructuring process, the Japanese Government agreed upon a 'Program for Economic Structure Reform'. This program was to facilitate the implementation of the measures set forth in the Deregulation Program. Although a number of commentators acknowledged that some significant improvements had resulted, they described Japanese deregulatory plans as 'quite modest'.[56]

3.45 Mr Hashimoto's economic reform program continued to undergo review. At the end of March 1997, the Japanese Government announced its final revisions to its three-year Action Plan.[57] In May 1997, the specific details of the program were approved by cabinet as the 'Action Plan for Economic Structure Reform'.[58]

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52 BT Funds Management, 'Cherry Picking in Japan', 1999.

53 Kosai Yutaka, 'Economic Reform', in *Journal of Japanese Trade Industry,* No. 3, 1998, p. 10.

54 Ian McLean, Australia Japan Housing Ltd, *Committee Hansard*, 15 April 1999, p. 365.

55 Michael E. Porter and Hirotaka Takeuchi, 'Fixing What Really Ails Japan, *Foreign Affairs*, vol. 78, no. 3, May/June 1999, p. 78.

56 Stuart M. Chemtob, Special Counsel for International Antitrust Division, US Department of Justice, Keynote Address 'The Frustration and Promise of Japanese Deregulation', 4 April 1997, in Japan Information Access Project.

57 Press Conference by Prime Minister Ryutaro Hashimoto following the passage of the FY1997 Budget, 31 March 1997.

58 *News from MITI,* 'Structural Reform of the Japanese Economy', November 1997, http://www.jef.or.jp/news/97nov.html (19 October 1998).

3.46 The Action Plan had three broad goals—

To create an environment that would encourage new business activities: the plan called for solutions to problems associated with factors such as:

- funding—to ensure the smooth supply of funds to new business activities;
- human resources—to facilitate the shift of human resources to new and fast-growing business fields and supply human resources with creativity and the spirit of challenge;
- R&D, especially in the area of technology, to strengthen such research as an important basis for new business activities and protection of intellectual property;
- promotion of advanced information and telecommunications systems.

It also sought to foster an internationally attractive business environment through:

- drastic deregulation, notably the enforcement of sweeping deregulation to correct Japan's high-cost structure;
- improved domestic distribution—the cost of which in Japan, as shown earlier, was extremely high;
- the efficient production, distribution and use of energy;
- the establishment of conditions under which information and telecommunications industries could grow and compete internationally;
- the reform of systems concerned with corporate organization and labour;
- restructuring the corporate tax system to make it more attractive for business.

Finally, it sought to lighten the public burden on taxpayers and businesses from the viewpoint of maintaining economic vitality.[59]

3.47 The reform program remained a central plank in the government's efforts to improve economic performance and was to undergo continued review and refinement.[60] Aside from the general objective of removing unnecessary regulations, the reform process was particularly intended to encourage new enterprises, develop human resources and promote and advance technology.[61]

59 The Action Plan for Economic Structure Reform, May 1997; *News from MITI,* November 1997.

60 For example see Takafusa Shioya, 'Japanese Economic Issues', Mr Takafusa Shioya, Director-General of the Coordination Bureau, Economic Planning Agency, 24 November 1997. Ministry of Foreign Affairs. See also General Affairs Division, Industrial Policy Bureau, Ministry of International Trade and Industry, 'An Outline of Economic Structure Reform', *Journal of Japanese Trade & Industry,* no. 3, 1998.

61 General Affairs Division, Industrial Policy Bureau, Ministry of International Trade and Industry, 'An Outline of Economic Structure Reform', *Journal of Japanese Trade & Industry,* no. 3, 1998.

Financial reform—Big Bang

3.48 Financial reform, one of the areas identified under the six reform packages, demanded most urgent attention. Until the late 1970s, Japan operated with highly regulated financial markets.[62] This system appeared to have performed well. Households placed their savings in bank deposits or postal savings accounts and the funds were channelled to selected industries at cheap interest rates. The economy certainly flourished under this system suggesting that funds were being effectively funnelled into profitable and productive areas; that bad loans were manageable and financial institutions successful.

3.49 But from the 1970s Japan, now a fully mature industrialised economy, saw its economic growth rate slow at a time when there was a gradual, though ad hoc, relaxation of some regulations including a slow 'decontrol of interest rates'. The deregulation process, however, took place without the establishment of an overarching effective system of prudential regulation and supervision.

3.50 Private savings began to outstrip the demand for private investment. With a slowing in economic growth and a subsequent lower demand for loans to finance plant and equipment investments by the large manufacturers, lending institutions moved into real estate financing which, as noted earlier, fed the boom economy of the late 1980s. With the collapse of the bubble economy, the faults and failings of the financial system, aggravated by the burgeoning bad debt problem, became increasing apparent and some officials began to agitate for drastic reform.[63]

3.51 In November 1996, Prime Minister Hashimoto announced a bold set of plans to overhaul Japan's financial system—the 'Big Bang' plan.[64] Japan's financial institutions had remained relatively domestic in focus and had not kept pace with changes in the international financial world.[65] Moreover, the anti-competition principle that characterised the catch-up model of Japan's postwar economic system was clearly at work in the financial sector. The 'convoy system' of financial regulation, which required all institutions 'to move in the same direction at the same pace', while protecting weak institutions from failure allowed the system to fall behind international standards.[66]

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62 Edward J. Lincoln, 'Evaluating Japan's "Big Bang" Financial Deregulation', Prepared for the Trilateral Forum on US-Japan-China Cooperation in the Asia Pacific Region, Berkeley, 11–12 November 1997.

63 See Edward J. Lincoln, 'Evaluating Japan's "Big Bang" Financial Deregulation', Prepared for the Trilateral Forum on US-Japan-China Cooperation in the Asia Pacific Region, Berkeley, 11–12 November 1997.

64 Structural Reform of the Japanese Financial Market—Toward the Revival of the Tokyo Market by the Year 2001, http://www.mof.go.jp/english/big-bang/ebb6.htm (26 April 2000).

65 See Professor Tessa Morris-Suzuki, submission no. 3; p. 13; Bradley Treadwell, Osborne Associates, submission no. 8, p. 3.

66 Noguchi Yukio, 'The Persistence of the 1940 Setup', *Japan Echo*, vol 24, Special issue, 1997; Taichi Sakaiya, Minister of State, Economic Planning Agency, Government of Japan, 'The Present and Future

3.52 The principal object of Hashimoto's ambitious initiative was to transform Tokyo into a world class financial market to rival, even surpass, London and New York. More specifically, the Big Bang reforms were to find a more efficient way to manage and invest private assets, involving as much as ¥1,200 trillion of individual savings, and to provide funds for the development of industries that would 'carry the coming era on their shoulders'. Put simply, the Big Bang was to open up the Japanese financial sector to international competition—to create a system where the market mechanism functioned to its full extent and where optimal allocation of resources would be achieved. [67]

3.53 Reform was to be based on the clearly defined principles of:

- Freedom—to establish a free market where the market mechanism prevails;
- Fairness—to create a transparent, reliable and credible market by clarifying and enhancing transparency of rules and protecting investors' interests; and
- Globalization—to work toward an international market ahead of its time by establishing a legal system, accounting system, and supervisory regime consistent with international standards.[68]

3.54 The Japanese Big Bang that Prime Minister Hashimoto had been calling for since late 1996 aimed at making up for lost time with a sweeping package of reforms covering not just the securities business but also various other aspects of the financial system, including specifically:

- the elimination of the barriers separating the banking, securities, and insurance industries;
- the lifting of the postwar ban on financial and other holding companies;
- the deregulation of insurance premiums;
- the liberalisation of foreign exchange;
- the reform of the corporate accounting system, with a shift from valuation of assets at acquisition cost to valuation at current market prices;
- a review of the financial regulatory system and, in particular, the strengthening of the supervision of financial institutions; and

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of the Japanese Economy', Speech at Yale University, Connecticut, May 2000, http://www.epa.go.jp/2000/b/0505b-daijinkouen-e.html (5 July 2000).

67 About the financial system reform, (The Japanese version of the Big Bang), http://www.mof.go.jp/english/big-bang/ebb1.htm. See also Professor Tessa Morris-Suzuki, submission no. 3.

68 Directions issued by Prime Minister Hashimoto, 11 November 1996 and Financial System Reform—Toward the early achievement of Reform, 13 June 1997, http://www.mof.go.jp/english/big-bang/ebb32.htm. See also Queensland Government, submission no. 18, p. 7; NSW Government, submission no. 25, p. 8.

- a revision of the Bank of Japan Law to give the central bank greater autonomy and to secure transparency in the financial policy making.[69]

3.55 The reform package was hailed as 'the most ambitious and far reaching set of financial reforms ever undertaken in Japan—truly a Big Bang'. Prime Minister Hashimoto directed that the package be implemented by 2001.[70]

3.56 The reforms also recognised the pressing need to dispose of the bad debts accumulated by the banking institutions. The government had already taken steps to solve the problem of the *jusen* companies. These companies were established in the mid-1970s as subsidiaries of banks, securities firms and life insurance companies. The *jusen* companies were not permitted to accept deposits and borrowed from other institutions, including banks and agricultural credit cooperatives, to provide loans. During the 1980s they turned aggressively to real estate lending. With the collapse of the property market, the *jusen* companies were saddled with massive amounts of non-performing loans. In 1995, the extent of their problem became public with a Ministry of Finance report estimating that their non-performing loans amounted to 9.6 trillion yen. The government stepped in to assist in the liquidation of the *jusen* which were dissolved in 1996. The banks were required to contribute significantly to the bail out. This measure did not, however, address the problem of the banks' bad debts.[71]

3.57 The government remained sensitive to the pressure for continuing economic and financial reform and frequently referred to its commitment to such action.[72] In June 1997, it brought forward its broad ranging plan for financial system reform.[73] The measures included abolishing operational regulations to ordinary banks in the short and long-term finance system, diversifying the business operations of securities companies, liberalising brokerage commissions for stock trading; liberalising the foreign exchange business and cross-border capital transactions; establishing accounting standards, including the use of market-to-market method for such financial instruments as securities and derivatives; and improving the practice and system of auditing to make them comparable to the international norm.[74]

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69 *Japan Echo*, vol. 24, no. 3, August 1997; Administrative Reform Program, (Outline), Cabinet decision, 25 December 1996.

70 *Japan Echo*, vol. 24, no. 3, August 1997.

71 Takatoshi Ito, 'Japan's Financial Crisis: Resemblances with East Asia', *Pacific Economic Papers no. 288, Japan's Financial Reform*, Australia-Japan Research Centre, February 1999, p. 2.8. See also Gavan McCormack, 'Is Japan Facing Financial Armageddon?', *New Asia Pacific Review*, vol. 3, no. 2, 1997, pp. 11–12; Professor Hiroya Ichikawa, 'A Road for the Economic Recovery of Japan: a Search for a New Paradigm', *Japan Reports*, Consulate-General of Japan, Sydney, May 1999.

72 See for example Economic Outlook and Basic Stance on Economic Management for FY 1997, approved by the cabinet on December 19, 1996.

73 Ministry of Finance, 'Financial System Reform', 13 June 1997, http://www.mofa.go.jp/english/big-babg/ebb32.htm (6 April 1999).

74 Ministry of Finance, 'Financial System Reform', 13 June 1997, http://www.mof.go.jp/english/big-babg/ebb32.htm (6 April 1999).

Fiscal structural reform—1997 the year of fiscal reform

3.58 The Japanese economy seemed to respond positively to the stimulus package of April 1995 and the on-going program of reforms. It showed signs of recovery with a return to positive growth and a spurt in economic activity.[75] In 1996, Japan registered a real GDP growth rate of 3.6%.[76] By the close of the year, the economic outlook was brighter. According to the Economic Planning Agency:

> Although the pace of recovery is gradual, demand in the private sectors is gathering the strength of steadiness. Thus, the basis for an autonomous economic recovery centred on private demand is being established.

It acknowledged that the unemployment situation, which had reached 3.4 per cent, was still serious despite continued improvement in the economy. Nonetheless, it asserted confidently that in FY1997 'an autonomous economic recovery led by increasingly firm private demand will be realised'.[77]

3.59 Taking heart from the boost in economic growth, Japanese authorities turned their attention to reducing the budget deficit in earnest. Although the various stimulus packages introduced during the early 1990s had sustained moderate economic growth, they had also eaten into public finances. Japan's fiscal standing had deteriorated sharply over recent years, with fiscal deficits surging from 2.0 per cent of GDP in 1992 to 7.3 per cent of GDP in 1996.[78] According to the WTO, in 1995 the overall fiscal deficit of central and local government rose to over 5 per cent and gross government debt to over 100 per cent of GDP.[79] Some commentators had no hesitation in declaring that the 'deterioration of the national budget had reached crisis proportions'. With increasing alarm, they could see Japan's national debt overtaking the country's GDP.[80]

3.60 Officials and the Prime Minister himself were worried that government debt would seriously undermine the long-term prospects of the Japanese economy. In January 1997, he designated the coming fiscal year: 'the first year of fiscal structural reform…the first year in which we take our first step toward rebuilding our fiscal

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75 Professor Craig Freedman, *Committee Hansard*, 15 April 1999, p. 342.

76 MITI, 'The Economic Stimulus Package of Japan', 15 April 1998.

77 Economic Outlook and Basic Stance on Economic Management for FY 1997, approved by the cabinet on December 19, 1996, http://www1.meshnet.or.jp/aep_home/English/outlook97.html (2 June 1999).

78 Queensland Government, submission no. 18, p. 7.

79 WTO Trade Policy Review of Japan, (1998), 20 November 1998.

80 Yasuo Kanzaki, 'Deregulation in Japan: Big Bang or Big whimper?', a talk delivered 7 March 1997: Katsuhiko Eguchi, Executive Vice President, PHP Research Institute Inc; Harano Joji, 'The Hashimoto Reform Program', *Japan Echo*, June 1997. See also, Nomura Research Institute, *Quarterly Economic Report*, vol. 27, no. 2, May 1997, p. 1.

system'. He announced the government's decision to raise the consumption tax, introduce local consumption tax and discontinue special tax cuts.[81]

3.61 On 18 March 1997, in explaining further his policy to contain the mounting fiscal deficit, the Prime Minister announced that the following five principles would underpin fiscal reform:

- The year 2003, rather than 2005, to stand as the interim target date for fiscal structural reform under which the deficit is not to exceed 3% of GDP.
- The three remaining years of the decade to be a period of concentrated reform—spending patterns in several categories to change without reserving any 'sacred cows' and specific quantitative targets for reduced spending to be set.
- General expenditure in the FY1998 budget to be set lower than the FY1997 budget.
- Significant reductions to be introduced for long term plans being pursued by the National Government.
- The burden borne by taxpayers, made up of taxes, social insurance premiums and the fiscal deficit, to be kept below 50% of the national income total.[82]

3.62 In outlining his budget for 1997/98, Prime Minister Hashimoto drew attention to the massive public debt that Japan had accumulated which amounted to 254 trillion yen outstanding in national bonds alone. At the very centre of his concern was the rapidly ageing population and the higher expenditure for social welfare programs it would demand. He stated, 'As our society ages and birth rates fall, our children and grandchildren will be saddled with a tremendous burden unless we take vigorous steps now to achieve fiscal structural reform'. He expressed an urgent concern for Japan's future noting in particular that:

> Every year the number of people eligible to receive pension benefits increases by almost one million. And as everyone is well aware, medical expenses are rapidly rising at the same time. If the system is not changed in some way, social security related expenditures will grow by close to one trillion yen annually. Under these circumstances, all obstacles must be overcome during FY1998 to ensure that we achieve a reduction in ordinary expenditures.[83]

81 Policy Speech by Prime Minister Ryutaro Hashimoto opening the 140th session of the Diet, 20 January 1997.

82 Press Conference by Prime Minister Ryutaro Hashimoto following the Passage of the FY 1997 Budget, 31 March 1997.

83 Press Conference by Prime Minister Ryutaro Hashimoto following the passage of the FY1997 budget, 31 March 1997.

Prime Minister Hashimoto expected resistance to change but declared his strong determination to see necessary reform implemented.[84]

3.63 In June 1997, he again highlighted the problem of ballooning debt and of his government's policy of fiscal contraction. He announced that at the end of FY1997, total long-term debt would reach 476 trillion yen, threatening to close in on the gross domestic product of 515 trillion yen. In citing these bald figures, he argued that, 'the deficit structure must be changed thoroughly through a comprehensive review of all expenditures without allowing for any sacred areas'.[85]

3.64 In attempting to balance the economic scales by protecting and consolidating public revenue, however, there was the danger that savings in public sector spending would widen the supply-demand gap. A tightening of the public purse would further weaken domestic demand, depress prices, erode tax revenues, and overall dampen economic activity. Nevertheless, the government for the time being remained committed to keeping a tight reign on the budget deficit.

3.65 The economy, however, was deteriorating at a rate that defeated the government's attempts to maintain positive growth. The government expected the economy to slow down in the first half of FY1997 due to factors such as the increased consumption tax, which was raised from 3 to 5 per cent, but anticipated that when coupled with structural reform measures including deregulation, the economy, led by private demand, would gradually recover.[86]

3.66 As expected, this fiscal policy did indeed register in the second quarter of 1997 with a fall in consumer spending. There was a slight recovery in the third quarter but, with the economic crisis deepening and spreading in Asia and consumer confidence at home fading fast, private consumption expenditure fell markedly, the economy spluttered, stalled and then began to slip backward. Japan's economy contracted at a seasonally adjusted rate of 0.4% in the December quarter.[87]

1997—The Japanese economy heads for recession

3.67 The Japanese people were alerted to the seriousness of the situation in November 1997. This most troubled month saw a number of well-known and established financial institutions fail in quick succession laying bare the precarious state of Japan's financial system. On 3 November, the Sanyo Securities Company,

84 Press Conference by Prime Minister Ryutaro Hashimoto following the passage of the FY1997 budget, 31 March 1997.

85 Press conference by Prime Minister Ryutaro Hashimoto on the Final Report of the Conference on Fiscal Structural Reform, 3 June 1997; Cabinet decision, 3 June 1997, http://www.kantei.go.jp/foreign/0624reform.html (27 May 1999).

86 Economic Outlook and Basic Stance on Economic Management for FY 1997, approved by the cabinet on December 19, 1996.

87 Australian Bureau of Agricultural and Resources Economics (ABARE), submission no. 21, p. 7. See also Nomura Research Institute, *Quarterly Economic Review,* vol 27, no. 3, August 1997, p. 1.

Ltd, after failing in its endeavours to rehabilitate its affiliate non-banks which had accumulated significant amounts of bad debts, reported that it would be suspending part of its business. On 17 November, the Hokkaido Takushoku Bank, Limited, one of the nation's largest banks, reported to the Ministry of Finance the difficulties it was having in continuing business on a normal basis and informed the Ministry of its intention to transfer its business to a transferee bank. A week later, Yamaichi Securities Co., a prestigious company that had once reigned at the top of Japan's securities industry, announced, after being declared bankrupt by the Tokyo District Court, that it would close its doors and surrender its securities business licence. Finally, two days later, on 26 November, the Tokuyo City Bank announced that in the face of serious liquidity problems it had agreed to transfer the bank's business to a transferee bank.[88]

3.68 The Hashimoto Cabinet feared that the collapse in the credibility of Japan's financial system might cause a panic with global repercussions.[89] On 26 November, the Minister of Finance and the Governor of the Bank of Japan issued a joint statement reaffirming their resolve 'to ensure the stability of interbank transactions as well as to fully protect deposits'. They stated:

> …we are determined to provide liquidity in a sufficient and decisive manner in order to prevent any delay in payments of deposits and other liabilities of financial institutions. We strongly request people not to be misguided by groundless rumors and to act sensibly.[90]

3.69 Alarmed by the failure of these firms and the serious erosion of confidence in the Japanese economy, the government announced in December 1997 and the following January measures to stabilise the financial system and to restore faith in the Japanese economy.[91]

Rescue package—December 1997

3.70 To rescue the financial system, the government set aside 30 trillion yen of public funds; 13 trillion was to recapitalise the debt ridden banking industry and 17 trillion to protect depositors, until 2001, in failing institutions. In February 1998,

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88 Statement by the Minister of Finance, 3 November 1997; Statement by Minister of Finance, tentative translation, 17 November 1997; Statement by the Government Concerning the Yamaichi Securities Co, 2 June 1999, Bank of Japan; http://www.boj.or.jp/en/press/danwa003.htm (24 January 2000); Statement by Minister of Finance on the Tokuyo City Bank, tentative translation, 26 November 1997. See also Taichi Sakaiya, Minister of State, Economic Planning Agency, Government of Japan, 'The Present and Future of the Japanese Economy', Speech at Yale University, Connecticut, May 2000, http://www.epa.go.jp/2000/b/0505-daijinkouen-e.html (5 July 2000). The term 'transferee bank' is taken from the official statement issued by the Minister of Finance.

89 Dr Tasuo Takao, submission no. 28, p. 6.

90 Joint Statement by the Minister of Finance and the Governor of the Bank of Japan, tentative translation, 26 November 1997, http://www.mof.go.jp/english/daijin/ele012.htm (30 March 1999).

91 Address by the Prime Minister Ryutaro Hashimoto on Measures to Stabilise the Financial System and Economic Management to the 142nd session of the National Diet.

the government enacted its 30 trillion financial stabilization package which finally secured a credible safety net for depositors.

3.71 Moreover, the government, all too aware of the importance to guarantee the soundness of financial institutions and similar agencies by promoting the speedy disposal of the non-performing assets, announced it would introduce the system of Prompt Corrective Action.[92] Under this system, banks would be required to conduct periodic self-assessment of capital, based on objective criteria and subject to external audit. When a bank's capital ratio fell below a certain benchmark, the newly established Financial Supervisory Agency would step in to put in place measures to minimise any further risks.[93] Mr Hashimoto stated that the government would introduce such action to ensure transparent and fair financial administration and to maintain the smooth supply of capital. It would also make 25 trillion yen available, including credit guarantees, by establishing new lending programs run by government financial institutions.[94]

Bad loans

3.72 By this time, people from both the public and private sectors, and from the media and academia, recognised that one of the major challenges confronting the country was the 'bad loan' problem.[95] One commentator likened the Japanese financial institutions to invalids in wheelchairs pushed by the authorities and kept alive by artificial life support—notably, 'the massive infusions of cash from the state sector…'.[96]

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92 Financial System Reform—Toward the early achievement of Reform, 13 June 1997, http://www.mof.go.jp/english/big-bang/ebb32.htm.

93 Curtis J. Milhaupt, 'Japan's Experience with Deposit Insurance and Failing Banks: Implications for Financial Regulatory Design?', Institute for Monetary and Economic Studies, Bank of Japan, *IMES Discussion Paper Series 99-E-8*, March 1999, pp. 23–4. The prompt corrective action regime came into effect in April 1998. The Financial Supervisory Agency (FSA), an independent agency which reports directly to the Prime Minister, took over the job of monitoring and supervising the country's banks from MoF's bank bureau at the end of June 1998. See also Robin Radin, 'The Evolution of Japan's Economic and Regulatory System: A Brief History', The National Investment Company Service Association, http://www.us-japan.org/JapanBoston/radin.htm (19 October 1999); Thomas F. Cargill, 'Briefing Paper', 15 December 1997, http://www.nmjc.org/JIAP/events/papers/carhdout.html (19 October 1999).

94 Address by the Prime Minister Ryutaro Hashimoto on Measures to Stabilise the Financial System and Economic Management to the 142nd session of the National Diet.

95 See Paul Blustein, *Washington Post*, 4 April 1998, p. AO1. Also Mr Jiro Ushio stressed that one of the most pressing issues was the need to deal with the bad debt that 'has hobbled financial revitalization', Jiro Ushio, Chairman's Address for the 1998 Annual Meeting, Keizai Doyukai, 22 April 1998; see evidence by Professor David Allen, *Committee Hansard*, 25 February 1999, p. 188.

96 Interview with Kenneth S. Courtis, 'Japan's Big Bang and the Asia Meltdown', NIRA Review, Spring, 1998). See also Brian Robins, 'Japan Shock Absorbers Lose Their Resilence', *Business Review Weekly*, 19 October 1998; Shigemitsu Sugisaki, 'The Outlook for Japan and its Global Implications', Address by Shigemitsu Sugisaki, Deputy Managing Director of the International Monetary Fund, the Kobe University/IMF Symposium, Kobe, Japan, 14 July 1998; David D. Hale, Global Chief Economist, Zurich Insurance Group, 'The Financial Crises in Japan and Asia: a Financial Insider's View', *JEI Report, no. 36A*, 25 September 1998, p. 3.

3.73 Moreover, there was a growing sense that the full extent of the debt problem was yet to be fully revealed. The IMF noted in October 1998:

> A distinctive aspect of the banking crisis in Japan has been that opaque accounting practices have masked the true size of problem loans for many years, and official statements regarding problem loans have lacked credibility in markets…The lack of transparency in even recognizing the scale of the problems in the banking sector has undermined confidence among businesses and the public at large, with deleterious effects on domestic demand…[97]

The message was clear—more radical steps needed to be taken; bad debts must be removed from balance sheets.

Public confidence collapse

3.74 The mood of uncertainty and distrust gathering around the bad debt situation served to erode further public trust in Japanese business and in Japan's economy as a whole.[98] Some analysts considered that the basic health of the economy rested on whether the government and the monetary authorities could 'revive the credit-creating mechanism—the engine of economic growth—by restoring confidence in the financial system'.[99] At the very core of this problem was the delay in finalising the bank recapitalisation scheme.

3.75 The government had clearly underestimated the damage that their austerity budget would inflict on the economy. The IMF concluded:

> In hindsight, the large-scale tightening of Japanese fiscal policy in 1996–97 was clearly excessively ambitious… At the time key policy decisions were made, Japan had experienced only about a year of solid recovery after four years of near stagnation. With that year of recovery boosted by substantial fiscal stimulus, there was reason to question whether economic expansion had yet been put on a strong, self-sustaining basis, capable of withstanding a large sudden withdrawal of fiscal support.[100]

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97 IMF, *World Economic Outlook*, October 1998, Chapter IV; Japan's Economic Crisis and Policy Options', IMF, 1998, p. 120. See also Tadashi Nakamae, 'Japan's Impending Financial Crisis will Expedite the Necessary Shift of Resources from the Old to the New Economy', Presentation for the OECD Business and Industry Policy Forum on Realising the Potential of the Service Economy: Facilitating Growth, Innovation and Competition, Paris, 28 September 1999. Joe Peek and Eric S. Rosengren, 'Determinants of the Japan Premium: Actions Speak Louder than Words', p. 13.

98 For example Mr Jiro Ushio, chairman of Keizai Doyukai noted, 'The most important issue currently confronting executives and the companies we run is the redemption of public trust'. Jiro Ushio, Chairman's Address for the 1998 Annual Meeting, Keizai Doyukai, 22 April 1998.

99 Nomura Research Institute, *Quarterly Economic Review*, vol. 27, no. 4, November 1997, p. 1.

100 *IMF World Economic Outlook*, October 1998, Chapter IV 'Japan's Economic Crisis and Policy Options', IMF, 1998, p. 116.

3.76 Mr Richard C. Koo drew the analogy: 'If you put a person who can hardly stand on their own feet on a diet, that could be fatal. And I'm afraid that's what the Japanese Government ended up doing…'[101] He argued that the expansionary fiscal policy had kept the economy going while Japanese banks, corporations and individuals were trying to correct their balance sheets. According to Mr Koo, 'As long as there's income flow, Japanese will pay back their loans'.[102] In summary the government's contractionary budget dampened aggregate demand and in effect crippled the economy.

3.77 Japan's respective annual growth rates had been 3.0% in JFY 1991 followed by 0.4% in 1992, 0.5% in 1993, 0.7% in 1994, 2.7% in 1995 and finally 3.4% in JFY 1996. The economy grew by only 0.9% in real terms in Calendar year 1997, the fourth lowest rate of growth recorded in Japan since 1956. The December 1997 quarter recorded—0.2% growth compared with the previous quarter, and a further contraction of 1.3% in the March quarter 1998 confirmed that Japan was in recession.[103]

Rescue package—April 1998

3.78 With no signs of improvement in economic activity in 1998, analysts began to talk of the economy slipping from recession into depression. Mr Douglas Ostrom, senior economist with the Japan Economic Institute, concluded:

> On the face of it, a long-term economic decline, coupled with a contractionary fiscal policy, weak export markets and bank failures leading to unusual difficulty in implementing monetary policy, make up a pretty potent and evil brew.[104]

3.79 The government accepted that Japan's economy was struggling to recover; that the series of failures of large financial institutions symbolised the parlous state of the country's economy. As Japan entered its second quarter of 1998, government officials, against the backdrop of huge government debt, were confronted with the large domestic supply-demand gap, weak consumer spending, a struggling financial system buckling under a substantial debt burden, low productivity growth, rising unemployment and a rapidly ageing population.[105]

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101 Richard C. Koo, 'Is Japan misunderstood?', Nomura Research Institute at the Economic Strategy Institute, 13 July 1998.

102 Richard C. Koo, 'Is Japan misunderstood?', Nomura Research Institute at the Economic Strategy Institute, 13 July 1998.

103 ABARE, submission no. 21, p. 2; NSW Government, submission no. 25, p. 5.

104 Douglas Ostrom, 'Limping Toward the Millennium: Japan's Economy in the Late 1990s', *JEI Report*, no. 14A, 10 April 1998, p. 6.

105 See New South Wales Government, submission 25, p. 5; and also Summary of Comprehensive Economic Measures, Economic Planning Agency, 24 April 1998; and Koji Omi, Speech, The Royal Institute of International Affairs, Chatham House, 29 April 1998, London, http://www.epa.go.jp/98/b/19980429b-daijin-e.html (7 June 1999).

3.80 To meet the growing economic crisis, the government put to one side its fiscal rectitude and once again resorted to a stimulation package to lift domestic demand.[106] On 9 April 1998, Prime Minister Hashimoto announced this new economic stimulus package worth around 16.7 trillion yen which included 10 trillion yen, or approx 2% of GDP, in actual fiscal spending by the central and local governments. At the time, this stimulus package was the largest in Japanese history.[107]

3.81 Overall, the package was designed to enhance industry development and to provide some funds for infrastructure development. It was built around three main pillars—fiscal policy to boost domestic demand in the short term; economic structural reform to encourage growth in the longer term; and measures to resolve the bad loan problem which was weighing down economic recovery.[108]

3.82 Of the 16 trillion yen, a total of around 7.7 trillion yen in projects was to be implemented by the central and local governments to expand domestic demand. It was to be allocated approximately as follows:

- 1.6 trillion yen in special projects for environment and new energy;
- 1 trillion yen in special projects for information and communications and science and technology;
- 1 trillion yen in special projects to improve social welfare, medical treatment and education;
- 800 billion yen in special projects for the efficient supply of diversified distribution services;
- 800 billion yen in emergent disaster prevention projects to protect national lands from disasters as well as people's lives and assets;
- 800 billion yen to special projects for inducing private investment through the redevelopment of downtown areas to maximise economic impact of public investment; and
- 200 billion yen in disaster reconstruction.

3.83 The central government requested local governments to increase their independent public works without financial support from the central government by 1.5 trillion yen to build up social infrastructure reflecting regional situations. [109]

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106 The Economic Intelligence Unit Ltd, *EIU Country Report*, 2nd Quarter, 1998, p. 19.

107 MITI, 'The Economic Stimulus Package of Japan', 15 April 1998. See also Queensland Government, submission no. 18, p. 6.

108 Speech by Minister Koji Omi at the Royal Institute of International Affairs, London, 29 April 1998, http://www.epa.go.jp/98/b/19980429b-daijin-e.html (7 June 1999).

109 Summary of Comprehensive Economic Measures, Economic Planning Agency, 24 April 1998.

3.84 The overall plan also included tax deductions amounting to over 4 trillion yen. On top of the 2 trillion yen reduction in individual income tax and individual inhabitants tax already in place, an additional 2 trillion tax reduction would be implemented within the calendar year while the 2 trillion temporary tax reduction would continue into the next year.[110] The government hoped that the income tax reduction would raise consumption through increased disposable income, lift private demand and give the economy a necessary fillip.[111] Structural reform of the tax system was also envisaged. [112]

3.85 Even though the fiscal deficit of the central and local governments stood at 4.7% of GDP, and accumulated government debt had climbed to 103% of GDP in fiscal year 1998, the government decided that, while relaxing its policy, it would maintain its basic stance toward fiscal consolidation. It acknowledged that the necessity for fiscal structural reform had not changed and that fiscal restraint was critical for Japan's future with its ageing population. The Prime Minister, believed, however, that in light of the severe economic situation the government should 'urgently examine what measures should be taken as an emergency approach, while maintaining the basic structure of the fiscal structural reform'.[113] The government announced that the Fiscal Structural Reform Act would be amended in order to provide flexibility so that it would be able to expand temporarily the fiscal deficit. In addition, the target year for reducing the fiscal deficit to 3% of GDP would be delayed from the year 2003 to 2005.[114]

3.86 Fiscal policy was only one prong of a multi-pronged approach to tackling the country's economic troubles. The government remained committed to implementing structural reform, with a special emphasis on the deregulation process to boost economic activity. In the financial sector, the long awaited 'Big Bang' program came into force as scheduled from April 1998.[115]

3.87 Some authorities expressed confidence that the measures in the April package would see the official projection of 1.9% real growth in fiscal year 1998 fully realised.[116] Others, not so confident, suggested that the scale of tax cuts would not be

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110 Statement by Prime Minister Hashimoto at the Press Conference on the Occasion of the Approval of the FY 1998 Budget, 9 April 1998, http://www.kantei.go.jp/foreign/980424fypress.html (10 October 1999); MITI, 'The Economic Stimulus Package of Japan, 15 April 1998.

111 Koji Omi, Speech, The Royal Institute of International Affairs, Chatham House, 29 April 1998, London, http://www.epa.go.jp/98/b/19980429b-daijin-e.html.

112 MITI, 'The Economic Stimulus Package of Japan', 15 April 1998.

113 Statement by Prime Minister Hashimoto at the Press Conference on the Occasion of the Approval of the FY 1998 Budget, 9 April 1998, http://www.kantei.go.jp/foreign/980424fypress.html (10 October 1999).

114 Speech by Minister Koji Omi at the Royal Institute of International Affairs, London, 29 April 1998, http://www.epa.go.jp/98/b/19980429b-daijin-e.html (7 June 1999) and MITI, 'The Economic Stimulus Package of Japan, 15 April 1998.

115 MITI, 'The Economic Stimulus Package of Japan', 15 April 1998.

116 Koji Omi, Speech, The Royal Institute of International Affairs, Chatham House, 29 April 1998, London, http://www.epa.go.jp/98/b/19980429b-daijin-e.html (7 June 1999).

enough to ‘bring shoppers back into the streets’ and generally ‘there remains a strong chance that this latest stimulus package will be insufficient and that more public money will be necessary’.[117] On the other hand, Minister Koji Omi stated:

> In the long run, such fiscal stimulus effects combined with positive impacts of the other structural measures in the package will surely contribute to economic recovery. This will lead to fully developing the potential of the private sector, expanding domestic demand, and putting the Japanese economy back on a sustainable growth path.[118]

3.88 In June 1998, the government put in place legislation intended to reform the financial system. Under this legislation individual components of the reform would be introduced rapidly and successively toward 2001, including ‘the introduction of new securities investment trust schemes, the replacement of the licensing system with a registration system for securities companies, full liberalization of brokerage commissions, the promotion of cross-sectorial entry in the financial fields, strengthening the function of the OTC markets, and enhancement of fair trading rules’.[119]

3.89 But the economy failed to respond—the pump-priming measures did not inspire market sentiment; the bad debts remained a nasty blot on the nation’s balance sheets and consumer confidence, already depressed, waned further. The Japanese economy continued to languish and unemployment which had risen from an average of 2.5% in the 80s to 3.1% in 1995 and, while still low by world standards, climbed to 4.1% in August 1998.[120]

3.90 According to one journalist, ‘the government has followed the pattern of its predecessors by announcing one package after another of public works projects, but these have proved insufficient at lifting the economy out of the doldrums, and promises of new packages are starting to ring hollow to jaded investors’.[121]

3.91 Criticism was being levelled at the government for doing ‘too little, too late’. The structural reform programs instituted by the government were making slow progress and events seemed to derail attempts by government to haul the economy back on track. For many Japanese, the attempts to reform had ‘generated considerable impatience both in Japan and abroad in the course of repeated cycles of anticipation, disappointment, and revisions accompanied by continued stagnation’. The call became louder and more persistent for government to make an unequivocal commitment to

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117 The Economic Intelligence Unit Ltd, *EIU Country Report,* 2nd Quarter, 1998, p. 20.

118 Koji Omi, Speech, The Royal Institute of International Affairs, Chatham House, 29 April 1998, London, http://www.epa.go.jp/98/b/19980429b-daijin-e.html (7 June 1999).

119 The Minister of Finance, statement on bills concerning financial system reform, 5 June 1998.

120 ‘The Challenge of Structural Reform and Pursuing Dynamism in Society and Economy’, Joint Report by the Social and Economic Outlook Committee and the Economic Entity Role Committee, June 1998, http://www.epa.go.jp/98/e/19980622e-keishingoudou-all-e.html.

121 Paul Blustein, *Washington Post,* 4 April 1998, p. AO1.

reform and to put in place definite, concrete and effective measures to deal with the bad debt problem.[122]

3.92 Unfortunately for Prime Minister Hashimoto, his reform agenda, while forward looking, did come too late. By the beginning of 1998, the outlook for the Japanese economy was bleak. The failure of successive LDP governments to undertake substantial structural reform had resulted in weak economic growth. In addition, the policy of fiscal restraint was ill-conceived. At a time of feeble economic growth, compounded by the effects of the Asian economic crisis, expansionary rather than contractionary measures seemed in order.

3.93 On 18 June, at the closing of the parliamentary session, the Prime Minister conceded that there was an 'excessive loss of self-confidence in Japan'. He acknowledged that his country faced a very severe situation 'marked by a weakening yen, sluggish stock prices and rising unemployment'. Nonetheless, he believed that 'the prompt and steady implementation of the annual and supplementary budgets, combined with the implementation of measures to resolve the issue of non-performing loans' would enable Japan to 'tap its potential strengths fully and restore vigorous economic growth pulled by the people and private enterprise'.[123]

3.94 But the apprehensions of the Japanese people could not be assuaged. Rumours about banks and banks' stocks being sold excessively prompted the Minister of Finance, on 19 June, to restate his commitment to ensure the stability of interbank transactions and to fully protect deposits. He drew attention to the new Financial Supervisory Agency, which was to come into operation within days and the two Financial Stabilization Acts which were to strengthen Japan's legislative framework in support of the government's commitment to stabilise the financial system.[124]

3.95 The people, however, remained unconvinced. Despite the new stimulus package, the implementation of reform measures and the attempts to stabilise the financial system, public confidence in the Japanese economy, especially the financial system, remained weak.

1998—The Obuchi Cabinet for 'Economic Revival'

3.96 The Japanese people registered their disapproval of, and frustration with, a government seemingly unable to revive their failing economy and to restore their faith in the future. On 13 July, following the humiliating defeat of the LDP in the upper house elections, Prime Minister Hashimoto, accepted responsibility for the party's poor showing in the polls and stood down.[125] Mr Keizo Obuchi became Prime

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122 Jiro Ushio, Chairman's Address for the 1998 Annual Meeting, Keizai Doyukai, 22 April 1998.

123 Transcript of Press Conference by Prime Minister Ryutaro Hashimoto at the closing of the 142nd Session of the Diet, 18 June 1998, http://www.kantei.go.jp/foreign/980709press142.html (19 October 1999).

124 Statement by the Minister of Finance, tentative translation, 19 June 1998.

125 Statement by Japanese Prime Minister Hashimoto, 13 July 1998 in Reference Documents as compiled in the *Foreign Policy Bulletin*, 2 July 1998 to 19 August 1998; Policy Speech by Prime Minister Keizo

Minister and on 30 July 1998 his administration was inaugurated. With great promise, he designated his cabinet the ‘Cabinet for Economic Revival’.[126]

3.97 On assuming office, the new administration acknowledged that it must completely sweep away the systemic risks that had plagued Japan’s financial institutions over the past six years.[127] Prime Minister Obuchi’s immediate objective was to rebuild the financial system and restore confidence in the economy. He signalled the end to the government’s policy of fiscal restraint and in noting the serious state of the economy announced his decision to suspend the Fiscal Structural Reform Act.

3.98 Under Mr Obuchi, the government’s highest priority was to address the non-performing loan problem.[128] On 7 August 1998, he announced that he would implement the ‘Comprehensive Plan for Financial Revitalisation’ which would use public funds to rescue the financial system. The implementation of this plan was expected to:

> …revitalise and stabilise the financial system, enable the financial system to restore its original function to provide necessary credit to economic activities, and restore international credibility.[129]

3.99 The government was particularly anxious to introduce the ‘bridge or receiver bank’ scheme. This scheme would ensure that the business of failed banks would be promptly administered. New public banks would be established as bridge banks to ‘maintain loans to sound borrowers in good faith even if no private receiver bank appears’.[130]

Obuchi to the 143rd Session of the Diet, http://www.infojapan.org/announce/announce/1998/8/807-0.html (2 June 1999).

126 Policy Speech by Prime Minister Keizo Obuchi to the 143rd Session of the Diet, 7 August 1998 http://www.infojapan.org/announce/1998/8/807-0.html (2 June 1999).

127 Speech by Minister Taichi Sakaiya, Sorbonne University, Paris, 7 January 1999.

128 Taichi Sakaiya, Minister of State, Director-General, Economic Planning Agency, Government of Japan, ‘The Present and Future of the Japanese Economy’, Singapore, 1 September 1999, http://www.epa.go.jp/99/b19990903b-daijinkouen-e.html (1 October 1999); Policy Speech by Prime Minister Keizo Obuchi to the 143rd Session of the Diet, 7 August 1998, http://www.infojapan.org/announce/1998/8/807-0.html (2 June 1999); Curtis J. Milhaupt, ‘Japan’s Experience with Deposit Insurance and Failing Banks: Implications for Financial Regulatory Design?’, Institute for Monetary and Economic Studies, Bank of Japan, *IMES Discussion Paper Series 99-E-8*, March 1999, pp. 23–4.

129 Comprehensive Plan for Financial Revitalization (1st Version), 23 June 1998, Government-Ruling Party Conference to Promote the Comprehensive Plan for Financial Revitalization, http://202.32.34.2/foreign/980707fina-rev1.html (19 October 1999); Policy Speech by Prime Minister Keizo Obuchi to the 143rd Session of the Diet, 7 August 1998, http://www.infojapan.org/announce/1998/8/807-0.html (2 June 1999).

130 Comprehensive Plan for Financial Revitalization (Second Report), 2 July 1998, http://www.kantei.go.jp/foreign/980707fina-rev2.html (19 October 1999).

3.100 Many officials now publicly acknowledged the magnitude and the urgency of the problems, particularly the troubled banking sector, confronting the Obuchi administration. The Economic Strategy Council of Japan submitted in the plainest language:

> The Japanese economy has been in a most severe situation. It could be thought that the economy now faces the entrance of a vicious circle in which the worsening of the real economy, represented by a large decline in private demand, leads to the malfunctioning of the financial system, which then feeds back to the real economy adversely. The projection of economic growth rate for this fiscal year is forced to be revised down to almost minus 2 percent over the previous year. It would be difficult to exclude the possibility of negative growth, to a significant extent, in fiscal year 1999.[131]

3.101 On 16 October 1998, the Diet passed legislation to tackle the current financial situation—this was not a reform initiative but a bail-out package to recapitalise Japan's 'rotting banking system' and to safeguard depositors.[132] It did nonetheless 'significantly redesign the governance of bank failure in Japan'.[133] In addition to the 17 trillion yen set aside to protect depositors, an 18 trillion yen fund was established to deal with failed financial institutions. A further 25 trillion yen was made available to facilitate the disposal of bad loans.[134]

3.102 Overall, this package to revitalise the financial system amounted to around 60 trillion yen or 12% of GDP.[135] Under this scheme weak institutions were to be weeded-out but public funds would be used to help struggling but economically viable institutions survive and develop.[136] A formally independent Financial Revitalization Commission was to administer the system. It would identify insolvent banks and determine what appropriate action should be taken. Insolvent banks would either be operated by a public administrator as a bridge bank or be temporarily nationalised by placement under special public management.[137]

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131 The Economic Strategy Council of Japan, 'Recommendations for Short-Term Policies', 14 October 1998, http://www.kantei.go.jp/foreign/981016recommend.html (11 March 1999).

132 See Grant's Online, 'Japan to pass ¥60 trillion bank bailout legislation tonight', 15 October 1999, http://www.grantspub.com/dispatch/0003.html (15 October 1999).

133 Curtis J. Milhaupt, 'Japan's Experience with Deposit Insurance and Failing Banks: Implications for Financial Regulatory Design?', Institute for Monetary and Economic Studies, Bank of Japan, *IMES Discussion Paper Series 99-E-8*, March 1999, p. 25.

134 Monthly Economic Review, the *Suzuki Journal*, November 1998.

135 OECD, *OECD Economic Outlook*, no. 64, December 1998, http://www.OECD.org//eco/out/eo64.htm (20 May 1999).

136 Taichi Sakaiya, 'The Present and Future of the Japanese Economy', Singapore, 1 September 1999, http://www.epa.go.jp/99/b/19990903b-daijinkouen-e.html (1 October 1999).

137 Curtis J. Milhaupt, 'Japan's Experience with Deposit Insurance and Failing Banks: Implications for Financial Regulatory Design?', Institute for Monetary and Economic Studies, Bank of Japan, *IMES Discussion Paper Series 99-E-8*, March 1999, p. 26.

3.103 Although the primary concern was to redress the problem without further endangering the economy, the issue of the use of public funds to prop up large ailing banks sparked debate. Some critics feared that the infusion of public funds would merely keep failing banks on life support for another 12 months or so.[138] Mr Taichi Sakaiya, Director General of the Economic Planning Agency, defended the policy to prevent major bank failures:

> It is clear that Japan's financial system suffers from a grave malady requiring swift surgery. But if that surgery involves the removal of too large an amount of tissue, the patient may die despite the excision of the diseased area. Some say that all the affected tissue must be cut out, no matter how much pain results from the operation. But unless we save the patient—the Japanese economy—we will have accomplished nothing.[139]

3.104 He explained that if one bank folds, even the healthy businesses that have relied on it for loans will have difficulties in finding new sources of credit which might lead to such borrowers experiencing problems that could further result in job losses not only for that particular company but for suppliers and subcontractors. The damaging effects would continue to reverberate through the economy.[140]

3.105 As Japan entered the final quarter for 1998, the urgency associated with reviving the ailing economy had not abated. The IMF in October 1998 reported that 'If the economy fails to respond as expected to programmed fiscal stimulus during the second half of 1998, the authorities should be prepared to take appropriate further action'. It stressed that the critical need at this stage was for Japan to reignite the process of economic recovery.[141]

Emergency economic package—November 1998

3.106 Acknowledging that the economy was in deep trouble, the Obuchi Government announced, in November 1998, an emergency economic package. This fiscal stimulus package of almost 17 trillion yen equivalent to around 3.0% of Japan's GDP was to help stabilise the financial system, counter the credit contraction and build confidence in the economy. With the inclusion of a permanent reduction in personal income taxation amounting to 4 trillion yen, the total scale of the package would exceed 20 trillion yen.[142]

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138 See Peter Landers, 'Moment of Truth', *Far Eastern Economic Review*, 18 February 1999, http://203.105.48.72/9902_18/p48finance.html (18 November 1999).

139 Sakaiya Taichi, 'Japan is Changing', *Japan Echo*, vol. 25, no. 6, December 1998, pp. 35–6.

140 Sakaiya Taichi, 'Japan is Changing', *Japan Echo*, vol. 25, no. 6, December 1998, p. 36.

141 IMF, *World Economic Outlook*, October 1998, Chapter IV, 'Japan's Economic Crisis and Policy Options', IMF, 1998, p. 117.

142 Ministry of Finance, Gist of the Emergency Economic Measures, http://www.mof.jp/english/eem/eco001.htm (25 May 1999) (page 2 of 3)

3.107 These emergency measures looked to restore public confidence in the economy and financial system by allocating the 17 trillion yen in the following way:

- 5.9 trillion yen to counteract the credit contraction by expanding the credit guarantee services of organisations and the lending facilities of government financial institutions;
- 8.1 trillion yen to social infrastructure in areas such as telecommunications and science and technology, the environment, social welfare, health and medical care and education;
- 1.2 trillion yen was to go toward the Housing Loan Corporation;
- 1.0 trillion toward the Comprehensive Plan to Create and Stabilise Employment, involving measures promoting the re-employment and expansion of occupational training; and
- 0.7 trillion for Regional Promotion Coupons to be distributed to families and recipients of old-age welfare pensions.[143]

3.108 The growing preoccupation with the more immediate economic problems did not overshadow the need for structural reform. Although the focus on fiscal policy led some to worry that it might be neglected.[144]

3.109 The government recognised that the Emergency Economic Package was a short-term urgent response. At the same time, it accepted that to secure medium and long-term growth, Japan needed to accelerate structural reform. The administration began to urge companies to cut back on white-collar over-employment, to streamline their supply structure in line with market needs and improve profitability. Minister Kaoru Yosano stated:

> Despite the financial crisis, the financial Big Bang is moving steadily ahead according to the original schedule, and substantial progress has already been made, including abolition of the Large Stores Law, elimination of telecommunications charges permission, and elimination of supply and demand adjustment under the Petroleum Industry Law. However, Japan will need to continue to push deregulation forward strongly in a wide range of areas, including distribution, transportation, energy, medical care and communications, developing an environment conducive to cultivating the buds of new industries.[145]

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143 Outline of Emergency Economic Package, provisional translation by EPA, 1998; 'Gist of the Emergency Economic Measures', Ministry of Finance.

144 For example Keidanren stepped up its public campaign for reform insisting that structural reform of the economy and society was essential, and ridding the nation of the barriers of regulation particularly important. Keidanren, 'For the promotion of deregulation aimed at economic revival and the establishment of a transparent system of governmental management', *Basic Thinking,* 20 October 1998.

145 Kaoru Yosano, 'Japan's Challenge Toward the 21st Century', Speech at the Foreign Correspondents' Club of Japan, 18 December 1998.

3.110 As 1998 drew to a close, the Japanese Government was aware of the job ahead in lifting the economy from its debilitating slump and, despite the economic gloom, it boldly set three specific goals for the coming 1999 fiscal year:

- To achieve positive economic growth in fiscal 1999. The Japanese economy registered a negative growth rate of 0.4% during fiscal 1997 and current projects indicated that the economy would again contract by about 2.2% in fiscal 1998.
- To stop the upward trend in unemployment—4.4% in November 1998. The Prime Minister conceded that unemployment may temporarily rise even further as a result of economic fluctuations. Nonetheless, he stated that they were committing themselves to the position that Japan would not allow the unemployment rate for the entire fiscal 99 year to rise above the 4.4%.
- To promote greater international harmonization. The Prime Minister stated that Japan was committed to avoiding the intensification of trade and economic frictions and to revitalise the Asian economy.[146]

3.111 Most economists agreed that Japan faced a daunting task in 1999 and predicted that it would mark the third year of negative growth.[147] The inability of officials to resolve the bad debt problem and the growing pessimism in both the household and corporate sectors about the ability of Japan to meet the challenges of a changing world sapped consumer confidence. The banking crisis went to the heart of Japan's economic troubles and a prompt resolution of this problem was seen as a prerequisite to establishing a durable economic recovery.[148] The OECD called for the immediate implementation of plans to restructure the banking system.[149]

3.112 The budget proposal for FY1999, drafted with a priority on promoting economic recovery, was submitted to the Diet on 19 January 1999 and passed on 17 March, the most rapid approval in the postwar period.[150] This budget continued the efforts of government to stimulate growth in the economy. Again, the emphasis was on public works expenditure, programs to generate employment, initiatives to support

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146 Speech by Minister Taichi Sakaiya, Sorbonne University, Paris, 7 January 1999.

147 The Japan Research Institute, Ltd, Economics Department, 'Prospects for the Japanese Economy, January 1999. See also The Economic Strategy Council, 'Strategies for Reviving the Japanese Economy' (Interim Report).

148 See statement by Michel Camdessus, Managing Director of the International Monetary Fund, Asia-Europe Finance Ministers Meeting, Frankfurt, Germany, 16 January 1999. Many other commentators reinforce this view that Japan must give top priority to cleaning up the bank mess. See Richard Katz, 'Economic Anorexia: Japan's Real Demand Problem', *Challenge*, March–April 1999, p. 92.

149 OECD, *OECD Economic Outlook*, No. 64, December 1998, http://www.OECD.org/eco/out/ec64.htm (16 March 1999).

150 Steady Approach for Economic Recovery, June 1999, http://www.mof.go.jp/english/economic1.htm (18 August 1999).

small and medium-sized enterprises (SMEs) and funding to encourage science and technology.[151]

3.113 Also during the first quarter of 1999, three tax reform bills were passed. This legislation lowered the highest marginal tax rate for individual income taxation from 65% to 50%; and reduced the standard rate of national corporation tax from 34.5% to 30%.[152]

1999—Hint of recovery

3.114 By mid 1999, the Japanese economy showed signs of recovery. Real GDP grew an impressive 1.9% in January-March quarter showing positive growth for the first time in 6 quarters since the third quarter in 1997.[153] Economists welcomed this result as a hopeful departure 'from the persistent shrinkage of the recent past'.[154] The Bank of Japan reported that the economy 'had stopped deteriorating and corporate sentiment had improved'. It pointed out, however, that there was as yet no evidence of a 'self-sustained recovery in private demand.'[155] Unemployment figures reached the worst-ever level of 4.8% in April 1999 with wages still trending downward and personal consumption remaining weak.[156] The government again emphasised the urgent need to restore confidence in the financial system.

3.115 As the year progressed, signs that the Japanese economy was no longer receding strengthened and anticipation for an economic recovery grew more hopeful. Nonetheless, fundamental problems needed to be addressed.[157] One analyst warned:

> Despite the spread of rosy expectations on economic recovery at the moment, it is necessary to maintain a cautious stance on the outlook of the economy.[158]

3.116 In support of this assessment, Mr Takashi Imai, Chairman of Keidanren, also noted that business executives could see the Japanese economy heading toward recovery but that economic growth to date was not self-sustained because corporate

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151 Steady Approach for Economic Recovery, June 1999, http://www.mof.go.jp/english/economic1.htm (18 August 1999).

152 ibid.

153 Akio Makabe, Dai-ichi Kangyo Research Institute, *DKR Economic Report*, vol. 2, no. 7, 15 July 1999.

154 Mitsubishi Research Institute, *Outlook for the Japanese Economy in 1999 and 2000*, June 1999, http://www.mri.co.jp/news/press/99_0701_1e.html (26 August 1999).

155 The Bank of Japan, *Monthly Report of Recent Economic and Financial Developments*, July 1999.

156 Akio Makabe, Dai-ichi Kangyo Research Institute, *DKR Economic Report*, vol. 2, no. 7, 15 July 1999.

157 Taichi Sakaiya, 'The Present and Future of the Japanese Economy', Singapore, 1 September 1999.

158 Akio Makabe, General Manager, Financial Market Research Department, Dai-Ichi Kangyo Research Institute, Tokyo Report: 'Will the Sun Rise in the Land of the Rising Yen? In *Economic Report*, vol. 2, no. 9, 15 September 1999, p. 2.

capital was still weak. He suggested that further fiscal and financial stimuli were needed.[159]

3.117 The government was well aware that a pick up in private demand was critical to recovery. In October 1999, the Economic Planing Agency foreshadowed further government moves to lift private demand:

> The Government will promptly decide on a comprehensive economic policy package, which will be a guideline for future economic management, and on the second supplementary FY 1999 budget. This is because the Government wishes to realise a smooth baton pass, toward a full-scale recovery, from public to private demand, while wiping out concerns that future weakening in public demand, among other things, may bring about an economic slowdown, and to establish a new solid foundation for economic development.[160]

3.118 The government, however, adopted a 'wait and see' approach before deciding on whether to introduce another stimulus package. On 11 November 1999, as widely anticipated, it announced yet another economic rejuvenation package, worth between 17 and 18 trillion yen—'the Economic Rebirth Package'. In introducing this new package as 'highly attractive, brimming with originality, hope and appeal', the government, nonetheless, acknowledged that private-sector demand remained weak despite the efforts of various policies. The aim of the package was to generate new demand to facilitate the smooth transition from public-sector-led growth to private-sector-led growth and to solidify the direction of Japan's socio-economic structural reform.[161]

3.119 The plan targeted SMEs and venture firms for special support to encourage their growth and development. The package was also designed to promote technological innovation and to accelerate the deregulation process by frontloading the schedule of the Three-Year Program for Promoting Deregulation. Measures to address the unemployment problem and the ageing population were also included.

3.120 Despite being hailed as innovative and bold, the package contained many recycled proposals and the overarching goals remained those as stated many times previously. Opinion remains divided as to whether this package would provide the

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159 Chairman Imai's Press Conference, 4 October 1999, http://www.keidanren.or.jp/english/speech/press/1999/1004.html (20 October 1999).

160 Economic Planning Agency of Japan, Monthly Economic Report (October 1999), http://www.epa.go.jp/geturei/1999oct.html (20 October 1999).

161 Policy speech by Prime Minister Keizo Obuchi to the 146th Session of the Diet, 29 October 1999, http://www.kantei.go.jp/foreign/souri/991029policy.html (15 November 1999); Economic Planning Agency, 'Principles of the Policy Measures for Economic Rebirth', explanatory statement by Minister Taichi Sakaiya, provisional translation, 11 November 1999, http://www.epa.go/jp/99/b/19991111b-taisaku-el.html (15 November 1999); 'Outline of the Policy Measures for Economic Rebirth' (summary), 11 November 1999, http://www.epa.go.jp/99/b/19991111b-taisaku-e2.html (15 November 1999).

necessary impetus to invigorate an economy beginning to stir from its economic torpor.[162]

3.121 In March 2000, the Bank of Japan was still insisting that there were no clear signs of a self-sustained recovery in private demand. This assessment was supported by figures showing a dismal performance for the October-December 1999 quarter in which the economy shrank 1.4%. This decline meant that Japan recorded negative growth for the second consecutive period slipping back into recession. Some analysts interpret this slump as a temporary phenomenon: others, as a continuing pattern of very low or negative economic growth.

3.122 Most recent projections are becoming more positive about Japan's recovery and have observed some lift in private demand. They have real GDP growing at 0.7–0.8% in 2000 and by 1.4% in 2001.[163] Even if this new 'rebirth' package together with the restructuring process succeeds in placing the Japanese economy on the road to recovery, serious economic problems remain to be tackled such as the enormous public debt and the continuing restructuring of the economy.[164]

3.123 The OECD with a note of optimism predicted that once the nascent recovery takes a firmer hold 'an early start should be made to addressing the rapidly increasing medium-term public debt problem, the more so as demographic trends will put further pressures on Japan's fiscal position over the longer term'.[165] But great care should be taken to ensure that public expenditure provides some insurance against any weakening in private spending, and that the restructuring process stays on course and does not cause any serious erosion of consumer confidence. Even those who interpret the recent signs of recovery in the most encouraging light accept that the road ahead for Japan will not be an easy one.[166] Indeed, the Japanese economy must pass through a long and difficult rehabilitation period before it regains robust health.

3.124 At the beginning of April 2000, Prime Minister Obuchi became gravely ill and on 5 April Mr Yoshiro Mori took office as Prime Minister. He named his new administration the 'Cabinet for the Rebirth of Japan' and confirmed that he will continue to carry forward the domestic and international policies of the former Prime

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162 *Australian Financial Review*, 12 November, 1999.

163 The Economist Intelligence Unit, *Country Report, Japan*, 1st quarter 2000, p. 3.

164 *NRI Quarterly Economic Outlook,* 17 March 2000, p. 25; *DKR Economic Report*, vol. 3, no. 5, 15 May 2000; *Monthly Report of Recent Economic and Financial Developments, (May 2000)* http://www.boj.or.jp/en/siryo/siryo/gp0005.htm (9 June 2000). The EIU put gross national debt at well over 100% and stated that Japan now has the worst public figures in the industrialised world; The Economist Intelligence Unit, *Country Repor*t, Japan, 1st quarter 2000, p. 20.

165 *OECD Economic Outlook* no. 66, preliminary version, November 1999, http://OECD.org/eco/out/Eo.html (19 November 1999).

166 See Kaoru Yosano, 'Japan's Challenge Toward the 21st Century', Speech at the Foreign Correspondents' Club of Japan, 18 December 1998.

Minister.[167] He held his position as Japan's Prime Minister after elections for the Lower House on 25 June 2000.

3.125 Despite the doubts and uncertainty about Japan's future, there persists a deep seated belief within Japan that the country will eventually emerge from their economic troubles. It will, however, be a new Japan.

> 'The Japan of tomorrow' that has recovered from the present recession will not be a restoration of the Japan of days past. We shall witness the birth of an entirely new and spirited Japan that will continue to enjoy prosperity in the 21st century.[168]

167 See Policy Speech by Prime Minister Yoshiro Mori to the 147th Session of the Diet, 7 April 2000, http://www.kantei.go.jp/foreign/souri/mori/2000/0407policy.html (9 June 2000); Taichi Sakaiya, Minister of State Economic Planning Agency, 'The Present and Future of the Japanese Economy', Speech at Yale University, May 2000, http://www.epa.jp/2000/b/0505b-daijinkouen-e.html (5 July 2000).

168 Taichi Sakaiya, 'The Present and Future of the Japanese Economy', Singapore, 1 September 1999.