

**Notes from**

**“Japan’s Economic and Political Problems and Challenges Ahead”**

**with**

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1. After three years of price decline and after the three consecutive quarters of negative growth, there have recently emerged slightly positive signs in the Japanese economy, such as progress in inventory adjustment, possible bottoming out of production, possible bottoming out of business sentiment of large manufacturers, and last but not least, the rise of stock prices.
2. Thus, the much feared March crisis has been averted, but there remain still a number of economic uncertainties in addition to new confusions in the political scene.
3. First, the rise of stock prices since February, which certainly reflects brighter prospects of Japanese exports due to the stronger than expected recovery of the American economy, and some revival of foreign and domestic investors’ interest in Japanese stock markets.
4. But, in addition to the purchase by Japanese public pension funds, which is often nicknamed PKO, price keeping operation, the recent changes in market rules, such as liberated share buybacks and restriction on short selling must have contributed to the prevention of the fall of stock prices at the end of the fiscal year. The introduction of artificial rule changes near the end of a fiscal term is always a problem, and there may be the possibility of a turn-around of stock prices in the new fiscal year unless the results of corporate performance for fiscal 2001 turn out to be encouraging.
5. Second, problems of non-performing loans. Under pressures from financial markets, the process of disposing non-performing loans has been accelerating. On the one hand, a number of large corporate borrowers, mostly in distribution and construction sectors have collapsed after failing to secure the continued support of lending banks, while some other borrowers have managed to retain the banks’ support through rescheduling of the payments of interest and principals, debt-equity swaps and/or debt forgiveness.

6. On the other hand, a number of smaller banks in difficulties have been forced to merge with other banks. Many banks are confronted with (1) the outflow of deposits in connection with the end of the official guaranty of bank deposits, (2) the losses caused by the sale of non-performing loans at discount, (3) the need to increase provisions for dubious loans, (4) the introduction of market to market accounting rules under the continued deflation, and (5) the consequent weakening of their capital position.
7. The recent rise of stock prices must have helped banks and borrowers to pass over the end of the fiscal year. But depending upon the results of on-going special inspections of banks by the regulator and the results of corporate performance for the fiscal 2001, which will be made public in the coming weeks, financial markets may destabilize again.
8. The authorities seem to be determined to avert a Japan originated financial crisis, even by injecting public funds if necessary in case of emergency, but there still remains some division of views among policy makers on the actual steps to be taken.
9. Third, political development and its economic implications. Our popular Prime Minister has suddenly lost his popularity, at least by one third, after the dismissal of his controversial but uniquely popular Foreign Minister last January and the revelation of the scandals involving two well known leaders of his own party.
10. In the meantime, the reputation of the bureaucracy has been greatly undermined through the events leading to the dismissal and scandals as well as their poor handling of the mad cow problem. The unexpected victory of a 37 year old independent over the experienced incumbent supported by all the three coalition parties as well as Socialists at the election of the mayor of Yokohama, the second most populated city in Japan, last Sunday, must indicate the growing disillusionment of the general public about the current political leadership, political parties and political practice.
11. The Prime Minister is facing a serious dilemma. Politically, unless he sticks to his own reform pledges, he will lost his popularity further. Economically, however, if he sticks too much to all of his self-imposed commitments, deflationary conditions may deteriorate further. He may have to accept some of the demands for more flexibility from his fellow politicians and others. He has already expressed his readiness to become more flexible on his repeated commitment to limit government borrowing.
12. The privatization of public agencies, which the Prime Minister has been advocating, is a desirable course of action, but the privatization at this time may not help to ease the current deflation. It is possible for some private banks to be at least partially nationalized, and as long as private banks are in trouble the privatization of government banks may have to be postponed.

13. Despite all sorts of problems and his indecisiveness on many important issues, his remaining strength is the absence of any immediate replacement. Thus, he is expected to stay as Prime Minister for the coming months, but whether he will be increasingly influenced by the old guards of his own party or he will be courageous enough to challenge them by calling a general election to trigger an overhaul of the entire political scene remains to be seen.
14. Fourth, the macro economic situation. With already enormous fiscal deficits, pressures are mounting for further relaxation of monetary policy, but such a policy alone cannot be effective to stimulate economic activities due to the still weak demand for credit and the unresolved banking problems too easily.
15. It is argued in and outside Japan that further monetary expansion will eventually create inflation and stimulate spending because of the anticipation of further price rise. But unless uncontrollable inflation is created or unless the prospects of the Japanese economy and society brighten, Japanese consumers may not be tempted to accelerate their spending.
16. Liquidity is already abundant, but prices, particularly those of assets, are not rising. This is because stock prices cannot rise unless the prospects for corporate performance improve; land prices cannot rise unless the demand for real estate strengthens.
17. Only the prices of foreign currencies can rise and have risen already, which means the yen has fallen. But if the yen falls too much, our trading partners will be greatly disturbed, as in 1997-98 when the Asian financial crisis was triggered by, among other things, the excessive depreciation of Japanese yen. If the yen falls too much, foreign investors will be likely to withdraw from Japan. It is also possible, on the other hand, for the yen not to fall so much if Japanese investors have to repatriate their investment abroad because of their difficulties at home.
18. Steps aiming at recovery and reform together, such as deregulation and tax credits, are necessary. Such an approach seems to have begun to gain more support finally, as seen in a number of suggestions from the private sector and remarks by several policy makers.
19. Unlike public spending or subsidies which can be and have been wasted for unnecessary projects or unprepared recipients, tax credits can be activated only after the private sector acts, and thus will be able to stimulate private sector activities and promote deregulation and administrative reform.
20. Obstacles to this approach are, among others, the traditional attachment to short-term "revenue neutrality" by fiscal officials and the two inflexible tax committees, one in the LDP and the other in the MOF. The records of the discussion at the

recent meeting of the Economic and Financial Council reported in today's Japanese paper unfortunately confirm such concerns of mine.

21. It is possible for the recently emerging positive signs to be short-lived, but it is also possible for them to be an omen of the beginning of the end of our long ordeal. Even if luckily the latter is the case, however, there may be the danger of such improvement inducing another postponement of necessary reforms. We have no reason at all to be able to be optimistic even if there might be a very small light at the end of the long tunnel.