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The Trezise Symposium on the Japanese Economy

The Japanese economy has undergone a decade of sluggish growth marked by three recessions, including the current one. This time, recession is accompanied by general price deflation, a situation unprecedented among industrialized nations since the Great Depression of the 1930s. Meanwhile, the financial sector sits on a rising mountain of bad loans. A serious financial crisis and deeper recession are real possibilities.

How did Japan, the preeminent success story in the past half century, end up in this situation? How serious are the various problems facing the economy at the present time—is financial crisis a real danger? How can the government restore the economy to a healthy growth path? These questions formed the core of the issues discussed at the Trezise Symposium on the Japanese Economy, held at the Brookings Institution in April 2002. The symposium was held in memory of Philip Trezise, a former foreign service officer and Brookings scholar who had been closely involved with economic matters concerning Japan during his long career. The meeting convened academics, present and former government officials, and business executives from Japan and the United States for a day of discussion on the principal problems facing the Japanese economy. This report summarizes the principal themes of that discussion.

The Causes of Japan's Economic Problems

Japan is often misread. While the economy faces serious economic problems that could erupt into crisis, the situation for the past decade has, on the surface, been far from a disaster. As I noted in my opening presentation, the annual average growth rate in the past decade has been 1.1 percent, low but positive. Koichi Hamada of the Japanese government's Economic and Social Research Institute noted further that demographics imply that the potential growth rate had diminished, though it is clearly well above one percent. But the main point is that the past decade has been one of underperformance, not outright decline, a situation Akira Kojima of the *Nihon Keizai Shimbun* aptly termed "the Big Stagnation." The lack of outright decline explains why visitors to Japan are struck with the signs of affluence—crowds of well-dressed shoppers in urban areas, considerable construction on new high-rises in Tokyo, and few homeless people on the sidewalks.

This evaluation, however, generated some debate. Richard Katz of the *Oriental Economist* noted that had the Japanese economy continued to grow in the 1990s at the average rate of the 1980s (3.7 percent), Gross Domestic Product (GDP) would be 25 percent higher today than it is. That view of potential growth was challenged, but even at a lower 2.5 percent growth rate, GDP would have been

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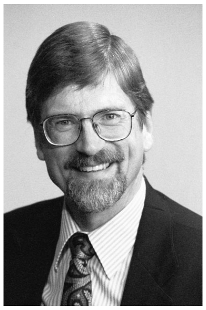

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Options for Averting a

16 percent higher, still a considerable gap between the actual level of affluence and what Japanese citizens could have achieved. In addition, Mimi Sasaki-Smith of PwC Consulting in Japan pointed out that the poor economic performance of the past decade has had considerable social costs: unemployment, crime, and suicides have all been rising. Beneath the façade of affluence, economic and social stress has increased.

The principal event causing sluggish growth and other economic problems was the speculative bubble in the stock market and real estate market in the 1980s. The Nikkei stock market average tripled in value from 1985 to its peak at the end of 1989. Real estate values in the six largest urban areas of Japan also tripled from 1985 to a peak in 1991. From 1987 through 1991, rising asset prices were accompanied by high real economic growth, averaging almost five percent. However, after tripling in value, both the stock market and the urban real estate market have lost all of their gains and are back at 1985 levels. The aggregate loss in asset values, according to Robert A. Madsen of Soros Private Funds Management is ¥1.1 quadrillion (or $8.6 trillion). Banks were left with an enormous amount of nonperforming loans, including loans to real estate developers and to manufacturers who had over-invested in increased capacity on the presumption that high growth would continue indefinitely. The shock from the drastic drop in asset prices was prolonged by a series of policy mistakes over the decade: Decisions to use deliberate fiscal stimulus came slowly; the 1997 tax increase removed stimulus at the wrong time, pushing the economy into the recession of 1997-98; policymakers were slow to relax monetary policy; and the Bank of Japan mistakenly raised interest rates in 2000, helping to choke off a modest recovery. Finally, the government let the nonperforming loan problem in the banking sector fester in hopes that a renewal of economic growth would enable deadbeat borrowers to once again service their loans.

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Underlying both the asset bubble/collapse and the policy blunders have been a variety of structural issues. A debate has occurred among economists as to whether the simple macroeconomic facts can explain Japan's problems, or whether the explanation requires recourse to these structural features. The participants at this meeting sided with the structural view. That is, aspects of both the Japanese economic system and politics are crucial in understanding why the bubble occurred and why policymakers were unable to devise better solutions. Hamada said emphatically that Japan needs both structural reform and macroeconomic stimulus. Katz argued that if the macroeconomic solutions to Japan's ills could be likened to gasoline, then structural reform was the engine; without fixing the engine, more gasoline was not going to make the economic car run faster.

Future Financial Crisis

What kinds of structural issues are involved? At stake is the set of rules and regulations leading to poor business decisions (such as lax accounting and disclosure rules), an overly intrusive government, and a political system with too many close ties to dysfunctional players in the economy. Akio Mikuni of Mikuni and Company argued that a key problem has been the behavior of Japanese banks, which have never expected borrowers to repay their loans (loans are routinely rolled over, so that borrowers need only meet the interest payments without ever repaying principal). He said that this led to low rates of return in the corporate sector, since corporations were not under pressure to earn higher profits. Furthermore, in a largely cartelized market, banks made no distinction (through either willingness to extend credit or in the interest rate charged) between safe borrowers and risky borrowers. Katz added that the lack of pressure from shareholders or bankers to maximize profits or pay out profits in the form of dividends led corporations to invest in unprofitable projects often unrelated to their core competencies (such as steel companies investing in flower shops to provide work for redundant employees). Therefore, the rules and regulations that led to this damaging behavior by both the banks and their borrowers is in urgent need of change.

Sasaki-Smith argued that when the financial sector underwent some deregulation in the 1980s, the banks should have become universal banks and acquired the functions of investment banks, but instead they stuck to their old lending model while vastly expanding loans to a risky real estate sector. Even in the recent past, a wave of mergers among leading banks has simply created old-style banks that would be "too big to fail" rather than transforming their businesses. Thus, past deregulation was insufficient or misdirected and failed to produce the necessary change in bank behavior.

Principal Participants

Following is a list of paper presenters and discussants that participated in the April 2002 Trezise Symposium on the Japanese Economy at the Brookings Institution:

Michael H. Armacost	The Brookings Institution
Robert Fauver	Fauver and Associates; Research Institute of Industry, Economy and Trade (RIETI)
Koichi Hamada	Economic and Social Research Institute, Cabinet Office of the Japanese Government; Yale University
Richard Katz	*Oriental Economist;* State University of New York
Akira Kojima	*Nihon Keizai Shimbun*
Edward J. Lincoln	The Brookings Institution
Alan Larson	Undersecretary of State for Economic Affairs
Robert A. Madsen	Soros Private Funds Management; Stanford University
Akio Mikuni	Mikuni and Company
Marcus Noland	Institute for International Economics
Richard J. Samuels	Massachusetts Institute of Technology
Mimi Sasaki-Smith	PwC Consulting, Japan
Tatsuya Terazawa	RIETI

At the heart of many of these structural problems lies the problem of transparency. The private interface between bankers and their clients is non-transparent, as is much of the interaction between the government and the private sector. In any economic system characterized by a lack of transparency, the problem is often the failure to transmit bad news. Kojima, in his presentation, stressed the importance of poor information disclosure in causing Japan's problems. During the high growth years in the 1950s and 1960s, the lack of transparency mattered little, but in a slowly growing economy, the efficient shift of economic resources (both capital and labor) from declining or poorly performing sectors to expanding, efficient sectors is crucial.

Impending Crisis?

For the past decade, the Japanese economic system has muddled through low economic growth without any implosion of the banking sector, despite the nonperforming loan problem. But can this situation continue, or is a much harsher financial and economic crisis likely to occur? While there were voices of relative optimism at this conference, participants generally felt that without reform, there was little hope for a better future, and that over the next few years, several factors will contribute to the government's ultimate inability to muddle through the way it has for the past decade.

The official estimate by the Japanese government's Financial Services Agency of the level of "problem" loans (nonperforming loans plus those to companies that could potentially be in trouble) is only ¥36.8 trillion ($280 billion at current exchange rates). Estimates in the financial community are generally in the range of ¥100 trillion to ¥250 trillion. Tatsuya Terazawa of the Research Institute of Industry, Economy and Trade argued that the fear of a financial crisis is exaggerated and felt that these private-sector estimates of the size of the problem are unrealistically high. He noted that banks have written off some ¥80 trillion of nonperforming loans in the past decade, and that the perception of a rising problem is due in part simply to tougher government standards in evaluating loans.

Others disagreed, supporting the much higher private sector estimates of nonperforming loans and pointing out that new nonperforming loans are materializing faster than banks write off the old ones, causing the outstanding total to rise. In addition, the pace at which banks are writing off loans is diminishing. Madsen argued that Japan has at most three to five more years to deal with nonperforming loans as the problem continues to grow. Marcus Noland of the Institute for International Economics suggested that the time available might be much shorter. He noted that the banks are only a subset of a generally dysfunctional financial sector that is harboring seriously underfunded pension plans and unachievable contracted returns on life insurance policies. Therefore, an implosion involving failure of large numbers of banks and other financial institutions may be more imminent in the absence of serious policy actions than even Madsen suggested.

Jennifer Kurz

Akira Kojima, *Nihon Keizai Shimbun*

The possibility of a serious financial crisis is heightened by the combination of recession and deflation that has affected Japan. By April 2002, real GDP had been declining for three consecutive quarters and the GDP deflator had been falling between 1.5 and 2.0 percent annually for the three years starting in 1999. Recession brings with it an increase in bankruptcies (and, therefore, nonperforming loans). Deflation further increases the debt burden on all borrowers, who have to service their fixed loans out of the proceeds from selling goods or services at shrinking prices.

I noted in my opening presentation that the annual decline in prices has been small, so that it should not have much negative impact on borrowers, but participants disagreed. Hamada argued that the cumulative drop in prices over the duration of a loan could be serious enough to force some corporate borrowers into default. Madsen noted that it is only firms at the margin that matter—as deflation has taken hold, borrowers who were already near the breaking point have been forced into default. Mikuni noted that with only 30 percent of Japanese corporations reporting positive profits, the number of firms in marginal positions is substantial.


Jennifer Kurz

Richard Katz of the *Oriental Economist*

Sasaki-Smith noted that further aggravating the nonperforming loan situation is the fact that bank managers simply do not display much sense of crisis—their predominant attitude is to hide problems until they can safely retire. Kojima agreed, saying that Japan's real crisis is the lack of a sense of crisis. Madsen noted that one could interpret the past decade as one in which most elements of society have protected vested interests, trying to preserve non-economic social values—weak banks and borrowers feared exposure of their problems, regulators were afraid to admit failure, and the dominant political party received support from most of the losers in the economy.

Solutions?

A crisis can be averted, but fixing the problems in Japan would require a combination of policies that the government was committed to implementing. Conference participants came up with the following broad options:

- Aggressive resolution of the nonperforming loan problem
- A structural shift to reduce the role of banking and increase the role of capital markets (bonds and equity) accompanied by increased transparency for capital markets to function properly
- Supportive macroeconomic policies as the loan problem is addressed, including continued fiscal stimulus and perhaps unconventional monetary policies
- Other forms of deregulation and structural change to encourage business activity

The critical issue is disposal of nonperforming loans. All participants favored aggressive action to force banks to shut down loans and to dispose of the collateral, which is almost always real estate. This last element has been generally missing. Even though banks have written off some loans, often the collateral has remained in the hands of the borrower or the banks. Hamada and others emphasized the importance of selling these assets into the market to put them in the hands of new owners at prices enabling them to earn a profit.


Jennifer Kurz

Mimi Sasaki-Smith of PwC Consulting

At the levels estimated by private sector analysts, the nonperforming loan problem is too large for banks to dispose of on their own. Therefore, any scenario of aggressive action on nonperforming loans will require government intervention to recapitalize some banks (since capital markets are unlikely to willingly put new capital into insolvent banks to bail them out) and liquidate those that are unsalvageable. Some of the banks' problems are the result of unethical or illegal behavior by the bankers themselves, but no nation can afford to let its banking system collapse. Such a bailout, though, must be accompanied by mandatory shutdown of nonperforming loans and sale of the collateral. The banks did receive two infusions of capital from the government in 1998 and 1999, but this condition was missing and undermined the effectiveness of the bailout.

To deal with the problem of taxpayer and political resistance to a banking bailout, several participants argued that culpable bankers should go to jail. Noland noted that in the much smaller American savings and loan crisis of the 1980s, some 1,600 bankers were indicted, of whom many were convicted and went to jail. In the Japanese banking crisis, only about 100 bankers have been indicted and few have actually been incarcerated. Richard Samuels of MIT noted that in Italy, prosecutors were given a free hand in the recent effort to deal with political and bureaucratic corruption. Vigorous prosecution destroyed the dominant party and went far in removing incestuous relations between government and the private sector.

Closely related to aggressive policy on nonperforming loans is a broader structural adjustment in the financial sector. Put simply, Japan has relied too heavily on a non-transparent banking system to mediate the flow of funds between savers and investors. Many conference participants favored a reduction in the overall role of banking and a concomitant increase in capital markets. This would force the increased disclosure of more accurate corporate information (essential for the proper functioning of capital markets), bringing needed transparency to the system.

The third critical element that achieved broad agreement among participants is the need for macroeconomic stimulus to support the economy as it is undergoing this repair and transformation of the financial sector. This consists of both fiscal and monetary policy, and participants argued that the opportunity remains for action on both fronts.

On fiscal policy, the concern is that the size of the Japanese government debt as a share of GDP (now approaching 140 percent) is so large that it would be imprudent to let it rise much farther. Based on this fear, Prime Minister Koizumi came into office advocating a policy of cutting the annual government deficit. Participants at this conference, including those from the Japanese government, rejected this approach. Hamada recognized that past policies emphasizing wasteful public works spending policies have been misguided, but argued that the government could pursue tax cuts. He suggested that tax cuts may emerge by the summer of 2002. Terazawa noted that while many observers are concerned about the size of the government's debt, the government has faced no market resistance to its bonds yet and that such resistance might not occur until the debt level is much higher, providing the government with continued leeway in pursuing fiscal stimulus. Therefore, while government debt levels face some future limit, the more important issue right now is to provide fiscal stimulus to cushion aggregate demand in the economy as nonperforming loans are shut down.

Monetary stimulus is a controversial policy area. Nominal short-term interest rates are close to zero and the long-term government bond rate is only 1.4 percent. Nevertheless, some economists have recommended an unconventional shift in monetary policy from interest rate targets to a quantitative policy anchored in a positive inflation target (of three or four percent). This would involve a faster expansion of the money supply until the change in overall prices reaches the announced inflation target. Katz was skeptical of the ability of the government to achieve any inflation target. But in general, participants concluded that such a quantitative policy goal pursued in conjunction with all the other policy measures was worth trying. By itself, however, monetary policy operations to end deflation is no panacea for the economy and might not succeed.

Finally, all participants favored further deregulation to free up competition in regulated markets and to provide a more robust set of rules for competitive markets. Kojima worried that the Koizumi government was pursuing too diffuse an agenda on this front and should stick to only a handful of key areas. Central in this approach is the need to improve corporate transparency. In addition, deregulation to encourage new or growing industries (such as nursing care for an increasingly elderly population) and to pull in foreign direct investment would be useful. Alan Larson, undersecretary of State for economic affairs, emphasized in his luncheon address the value of more direct investment in assisting structural change. Robert Fauver of Fauver and Associates went even further in his presentation, proposing a "super economic partnership" between the United States and Japan, an open market agreement going well beyond a traditional free trade area. In his view, negotiation of such an agreement would impose legally binding rules in Japan on many of the structural issues discussed at the symposium and pave the way for more inward direct investment. There was some skepticism as to the viability of Fauver's grand bargain, given the lack of political interest in such a move in Washington in the past and the probable difficulty in managing a successful negotiation of this breadth.

On a separate issue, Madsen argued that substantial yen depreciation accompanied by a substantial increase in Japan's current-account surplus (perhaps even a tripling from current levels) would be a necessary and unavoidable part of the solution to Japan's various problems. Katz and others disagreed that the rest of the world would absorb a large increase in Japan's surplus—either for straight economic reasons or political resistance. Nonetheless, it is important to keep in mind that many of the possible reform scenarios could generate at least a temporary decline in the value of the yen.

Conclusion

Accomplishing these reform policies requires political and business leadership. Samuels argued that Japan has had ample leadership in times of crisis in the past. While leadership has been particularly weak in the past decade, this situation may change, with a new generation of political leaders emerging in the midst of economic malaise. Others noted that entrepreneurship and technical skills, including in the banking industry, are not in short supply and only need the right environment to provide a positive economic boost. Therefore, while the past decade has been very

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disappointing, Japanese society certainly has the capacity to fix its economic problems and return to a robust economic growth path.

Despite the lack of any disaster in the past decade, Japan faces very serious problems that could erupt into a major financial crisis and a severe economic decline at an unpredictable point in the next several years. Some participants felt that a crisis might actually be cathartic, in that it would force the government to implement more rational economic policies. Nevertheless, the economic and social consequences could be severe. Even if the economy does manage to "muddle through," the result could be continued underperformance and erosion of living standards. The surface appearance of affluence should not obscure the very real and dangerous dilemmas this economy faces.

Participants generally credited Prime Minister Koizumi with bringing critical issues such as nonperforming loans squarely before the public, but no one felt that his government was making adequate progress. If political leadership does emerge, and the latent skills in the private sector are unleashed, a crisis will be averted. If not, Japan faces a potentially devastating financial and economic crisis.

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