Japan's Financial Malaise Revisited:
The 'Art' of *Sakiokuri* (Postponement)

Philip Trezise Memorial Symposium on the Japanese Economy

The Brookings Institution
Washington, DC

April 9, 2002

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I. Diagnosing Japan's Deflation

Policy Blunders in Supervision of Financial Institutions

In 1999, Alan Blinder contended in his book, *Central Banking in Theory and Practice,* that central bankers must learn more about economic theories AND economists must learn more about central banking practice.[1] Japan's experience of the past decade suggests that this message should be extended: Pundits must learn more about how financial institutions, particularly banks, and financial markets function.

Throughout Japan's financial malaise and the ensuing deflation, pundits have offered a "panacea" after "panacea" in macroeconomic policies, often with a scant understanding of how financial institutions and markets work. Indeed, understanding them is critical because, after all, the main reason for the malaise of the Japanese economy has been the overhang of banks' excess lending – some of which have turned into non-performing loans (NPLs) – and, on the flip side, the overhang of excess borrowing by firms.

This should not be interpreted as an underestimation of the importance of macroeconomic policies. As the past decade has proven, while macroeconomic stimuli are imperative for creating an environment that is conducive to banks' debt liquidation, they alone cannot bring a final resolution to Japan's financial malaise. Unequivocally, liquidation of NPLs is an absolute precondition for sustainable economic recovery. This simple conclusion, though widely accepted by now, is amazingly still not totally well understood even by some economists.

In this context, the Koizumi government deserves a credit at least for squarely placing this issue to solving Japan's deflation, unfortunately at no avail to date. One public entity that has been pushing for this resolution is the Bank of Japan – undoubtedly, reaching this conclusion by virtue of their daily operations in the financial markets. This is not to suggest that they have always been right in the conduct of monetary policy. Much can be said about BOJ's slowness of monetary easing throughout the 1990s.

However, BOJ's mistakes – even the hiking of the overnight call rate by 25 bps in 2000 and reversing it shortly after – are dwarfed, albeit inconsistent in policy, by the mistakes made in other public policy areas. Certainly, this turnaround in monetary policy had a far less impact on the economy than the nine trillion yen fiscal tightening in FY1997.[2] However, the most notable area of policy blunder, by far, has been in the area of bank supervision.

The most important question, therefore, ought to be why the financial supervision authorities – not just ex-Ministry of Finance and now the Financial Supervisory Agency (FSA) but also successive governments since 1990 to present – have allowed the overhang of NPLs to continue growing. This question can be answered by first asking why the Japanese government had wishful thinking for so long that Japan could grow out of bad debt problems through macroeconomic policies without forcing banks to liquidate NPLs promptly. To be sure, assigning blame is not the intention of this paper, but analyzing why mistakes have been – and are still being – made in order to delineate the next agenda for banking reforms.

*****************(Please skip the following section and go straight to page 6, if you wish to move directly into banking problems and the prospects for their reforms.)************

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[1] Alan S. Blinder, Central Banking in Theory and Practice, Cambridge: MIT Press, 1998.

[2] Even Ryutaro Hashimoto felt compelled to admit in his failed second bit for the premiership a year ago that the premature fiscal tightening by his government, which sent the economy into a tailspin in 1997-98, was a big mistake.

Cyclical as well as Structural Problems

At the risk of being repetitive from the previous panel, it is, nevertheless, necessary to clarify two key intertwining debates in diagnosing Japan's financial malaise before discussing the prospects for banking reforms. The first is if Japan's protracted stagnation – and its ensuing deflation – is cyclical or structural in nature. The second is if it is a demand-side or a supply-side problem. After treating it as cyclical in nature and a demand-side problem for so long, the government and many observers – including the IMF and the OECD – are now viewing the problem as structural in nature and a supply problem. Although it is important that they expanded their focus, the reality is a lot more complicated. It becomes, therefore, a source of confusion, with no consensus among economists on what needs to be done.

For example, the government's white paper on the economy and finance, just published in March, listed NPLs at the top of its agenda for structural reforms. Shigeto Tsuru objected to this on the grounds that NPLs derived from an economic bubble, which is an extreme swing in the economic cycle.[3] The difference is partly semantic but it is hugely important as it forms a diagnosis.

If one defines this protracted economic stagnation – and the accompanying deflation – as a part of a long downturn that began in the spring of 1991, as Tsuru does, it is a cyclical problem. This view implies that any upturns and downturns seen during this period were insufficient to be counted as regular economic boom-bust cycles. But if one acknowledges them as cycles, one must also recognize that Japan has been in a long structural downturn.

Although bubbles are indeed extreme swings in economic cycles, it is more appropriate – at least for the intensive purpose of diagnosing – to consider Japan's financial malaise as both cyclical and structural in nature, as the late Yoshikazu Miyazaki called this *fukugo fukyo* (combined recession.)[4] After all, it was never resolved by a few economic upturns. Once more, we are experiencing the economy's bottoming out, without bottoming out in NPLs. Moreover, it has been deeply rooted in such structural problems as over-banking, banks' over-dependence of their capital base on latent profits from cross-shareholdings, and an inadequate system of corporate governance, including credit risk analyses.

Demand Shortfall AND Supply Overhang

On the second issue, it should be understood that Japan's current deflation is caused by both supply and demand. In his attempt to show that Japan has been in a liquidity trap, Paul Krugman reduced the cause of Japan's problems to a matter of "*too little demand, not too little supply*."[5] This is indeed the key to understanding Japan's deflation. However, in the view of this author, he did not go far enough. Japan's deflation is caused by "*not only too little demand, but also too much supply*".

To be sure, they are not the same. Japan's severe output gap – suggested anywhere between ten and 20 percent depending on how you calculate – has been caused by a demand shortfall as well as by an overhang of excess supply at the aggregate level. Likewise, a demand shortfall and an overhang of structural excess capacity are found in various industries, most pronounced in the banking, construction, and retail sectors.

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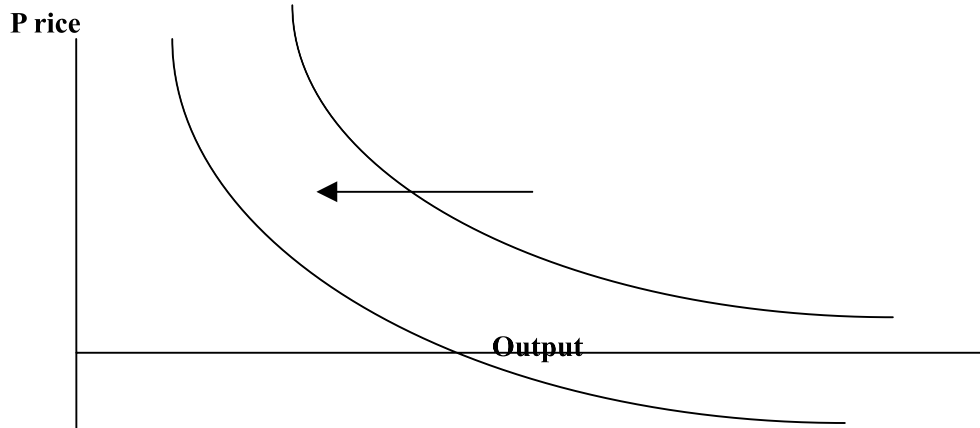
[3] Shigeto Tsuru, 'Keizai Zaisei Hakusho ni Gimonten Ari' (the White Paper on Economy and Finance), *Ekonomisuto,* March 5.
[4] Yoshikazu Miyazaki, *Fukugo Fukyo* (Combined Recession), Tokyo: Chukyo Shinsho, 1992.
[5] Paul Krugman, "What Is Wrong with Japan" <http://web.mit.edu/krugman/www/nikkei.html>

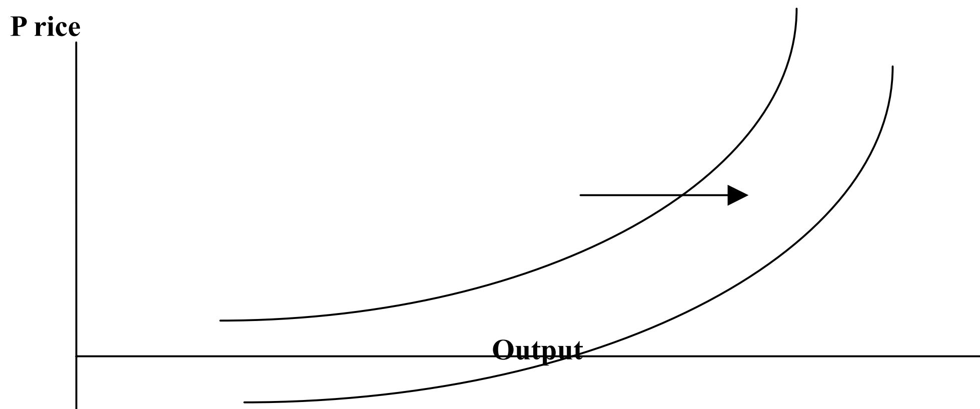
In a normal cyclical downturn, a falling demand – a shift of the demand curve to the left – can be reversed by stimulating demand via fiscal and monetary easing. (Figure 1)

Figure 1: Demand Curve



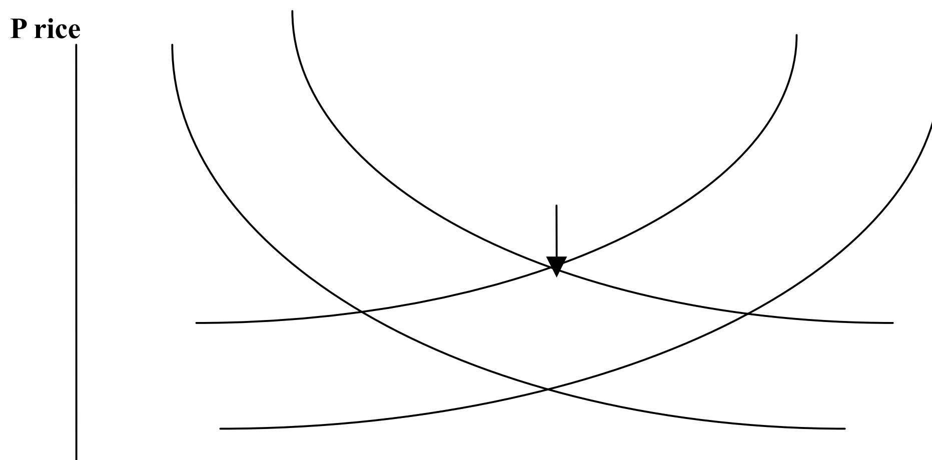
However, when too much supply is built – a shift of the supply curve to the right – far in excess of demand on the basis of irrational expectations in the rise of demand, as in any bubbles, particularly in Japan of the 1980s – an overcapacity surfaces. (Figure 2)

Figure 2: Supply Curve



To reiterate, Japan's current deflation – sharply falling prices, coupled with contracting GDP – is a result of both a cyclical demand shortfall as well as a structural supply overhang at the aggregate level as well as in a number of sectors. (Figure 3)

Figure 3: Deflation



Output

Trying to fill a structural supply overhang strictly by stimulating demand implies that demand must be created to an irrationally high bubble peak level, which is simply not sustainable. Only through the Schumpeterian notion of "a creative destruction of capital", followed by a reallocation of resources via new investments, equilibrium can be restored and new growth triggered.[6]

It should be noted in this context that the overcapacity that has been created by the hollowing out effect has also been exerting downward pressures on prices and growth in Japan. In 2001, some pundits argued that this is a "good deflation", and therefore to be endorsed. While these pressures are undoubtedly aggravating the Japanese economic scene, let us not confuse these issues. The hollowing effect can be and must be overcome by restructuring the economy, by reallocating resources and by creating a new dynamic comparative advantage in higher value added areas.

Other advanced industrial economies are also faced with the same intensifying international competition. While Japan is faced with deflation and a liquidity trap, it is experiencing disinflation – the absence of inflation with positive growth. We must, therefore, come back to the issue of Japan's current deflation that derives from debt deflation, which and from Japan's inability to deal with NPLs decisively enough.

************ (Continued from page 3 for those who skipped the section on the macroeconomic analysis.)

In short, while economic stimulus packages and monetary easing have helped jumpstart cyclical upturns, they have been insufficient to stage a genuinely sustainable recovery. More importantly, such upturns have not led to a reduction in the total outstanding amount of NPLs; banks have not been liquidating debts faster than they accumulate. Even worse, trying to resolve this financial malaise mainly through macroeconomic policies, without drastically liquidating NPLs, has led to a well-publicized grave side effect of mounting public debts, as well as to an unintended peculiar consequence in the short-term money market.

Indeed, during the October - December quarter, despite the quantitative monetary easing, domestic banks' total outstanding amount of deposits with the BOJ declined by 1 trillion yen to 7.6 trillion yen, while that of foreign banks nearly doubled from three months earlier to 4 trillion yen. This is because foreign banks have been exploiting credit rate differentials between them and domestic banks by procuring yen funds at negative interest rates from the Japanese banks and depositing them

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[6] Mineko Sasaki-Smith, "Japanosclerosis: Overhang of Excess Capacity", *Inside the Japanese Economy*, Tokyo: Morgan Stanley, October 12, 1995, pp. 2-3. The structuralist approach to the notion of over-investment and excess capacity is very Schumpeterian. It is found in the global glut theory that became a common approach in analyzing why new protectionism surged in the 1980s. Bradford De Long of the University of California at Berkeley and Krugman's friend noted: Observers of business cycles have long felt that the over-investment approach contains profound truth, yet it has never been well integrated into old Keynesian, new Keynesian, monetarist, or new classical business cycle theories. This author believes that this is the reason why Krugman never accepted the notion of capacity overhang and the global glut theory.

at the BOJ.

These two consequences clearly underscore the limit to the efficacy of fiscal and monetary easing as a means to stimulating demand. While monetary easing is absolutely necessary to keep the liquidity in the system, particularly for the troubled banks, it has not led to the revitalization of banks, firms, or the equity market.

Too Big to Fail

To be fair, it is not that banks have done nothing. They have been writing off, in their minds, huge amounts of bad loans. But as long as NPLs continue to grow faster than they are written off, it means that banks are not writing them off fast enough to resolve the NPL problem. Even when banks kept declaring how they were soon to finish "resolving" the problem in the 1990s, what they were doing was mostly writing down bad debts (i.e., putting up loan loss reserves on the balance sheets) without liquidating collateralized property – which has now come to be called *saishushori* – "final resolution."

In fact, banks continue to throw "good money after bad" – namely, extending additional loans to troubled borrowers so that the borrowers can be kept afloat to pay banks interest. They obviously do so to avert their loans from turning into non-performing, with a hope that the borrowers would eventually be revived. Faced with ever rising amounts of NPLs against the backdrop of deepening deflation in the past couple of years, however, banks have finally started to resort to terminating credit lines to troubled big borrowers, thereby forcing them into bankruptcy, such as was the case with Sogo in 2000 and with Mycal in 2001.

Nevertheless, the recent Daiei case underscores the inadequacy of many "resolutions." In yet another round of their revival plans, a group of banks announced their debt forgiveness that is sufficient to avert Daiei's imminent failure, yet widely perceived insufficient to truly revive Daiei. Burdened by the past long-term relationship in the "main bank" system and pressured by social obligations, the Japanese banks have been reluctant to call in loans even as the risks of such loans increase. As long as this situation remains intact, we can hardly expect banks to facilitate a necessary resolution to firms' excess borrowings, restructuring, consolidation, and revitalization of troubled companies and industries.

Meanwhile, major Japanese banks have merged to form huge financial groupings. Three of the four mega banks aspire to survive as global universal banks when even the United States and the United Europe have only a few. Can Japan really afford three global universal banks? Bank executives must soon reexamine their current business models to assess how they can realistically become profitable as global universal banks. Although Citi Group and J.P. Morgan-Chase have followed a similar model, which many Japanese banks undoubtedly hope to emulate, we are in an era when immensely intensive global competition forces firms to adopt the strategy of "select and focus" only on where they have competitiveness to remain profitable.
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Out of these mega-mergers, two "benefits" are supposed to have emerged. Firstly, mega banks have virtually turned "too big to fail." Indeed, the authorities encouraged their mergers believing that they would be better protected from market attacks. Secondly, they are supposed to enjoy the scale merit, particularly in such areas as information technology. Whereas the size of their assets and the number of their branches and employees may be among the world largest, their competitiveness and profitability are not strong enough to guarantee their success.

Furthermore, Mizuho Group's current fiasco with their computer systems attests

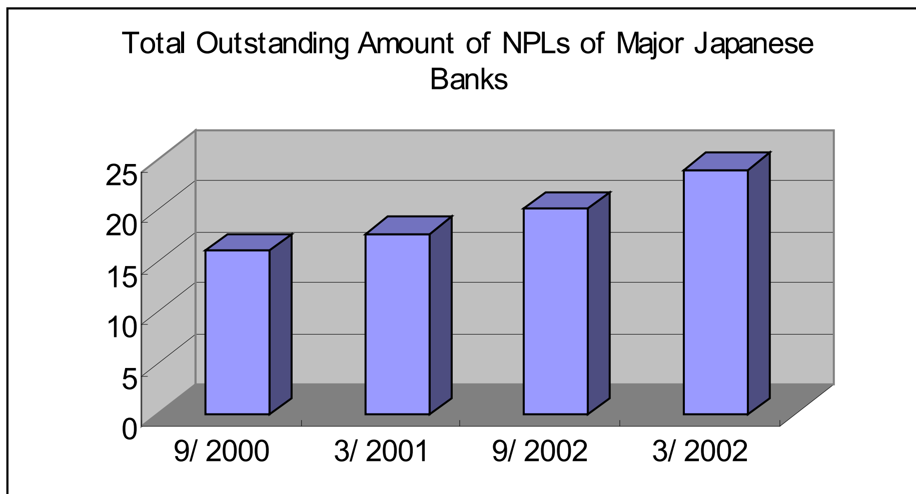
to the contrary of the banks' intention. Instead of benefiting from economies of scale, they have been burdened by "perils of scale." Unable to agree on one integrated system in the merger, out of their intense rivalry among the three banks, they decided to connect three systems for the first year or two. This fiasco may foretell more of their problems and contradictions to appear, underscoring that the current Japanese style of mergers is yielding little positive impact from supposed synergies.

II. Prospects for Banking Reforms

Banks' Further Deteriorating Financial Conditions

As of this writing, the prospects for banking reforms are not encouraging for three main reasons. Firstly, banks' financial conditions are too grave to expect any meaningful resolution on their own unless a sudden big boom in the stock and property market ensued – highly improbable. They are running out of capital with which to write down their planned 6 to 10 trillion yen of NPLs in FY2002. Unless they receive additional public funds in their capital base, the pace of writing off bad debts would inevitably slow down. This is because their ability to finance in the capital markets has become increasingly more difficult and enormously expensive due to their deteriorating credit ratings.

In fact, an estimated 7.5 trillion yen in NPLs written down in FY2001 notwithstanding, the total outstanding amount of NPLs of the 12 leading banks has jumped 40% in one year to over 24 trillion yen at the end of March 2002.[7] This reflects lower share prices as well as stricter standards at which the FSA re-categorized bank NPLs in their most recent round of banking inspection, merely underscoring their leniency a year ago.



Source: *Nikkei*, March 27, 2002, p. 1.

Although the latent losses of these banks' equity holdings are estimated to have shrunk by about two trillion yen from six months earlier to the total of 1.5 trillion yen at the end of March 2002, and their average capital adequacy ratio specified by the Bank of International Settlements (BIS) is said to have stood at 10.5% – above the required 8% level to operate internationally, it is widely believed that these figures give far too optimistic a picture.

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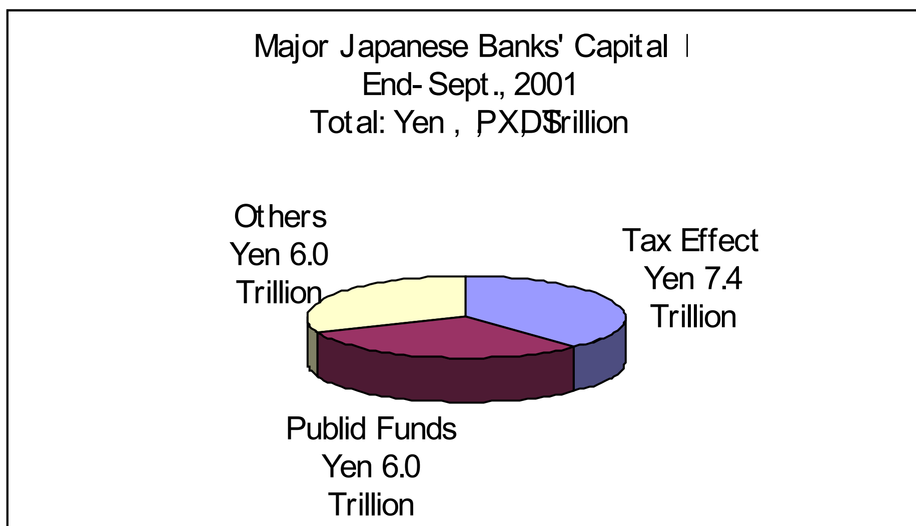
[7] Furyo Saiken Ichinen de Yonwari Mashi, *Nikkei*, March 27, 2002.

For one, this ratio is indeed artificially inflated by public funds and the special amortization benefit of future taxes on these banks' expected earnings over the next five years. Unconfirmed newspaper stories have suggested that Governor Hayami put this average ratio at the 7% level at the end of FY2000 (a year earlier), as compared with the announced ratio of 11% once you take away the public fund portion of the capital base and translate this special tax effect by the US standards.[8] He has been quoted in tabloids for having suggested this average ratio of 6% at the end of March 2002, although there is no way of confirming these reports. In any event, for Hayami's comfort, this ratio is too low for the leading banks to operate internationally.

(The author is naturally compelled to rely on official announcements, mass media, and "guesstimates" by those who are in a position to learn more, because the officials at the FSA are the only ones who are in a position to obtain a full information on the exact financial standings of these bank).

In fact, in February and March, the research arm of the Daiwa Securities and the Japan Center for Economic Research both argued what many of us suspected – that is, Japan's leading banks are virtually insolvent. According to the calculation by Hideaki Akimoto of Daiwa, of the estimated 17 trillion yen combined capital of major Japanese banks at the end of March 2002, (down from 19.4 trillion yen at the end of September 2001), 7 trillion yen is preferred shares held by the government (public funds) and about 8 trillion yen is the aforementioned amortization effect on future taxes, leaving only 1 trillion yen of real capital. (The above text does not correspond to the table below, which is for end-Sept, 2001.)



Source: Daiwa Securities

Because these preferred shares cannot be used for writing down bad debts and the tax effect will lose its asset value unless these banks will have a combined profits of 20 trillion yen over the next five years, he asks how it is possible for them to write down planned 10 trillion yen of NPLs in FY2002 with only about 3 trillion yen operating profits forecast for FY2002.[9]

These figures will naturally change if some of Akimoto's assumptions play out differently, such as future earnings, share prices and the amount of NPLs to be written down. But the underlying reality

[8] Ginko no Jikoshihon Mizubukure, *Nikkei*, March 13, 2002. On April 5, tabloids run stories that Hayami suggested the ratio at around 6% for end-FY2002.
[9] Hideaki Akimoto, Ginko Kabu wa Shometsu Suru, Nikkei, Feburary 28, 2002. Ohte Ginko wa Jisshitsu Saimu Choka, Nikkei, March 15, 2002, p. 5. Mitsuhiro Fukao, Koteki Shikin no Saichunyuu Fukahi, Nikkei, March 15, 2002, p. 33.

is that these major banks are incapable of continuing to write down NPLs even at the current slow pace without additional public funds. To make the matter possibly much worse is the fact that the market-to-market accounting for their latent losses from the off-balance-sheet derivatives trading has been postponed for another year. We are, therefore, unable to know if they hold latent losses on these investments as long as they continue to roll over.

Eroding Political Sense of Urgency

Secondly, the government's sense of urgency for the resolution of bad debt problems appears to have now ebbed again, as soon as the "March Crisis" was averted by the rise of share prices – alleged to have been triggered by the banning of short sell orders at prices lower than the last trade. It has been déjà vu all over again. As witnessed in the past decade, when the economy starts to slide and financial problems deepen, a resolution is postponed on the excuse that it is too risky and too painful for the society to undergo. Yet, as soon as the economy bottoms out and share prices rebound even a bit, the badly needed resolution is postponed again with an illusionary expectation that Japan can grow out of its financial malaise without writing off more NPLs.

When March ended without a fiasco, Finance Minister Shiokawa asked publicly what some people meant when they warned of the March crisis. The head of FSA, Yanagisawa, continues to insist that these banks do not need any additional public funds and that they are prepared for the lifting of the payoff ban in place since April 1. On the surface, the legal justification for additional public funds – i.e., the imminent financial crisis – has hence disappeared.

As a consequence, not even Hayami, who made a personal plea directly to Koizumi in March, is in a position to publicly push for a capital injection for now. Bank executives are trying to avoid more public funds so that quasi-nationalization will be averted. Critics have accused Yanagisawa of avoiding more public funds so that his responsibility for the second round of capital injection in spring 1999 would not be pursued.

To be sure, it is not that the injection of more capital would guarantee a resolution at all. To reiterate, the absence of it means that the pace of writing down NPLs by these banks will not be hastened. It should be argued that the capital injection, without mandating the pace of and the degree to which these banks must liquidate their bad debts on the outset, was a big policy blunder. Faced with a serious banking crisis in 1998 and 1999, the authorities injected capital into these banks too hastily, without establishing firmer rules as a quid pro quo for such capital. Banks have currently little incentives to rapidly write off massive NPLs.

There has also been an insufficient national debate on the role of the state in resolving this financial malaise, particularly on who pays for the resolution or for the lack thereof. As a result, the government has resorted to applying the rules in an ad hoc manner to each rising situation, leading to an inconsistent adherence to the rules of lenders' responsibility and investors' responsibility. Although the general public remains acquiescent for now, the tolerance of average citizens cannot be taken for granted. It is imperative that the authorities and bank managements become more accountable for the continuing use of tax money for bank bailouts as well as for fiscal and monetary easing that are keeping this economy from an implosion.

Judging from what Yanagisawa utters publicly that the FSA would not intrude into banks on the matter of how to run their banks, we are unlikely to see a drastic change in the style and substance of banking supervision under his FSA, although a significant portion of these banks are now owned by public funds. More public pressures, like those exerted last September, for a much more stringent categorization of NPLs, are likely to bring changes in the FSA's bank supervision.

In the eroded sense of urgency, a drastic resolution at the national level is highly unlikely. It could take another serious crisis or two to force the authorities to resort to a final resolution. Meanwhile,

we are reminded that there were apparently 29 cases of BOJ's Lombard rate lending in March alone, suggesting that there was indeed a crisis of many smaller banks and *shinkins* – contrary to the aforementioned Shiokawa comments.

Complacency of Bank Management

Thirdly, evidences are abounds for the complacency of bank executives in bringing their problems to a close and bringing about genuinely necessary reforms. Inadvertently helping such complacency has been a group of pundits who have recited two sets of claims that have quickly been echoed by bank executives and FSA officials as justification for the absence of resolution. Both claims obviously downplay or even outright deny any notion that the solution to Japan's protracted stagnation and deflation lies in mounting bad debt problems.

The first is the claim that deflation and NPLs are like a chicken and an egg. According to those who push this line, because deflation is a monetary phenomenon and it creates more NPLs, deflation needs to be stopped by monetary policy before banks write off NPLs. Here, causes and effects are mixed up. Of course, deflation is a monetary phenomenon. But only simple monetarists believe monetary policy alone can solve deflation. Money does not flow in a vacuum. Money flows between the monetary economy and the real economy where actual economic activities take place.

But as Alan Greenspan aptly noted, since 1998 there has been a financial dis-intermediation in the Japanese banking sector. In other words, the transmission mechanism of liquidity from the banking sector into the real economy has been malfunctioning as the Japanese banks cannot expand their lending by taking more risks and firms do not have the appetite to borrow. Indeed, as written widely by Paul Krugman since 1998 and discussed above in this paper, Japan has been in a liquidity trap.[10] Suffice it to say, it is precisely these banks that are stopping liquidity – injected by the BOJ – from flowing into the real economy. As soon as banks start playing this role of financial intermediary again, economic activities will pick up and deflation will be rectified.

At least since March 2001, when the BOJ started a quantitative easing, those who have insisted that the BOJ has not been doing enough fail to understand this reality. There is even a group of pundits who fully understands this reality but, nevertheless, wishes to put all the blames of Japan's past policy blunders on the central bank.

Moreover, no one disagrees with the notion that deflation creates more NPLs. However, we cannot ignore the fact that the origin of current deflation is debt deflation. Although deflation showed up more explicitly since 1998 in Japan, debt deflation has been evident ever since the stock market crash of 1990 and the burst of the real estate bubble in 1992. As many advanced industrial economies also experienced debt deflation in the late 1980s and early 1990s, in the aftermath of a burst of real estate bubbles, debt deflation needs to be dealt with as a cyclical problem via drastic debt liquidation. Other advanced industrial economies hence did not allow debt deflation to develop into genuine deflation, while Japan's inability to deal with it quickly enough has resulted in real deflation.

In this context, any efforts by the government to prevent an inevitable further fall of the stock and

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[10] Paul Krugman, Japan's Liquidity Trap <http//web.mit.edu/krugman html>
It must be noted that Japan's current liquidity trap differs slightly from the Keynesian liquidity trap – namely, long-term interest rates remaining relatively high, reflecting the lack of demands for long bonds as people expect yields to rise and lose money. The yield on the benchmark ten-year Japanese Government Bonds has been at historically unprecedented levels of below 1.6% during a large part of the past five years as Japanese financial institutions have been buying long bonds.

property markets through any form of price keeping operations would be, in effect, futile and counterproductive. Such efforts would simply delay the necessary bottoming out process further, thereby slowing an ensuing genuine recovery. This is because investors' expectations of a further fall keep them out of the market. However painful it may be, allowing the market to reach its natural bottom, even with overshooting, cannot be prevented by policy gimmicks. But as soon as investors start to believe that the market has bottomed out, they will reenter with expectations of a rise.

The second claim has been by a group of academic economists and some LDP politicians that deflation can be rectified only if the BOJ can be forced into accepting inflation targeting, or price level targeting policy. The rationale for the price level targeting is that you can entice consumers to spend if the BOJ can create a credible belief of inflation in a medium term, such as in two years. Again, Krugman is one of the pioneers in pushing this concept for liquidity-trapped Japan.[11]

Characterizing this move by LDP politicians and some economists as the "BOJ bashing," Ryutaro Komiya argued that their criticisms of the BOJ totally miss the point.[12] This author has also contended that their criticism of the BOJ is misplaced, diverting the public attention from the real issues and blaming the BOJ for others' mistakes. When one examines the US academic debate on inflation targeting, it becomes apparent that what has been claimed as a great success of inflation targeting abroad has in fact not been empirically proven. Inflation targeting has only been implemented against the backdrop of a disinflationary environment in the global economy where inflation may have declined anyway without the policy of inflation targeting. After all, robust economic growth, with falling inflation, was most evident in the 1990s in the US economy where inflation targeting was not adopted.[13]

While it is beyond the call of duty of this author to discuss further why price level targeting is unlikely to be successful in Japan at this stage, a few factors still need to be stated. While one cannot disagree with the idea of integrating expectations into public policy implementations, it is not rational to expect the average consumer to believe in a 2% inflation in two years when the financial malaise is deepening and the prospects for their job security and wage growth do not look promising. After all, the Japanese save for three main reasons: the down payment of their homes, their children's education, and retirement. The last two cannot be frontloaded, while people buy homes only when they feel secure enough about their job and income prospects.

Consumers should start spending again when they have a credible belief of improving job and income prospects. The Japanese banks' management should not expect price level targeting to take them out of their problems. It must also be recognized, however, that some advocates for price level targeting are indeed really hoping for a strong enough inflation – not just a moderate 2% inflation – to bail out all the problems. Such an idea is dangerously enticing for those who want to see inflation eliminate the overhang of banks' NPLs, firms' excess borrowing, and mounting public debts. Undoubtedly, this is the reason why the idea of price level targeting is very popular among bank executives. This idea is very problematic in two very distinct ways. First, against the backdrop of a liquidity trap, it has been virtually impossible for the BOJ to create even moderate inflation, let alone halting deflation, when the economy continues to be pressured by debt deflation. Second, getting inflation to bail out these problems implies a massive transfer of wealth from savers to borrowers and a morale hazard of an unprecedented degree. In the end, while this route may still be chosen as the easiest way out, it would be a cop out and a detriment to innocent savers.

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[11] Paul Krugman, The Return of Depression Economics, New York, W. W. Norton, 1999 and various pieces on <http//web.mit.edu/krugman>

[12] Ryutaro Komiya, "Nichigin Hihan Kento Chigai Ooi" (Many Misplaced Criticisms on the BOJ), Nihon Keizai Shimbun, March 11, 2002, p. 23.

[13] More on this discussion, Mineko Sasaki-Smith," Amerika de Tenkai Sareru Infure Mokuhyou Ronso", *Kinzai*, January 21, 2001.

Appendix: Agenda for Bank Reforms

Authorities' Agenda:

1. Forcing banks to liquidate NPLs faster than the government's three year target
2. Deciding on how to end this financial malaise from different options:
    1). Quasi-nationalizing some leading banks by injecting more public funds,
    2). Outright nationalizing some leading banks,
    3). Leaving the market to shake some banking sector, leading to failures of even leading ones – too messy as a realistic option
3. Letting the markets bottom out:
4. Revitalizing banks
    Deciding how to recapitalize banks
    Setting a clear vision as to how many Japanese banks can realistically survive as global universal banks,
    Further consolidating banks into a smaller number – thereby eliminating excess capacity,
5. Determining remedies,
    Adopting remedies for social dislocations, such as unemployment problems and retraining issues,

Banks' Agenda:

1. Liquidating NPLs at a drastic pace to ELIMINATE them,
2. Recapitalizing themselves to comply with the upcoming BIS rules for the capital adequacy,
3. Re-establishing new, realistic, and profitable business models,
    Choosing to become a global universal bank, a global commercial bank, a global investment bank, a domestic retail bank, a domestic bank for mid-market, or a super regional retail bank,
    "Select and focus" areas of expertise:
        Lending
        International syndication
        Investment banking
        Custodian business
        Derivatives products
        M & A
        Private banking
        Internet banking
4. Reestablishing a network of alliances and clients,
5. Building own core competency,
6. Enhancing management via CRM, SCM, HCM, brand management, etc.
7. Raising productivity via structural and process redesigning, retraining,
8. Enhancing IT capacity and capability – including E2E & B2B, retraining,
9. Adopting an effective knowledge management and
10. Adopting a system of properly pricing risks and rewards,