JAPAN: IS THE CRISIS OVER?

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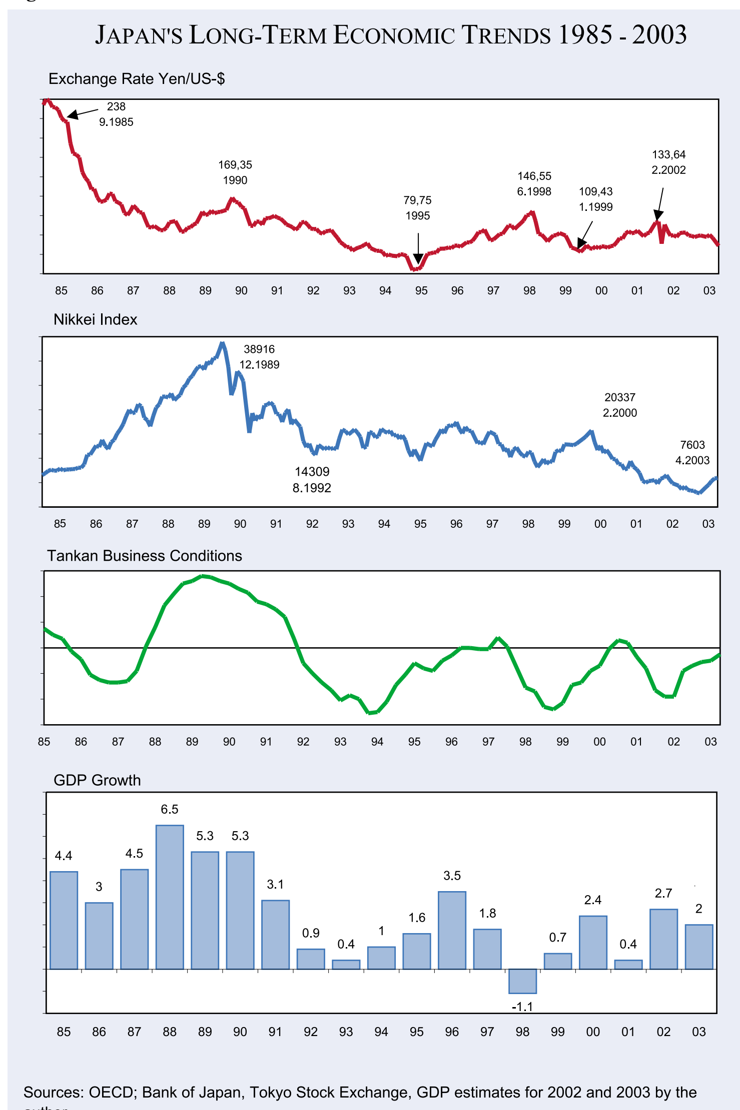
For Japan, the decade following the burst of the asset-price bubble in the early 1990s has been a virtual economic disaster. Japan, which was until the late 1980s the fastest growing economy in the OECD area, has become the slowest one with a meagre average growth rate of just 1.1 percent from 1992 to 2002. Apparently, the collapse of the stock-market and land-price bubbles marked a deep and decisive point in Japan's post-war history (see Figures 1 and 2). During the following post-bubble phase, no sustaining economic boom could be achieved despite a great number of lavish fiscal spending packages and extensive monetary easing. To the contrary: Economic policy could not prevent the ascent of deflation – the first time ever since the 1930s that this monetary phenomenon has returned to an industrial country. Furthermore, in spite of regulatory changes and heavy capital infusions, the Japanese banking crisis could not be finally solved and the amount of non-performing loans held by Japan's banks kept rising. A great many of other structural problems such as poor corporate governance, excess regulation, rigidities in the political system and the lacklustre performance of a great range of protected industries were responsible for the economic stagnation and the nearly absent productivity growth in the 1990s. Last but not least, as a consequence of high and rising fiscal deficits, Japan has accrued a gross fiscal debt of probably 150 percent of GDP at the end of 2003. If debt accumulation cannot be stopped, a major fiscal crisis is looming.

Figure 1



Sources: OECD; Bank of Japan, Tokyo Stock Exchange, GDP estimates for 2002 and 2003 by the author.

Economic stagnation in the 1990s, but recent recovery

However, since mid-2002 there have been visible signs indicating a turnaround of at least the macroeconomic situation. Real GDP showed positive (seasonally adjusted) growth for seven quarters in a row. The latest data for the third quarter of 2003 showed that Japan grew

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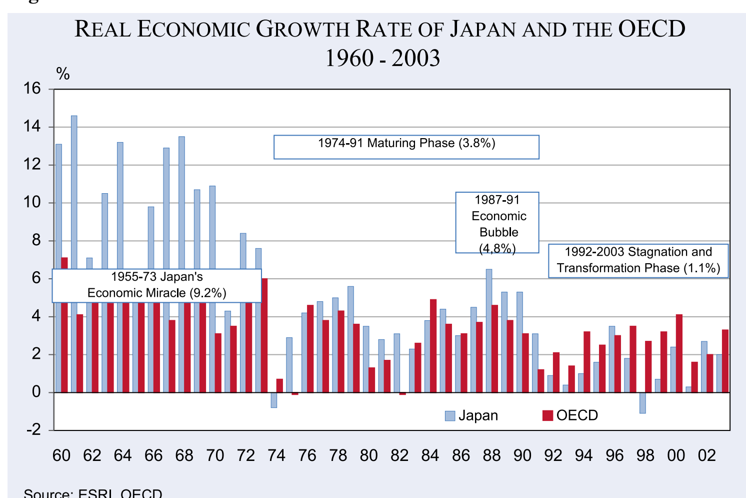
Figure 2



by a real 0.6 percent quarter on quarter and by 2.2 percent on an annualised basis. Japan's economic revival is strongly supported by economic indicators: According to the Bank of Japan's Tankan survey, business sentiment and the business outlook are improving, especially among the large manufacturing firms. Investment confidence and consumer confidence are also getting better. Production, inventory, capital utilisation, corporate profits and capital investment are all rising. Only private consumption has not gained momentum yet. Reflecting the substantial improvement in the macroeconomic situation and in business sentiment, stock prices have recovered sharply.

Demand and supply-side problems coincided

However, Japan had already experienced two short cyclical upturns during the 1990s. They had been driven by fiscal spending and export demand, but faded away quickly under the assault of macroeconomic shocks and structural problems. To be sure, the current upturn seems to be broader. It is increasingly being driven by private domestic demand, especially by capital investment. According to the official diffusion index, the recovery spread throughout 80 percent of all industrial sectors within the latest reported 6-month span. Nevertheless, the crucial question remains: Will the current recovery be sustained and become a longer lasting boom or will it fizzle out in the same way as the short recoveries of 1996 to 97 and 2000? To reach a well-founded answer to this question, at first a short overview of the causes and the more relevant consequences of Japan's long-lasting economic slump will be needed. This will be followed by an examination of the mainsprings of the current recovery, and finally the question itself can be addressed.

What went wrong? Demand shocks, structural problems, fiscal deficits

There are two distinct views on the causes of Japan's economic stagnation. One side blames a sequence of unfavourable macroeconomic shocks and the persistence of insufficient aggregate demand. The other side stresses structural or institutional impediments which both affect productivity growth and aggregate demand. The debate goes far beyond mere academic reasoning and has real implications for Japan's economic policy making. According to the first "demand-oriented" strand of thinking, a more appropriate fiscal or monetary policy, in particular a more powerful stimulus, is needed to lead to economic revival. The opposing "supply-oriented" group, however, considers major structural reforms as the necessary condition for overcoming the existing growth impediments. One must object to such one-sided views. The two explanations do not necessarily contradict each other. Japan's economic stagnation and transformation crisis is both a demand-side and a supply-side problem, as can be shown by the long list of its major economic problems and growth blockades.[1]

- The sustained economic stagnation is obviously caused by insufficient aggregate demand.[2] The country's decade of stagnation started with the collapse of the asset-price bubble (1990 to 1992) and was continuously aggravated by a sequence of unfortunate demand shocks: A steep yen appreciation (1992 to 1994), an excessive fiscal consolidation (1997), the Asian crisis (1997 to 1998) and the burst of the new economy bubble (2001 to 2002). Alas, since 1992, Japan's economy has been afflicted by a substantial demand gap, which originally resulted from the sharp decline of business investment subsequent to the burst of the asset-price bubble. The continu-

[1] For an overview on Japan's demand-side and supply-side problems, see: Hanns Günther Hilpert. *Japans endlose Wirtschaftskrise. Perspektiven für Japan und die Weltwirtschaft,* SWP-Studie Nr. 4/2002, pp. 11–34.

[2] For an estimation of potential growth and the output gap see: Tamin Bayoumi, "Where Are We Going? The Output Gap and Potential Growth," in: Tamin Bayoumi and Charles Collyns (ed.), *Post-Bubble Blues: How Japan Responded to Asset Price Collapse,* Washington D.C.: IMF, 2000, pp. 89–106.

ing decline of investment reflects both cyclical and structural elements, the latter apparently being the dominant driving force. The investment share in GDP has fallen from 20 percent in 1990 to 15 percent at present.[3] Today, Japan still has excess capacities. According to the latest calculations of the Mitsubishi Research Institute, the output gap was still 5,2 percent in the second quarter of 2003.[4]

- As a result of the output gap and also pushed by exogenous factors like an increasing inflow of cheap imports and technology-driven price decreases, the Japanese economy entered a state of deflation. Since 1991 real estate prices have fallen by an annual average of 5 percent, wholesale prices by 1 percent. In 1995 the GDP deflator turned negative and since 1999 the consumer price index has been falling by an annual average of about 1 percent. Although deflation is still mild in Japan, it is entrenched by now. Cheap imports from China continuously fuel further price decreases. Private households and business firms are currently postponing consumption and investment in the expectation that prices will fall further.
- Japan's economic growth is not only affected by a deflationary gap, but also by a low and falling rate of total factor productivity (TFP).[5] Miscellaneous structural and economic impediments prevented a successful transition from the former mainly investment-driven growth to the required productivity-led growth. These impediments include an unfavourable demographic structure, an underdeveloped venture capital market and poor innovation management, as well as a conservative industrial policy, which favours incumbent inefficient sectors by means of regulation and subsidies.[6]
- Generally, the backwardness of the majority of Japan's domestic industries such as agriculture, construction, almost all service industries and large parts of manufacturing is one major growth impediment. Actually this "dual" sector represents the majority of Japanese production and employment. Most firms from this sector only survive because of protective regulation, government contracts and subsidies. Instead of restructuring, the dual sector has expanded its share in the 1990s. As a result, the share of the efficient competitive export industries, which have to bear the cost of inefficient business services, has declined.[7]
- As a result of the burst of the asset-price bubble, Japan has been struck by a banking crisis.[8] Both in terms of absolute figures and relative to GDP, the Japanese banking crisis is exceeding all recent banking crises in other industrialized countries. According to the latest report of the Financial Supervisory Agency (FSA), non-performing loans held by the major banks amounted to around 35.3 trillion yen at the end of March 2003, which is equal to about 7.1 percent of Japan's GDP. However, the real problem is not the losses incurred, but the apparent institutional failures in financial regulation and the spread of moral hazard within the finance industry. For example, it has come to light that risk management by the banks has either been lacking or underdeveloped, that corruption in the finance industry and in government is not rare, that the supervisory authorities have been complacent even in the case of blatant law infringements, and that regulation has generally been rather discretionary and non-transparent. Furthermore, the banks' bad loans are mirrored in companies' bad debts. By far too many technically insolvent companies are being kept alive

Regulation failures and moral hazard problems beset the banking industry

[3] See: Taizo Motonishi and Hiroshi Yoshikawa, "Causes of the Long Stagnation of Japan during the 1990s: Financial or Real?" *Journal of the Japanese and International Economies 13* (1999), pp. 181–200; Ramana Ramaswamy and Christel Rendu, "Identifying the Shocks: Japan's Economic Performance in the 1990's," in: Tamin Bayoumi and Charles Collyns (eds.), *Post-Bubble Blues: How Japan Responded to Asset price Collapse,* Washington D.C.: IMF, 2000, pp. 45–88; Günter Weinert, "What Went Wrong in Japan. A Decade-Long Slump," *Vierteljahreshefte zur Wirtschaftsforschung,* 70 (2001) 4, pp. 463–466.

[4] See: http://www.mri.co.jp/REPORT/ECONOMY/2003/er030803.pdf.

[5] See: Fumio Hayashi and Edward C. Prescott, "The 1990s in Japan: A Lost Decade," *Review of Economic Dynamics* 5 (2002), pp. 206–235; Yujiro Hayami and Junichi Ogasawara, "Changes in the Sources of Modern Economic Growth: Japan Compared with the United States," *Journal of the Japanese and International Economies* 13 (1999), pp. 12–16; Stefano Scarpetta, Andrea Bassanini, Dirk Pilat and Paul Schreyer, "Economic Growth in the OECD Area: Recent Trends at the Aggregate and Sectoral Level," *OECD Working Paper* No. 248, Paris: OECD 2000; Hiroshi Yoshikawa, "Technical progress and the growth of the Japanese economy," 16 (2000), 1, pp. 34–45.

[6] For this interpretation see: Hayami and Ogasawara, *Changes in the Sources of Modern Economic Growth: Japan Compared with the United States,* pp. 12–16, 28; Jonathan Eaton and Samuel Kortum, "Engines of growth: Domestic and foreign sources of innovation," *Japan and the World Economy,* 9 (1997) 2, pp. 235–259; David E. Weinstein, "Historical, Structural and Macroeconomic Perspectives on the Japanese Economic Crisis," in: M. Blomström, B. Ganges, S. La Croix (eds.): *Japan's New Economy,* Oxford: Oxford University Press 2001, pp. 35–44; Hiroki Kawai and Shujiro Urata, "The Cost of Regulation in the Japanese Service Sector", in: Mordechai E. Kreinin, Michael G. Plummer, Shigeyuki Abe (eds.), *Asia-Pacific Economic Linkages*, Amsterdam: Pergamon, 1999; Scarpetta, Bassanini, Pilat, Schreyer, *Economic Growth in the OECD Area: Recent Trends at the Aggregate and Sectoral Level.*

[7] See: Richard Katz, *Japanese Phoenix. The Long Road To Economic Revival,* Armonk 2003, pp. 40–58; McKinsey Global Institute, *Why the Japanese Economy is not Growing: Micro Barriers to Productivity Growth,* Washington. D.C.: McKinsey July 2000.

[8] For more details on Japan's banking problem, see: C. Fred Bergsten, Takatoshi Ito, Marcus Noland, *No More Bashing. Building a New Japan-United States Economic Relationship,* Washington D.C.: Institute for International Economics, pp. 69–85; Thomas Cargill, Michael Hutchinson, Takatoshi Ito, *The Political Economy of Japanese Monetary Policy,* Cambridge, MA: MIT Press.

by the joint complacency of government authorities and financial institutions. For much too long, banks were made to trust in the so-called "convoy system", which stipulated that while no bank could fail, all banks would be liable for one bank's losses. In spite of capital infusions by the authorities and the increasing provisioning and write-off of bad loans by the banks, the amount of non-performing loans (NPL) increased from 1998 to 2002. It only slightly decreased during 2003.

- A disastrous consequence of the decade-long economic stagnation and the expansionary fiscal policy has been the steep rise in Japan's public debt, amounting to almost 150 percent of GDP in gross terms at the end of 2003. This is the highest ratio of all OECD countries. Admittedly, in net terms the public debt is substantially lower, and virtually all debt is denominated in Japanese yen and is owed to Japanese creditors. But there is also a large amount of hidden debt on Japan's public books, and the rate of debt accumulation has increased substantially since 1998. It must be feared that the public debt will get out of control once nominal interest rates start rising.[9]

Economic policy proved ineffective because of poor political governance

Japanese economic policy: The crisis, vested interests, and looking for direction

The steep decline of economic growth and the length of the period of economic stagnation raise the question of the role and responsibility of government policy in countering the various negative trends. In fact, throughout the 1990s and until the present, various demand-side and supply-side policy approaches have been tried, ranging from aggressive fiscal and monetary expansion to structural reform. From 1992 to 1998 eight fiscal stimulus packages were launched, totalling more than ¥100 trillion of officially announced expenses. To suppress deflationary trends, monetary policy became increasingly expansionary, and since mid 2001, the Bank of Japan has been officially operating a zero-interest-rate policy. There were also different supply-side measures in order to stimulate investment and remove growth impediments, for example industrial deregulation, privatisation and restructuring of state enterprises, continuous efforts to clear up the banking crisis, as well as measures to attract foreign direct investment.

It cannot be surprising that Japanese economic policy has been heavily criticised both by academics and the media because of its great many mistakes and its poor results By at times contradictory arguments, government policy was blamed for misjudging the actual economic conditions, for aggravating the situation by outright policy mistakes, for lacking honesty in the analysis of the underlying economic and structural problems and for protracting the necessary remedies, and for acting too weakly against powerful vested interest groups. For the most part these charges cannot be denied. It is revealing, for example, that critics have convincingly shown that the fiscal stimulus exerted in the 1990s was insufficient[10], that the monetary policy to fight deflation proved to be much too restrictive[11], and that the structural reforms were inadequate.[12] One may wonder why Japanese economic policy proved to be so ineffective. Three reasons may explain the policy failures:[13]

1. Japan's economic policy has failed to take coherent action towards reforms because the aims and the content of reform are yet to be theoretically and politically determined. With the collapse of high economic growth and with the resulting demise of the Japanese-style economic model – both formerly regarded as the basis of Japan's post-war consensus society – an intellectual void has opened up. Although the need for reform is generally agreed on, Japan's political and business elite has not yet agreed on a final vision for Japan's post-industrial society. However, as long as there is no basic reform concept, all current economic and political reforms will proceed without vigour and without a sense of direction.
2. The political governance system, based on the cosy relationship between politicians, bureaucrats and business, is a major roadblock against structural reform. When vested interests are at stake, this "iron triangle" is wielding stronger political power than the elected executive

[9] For more details see: Hilpert (2002), pp. 24–29 and 45–47.

[10] See: Adam Posen, *Restoring Japan's Economic Growth,* Washington D.C.: Institute for International Economics, 1998.
[11] See for example: Bennett T. McCallum, "Japanese Monetary Policy," Shadow Open Market Committee, 30.4.2001 (htto://www.somc.rochester.edu/Apr01/McCallumApr01.pdf); Meltzer (2001), *Monetary Transmission at Low Inflation: Some Clues from Japan,* pp. 13–34; John B. Taylor, "Low Inflation, Deflation, and Policies for Future Price Stability," in: *Monetary and Economic Studies* 19 (2001) Special Edition February 2001, pp. 35–52.
[12] See: Katz (2003), pp. 193–297; Edward J. Lincoln, *Arthritic Japan,* Washington D.C.: Brookings Institution Press, 2001, pp. 94–152.
[13] For the following reasoning see: Hanns Günther Hilpert and Helmut Laumer, "Japans steiniger Weg ins 21. Jahrhundert," *ifo Schnelldienst* 51 (1998) 21, S. 11–25.

branch, but is not accountable to Parliament or to the electorate. Although some political reforms to overcome the old system have been carried out, vested interests are still well entrenched. It will take considerable time for a new system to become effective.

3. In Japan's current political and economic environment, there seems to be a disastrous dilemma between Keynesian expansionary policy and structural reform policy. On the one hand, a rigorous structural policy writing off bad loans and closing down companies loaded with bad debt would trigger rising unemployment. National income, production and employment would fall further and Japan's deflationary gap would widen. On the other hand, Keynesian demand stimulation would politically restrain the progress of reform. Anti-reform forces from government, administration and business would argue that structural reforms had to be postponed in order not to endanger the economic recovery. For exactly this reason they rather supported either fiscal or monetary expansionary policy.

The mainsprings of the current recovery

The extent of Japan's economic and structural problems shows clearly that only an appropriate mix of demand-side and supply-side policy measures can be successful. Stimulating demand and restoring economic activity are necessary but not sufficient to overcome the stagnation. For a sustained recovery more than an economic upswing will be needed. The existing structural growth impediments have to be overcome as well. Otherwise the current recovery will falter in the same way as the short upturns of 1997 to 1998 and of 2000. A closer look at the mainsprings of the current economic recovery may clarify which structural improvements have been achieved, which economic policy changes have occurred so far.

Is Corporate Restructuring Proceeding?

The past decade of macroeconomic crisis and stagnation gave also rise to a fundamental microeconomic crisis in Japan's industrial structure and corporate governance system. The salient features of the corporate governance crisis were continuous operating losses, a highly leveraged balance sheet, a meltdown of shareholder value, unprecedented breaks of the implicit promises of lifelong employment and seniority-based wages and salaries, violations of law and regulations as well as frequent cases of internal corruption.[14] With the economic slump continuing and the deflation proceeding, it became increasingly apparent that consolidating one's operations would not suffice to attain a meaningful transformation of the dysfunctional corporate system. Rather, companies had to limit the demands of "exploitative" employees, management, business partners and regulatory authorities, and subordinate their stakeholders' interests to the primary goal of raising the profitability of assets and equity. But the legal environment also had to adapt. This challenge has been increasingly taken up both by business and government. In particular the large manufacturing companies have been restructuring by carrying out internal corporate reforms, by downsizing and by cost cutting. As a result profits of non-financial firms on the Tokyo Stock Exchange are now 30 percent higher than at the peak of the bubble.[15] According to a corporate survey by the Ministry of Finance, debt/equity ratios have fallen substantially from 219 percent in 1995 to 155 percent in 2002.[16] The government has also done much to create a more transparent, accountable and efficient business environment. The commercial code and the bankruptcy law have been reformed, accounting and auditing rules have been changed, shareholder rights have been strengthened, and payments into corporate pension plans have been made portable. Without doubt, Japan's currently increasing capital spending as well as the stock market rally owe a lot to the improved profit situation of Japan's large manufacturing companies. However, two important reservations must be added:[17]

Restructuring by large corporations has resulted in rising profits and lower debt/equity ratio

1. Although the financial situation of the corporate sector has improved somewhat, it is far from satisfactory. Across the board, debt-equity ratios are still high, return on assets is still low in Japan when compared to the situation in other major economies. In other words, excess capacities are still in place and industrial restructuring has only come halfway.
2. To date, progress has been uneven across industries and across firms, reflecting once more the

[14] See: Martin Schulz, "The Reform of (Corporate) Governance in Japan," *Vierteljahreshefte zur Wirtschaftsforschung,* 70 (2001) 4, S. 530–32.
[15] For this ratio see: The Economist, 10.9.2003, Japan's rock bottom.
[16] See: Ministry of Finance, Financial Statements Statistics by Industry. 2003.
[17] For details see: T. Baig, D. Iakova, K. Kang, T. Konori, S. Kim, Japan: Selected Issues, Washington D.C.: IMF 2003, pp. 3–15.

dual structure of Japan's economy. The restructuring successes are limited to the larger manufacturing companies. Many smaller companies and most companies in construction, real estate, retail trade, mining and agriculture are still showing highly leveraged balance sheets and rather low profits. The latter companies can only survive because of low nominal interest rates. The persistence of such weak borrowers stresses the need for further industrial restructuring and the exit of nonviable firms.

Has monetary policy become more expansionary?

For a long time, the Bank of Japan (BoJ) has been under considerable pressure to fight deflation and to stimulate economic growth by pursuing a more expansionary monetary policy. It has especially been urged to set explicit inflationary targets. Former BoJ Governor Masaru Hayami objected to his vociferous critics from academia, the IMF and the Japanese government, saying that the BoJ had already done everything possible by pursuing a zero-interest-rate policy since September 2001, with the official discount rate set at 0.1 percent and the overnight call rate at 0.002 percent, later at 0.001 percent. In spite of zero interest rates, however, monetary transmission would disappear in the dysfunctional banking sector. It was concluded, therefore, that the consolidation of Japan's financial institutions and the enforcement of structural reforms should come first. A further expansion of the money supply could become inflationary and thus create new structural defects. These reservations notwithstanding, in September 2002 Governor Hayami introduced an important policy modification by starting the so-called quantitative easing. Beyond mere liquidity expansion, the monetary base was to be increased by purchases of large quantities of Japanese government bonds (JGB) and company equities. These purchases were also to improve the balance sheets of the weak banking sector. When the new BoJ Governor Toshihiko Fukui assumed office in March 2003, he announced that he would continue the zero-interest-rate policy and the quantitative easing not only until prices will have stabilised, but even afterwards. In other words, from now on the BoJ will be committed to monetary expansion until well after deflation changes into inflation. Although the BoJ does not set an explicit inflation target, implicitly it has pledged to sustain its monetary expansion. Supposedly this pledge has been made to create inflationary expectations. But besides influencing the market participants psychologically, the BoJ's more important monetary goal may have been to influence the relative prices of financial assets.

Zero-interest-rate policy and quantitative easing to be continued

- By expanding the money supply via additional purchases of JGBs, the BoJ not only successfully pushed down interest rates in the JGB primary market, but also generally reduced interest rates in the corporate bond market from 3.5 percent to 1.5 percent.
- By buying stocks and non-performing-loans from the banks' portfolios, the BoJ stimulated and promoted Japan's post-March 2003 stock market rally.
- By heavy intervention in the foreign exchange markets, the BoJ slowed down the yen appreciation against the US dollar considerably.[18]
- By actively lending to the small and medium-sized firms that suffer from the banks' balance sheet consolidation and credit rationing, it improved the firms' financing and investment conditions.

The strategy seems to have succeeded. The reduced long-term interest rates, the higher share prices and the BoJ's loan extension to small and medium-sized firms are effectively reducing the refinancing costs for business and private construction, stimulating investment. Furthermore, business sentiments are improving. With regard to the ailing banking sector, however, the BoJ's expansionary monetary strategy looks risky.

Will the bad loan problem be solved at last?

The bail-out of Resona Bank, the country's fifth largest, in May 2003 sent strong signals to Japan's financial markets. The government made it clear, that it will not hesitate to nationalise a bank that is not capable of disposing of bad loans and of raising profitability. But the generous terms of the Resona rescue also showed that the nationalisation of a bank is not necessarily to the detriment of the bank's depositors, its borrowers and not even its shareholders. Furthermore, this action presented an effective strategy for solving the banking crisis. On the one hand, the banks are forced by the FSA to write off their non-performing loans, to identify their problem loans and problem borrowers, to

[18] If compared to the appreciation of the euro against the USdollar in the light of the non-intervention policy of the European Central Bank.

assess accurately their equity capital, and finally to improve their profits. Owing to the FSA's stricter supervision, the accounting of the banks is more rigorously checked, effectively stopping such former practices as understating the amount of core capital or assessing unrealistically high the tax-deferred assets as part of the core capital. On the other hand, if banks like Resona cannot improve their situation and bankruptcy is looming, the authorities will step in and nationalise the institution. Obviously, there are banks in Japan which are too big to fail – to the comfort of depositors, borrowers and shareholders.

Figure 3

Source: Bank of Japan.

For the time being, the new strategy seems to be working very well. During the past fiscal year, the amount of non-performing loans held by the major banks decreased substantially for the first time since 1996 (see Figure 3). Admittedly, the amount of non-performing loans remains high, the banks' capital base is still small and is highly exposed to the volatile stock market. But banks are stepping up their restructuring, and the official roadmap for the rehabilitation of the financial sector, which prescribes the reduction of non-performing loans to a ratio of 3 to 4 percent of a bank's total loan assets, is looking increasingly realistic. Apparently, the financial environment has brightened for the banking sector. The economic recovery and the rebound of the stock and the bond markets have improved banks' profitability. In particular the various governmental support operations, that is (1) the implicit guarantee of the continued existence of the major banks, (2) the purchase of company shares and non-performing loans from the banks' portfolios, (3) the stimulation of the bond and stock markets by massive purchases, (4) the propping up of the stock market by official restrictions on stock futures or by unofficial verbal intervention, have paid off at last.

Obviously the current strategy has ameliorated the worst effects of the financial crisis. But the strategy applied has also inherent flaws and severe systemic risks. There are three critical points:

1. Although the banking crisis has already lasted more than ten years, there are still substantial excess capacities in the banking sector.[19] In the current environment, however, there exist two structural impediments to the necessary (and unavoidable) capacity reduction. First, with the government implicitly guaranteeing the continued existence of the larger banks, a capacity reduction by the exit of one of the bigger players cannot take place. Second, with nominal interest rates so low, it is difficult for banks to raise core profitability. Thus the income value of retail banking has decreased and the process of consolidation has been slowed down.
2. In spite of the long duration of Japan's banking crisis, the major problem of the non-performing borrowers, which lies behind the non-performing loans problem, has not been earnestly addressed yet. Japan's big banks are heavily exposed to so-called "zombie-companies", which have little or no prospect of ever becoming viable again and survive only because of protective regulation, government loan guarantees and their uncomfortably close bank relationship. The elimination of such non-viable borrowers is not only hindered by government protection but is also delayed by the low nominal interest rates. With interest rates so low, even "zombie-companies" can still service their debt despite little cash-flow and despite being technically insolvent.[20]

Stricter supervision by the FSA has shown results but government guarantees make for moral hazard problems

[19] A comparison of the banking industries of Japan and the United States shows that the Japanese banking sector would need to shrink its lending volume by 20 percent. This would necessitate closing around every third Japanese bank. For the calculations see: Takeo Hoshi and Anil Kashyap, "The Japanese Banking Crisis: Where did it come from and how will it end?" NBER Macroeconomics Annual 1999, pp. 40–43.
[20] See: IMF, *Japan: Financial System Stability Assessment*, Washington D.C. 2003; Katz 2003, pp. 88–91.

3. The combined actions of the BoJ and the FSA mark a return to the former convoy system, incurring severe moral hazard problems. Thanks to government guarantees, the banks no longer have to fear bankruptcy risks but they only have to subject themselves to a rather discretionary and discriminatory supervision. The banks' loan risks are socialised. Thus a higher quality of credit analysis and higher standards of lending prudence cannot be expected, especially as long as Japan's major problem borrowers are safeguarded by protective regulation and also by (implicit and explicit) government guarantees. Owing to the massive purchases of bonds and company shares by the BoJ, the bond rally and the stock market rally seem to be exaggerated.

Conclusions

Many structural problems remain unsolved

Economic indicators clearly show that Japan's current economic recovery is for real. Three powerful business and policy trends are driving the upswing. First, the successful restructuring by some major manufacturing companies, second, an unconventional expansionary monetary policy which is bypassing the dysfunctional banks and is targeting directly the relative prices of financial assets, and third, a more powerful approach to rehabilitating the banking sector. Admittedly, deflation has not been overcome yet and it will take several years for a final solution of the banking crisis. But the situation on the price front and in the financial arena is improving rather than deteriorating further. However, Japan's other structural problems persist. Restructuring of the weaker part of Japan's domestic industries has not seriously started yet. For example, there are still many technically insolvent large companies, mostly in the construction, real estate and the domestic trade sectors, which are only kept alive by debt waivers, low nominal interest rates or even generous government contracts. Generally, as long as excess capacities in Japan's economy are not reduced, the macroeconomic output gap will endure and Japan's private domestic demand will not recover. Furthermore, as a consequence of the remaining structural deficiencies, productivity growth will not recover and Japan's long-term potential growth will remain low.

If Japan's unresolved structural problems were not enough, the current economic policies to overcome deflation and the banking crisis are adding even new risks and distortions. First, the generally discretionary supervisory policy in the financial sector, in particular the implicit government guarantee for the larger banks, creates severe moral hazard problems. Second, the monetary expansionary policy with the Bank of Japan purchasing government bonds, stock market shares and foreign exchange on such a massive scale, is unprecedented. The strategy is apparently working well as long as deflation is entrenched and nominal interest rates are low. But with a successful turning around of inflationary expectations of the private sector, a major private and public debt problem will turn up. Once nominal interest rates start rising again, repayment or refinancing one's debt will become increasingly difficult. Both the corporate sector and the state will face a severe consolidation crisis. In dealing with the public debt problem, the Japanese government will either have to push through broader and higher taxation or inflate the domestic currency – all public debt is denominated in Japanese Yen – or declare default.