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*Economics vs. Politics: Takenaka's Prescription for the Japanese Economy?*  
Japan Chair

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**William Breer:** We have five distinguished panelists to discuss this issue. We'll open with a detailed discussion by Larry Meyer, former member of the Federal Reserve Board.

**Laurence Meyer:** The topic is Takenaka's prescription for dealing with the banking sectors problems, and its role in the broader agenda. A drama is unfolding, beginning with the replacement of Yanagisawa with Takenaka. Yanagisawa was a defender of the status quo, and his exit was a prerequisite for change. The Takenaka plan was bold and decisive. What followed was political backlash and retreat. The question is "was the initial program too bold?" Should we be hopeful, skeptical, or both at this point? What are some of the prerequisites in terms of dealing with the banking sector?

We in the US know about bursting asset bubbles and post-bubble hangovers, hangovers that give rise to dramatic declines in equity prices, capital overhang from a frenzy of investment during the boom period, and balance sheet problems. These problems in Japan have been more severe because they have undermined the health of the Japanese financial infrastructure. This is partly because equities play a much larger role in banking structure, and partly because land values declined as well as equity. Japan slid into a debt-deflation cycle. Now, they have to worry about not only the stock of bad loans, but also the flow of new bad loans. This is even more difficult in Japan because the banking system is heavily depended on, whereas in the US we have more diverse capital markets.

Deflation is important. Central Banks know how to reduce inflation, but reducing deflation is less clear. Monetary policy can only go to zero. Conventional means of monetary policy can become exhausted.

Even if we eliminated politics, the problems are very difficult. There is no magic bullet. We need a package of programs complementing each other, doing a number of things together at the same time.

The options for conventional macroeconomic policy have been nearly exhausted. The monetary policy rate has been driven to zero; fiscal deficits and debt-to-GDP ratios have ballooned.

A lot of the good policies involve short-run pain for long-run gain. If you can't offset the short-run pain with more macro policies, it makes you reluctant to move forward. This adds up to paralysis.

How can we develop an agenda that pursues structural reform and at the same time mitigates short term pain? This has been made even more difficult due to the lack of cooperation and trust between agencies.

What can we take from this latest flurry of discussion? We do seem to be moving towards a combination policy. Structural reform is being accompanied by an easing of monetary policy. The BOJ reluctance to ease policy up until this point is due to its belief that monetary policy alone could not solve problem, and they didn't want to be out there alone. Now they are showing qualified support for the program. The plan in question, however, is vague, devoid of deadlines, and leaves lots of questions unanswered.

The government could not have introduced this plan in a way that could have done more to undermine people's confidence in it. First they leaked a bold plan, then they retreated from the political backlash, then offered a plan that was vague and far less bold.

What are the criteria for measuring banking reform? This first key is to get banks to admit that they are undercapitalized. Banks say that they are capitalized and that they meet deposit standards. They can only say this because they are allowed to under-reserve for their loans. A good reform must produce a hole in the banking system and force banks to ask for a public injection of funds. The original Takenaka plan met this criteria; it's not clear whether the subsequent plan does. The current plan encourages, but does not force, the banks to change the way they evaluate non-performing loans (NPL) and use a discounted cash-flow method.

Once you get banks to admit that they are under-capitalized, you have to inject public funds into the system. This is not lending; it is an injection of public capital. But there has to be conditions attached to the funds. The government ought to get common stock as part of this. Management should be replaced.

Any troubled bank should be separated into a "good bank" and a "bad bank," with the good bank getting the healthy loans, and eventually being sold on the market. The bad bank should get the bad loans, which should go on to a third party, which would liquidate the assets or restructure firms that are viable. It is important that the bad loans be disposed of rapidly. The restructuring of firms affected by bank reform is another important aspect of any plan.

How do the Takenaka plans stand up to these criteria? The first, bolder, plan generally fulfilled them. It required better reserving against loans and had a stricter treatment of deferred tax credits. These credits only come into play if the banks have profits five years from now, by no means a sure thing. These credits account for about half of the big banks' capital. The initial plan would have reduced them to around 10%

(which is best-practice around the world). This would have nationalized most of the large banks in Japan.

Was it too aggressive? Would the government have been able to nationalize so many banks at the same time? Is the compromise plan a pragmatic compromise, or was it a political retreat from the vested interests and political pressure? In order to evaluate this plan, we must ask the question “compared to what?” Should it be compared to what was in place previously? If we do, many good things can be said about it. Or should it be compared to an idealized plan/ the first plan? In that case, it looks like it is backtracking rapidly. As it is, the final plan lacks details and timetables. It exchanges decisive action for a call to “study the issues.” It is encouraging rather than mandating better loan evaluation. We have to give this plan an “Incomplete.”

Skepticism has been the right approach for the last ten years. If we had been skeptical every time a new plan was floated, we would have maintained a pretty good batting average. I do see some hope in the increase in trust and cooperation between the government agencies.

**William Breer:** Thank you, Larry. Mr. Saito is the vice-president and senior Japan analyst with the G-7 group. In the past he has been with the Dai-ichi Kangyo Bank, which is now part of Mizuho Bank in Tokyo, where he secured financing and cultivated investment opportunities for DKB clients.

**Tsuyoshi Jin Saito:** Our clients are entirely investment banks and hedge funds, so I may have a slight bias. Much confusion exists in the global business community. Analysts can't even agree if there *is* a plan, not to mention whether the plan is effective. Some say that this is just a very vague general principle, while others say that there is something to it.

It seems to me that there are three schools of thought. The first school is the “no plan school.” For this school, everything is just a big public relations campaign. The second school is the “watered-down school.” They say that the original plan has been watered down to the point that even if it is implemented, it won't matter much. The third school, the “cautious optimists school,” say that the plan is real and has teeth. They place their skepticism not on the plan itself, but rather on its implementation. If it is implemented vigorously, it could mean something. I belong to this third school.

Because the Takenaka plan is real and has teeth, it will be hard to implement. In my assessment, this is the first honest attempt to address NPL problem in post-bubble Japan. All previous attempts were meant to hide the problems, not to deal with them. If the bank regulators goal was to hide the problem, they succeeded. Of course the NPL's didn't disappear.

As Dr. Meyer said, we should compare the current plan to the situation in the past and what will happen in the future.

After the bubble burst, the Japanese government was in complete denial. This lasted until 1995. Then, in 1995, with the Jusen crisis, the government was forced to step and spend 685 billion yen, a sum that looks like peanuts today. The Diet went into paralysis. This served as a warning to bank regulators, reminding them that this is a not an easy subject to tackle.

By 1997-98, after the first wave of the financial crisis hit Japan, the Sasanami committee was organized. It injected 1.8 trillion yen of public money still peanuts, but it was the best they could do given public sentiment. In 1998-99, the second wave of the financial crisis hit Japan with the problems of the Long Term Credit Bank. This time the Yanagisawa committee injected 7.5 trillion yen in public money. This was the first significant amount, but even then I recall talking with a policy maker at the time who told me that they didn't calculate this number based on how much was needed, but rather on how much they could inject into banks without nationalizing them.

Past regulation of the banking industry allowed banks to book the value of their loan assets based on how much they could spare within the capital adequacy ratio. They then set aside loan loss provisions, so that the real financial condition of the borrowers was never reflected in the balance sheet. If the bank booked the value of the loan asset to secure a sufficient capital adequacy ratio, then all banks would be financially sound and well capitalized. There is no need for public money. Since banks are sound, the government would only use public money if the nation's financial system faced a challenge. This is the systemic risk argument, and it avoids addressing individual banks' balance sheets. This was the logic that the Yanagisawa committee followed when they injected the 7.5 trillion yen. The money injected, however, was in the form of loans. Since no banks were getting nationalized, there was no reason to purge management.

Everything up until now had this banking regulation framework in mind. In my assessment the Japanese government failed to deal with the bad loan problem because they simply did not want to face it. The only reason I'm hopeful about the Takenaka plan is because I see a Japanese policy maker that is not pretending, like an alcoholic, that there is no problem.

If the clause of the tax credit Dr. Meyer was speaking of were kept, all big banks would have to be nationalized directly or indirectly by March 31 of next year. From my conversations with policy makers at the time, I believe that they were willing to compromise on that point. They knew that their political capital was insufficient to push through this point. When Takenaka conceded this issue, I didn't feel a sense of defeat. I got the sense that they made a tactical move to keep everything else intact.

What was in the original plan? As Dr. Meyer said, banks would have to book the value of their loan assets based upon the borrowers' ability to generate cash, not upon how much banks can spare to secure their existence. If this were vigorously implemented, it would be wonderful. The original Takenaka plan said that banks would have to use this accounting system by March 31.

In the past, several banks with the same borrower would classify the loans to the borrower differently. This came about because of the overriding concern of the Yanagisawa regime for keeping the banks well capitalized. This meant that if Bank A could spare more money, they did. If Bank B couldn't, they didn't.

The Takenaka plan gets rid of this nonsense. It says that if several banks have the same borrower, that borrower's loans all have to have the same classification. Furthermore, it has to be the toughest classification amongst all the banks. The government will conduct a special investigation in March to make sure that the banks don't collude with each other on relaxed loan classification. Since most of the big borrowers are publicly traded companies, any analyst can calculate the discount cash flow of the company. This makes it harder to lie about a borrower's ability to generate cash.

After evaluating loans at March 31, some banks will have to be re-capitalized by the government in exchange for common stock (not preferred stock). The government would get to place a government representative in management, and the old executives would get purged.

The RCC, which would take in the bad loans, is currently working on an unbiased, numerical formula that would prevent the dispersal of NPL's from becoming politicized by politicians. This formula (probably a 1:10 cash flow to debt ratio) would force the rehabilitation of the big retail and construction companies.

Compared to the original Takenaka plan, which would have called for the immediate and simultaneous nationalization of the entire banking system, this new plan is a retreat. But life is often a function of expectation. Compared to the Yanagisawa regime, I find this plan to be a hopeful step. The question for me is implementation. The key is how much Prime Minister Koizumi can back Mr. Takenaka (an academic without a strong power base). Because it is an outsider plan, I have a lot of hope. But I also have a lot of skepticism about its implementation.

**William Breer:** Thank you very much Mr. Saito. We're going to move onto Peter Ennis now. Peter is the editor-in-chief of the *Oriental Economist* in New York. He writes frequently on Japanese economic issues. We're delighted to have him here.

**Peter Ennis:** I'm supposed to talk a little bit more about the political background over which this drama has played out. I'm treading on thin ice here, as I'm not an economist, but I would like to make a few comments on the economic background.

In my view there really is no chance of an economic recovery in Japan until the bad debt problem is dealt with. It is no longer credible to argue that Japan should emphasize growth first, and then deal with the bad debt problem. That had been the anti-reformist argument for some time, and still is to some extent (the Hashimoto faction put out a statement to that effect a few weeks ago).

The problem with that perspective is that it has already been tried. Interest rates near zero and massive fiscal stimulus failed to generate a self-sustaining recovery.

Bad debts reflect bad borrowers. This is the key to the political situation. Bad borrowers are people, i.e. constituents.

In economic terms, this represents excess capacity. With interest rates so low and companies knowing that they'll be bailed out, cutthroat pricing practices add to deflation. Rather than deflation being the cause of the bad-debt problem, I would argue that the bad-debt problem is contributing to deflation. This rules out the "growth first followed by bad debt restructuring" approach.

It's important to recognize that Japan is not alone in having to deal with bad debt problems. It took the US ten years to fully come to grips with the S&L crisis. In 1981 7% of US S&L's were already losing money. Regulators and Congress tried to deal with the problem by letting S&L's grow out of it by engaging in new types of business. The results were a disaster. It was only when the first Bush administration came to office in 1989 that the government came to grips with the problem. The RTC (Resolution and Trust Corporation) was created and Congress appropriated money to deal with the problem.

There are, however, huge differences between the S&L crisis and the problem in Japan. The problem in the US was far smaller than the one in Japan. Also, the US was much better prepared with respect to infrastructure to deal with its bad debt problem. We had well-entrenched bankruptcy courts, armies of accountants who could be hired by the RTC to pour over the books of failed S&L's, many buy-out specialists, experts in corporate rehabilitation, and investors expert in dealing with distressed properties. As a result of the efforts of the RTC, when the market hit bottom, investors were ready to move in. The transition was relatively quick.

The problem in Japan is that this infrastructure really doesn't exist. In addition to the faults in the market structure, Japan's unemployment system lacks the depth and breadth that will be necessary to deal with the very rapid increase in unemployment if the bad debt problem is dealt with. This is important politically because you will find an institutional resistance because so many people are aware that they are not prepared to deal with the social fallout.

What does this mean for the prospects of reform? These things tend to take the form of windows of opportunity. For example, the transition from the Reagan Administration to the Bush Administration opened a window of opportunity for the US government to come to grips with the S&L crisis. We've seen the same pattern in Japan; however, the window of opportunity was not taken advantage of.

The last time a window of opportunity appeared was the summer of 1998, when the Long Term Credit Bank was going under. A loose coalition of younger politicians from the LDP and Democrats worked together to try and come up with a comprehensive

package. It was comprehensive in the sense that they would let LTCB go under while rapidly expanding the social safety net. The young Diet members were very much aware of the need for a link between a hard-line policy on the banks and an increase in the social safety net.

The younger politicians were defeated. Ultimately capital was injected into the bank with no conditions. Thus, some bad loans were warehoused at the RCC while others were allowed to stay on the books. Instead of being dealt with, the bad loan problem grew.

We've seen in the month of October another window of opportunity that has been effectively shut. October has shown both the best and the worst of Prime Minister Koizumi. We have seen his best in the appointment of Takenaka and the willingness of the Prime Minister to back Takenaka in the appointment of outsiders.

The LDP old guard is enraged with the way that Koizumi is operating. He is governing around them rather than through them. He is trying to rule through his own office, and through the cabinet office.

On paper, I agree that there are some positive elements in even the final plan that Takenaka came up with. However, Koizumi has allowed the forces of resistance to set the terms of the debate. Takenaka was hauled in front of the Diet and lambasted by Aso Taro with the argument that he was endangering the Japanese economy by forcing a hard landing.

I think Takenaka understands the need to link a hard-line on the bank issue with an expansion of the social safety net. The problem is that this runs right up against Koizumi's pledge not to expand the fiscal deficit. This is Koizumi's fatal economic flaw. His definition of reform is pretty narrow. Basically he believes that he can change the power structure of Japan by cutting off the corrupt public works spigot utilized by his LDP opponents. If you talk with Koizumi about the bad-debt problem, his eyes glaze over. If you talk to him about cutting public works he gets very animated. That's what he's really interested in. He hasn't yet seen the link between dealing with the bad debt problem and the need for a temporary (huge) expansion in government spending to create a macroeconomic floor for the economy that will help people who are going to get hurt. As long as he misses this link, he will be vulnerable to attacks from the anti-reformers.

Is reform dead? I think the window of opportunity this time around is closed. But I think a new window of opportunity will arise faster than this latest one. I don't think this latest plan will come anywhere close to solving the problem. I don't think there was anything in this plan that Yanagisawa himself couldn't have come up with.

Even if, starting today, the Japanese government did everything right, it would take at least five or six years to solve the problem. Putting in place the infrastructure needed to smooth the transition is going to take time. And the fact is the government is not going to do everything right; no government does everything right. It is very possible

that Koizumi is not the person who will lead to a solution. Perhaps we've reached the limits of the prime minister's ability to lead on this problem.

I'm not even sure that the LDP will be in power when a solution is reached. I've thought for quite some time that in order to get the needed reforms, the LDP is going to have to split. I think this is going to take some time.

**William Breer:** Thank you very much Peter. I'd like to have Mr. Ogata go next.

**Shijuro Ogata:** The recent Takenaka appointment can be viewed as a microcosm of the current economic and political confusion in Japan. The outsourcing of the entire economic policy management by the prime minister to a single, un-elected cabinet minister is quite unique in a parliamentary democracy. While I appreciate Takenaka's personal brilliance, I think the authority delegated to him is too large for his limited ability and political power.

The original Takenaka proposal had at least two deficiencies. First, it lacked a parallel package of anti-deflation measures. Bad loans and deflation are two problems that aggravate each other, and thus have to be dealt with together. Secondly, revision of the accounting regime should be undertaken in stages.

Even though the final version of the new packages is watered down, it has at least two merits. First of all, bankers have been warned about the urgent need to deal with their bad loan problems. Now there is a greater readiness on the part of the government to activate its right to demand that those banks that have failed to meet the predetermined requirements must convert government owned non-voting preferred stocks to ordinary stocks with voting rights. This is a step towards nationalization.

Secondly, the plan reminded us that that the bad loan problem is not simply the problem of banks but also the problem of borrowers. A simple injection of public funds to problem banks alone could not solve the problem. Although I am in favor of the rationalization, including privatization, of government banks, those government banks should be fully utilized while private banks are in serious trouble. In that context, the proposal to establish an Industrial Reconstruction Corporation may not be a bad idea.

Having said that, both the banking reform plan and the anti-deflationary measures share a serious drawback: the lack of serious attention to the need for tax reform. The generous counting of deferred tax assets as Tier I capital at present may be, I suspect, also not unrelated to the rigidity of our tax system and taxation policies, for which both Koizumi and Takenaka seem to be responsible. In the newly announced anti-deflationary measures, some new tax incentives have been mentioned, but I am not too optimistic about their quick implementation. Sadly, I know the power of tax committees in the LDP as well as in the MOF. Koizumi the reformer has never openly challenged these groups.

In the case of Takenaka, his macroeconomic policy prescriptions have been primarily focused on monetary policy. He has been advocating further monetary

relaxation through the establishment of inflation targets by the BOJ. Either he is bound by Koizumi's pledge to cap public borrowing at 30 trillion yen, or he believes that deflation is a primarily monetary phenomenon (or both).

In my view, however, deflation is not only a monetary phenomenon but also a real economic phenomenon resulting from excess capacity and deficient demand. In addition to monetary policy new tax incentives and more deregulation are called for.

Finally, the fact that Koizumi failed to support fully Takenaka against the opposition from various quarters is very serious. Now his leadership is in question. Because of the absence of an appropriate substitute he cannot easily be replaced. This is Koizumi's strength and Japan's weakness.

If those candidates that could emerge as his possible replacement are seriously examined, even the LDP old guard cannot but support Koizumi. I do hope that he will soon appoint a powerful political figure as Deputy Prime Minister in charge of economic policy coordination, although I know how difficult it will be to find a suitable person for such a post. Thank you.

**William Breer:** Thank you very much Shijuro. Who is your candidate for that job?

**Shijuro Ogata:** That is a very good question. One easy solution is to make Shiokawa Deputy Prime Minister and appoint Mr. Noda of the Conservative Party Minister of Finance. However, I know that the Finance Ministry people will hate him. Or you could appoint Takenaka Minister of Finance. However, I think that because of Takenaka's arguments for macroeconomic policy, he may not be appropriate.

I discovered an interview by Mr. Gotoda, former Deputy Prime Minister from the Nakasone cabinet. In it, he said that this cabinet is a very interesting cabinet, one that picked up many technically capable people. But, he saw two problems, the first being that of Foreign Minister Makiko Tanaka. While her father was a self-made man, she was just the daughter of an established politician. He was quite right, of course (I was worried too). Secondly, Gotoda felt that Shiokawa ought to have been appointed Deputy Prime Minister instead of Finance Minister.

I had a chance to talk with Mr. Nakasone. He agrees with my idea, but he didn't mention any particular names.

There are two important jobs for a Prime Minister. One is foreign policy. The other is economic policy. No Prime Minister can handle both of them. In that case, he or she should have a strong deputy. But Koizumi, without knowing so much about the economy (except short-sentenced conclusions), hasn't appointed any such person. That is my concern.

I agree with the importance of outsiders. But this is parliamentary government. Without the support of parliamentarians and bureaucrats, nothing can be done. Outsiders can produce ideas, but they cannot do more than that. That is my problem. That is why

I'm in favor of an appointment of a Deputy in charge of economic policy coordination. Koizumi cannot be easily replaced, even by me.

**William Breer:** Thank you very much Shijuro. Remember, you heard the Shiokawa proposal first at CSIS. I would like to invite Ed Lincoln to make some comments. Ed is a senior fellow at the Brookings Institution, and is a well-known institution in Washington himself.

**Edward Lincoln:** I'm reminded of a time in fourth grade when we had to give oral book reports. I was the last person to go, and it turned out that two other people in class had chosen the same book that I had chosen. Being a fourth-grader, you were supposed to tell what happened in the book. There was nothing left for me to tell that had not already been told by the others. So I could simply stop by saying that I agree with everything that's been said here, but that wouldn't do. So I do have some things to say.

Let me start by emphasizing something that has come up in some of the other presentations, particularly Larry Meyer's. The situation we face in Japan today is very unusual. What we see is basically outside the parameters of what we have seen in industrial nations in the last fifty years. That makes it all the more difficult for economists to figure out what the problem is and what the solutions are, because the solutions that we've seen in the last fifty may not work in the present time. We have to go beyond the limits of what we've done in the past.

The reason that we're facing this is that we have a combination of four things. One is a very large non-performing loan problem. Even the Japanese government admits that it is about \$400 billion. The second is an economic stagnation that has lasted ten years. This is not a recession (growth has been positive), but it is about two percent less annually than it might have otherwise been. The third is deflation. We haven't seen this combination of stagnation and general price deflation since the 1930's. Fourth, we appear to have reached the normal limits of fiscal and monetary policy. There is a very high level of government debt to GDP (140%) and interest rates that are close to zero.

Now let's examine the current problem. We are looking at an issue that I find to be wonderfully Japanese. First we've had the announcement of a major plan by the government. However, the plan itself is highly ambiguous. The problem that confronts those of us sitting here in Washington, seven thousand miles away, is that we're trying to figure out what this plan means without being involved in the back-room discussions in Tokyo.

The good news is that, due to this ambiguity, there is the very real possibility that this plan is worth something. One could have reacted to the same skepticism to the Hiraoka plan on reform of the government (back in the 1980's), which was also highly ambiguous. However, in 1985 it ended up producing the "privatization" of Kokutetsu and NTT, which, fifteen years later, actually looks like a significant step. So we don't know.

The FSA could prevent collusion between bankers on loan classification, but it all depends on the relationship between Heizo Takenaka and the bank examiners. Again, we don't know.

I was in Japan three weeks ago, and I was struck by the extent to which Heizo Takenaka was being portrayed in the media as being hugely controversial. Nothing that he has said has ever been controversial to other economists. We've all been discussing these issues for a number of years, and there is something of a consensus about what the problem is and what needs to be done. Not so in Japan. It's usually a bad sign in Japan when there is a media frenzy going on about how controversial you are. It's usually a precursor to being chopped down. The first step of that was that he was hauled back from his initial positions, and we've gotten this plan that has been watered down.

One of the elements that I have found to be missing is the lack of coercion and punishment. Japan is a democracy, and the government can pass any law that it wants. Many think that the endgame will see a nationalization of the banks. Takenaka tried to get at that through the issue of calculating the capital base of the banks. That got shot down. When you talk to people in Japan on both sides of the issue, you will never hear them say that we need a law that forces banks to adopt a particular policy, either towards NPL's or being taken over (or anything else). Until we get to the point where the government uses coercive force on the banking sector, we aren't going to see any progress.

Punishment is a similar issue. In order for the government to go forward on the banking issue, it will have to use public money. The public has to feel that its money is being used in the right way. As was the case in the US in the 1980's, the Japanese public thinks the bankers are a bunch of crooks that should have to pay for their own mistakes. Why should we bail them out?

Well, don't bail them out. Put them in jail. Over the course of the 1980's we indicted 1600 people in the US, of whom several hundred went to jail. How many bankers have gone to jail in Japan? My guess is, at most, a couple of dozen. I think the public needs more blood. I mean that seriously. The public has got to believe that bad people are being punished.

The one thing that I found encouraging about this is that it is the first time in four years that I have had any sense of a productive dialogue between agencies in the Japanese government. We've all been talking about the need for a package. Probably the most important thing was not in the announcement of this package, but what had happened the day before. The BOJ had announced that it would accelerate the growth of the money supply. They had been resisting that, using their resistance as a tool to get the rest of the government to act. The fact that they acted suggests that behind the scenes some agreement has been worked out between Takenaka, the BOJ, and maybe the MOF, that the monetary expansion will happen. There is talk in the package about expansionary fiscal policy in the form of tax cuts. It is the first time I've seen a retreat from Koizumi's hard-line on fiscal policy.

Now I'm going to make a couple of comments on how this fits into Japanese society. I think Japanese society has gotten exactly what it wanted. It's easy for us to say that it's the fault of the LDP, or it's the fault of Koizumi, or it's the fault of the nature of the office of the Prime Minister. However, I think the public is not ready for dramatic change. I say that because if you look at Japanese society, most people are better off today than they were a decade ago. Income levels are up on average. Housing prices are down. Investment income is down, which affects income levels of elderly people. However, for some reason they are not out marching in the streets.

Meanwhile, there are many vested interests in Japan that would lose something in the short-run in exchange for rather undefined benefits that would come from the revival of economic growth. Most people don't seem to want to make that trade-off.

I think the public is deeply ambiguous. They are unhappy, and they want to hear the rhetoric of reform that they're getting from Koizumi. But, by and large, the broad public is not angry enough about the lack of boldness in attacking these problems. Just like the politicians and businesses, the public is afraid of bold change. Until the public becomes angrier, I'm not sure that the politicians will move.

**William Breer:** Thank you, Ed. Before turning to the floor, I'd like to invite further comments by our panel.

**Shijuro Ogata:** Just taking up the last comment, about the public not being prepared. I agree with Ed for two reasons. In my view, there is still a cynical priority attached to job security. Even with high unemployment, many people are still employed (even if its only reading newspapers at the office). Thus, the victims of the last ten years are the balance sheets of the government (local and central), companies, and a few households. This has created a sense of complacency. Also, the Japanese public is not ready to be organized politically. There has been a decrease in the unionization of the labor force.

Conservatives have dominated politics for many years. Certain families of politicians have also dominated politics for many years. That is my concern. Our Prime Minister is a third generation politician, our chief cabinet secretary is second generation, the deputy chief cabinet secretary is second generation on his father's side, third generation on his mother's side. Everybody criticizes Suzuki Muneo for being too greedy and aggressive. But if you have political ambition, but no political family background, you have to be like that. Politicians born with a silver spoon in their mouths do not take that fact into account. If this continues, I'm afraid that our society will be divided into families with politicians and families without politicians. Families without may become increasingly less interested in politics, and may stop voting. That is one reason why this last bi-election had only about thirty percent voter turnout.

**Peter Ennis:** I think that Ed is really on to something about the ambivalence, although I would characterize it a bit differently. I think the people in Tokyo are extremely worried. The security that long-term employees thought they had is gone.

As Japan reforms, what will it become? Will it be a European style social democracy, or an American style freewheeling capitalist system? It's that lack of vision that is upsetting people. It's reflected in the pathetic showing of the Democratic Party. They can't articulate where they differ with the LDP. Either they don't know or they're afraid to say. The lack of a clear model towards which Japan will reform is the source of the reluctance to reform that Ed was referring to. But I don't think its complacency at all.

**Shijuro Ogata:** A number of Japanese actually looked to the American model. These people were very disappointed with the emergence of one scandal after another (in America). Japan has lots of corporate scandals, but our scandals are usually caused by individuals trying to help the company, not individuals trying to help themselves. I'm really frustrated. I studied in America, and I know the advantages of the American system. But now, it's terrible.

**William Breer:** Now we're open for questions from the floor.

**Paul Hewitt, CSIS Global Aging Initiative (Question):** I've been following the demographic change in Japan with regard to the economic problems. The problem of bad banks, and bad loans, is really a problem of bad companies, which is then in turn a problem of bad labor markets, and the role companies have been assigned in labor markets to absorb people who are not productive. The lifetime employment scheme has warehoused tremendous numbers of people that are a drain on profits and payrolls that are not actually producing much. The statistics that have come my way have suggested that there was a good reason for not letting Takenaka initiate his plan. The patient would have really been killed by the medicine. The first statistic is that under one estimate, there are 17 million unemployed within companies. The second is that prices are 60% above what they would be in a perfectly competitive economy, suggesting that real reform would unleash more deflation and terrible unemployment. The third statistic is the government debt: at 140% of GDP, they are only paying 1% interest. This creates a slippery slope, because if they were to pay market rates on the debt, payments would explode.

Is it possible that Japan is in too deep, to the point that even the best-intentioned reforms will not succeed?

**Peter Ennis:** I would put it in the opposite way. I view the aging of the population and the required boosting of returns on pension funds as a rapidly rising source of pressure for reform. If the pension funds don't start generating higher returns, there will be no way for Japan to afford these people. The only way to generate higher returns is for corporations to start focusing on return on assets, return on equity, which can only be achieved by reform. So it's like reform through the back door.

**Edward Lincoln:** As long as you can take care of half or two thirds of NPL's you would still see a pretty sizeable jump in return on assets that would get Japan back into the parameters of a functioning economy. They will reform; otherwise they will explode.

But an explosion is not the end of the world- no economy just ends. You may get a pretty dramatic event, perhaps the top ten banks in Japan declaring bankruptcy. That would force action. Something of that sort may be coming down the road. It will look like a disaster, but it might finally knock the policy process loose and move things in the right direction.

**Laurence Meyer:** Paul, I think you've indicated how difficult it is, because the problems are interrelated. It's the reason that there is concern that a better safety net has not been put in place to cushion the pain associated with some of these programs. That's why the combination aspect is important. We want to see the monetary authorities do as much as they can do to fill this gap, and we want to see the fiscal safety net put in place. But you are taking risks in not taking action, and you are taking risks in taking action. You can solve this problem after the crisis has occurred, which forces bold action, or you can be preemptive. But I don't think that anyone would sleep well at night, even if they had the opportunity to put together the best plan they understood.

**Shijuro Ogata:** Everyone has been saying that Japan would change once a real crisis comes along. But what is a real crisis? For those of us old enough to remember the terrible days after the war, this is not a crisis at all.

I have often been asked what I think of the future of Japan. I can only present the worst and best scenarios. The truth will be somewhere in between. In the worst scenario, Japan will have a very expensive aging society. There will be a continued brain drain and a hollowing out of industrial activities. There will be delayed deregulation, high cost of living, and a limited inflow of foreign direct investment. Japan will be a surplus country. Because of the size of the economy, Japan will continue to be invited to the G-8, but will be a very inactive member.

The best scenario involves Japan being not only developed, but also developing. There will be progress in deregulation and an increase in foreign direct investment. FDI doesn't come to Japan because the land price is high and there is lots of regulation. There will be an inflow of foreign labor. Perhaps we will also have a higher birthrate and more creative education, rather than the standard education that I suffered from. Possibly Japan will become more active in international affairs.

Which of these scenarios actually occurs depends more on the younger people here than me.

**Tsuyoshi Jin Saito:** The anti-deflation part of the package was added at the last minute, and everyone knew that it was empty. Takenaka sees two parts to the Japanese economy. The first part is the large, globally traded segment. The second is the local, small companies. His strategy is to attack the big borrowers: the big construction companies and the like. This would minimize the political outcry. Once he forces them to go bust, the surviving companies would lose their competitor. Their cash flow would become positive and American investors would invest in them. That is his strategy.

**Laurence Meyer:** Just a comment. Now you really have me worried. What you're telling me is that I've totally misread what I thought was the only positive element in this plan, namely that the government had come the realization that a combination was necessary that had to be complimented by both new monetary and new fiscal measures; an expansion of the social safety net. What you're telling me is that this was an afterthought. That's a terrible indictment.

**Tsuyoshi Jin Saito:** The country will need a serious safety net only if Takenaka is successful at making the big banks and corporations go bust. That's a big if.

**Arthur Alexander (Question):** In Sweden, the NPL problem of the early 1990's is nothing but a footnote. Can we see something like this for Japan?

**Shijuro Ogata:** We received a visit from the former cabinet minister of Sweden, and we learned quite a lot. However, the situation is different. The number of banks involved was quite limited in Sweden. The outside economy was also in much better shape.

**Peter Ennis:** Sweden had in place very deep social democratic institutions that Japan does not have.

**Tsuyoshi Jin Saito:** In the case of Sweden, one of the most beautiful things was that the ruling party and opposition got together and set aside their differences in order to fix the problem. All the decisions were shared. In Japan, not even everyone in the ruling party can agree on an approach.

**Joan Seagall (Question):** I have a question about the Koizumi-Takenaka dynamic. Going forward, do you see Koizumi supporting Takenaka, and do you think Takenaka has a strategy?

**Shijuro Ogata:** Koizumi's leadership is being questioned. He appointed Takenaka economic tsar. He reiterated his support for Takenaka. And then he backed away from Takenaka. If I were Takenaka, and Koizumi were to continue with this ambivalent attitude, I would resign. This is a good question to ask Koizumi.

**Peter Ennis:** My understanding was that Takenaka was Koizumi's first choice. He appointed him without consulting anyone. That was the best part of Koizumi. As far as the relationship between the two goes, I know that Takenaka is extremely disappointed. But he's a very tough guy; I'd be very surprised if he left on his own.

Now, why did Koizumi not back Takenaka? Number one: Koizumi is worried about his power base. Things could get bad for him very quickly if he doesn't deliver. Number two: If Koizumi backs down on fiscal austerity and allows an expansion of public works, it will be very bad for him.

**Naoki Shibutani:** I think the Japanese people are concerned about the current situation in Japan and are ready to accept drastic reform. I think the Japanese people are

concerned that there is no clear vision for future growth after they've endured the Takenaka plan. One of the reasons the United States has succeeded in recovering from the recession was not only by clearing away its bad debt but also by stimulating high-tech industry. On the other hand, there are no Microsofts, no Ciscos, and no Dell Computers in Japan. I think Japan should have economic measures to strengthen its high tech industry, for example, by giving tax benefits for R&D or by allocating certain amounts of government expenditure for venture companies. Why are there no such kinds of discussions in Japan?

**Laurence Meyer:** Part of the problem is that market entry and exit are very difficult in Japan relative to the United States. It's harder for new firms to get started in these environments. It's the nature of the regulatory and structural framework. That's why structural reform is one of the important aspects. Deregulation and privatization gives an opportunity for increased dynamism. Old firms will be hurt, so there will be short term pain. But in the long term reform will build the momentum for new ideas and new firms that will generate jobs. The problem is how you deal with the pain in the interim period. That is why broader structural reform, not just banking reform, is important for the longer run dynamics of the economy. In some sense it might even be the most important reform. However, you are going to have to have a banking system that works that will be able to provide the funds for new firms.

**Shijuro Ogata:** I think that there are some Japanese companies that are internationally competitive. The problem is that they are keeping competitive by globalizing, i.e. hollowing out. We can't offset this hollowing out because of delays in deregulation. That's why I was in favor of inward direct investment.

**End of recording**