Japan: The Road To Recovery

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I. Overview

It is now widely understood that Japan is in a full-fledged recession, with nearly all sectors of the economy in retreat. The extent of Japan’s economic difficulties is even clear to those bureaucratic champions of the Japanese system, who in recent memory were telling the public that recovery was right around the corner. But they still do not appreciate how bad things are going to get.

The economy has been trapped since the beginning of the decade in doldrums that cannot be escaped with one more round of spending on unnecessary public works. Japan’s policy elite is unlikely of its own accord to promote measures that could replace the mercantilist thrust of Japan’s political economy, with a system aimed at maximizing living standards for the broad mass of Japanese. The current system will have to break down to the point where the economic conditions for ordinary people become sufficiently desperate that they demand real reform.

If we wish to understand what Japan will need to do in order to overhaul its economy, we have to go back at least to the Meiji period, when Japan began its push to catch up with the Western powers. During this time, a variety of institutions were imported from the West: legal systems, political parties, universities, stock markets, boards of directors, and accounting standards to name just a few. But most of these institutions were grafted on to existing arrangements to create the outward trappings of a modern,
constitutional state behind which traditional social structures and power alignments continued to determine what actually happened. Recently, Japan's economic policy decision-making has been coming under increasing scrutiny worldwide, particularly in light of the collapse of several economies in neighboring Asian countries. Until quite recently, Asian countries formed the world's fastest growing region and had become a focus of attention by businesses and investors worldwide. The story of what happened in that region is essentially a by-product of events in Japan.

The seeds of Japan's problems lie truly in its accomplishments. The economic success story that saw Japan rise in three short decades from devastation to the front rank of the world's industrial powers changed the external context in which Japan does business. Back in the 1950s and 1960s, Japan could exploit external markets without affecting them. But Japan is now too large.

Of course, economically speaking, Japan can be made "smaller" in relation to its external markets, as it were, by shrinking the value of the yen. But even here we see the law of unintended consequences in action. The last time the size of the Japanese economy was deliberately shrunk in relation to its external markets occurred back in 1995, when the Japanese authorities cooperated with the US Treasury in moving the yen down from its historical highs in the wake of the Mexican peso collapse. In escaping one crisis however, Japan unwittingly set the stage for another. Asian countries, whose currencies were largely tied to the dollar, found their competitiveness across a wide range of industries destroyed by the weak yen. In combination with a flood of cheap capital emanating from Japanese banks and then a sudden reversal as the banks called their loans in the region and cut their credit lines, this decline in competitiveness set the stage for the panics that critically damaged what had become Japan's most important export markets.

Japan's policy makers in the economic ministries and the leading business bureaucracies do not want to acknowledge that Japan's external markets are no longer limitless, and can no longer be taken as givens, because acknowledging the reality of Japan's changed circumstances means acknowledging that their own control over economic decision-making is slipping from their grasp. It means acknowledging that they are being forced to surrender power to markets which they do not understand and cannot trust. But widespread acceptance of this reality is the only way out of the morass into which the economy has sunk.
II. The Origins Of Japan's Problems

The core of Japan's problems lies with long-established economic policies that aimed at the maximization of savings. Savings were not allocated on the basis of the free play of market forces, but rather to those industries that were either politically powerful, or deemed essential by Japan's economic mandarins. The savings financed capital expenditures far in excess of those required by the domestic economy, and this capital spending, together with trained labor also allocated by political rather than economic forces, made many Japanese companies in a wide range of industries into world leaders when measured by technology, costs, or market share; but not by profitability. For the beneficiaries of the Japanese system in the great corporations did not need to consider the profitability of their investments. They were engaged only in the expansion of production. Their solvency was the responsibility of their banks and of the government; a government that in turn ensured the solvency of the banks. The final guarantee of the solvency of Japanese industry lay with Japanese households whose savings financed the entire industrial structure. The strength of that guarantee directly correlated with the extent of the savings, thus the entire economic policy apparatus aimed at maximizing those savings.

Those savings took the form overwhelmingly of bank deposits. Under an unwritten social contract, households put their savings into banks or the post office and accepted very low interest rates in
return for an implicit guarantee that the principal would be safe. Thus, losses incurred by the banks and industrial firms, which used those deposits to finance their activities, could not be written off directly through a concomitant write-down of deposits. The only way for the economy as a whole to write off losses, other than direct compensation to loss holders financed by taxes, was through general inflation that reduced the actual purchasing power of the deposits. But in the 1990s, the Japanese authorities found that they could no longer engineer inflation, because Japan’s position as the world’s leading net creditor nation made it impossible. In essence, the inability by Japan’s policy elite to generate inflation coupled with their refusal to acknowledge this, forms the ultimate explanation for the persistence of Japan’s bad loan problems.

The Japanese system continues to work so well in extracting savings that savings are running far ahead of domestic investment requirements. This excess flows out of the country where it finances Japanese exports that today are not politically welcomed by their trading partners. The day will surely come when a reduction in Japan’s exports coupled with a low level of domestic consumption, will be woefully insufficient to support the entire production apparatus, an apparatus that by some measures is the world’s largest, and in any case far outstrips Japan’s domestic needs. The politically engineered suppression of the purchasing power of the Japanese economy will then pull Japan down into a recessionary abyss far deeper than anything seen since 1945—a process that may have already begun.

It was the high savings rate that financed Japan’s integrated production facilities, and the high savings in turn resulted to a very large extent from a tax code structured to induce them. Historically, interest income was not taxed at all for practical purposes, while today it is taxed separately from ordinary income at a modest 20 percent rate. Thus, for Japan’s better off households, bank deposits are the equivalent of tax-exempt municipals for their American counterparts. After all, the marginal tax rate in Japan is 65 percent, making savings deposits, with their 20 percent tax, look very attractive when contrasted with other potential uses for funds.

Meanwhile, Japan’s corporations likewise paid what were effectively tax-exempt rates for these funds. Indeed one can argue that in a sense the entire Japanese financial system functions as a huge tax-exempt market, except no fully taxable investment alternative paying higher interest rates has been available to Japan’s investors. The benefits from this set-up flow directly to well-connected
companies who can deduct already low tax-exempt interest rates from taxable income. That, after all, was the intention behind the system: to ensure that companies in so-called "strategic industries" enjoyed financing at costs that gave them a competitive edge over foreign rivals. Banks were the vehicles by which companies obtained access to household savings, and in turn the Ministry of Finance so thoroughly dominated the banks that they were in effect little more than MOF franchises.

The Tax System
Taxation plays a key role in Japan's excessive savings and is very much related to the exercise of political power. In Japan, taxes are carefully structured to minimize any political reaction or backlash, as despite Japan's heavy tax burden, taxes are barely noticeable to ordinary people. Out of 99 million eligible voters and 55 million tax payers, only 8.5 million file independent tax returns, while the rest have their returns filed for them by their employers. To begin with, the minimum annual taxable income starts at about ¥5 million, by far the highest number among the OECD countries at present. Secondly, salaried workers with taxable income do not go through the annual ordeal of their American counterparts of preparing and filing complex tax returns; instead, taxes are withheld by their employers before the employee ever sees the money. Third, the MOF has worked for decades to supplement income tax revenues with consumption taxes, despite the well known dampening effect of such taxes on consumer spending. But consumption taxes have the great virtue in the MOF's eyes of being nearly invisible: consumers simply factor them into the final sales price. Finally, helping to make taxes invisible is the widespread use of withholding tax for financial income.

Japanese financial institutions are subsidized with tax reductions on financial products, and the marketability of these financial products depends heavily on tax treatment. If disclosure of financial information is not used to price securities or to determine the viability of public companies, then accounting has really only one function: tax assessment. Japan's accounting regulations are largely determined by tax considerations, making them subject to political horse trading. Tax policy is never discussed from a macroeconomic perspective, but rather in the light of conditions in each industry. This enables the MOF to control individual industries by striking deals. Each segment of the financial community competes to get the
best tax breaks in order to increase the after-tax return of each product.

Postal savings receive the most favorable treatment. Conventional wisdom in Japan has it that the MOF overlooks tax evasion that utilizes postal savings. This is because the MOF largely controls the disposition of the assets of the postal system, one of its key instruments of control over the Japanese economy. Postal savings form the biggest component of the notorious second budget, which the MOF has at various points in the last decade used to prop up prices of Japanese real estate, Japanese Government Bonds, Japanese equities, US Treasury Bonds, and the dollar.

Many predict that changes in the foreign exchange law called for in the Japanese government’s “Big Bang” will be the catalyst for the most profound changes in the Japanese financial system. However, this will only be true if the tax laws change to permit the free flow of cross-border funds. In 1985, many heralded the introduction of bankers’ acceptances as a key vehicle in allowing foreign participation in the short-term money market, and believed it would bring about a full-fledged liberalization. But these hopes turned out to be false, since these acceptances ultimately carried heavy stamp duties, which were unacceptable to most investors.

Without tax reform, the ending of controls on individual Japanese making investments abroad will have no effect. Interest income that Japanese savers receive directly from abroad is subject to progressive taxation as part of regular taxable income. However, interest income received within Japan from Japanese financial institutions or Japanese entities through Japanese financial institutions is subject to only 20 percent withholding tax and is separated from taxable income. In investing in overseas assets, Japanese who transfer money in excess of ¥2 million ($14,800 at ¥1.35 = US$1) abroad are legally required to report this to the tax authorities. All transfers of any money from abroad must also be reported. This means that interest income from abroad will be taxed at progressive rates while domestic interest income will be taxed at only 20 percent. Equally important, anonymity is available to domestic owners of financial products but not to owners of foreign financial products. The current tax system as a whole discourages the outflow of money from Japan, unless that money is under control of institutions licensed by the MOF.

At present, the tax code also discourages households from putting their savings into equities. Dividend income in excess of a
certain amount is subject to progressive tax rates at the maximum rate of 65 percent whereas interest income is subject to modest and flat 20 percent regardless of a level of income. As a result, corporations do not willingly increase dividends because of double taxation, and they have not needed to do so. As long as corporations could manipulate stock prices by selling and buying shares from each other, dividends did not matter. The tax system played a crucial role in ensuring that stock prices could be manipulated; companies were effectively punished for selling equities and rewarded for holding them. Companies are allowed to deduct from taxable income losses from declines in the market value of equities they hold. But they are taxed on any capital gain resulting from sale of stock at the full corporate income tax rate. Meanwhile, individuals pay a capital gains tax of only 1 percent of total sales proceeds regardless of the actual gain or loss, giving them every incentive to sell.

Tax treatment of debt securities is just as incompatible with a financial system governed by market forces rather than bureaucratic imperatives. There are two classes of bondholders in Japan: institutions officially authorized to purchase bonds as registered bondholders, and everyone else. The officially authorized institutions are primarily domestic financial institutions licensed and controlled by the MOF. The Bank of Japan serves as registrar for Japanese Government Bonds ("JGBs"), while banks and trust companies are registrars for corporate and municipal bonds. Officially registered institutions can buy bonds as registered holders and receive full coupon payments without being subject to withholding tax. All other investors, including foreign investors, are subject to withholding tax and may not register as bondholders with either the registration system for JGBs, or that for corporate and municipal bonds. They are thus blocked from direct participation in the main bond markets where domestic financial institutions trade. In the case of JGBs, foreigners avoid the withholding tax by trading so-called name registration forms issued by actual registered owners, exposing them to credit risks of the domestic registered holders. This discourages foreign participation in the JGB market since foreigners are effectively buying Japanese bank credit risk at Japanese sovereign prices. As for corporate bonds, the registration system creates a two-tiered system whereby non-designated investors must purchase certificates subject to withholding tax and can only trade in a separate and limited market for those in physical possession of certificates.
Thus, the system permits the MOF and designated financial institutions to control bond prices.

**Current Account Maximization**

The Japanese tax system thus produced chronic excess savings, another way of saying chronic current account surpluses. For many years, the MOF has tactfully amplified the voices of economists and other commentators who argued for the usefulness of Japan’s current account surplus in the world economy as a source of capital for the world. Since newspapers and academic writings repeat this line over and over again, domestic pressure on the MOF to take measures to reduce the current account surplus has been largely smothered. Presumably, MOF officials can grasp the argument that huge chronic current account surpluses are not indefinitely sustainable. But they cannot accept a reversal of Japan’s postwar policy of unlimited expansion of production capacity, which is implied in any structural reduction of the current account surplus. Such a reversal would undermine the MOF’s power and legitimacy, as historically, industries and banks depended on MOF for guidance.

The Japanese economic system is thus predicated on the ability to export surplus production, the result of which is an onerous imbalance in the relationship between Japan and the rest of the world. The country’s net creditor position is now on the order of $700 billion and may exceed $1 trillion by the turn of the century. Over the past 25 years, the soaring yen against the dollar meant that continuous expansion of productive capacity by exporters did not result in a concomitant expansion of yen cash flow: the real origins of Japan’s huge bad debt problems. Recently, when Japanese banks began to reveal the extent of their bad debt problems, they were effectively revealing the end of the MOF’s ability to control outcomes, as the main bank system which enables banks to extend credit in large amounts to large companies has turned into the dynamite that threatens to blow up Japan’s financial system. The government cannot protect and support faltering companies forever, especially in the light of fierce global competition prevailing in many industries.

The MOF has chosen to defer needed structural changes in the Japanese economy by working with the US Treasury to orchestrate a strong dollar. As production rises without any concomitant rise in consumer spending, exports pick up while imports are again
being priced out of Japan. If and when the current account surplus rises again to a record high, which it almost surely will, the yen will again rise against the dollar. The next cycle of dollar weakness may force Japan to reduce production capacity in key industries fostered by the government. Since production capacity in Japan includes lifetime employees, the unemployment rate will climb, bringing it into line with that of market-driven economies, and the effect will be to demonstrate the fallibility of the government. Bureaucrats will see their control over economic policy weaken as market forces, the only alternative to bureaucratic control, come to dominate economic decision-making.

By reversing exchange rate policy in 1995 with American cooperation, Japan tried to export its way out of its economic doldrums. This policy has failed so far to ignite a strong boom in capital outlays. Japanese government officials seem not to have understood that Japan is burdened with production capacity far in excess of any conceivable domestic demand. Thus, any recoveries in external demand simply result in expansion of the trade surplus. Without meaningful expansion of external demand, impossible for a country in Japan’s net creditor position, the domestic market cannot tighten, and increases in prices of land, stock, wages, and products cannot be generated. Deflationary pressure will continue to develop, making it increasingly difficult to service debts, whether through cash flow from operations or from asset sales.

Meanwhile, the US, which has functioned as the world’s locomotive during the post-war era, has also become its largest debtor nation. Following the 1985 Plaza Accord, which resulted in a near-halving of the dollar’s value, American companies regained competitiveness in a number of industries as well as further entrenching the American dominance of the high-technology and information sectors. But the restoration of American competitiveness is directly threatened by the devaluation of virtually all Asia’s currencies, as well as the present weakness of the yen.

The region’s trade surpluses with the US are mounting quickly, but the truth of the matter is that the only way out of the region’s difficulties is external demand. The alternative is continued turmoil leading almost certainly to political unrest. But, it is by no means clear, however, that adding exploding external deficits to America’s huge net debtor position is compatible with continued dollar strength. At some point, it appears inevitable that either the foreign currency markets or the bond markets, or more likely both, will force a
reduction in the level of American external deficits. It should be understood that the primary pillar that undergirds the strength of the dollar, and thus the ability of the US to run external deficits, is the Japanese financial system. While maintaining external demand for Asia’s products is essential from both an economic and a broader political-cum-security point of view, the US at the same time will probably face the need to reduce its own current account deficits, or risk a sharp weakening of the dollar, and possibly a recession as dollar interest rates rise to finance American external deficits. The only alternative to the American market for Asian exports is, of course, Japan. But Japan’s ability to absorb imports has shrunk by a full 1/3 since the currency realignment of 1995.

Given these circumstances, the pressure on Japan to overhaul the structure of its economy in order to put domestic demand in the driver’s seat is becoming overwhelming. Japan should now theoretically be running a current account deficit anyway, given its stature as the world’s leading net creditor country. Such a deficit would not only benefit the Japanese population, but could form the key to resolving the Asian crisis. Of course, there are plenty of reasons with which market observers and participants justify to themselves today’s weak yen regime. But what this reasoning ignores is just how dependent the United States is on a continued flow of funds from the rest of the world; most particularly from Japan. The funds keep flowing because of a set of politically determined policies in Japan that have brought about a recession, and this is no accident.

Socialization of Market Risks
When corporations and their banks suddenly appear exposed to the risk of failure, scared depositors will begin withdrawing funds. Already, banks can no longer manipulate the prices of securities. A graphic example of this was provided when the MOF arm-twisted banks into mounting a stopgap rescue operation for Nippon Credit Bank in 1997. In the past, such a clear sign that the MOF was moving to deal with a problem would have surely generated a stock market boost. But this time, shares of the banks as a sector fell. And as securities decline in price, the exposure of “main banks” to failing borrowers will be spotlighted. Banks are now willing to securitize their loans, particularly those of weak borrowers, and sell other securities they now hold. This is tantamount to
saying they will give up their roles as main banks. But the MOF cannot permit investors and depositors to lose money; as it has effectively promised to keep them whole. It is not likely, that the MOF can continue to protect everyone in the wake of the crumbling of the main bank system, as it will be forced to retreat from some of its commitments, and will be unable to deliver all results promised.

Socialization of credit risk protected banks from the consequences of credit mistakes, but as a result the banks do not grasp the role of equity capital. The BIS capital adequacy guidelines are, to them, simply a matter of presentation, not substance. Japan’s Ministry of Finance, which oversees accounting standards and disclosure requirements, is far more concerned about maintaining the viability of the institutions it supervises than it is about ensuring that outside investors have the information they need to understand what is going on inside those institutions. The MOF is determined that publicly disclosed information will never trigger the failure of a licensed Japanese financial institution; or a major Japanese company for that matter. The MOF wishes to ensure that any decisions to cut off life support to companies or banks that may be terminally ill continue to be made by bureaucrats behind closed doors, not by the credit markets.

In the past three decades, thanks to this system, Japanese banks could operate with zero or even negative equity without any problem. Problem loans were either not recognized on the books, or explained away with supposedly huge unrealized capital gains. The government did whatever necessary to keep high the growth rate of nominal GDP (that is to say, real GDP plus the rate of inflation), for constantly rising nominal GDP melts away bad loans as they occupy an ever diminishing share of bank balance sheets. Indeed, propping up nominal GDP has been perhaps the overriding macroeconomic policy goal of the Japanese government. In the late 1980’s with MOF encouragement, the Japanese financial system created the largest bubble in history with excessive credit expansion. In the early 1990’s, the government launched some $600 billion in fiscal stimulus packages, much of it in the form of public construction of questionable merit. In 1995, the government poured resources into the foreign exchange market to prop up the dollar, thus providing a boost to exports that it was hoped would translate into broader growth, while interest rates have been cut to historical lows.
However, none of it worked. The economy has hovered on the edge of deflation and recession for six years now. The failure to induce growth in nominal GDP has made it impossible to dissolve the problem loans that burden Japan's banks, and it made glaringly obvious the achilles heel of the Japanese banking system: the lack of equity. It is inadequate equity that has put the entire system into crisis. In the absence of sufficient equity, problem loans cannot be written off without bringing down the banks that made them. Banks are responding by liquidating their equity holdings and calling in loans, although very timidly.

Interest rates and the foreign exchange rate form two components of market risk that the MOF still basically controls. But a third component, asset prices, has in recent years, slipped out of the MOF's grasp. The finance ministry can no longer support assets such as equities and real estate at astronomical levels. At the same time, MOF control of the fourth and final component of financial risk, credit risk, or the viability of major banks and listed corporations, has also been under attack. Indeed, MOF appeared temporarily to have lost control of credit risk last fall with the collapse of Hokkaido Takushoku Bank and Yamaichi Securities. The injection of capital into banks that occurred in March may have restored some control to MOF of credit risks, but this has proven only temporary.

The ability of MOF to control the yen/dollar rate, interest rates, and credit risks cannot survive much longer. The willingness and ability of other countries to absorb Japan's huge current account surpluses is not limitless. The normal process by which current account surpluses come down occurs when capital outlays increase, kick-starting economic activities. But so much excessive capacity exists in Japan that this country will have to run current account surpluses amounting to 3 percent or more of GDP for a number of years before capital expenditures revive significantly. It is unlikely the world can tolerate this, and it is out of the question if the American economic expansion ends.

Meanwhile, the Bank of Japan expands its assets at an annual rate of some 40 percent in keeping with its easy money policy. But since the MOF has had to give up its grip on asset prices, problem loans have climbed out of control, causing both domestic and foreign depositors to pull funds out of the Japanese banking system. These drains on the banking system are forcing the BOJ to print money at such speed. The economy has not responded. Japanese banks have reacted to the funds drainage by raising money from
the BOJ. In the end, however, they will be forced to reduce their assets, sell off many of their loans and investments, or allow them to mature without replacing them. This will not only inevitably slow the Japanese economy, but have economic repercussions overseas, given the major role Japanese banks have played as credit providers in such disparate places as Southeast Asia and southern California. Finally, the shrinkage of bank balance sheets will make it much more difficult for the MOF to stem a wave of bankruptcies.

It is important to understand that while the government may have given up its policy of supporting asset prices at astronomical levels, asset prices have not yet fallen to market clearing levels. Excess production capacity has not been shut down, and inventories have not been reduced. As a result, profits continue to be anemic. In such an environment, lower interest rates do not bring about any increase in borrowing and do not stimulate economic activity. Today, they only produce aggressive purchases of dollars for yen. Not, however, because domestic investors are borrowing low interest yen to buy higher interest dollars, but because the worldwide flight from Japanese banks has forced Japanese banks to fund their dollar assets by purchasing dollar liabilities with yen. So, while the Bank of Japan’s balance sheet may be exploding, that is not translating into any commensurate increase in loan volume by Japanese banks.

Disclosure Requirements

Much discussion of the deficiencies of the Japanese financial system has focused on the issue of disclosure. Many in and out of Japan suggest that strong public disclosure standards are a prerequisite to a well-functioning capital market, and they cheer the government’s professed determination to bring Japan’s accounting system into line with international standards.

Japan in fact already has quite a good disclosure system, but it operates for the benefit of the mandarins at the MOF and other insiders and not for the public at large. Companies must file audited financial reports with the MOF within three months of the end of the fiscal year, complete with detailed notes. Not for another two months does the MOF then print them up and make them available to outside investors at Y1,400 a copy. In the meantime, companies announce summaries of their financial results about two months after the fiscal reporting period ends, but without any meaningful details. It is to these summaries that the markets react.
not the detailed information that only trickles out slowly, months after the fact.

Economic ministries such as MOF, MITI, the Health and Welfare Ministry, and the Posts and Telecommunications Ministry are privy to inside information from companies in the industries they oversee. The companies consult ministry officials on a virtually daily basis. These ministries do not allow the viability of important publicly traded companies in key industries to be determined by accounting evidence that a company might be unable to meet the demands of creditors. When such cases occur, a company’s so-called main bank is effectively required to provide the liquidity to keep the company in business. This way of doing things naturally demands that the government stand behind the banks.

Indeed, the MOF and the Bank of Japan have total access to bank’s books. Japan’s bank licensing system gives the MOF essentially unlimited power to uncover what is going on inside banks. This suggests the ultimate responsibility for Japan’s bad loan problem lies with the MOF. Given MOF oversight, there was no such thing as a problem loan from the perspective of the individual bank. Banks kept churning out loans that fueled the uninterrupted growth of the Japanese economy whose production was absorbed by a seemingly huge and infinite external market.

Japan’s bad debt problem is not the result of speculative banking practices by individual banks, rather, the bad debt problem is a direct result of policy decisions taken by MOF officials. After the sharp rise of the yen against the dollar in 1985 that severely injured many industries, the MOF launched a vast operation to rescue these industries and the banks that financed them. In order to compensate for shrinking cash flow, prices of assets such as stocks and land were deliberately raised. Usually, a reduction in cash flow lowers the prices of the assets generating that cashflow, but the reverse happened in the late 1980s. The term to describe this situation where asset prices are far too high for the cash flow the assets are capable of generating is of course a bubble.

Funds flowing into the banking system that fueled the asset bubbles were available because of a widespread understanding in Japan, that the MOF stands behind all deposits. The MOF has, in fact, admitted that disclosure requirements are inadequate, by saying that depositors do not have the means to evaluate bank risk on their own. This is the justification they have used to bail out all depositors to banks that have failed. The government is legally
required only to bail out deposits up to ¥10 million, but in cases such as Hokkaido Takushoku Bank and all other bank failures, all depositors have been made whole. Even in the interbank market, rumors that a bank might be insolvent did not halt the flow of funds until the failure of Sanyo Securities whose interbank debt was frozen at the reorganization court filing, albeit only momentarily. Since the Sanyo collapse, those banks with little credibility have been denied access to the interbank market and consequently have to be funded by BOJ directly.

The fact of the matter is that we already know which banks in Japan are in trouble. And while improving accounting rules would probably be a good thing, they would not in and of themselves enable us to measure the extent of the bad debt problem. Bankruptcies do not serve as much of a guide either, as bankruptcy proceedings are not made public, and the assets of a bankrupt entity represent liquidation value, not the going concern value. This gap is not fully appreciated in Japan, because until recently liquidation values were far higher due to extremely high land prices.

Calling for tightened disclosure before deposits are marked down to reflect their true value is putting the cart before the horse: at present, no one has been really hurt, so no one really cares. It is only when depositors lose their money that they will insist on accounting and disclosure systems that can help them evaluate risk. Accounting practices will change when people understand that even large companies and banks can fail. Since the laws governing financial markets are ultimately hollow, and since neither criminal nor civil sanctions in effect exist in the Japanese financial markets, disclosure becomes ultimately meaningless, irrespective of the extent to which accounting rules may be changed.
III. Reforming The System

The widely advertised cure for Japan's problems is to turn Japan into a more risk-sensitive economy, thereby forcing the shutdown of unprofitable production capacity. No economic turnaround in this country is possible until asset prices fall to a level where market players find it profitable to purchase them. Unemployment will have to accelerate until it forces the creation of an efficient labor market. Interest rates and the yen will have to rise to the point where unprofitable companies are forced to close their doors. The profitability of those left standing will have to recover sharply. But such a shutdown would injure many domestic interest groups, as well as undermine the power of Japan's permanent bureaucracy. The entrenched domestic opposition to any genuine transformation of the Japanese economy is thus very great. Some look to political pressure applied by the US to overcome the opposition, and it is certainly true that such pressure has historically played a very important role in bringing on policy shifts in Japan.

This is so, because whatever appearances may be, politicians in Japan do not originate policy. Their role is to formalize what is decided by the bureaucracy, and bureaucrats in turn follow precedent. Outside direction of the bureaucracy has been the exception, not the rule in modern Japanese history. Given Japan's pivotal role in the Asian crisis and the danger to both global finance and regional security stemming from that crisis, the US may muster the stamina
to impose a change of direction on Japan, but there is an inherent conflict of interest for the US in any overhaul of the Japanese economy that turns Japan into a genuine market economy. For the US has benefitted enormously from the current Japanese system, as cheap Japanese products and low-cost Japanese financing have permitted the US to run huge external deficits without paying any of the usual costs, while keeping inflation low and American financial markets buoyant. Any serious overhaul of the Japanese economy would raise the price to Americans of both Japanese goods and Japanese money, leading almost surely to a significant slowdown in the American economy.

The normal institutions of advanced democratic countries that could be expected to force reform, exist in only superficial forms in Japan, among such institutions are:

- A fully independent judiciary with the resources necessary to play a fully fledged role as the final arbiter of economic disputes.
- An investigative press that defines its mission as uncovering the truth rather than supporting the social order.
- A genuine opposition with the resources and the will to govern, that could and would impose political control over the bureaucracy.
- Shareholders who are able to discipline management.
- Banks that extend credit on the basis of their assessment of a borrower’s ability to turn a profit.
- An accounting profession performing according to internationally accepted norms and procedures.
- Economists and other intellectuals who do not depend on government bureaucracies for their livelihoods.

Instead, Japan’s ruling bureaucracy has avoided the pressure for reform by extending a blanket safety net that co-opts the formation of any genuine opposition to its continued control of economic events. But as the government simply picked up the tab for any and all losses, a moral hazard problem of horrendous proportions arose. As it becomes clear that the safety net can continue to function only if taxes rise to ruinous levels, bankruptcies will simply have to be allowed to take place. Indeed, we have begun to see this happening in the past year as what had once been
unthinkable, bankruptcies by well-connected Japanese firms, is becoming more common.

The overriding policy goal must be the reversal of the traditional aims of maximizing production and savings by suppressing consumption, maximizing the current account surplus by driving up the dollar, and socializing all market risks through the support of stock prices and land prices, the suppression of interest rates, and the blurring of credit risk. These must be replaced by an entirely different program. The primary elements of this program include the following.

**Overhaul of the Tax System**

Ultimately, instead of the endless accumulation of dollars necessary to depress the yen, the Japanese economy must be overhauled, through redefining the economic role of the households from that of passive savers at depositary institutions to active spenders and investors. This, in turn, can only happen with a complete overhaul of the Japanese tax code. Interest income would need to be subject to comprehensive and progressive taxation, while interest expenses, particularly those expenses incurred in financing home purchases, must be made deductible from taxable income.

The overriding goal of tax reform should be the sensitizing of ordinary people to their tax burden, and their political participation in determining the size of that burden. While taxing savings at the same rate as ordinary income would be politically easy, as savings are concentrated in relatively few hands, providing tax deductions for mortgage payments would be somewhat harder, because the number of tax payers who would benefit from such provisions is relatively limited. In fact, Japan’s current political set-up serves rather well the interests of those with high net-worth. It remains to be seen whether tax reforms that would replace incentives to save with incentives to spend can be implemented for the sake of economic structural change. Such a change would not really compromise the interests of better-off people; in fact, in the long run, it would help them by strengthening the overall economy. The political ramifications of an overhaul of the tax code, sufficient to bring about genuine liberalization, are far too radical to permit an overhaul without much time and effort. If the MOF were really serious about reform, it would already have outlined its intentions to do so.
The benefits of tax reform however would be many. Better off families would likely spark a housing boom as they borrowed money to buy bigger houses, increasing their interest expenses to offset the increase in taxable income that would come from taxing interest income as if it were regular income. Less well-off families, with smaller deposit holdings and in tax brackets lower than 20 percent, would see a rise in their after-tax interest income. Financial institutions would see an expansion in lending opportunities to better-off households. The corporate sector could anticipate an increase in economic activities centering on housing, that would help offset the burden of higher interest rates. Tax revenues stemming from the application of progressive taxation on higher interest rates would help offset losses flowing from making mortgage payments tax deductible. Finally, foreign investors would find yen assets more attractively priced with elimination of the with-holding tax system in addition to higher interest levels available if Japanese interest rates were set in a fully taxable rather than tax-exempt market.

Structural Reduction of the Current Account Surplus

Instead of boosting the Japanese economy as intended, the weakened yen has badly damaged the competitiveness of Asian industries, leading directly to the present crisis in those countries, and creating a boomerang effect in Japan. Japanese banks hold hundreds of billions of now questionable Asian loans and Japanese companies find a principal outlet for their exports shrinking fast. Instead of fearing a stronger yen, Japan should welcome it. If the yen were to appreciate against the dollar, many countries would find their competitiveness in the US market enhanced vis-a-vis Japan, as well as improving their sales in Japan. While this would cause some pain to some players in Japan, Japanese investors in the region would at the same time see their investments recover. With a recovery in the region, imports of American goods would increase, easing the pressure on America's external deficits.

The last and really only hope for the current system is a general inflation that would transfer wealth from the savings of the household sector to the banking system, and then onward to producers. In an attempt to create this inflation, the MOF and the BOJ have consistently fostered monetary growth rates in excess of those that conventional analysis would deem appropriate. The
exchange rate of the yen has been suppressed in order to inflate import prices, and both long and short term interest rates have been lowered. The hope was that asset prices would rise relative to their underlying fundamentals, and companies would undertake real restructuring.

Japan's governing elite does not understand that those very policies have brought Japan closer to the brink of destruction. As long as Japan's elite continues to believe they might still succeed in engendering a boom of inflation, it will undertake real restructuring. However, the potential for such a boom is in excess of domestic demand, and unless companies face bankruptcy, they will continue to produce, thus crowding out domestic consumption, reducing employment, and increasing the risk of inflation. Japan's policy is a long-term one, and more factories will not be closed until they are in jeopardy.

Japan's production capacity is significantly higher than the world can absorb. As long as any positive cashflow at all can be extracted, they will continue to produce, thus crowding out domestic consumption, reducing employment, and increasing the risk of inflation. Japan's policy is a long-term one, and more factories will not be closed until they are in jeopardy.

The system of maximizing the current account surplus worked well. The system of maximizing the current account surplus worked well. The system of maximizing the current account surplus worked well. The system of maximizing the current account surplus worked well.
Giving Equity Capital its Proper Role

Changing this economy into one that will generate current account deficits means, inevitably, that some portion of Japan's production capacity will have to be shut down, and that its financial infrastructure will likewise have to be slimmed down. In other words, the Japanese economy will need to become sensitive to risk and return. However, any move in that direction encounters enormous obstacles. One of the biggest is that few bankers, policy makers, or even businessmen in Japan genuinely understand the function and needs of equity capital. They have never had to worry about it in the past. Individual players in the Japanese system took capital for granted. The government subsidized banks and important industrial companies in a variety of ways, and deliberately created hospitable environments to encourage revenue and capacity growth. But it was not only the government per se, as companies in virtually all industries in Japan are organized into industrial associations that help set prices and allocate production volume in a manner that would be flatly illegal in the US. If such arrangements proved insufficient to maintain profitability, the government has since pre-war times been expected to intervene to ensure adequate profits.

Many economists wonder why the Bank of Japan does not simply print more money in order to trigger inflation and thus boost nominal GDP. The fact is that the BOJ is actually trying to do this, as its printing of notes in circulation is rising at an annual rate of more than 10 percent. But much of this currency is simply being hoarded by households frightened of new reports of failing banks, and much of the rest of it leaks abroad as households chase foreign investments with higher returns and supposedly greater security. The banking system, particularly weaker banks, is actually suffering deposit withdrawals. As banks seek to reduce their leverage ratios, a deflationary cycle is put in motion. Unless the bad loan problem is solved, permitting a recovery in confidence in the banks, the Bank of Japan's monetary policy cannot stimulate nominal GDP, no matter how inflationary it may seem on the surface.

Ending the Socialization of Market Risks

Mechanisms are needed that would permit inefficient industries and companies to be closed, or absorbed by their more efficient competitors. No market in corporate control has ever been allowed to take root in Japan, meaning that management not only need not
fear bankruptcy, but did not have to worry about either takeover or pressure from disgruntled outside shareholders. The result as we have seen is a moral hazard problem of huge dimensions that has afflicted Japan with enormous overcapacity, capacity that can only be maintained by depressing both interest rates and the value of the yen, thereby shifting the costs outside Japan to other countries in Asia. Reform will require a complete overhaul of existing accounting and legal systems so that those responsible for asset deployment can be made accountable for their performance, and so that risk can be properly assessed and brought into line with return.

Japan's mandarins in the economic ministries, the great banks, and the federations of industrial associations do not want to see reform, not so much because it will deprive them of the power to allocate managerial resources at their own discretion, but simply because they do not understand the alternative system: a market economy. The deposits draining from Japanese banks have become a torrent, as they flood into currency in circulation and overseas assets, causing a rundown in reserve deposits. Japanese banks in turn are facing a liquidity shortage, resultant callback of their loans, and liquidation of investments. Principal among the investments that will have to be liquidated are dollar assets, and as Japanese financing for the American external deficits contracts, the pillars of American economic prosperity — strong dollars, low inflation, and buoyant financial markets — will come under great strain. If the world's principal engine of demand falters, then we truly enter uncharted economic waters, and the country that is likely to be hurt most is Japan itself.

To end the socialization of risk, to establish a clear link between risk and reward, today's almost completely intermediated financial system should be replaced with disintermediated securities markets as the primary source of corporate finance. Properly functioning securities markets allocate funds to profitable issuers and starve the unprofitable, and would thereby force elimination of the great drag on the Japanese economy: unprofitable production capacity. City banks must not be allowed to interfere with the necessary purging, as they will have to be prohibited from supporting large companies. In other words, their role as 'main banks' must end.

The government's attempts to control all financial risks should be abandoned. The government has a huge war chest that it uses for this purpose. It is the Trust Fund Bureau of the Ministry of Finance, and it is funded with postal savings, postal insurance, and government
pension funds. This bureau should be shut down. The government should tap personal savings through private intermediaries at market driven rates of interest rather than unloading JCP’s on the Trust Fund Bureau. The Temporary Interest Rate Adjustment Law, which exempts financial institutions from anti-trust requirements and permits administered, cartelized interest rates on both lending and deposits, should be repealed so that interest rates are determined by market forces. The core of the MOF’s licensing system should also be changed. This system, by which the MOF licenses financial institutions to do business, gives the MOF immense power over credit allocation, leaving banks as little more than deposit gatherers. Both the risks and rewards of credit allocation should rest entirely with bankers who would thus be forced finally to understand real credit analysis.

Creation of a Genuine Labor Market
With the flow of funds in the economy finally freed from government control, the next most important reform must be the creation of a genuine labor market. Today, we have essentially a one-window market. It opens for young people on finishing their education and then promptly closes. Company employees are expected to work for 30 years, or most of their productive lives, for single employers during which time wages rise according to seniority but not according to contributions. Japanese workers are underpaid for their contributions during their younger years, and as they age, the situation is reversed. This system can only work for bureaucracies and companies that can promise incoming recruits their jobs will be safe for 30 years. Only companies that are free from the risk of bankruptcy, those protected by the government and the main-bank system, can make this promise. Smaller firms, whose viability is not protected, cannot therefore compete for high-quality white-collar and engineering recruits. Bankruptcies of those protected entities like Yamaichi, and the ending of lifetime employment are, of course, violations of a long-held, implicit social contract. But only by doing so can Japan mobilize underutilized labor.

Building an Infrastructure of Accountability
Finally, reform depends vitally on building an infrastructure of accountability. It is no longer possible for the Japanese government to compensate everyone, to allocate losses and burdens while fulfilling
all of the implied social contracts. For loss-allocation to be carried out in a manner that is perceived as just and fair, Japan needs transparent, impartial accounting standards and universally followed judicial procedures. The number of accountants and lawyers in Japan is minuscule in proportion to the size of the economy. This is the result of deliberate policy, lest such professionals interfere with the informal methods used by power-holders to cope with losses. This must change, and measures must be implemented to build the accounting and legal infrastructures necessary to a mature economy governed by market forces.
IV. Dealing With The Banking Crisis

In the meantime, Japan's most pressing problem is the banking crisis. Many believe Japan lacks experience in coping with the sorts of problems it now faces with its banks. Foreign financial experts often advise Japan's monetary authorities to study the US savings and loan crisis, the US banking crisis of the early 1980s, the UK secondary banking crisis, and the Scandinavian banking crisis of several years ago. But in fact, Japan does have the historical experience of coping with a system-wide banking crisis. The historical crisis occurred in the wake of Japan's defeat in World War II. Its neglect today has several explanations. It occurred because of the war, in other words because of national policy; whereas, according to conventional wisdom, today's problems are the result of bubbles fueled by greed, not national policy. The previous crisis happened before the postwar constitution was put into effect, while Japan was occupied by a foreign power. Naturally, today's financial system is vastly more complicated and more subject to international influences. Despite these overwhelming differences, however, the previous crisis offers some lessons for the present one. The tools used then seemed to have been patterned after those used in the US banking crisis of the 1930s and should be applicable to the current crisis with some modifications.

The two crises, although vastly different in scale, were qualitatively similar from a financial point of view: deposits in the
Japanese banking system represented claims on real assets that could not generate cash sufficient to pay off deposit holders. In the 1940s, the assets had either been destroyed in war or they had been ordered shut down by occupation authorities who demanded the closure of Japan’s war-making apparatus. Today, the assets purchased at bubble economy prices bear no relation to their underlying ability to generate cash. They have been kept on life support by extremely low interest rates, an undervalued yen, and the absence of any pressure on companies to liquidate unprofitable assets or face threats of bankruptcy or takeover.

In the immediate postwar years, the MOF’s response to the crisis was to freeze deposits. The MOF was forced to take this step by the Occupation’s refusal to allow the Japanese government to compensate companies for war-related losses, something the government had originally intended to do. Accounts were separated into sound and unsound accounts, and at the various city banks, depositors finally received some 70-80 percent of the face value of the deposits depending on individual conditions. Even deposits of the postal savings system, previously regarded as sacrosanct, were written down by some 30 percent. Although the historical record is incomplete, equity interests of bank shareholders survived without being diluted even after depositors sustained losses. At the same time, reorganization and reconstruction of both industry and banks were launched.

Of course, the measures were not sufficient to restore the system to health. The conditions of the time, a near complete destruction of Japan’s productive capacity, ultimately required inflation to wipe out monetary savings that were far in excess of functioning productive assets. Rising prices were needed as an inducement to renewed production and investment. The deposit freeze formed part of an anti-inflation program announced in February 1946, but inflationary pressures overwhelmed the program, allowing the necessary cure to occur. Paradoxically, today the MOF is trying to induce inflation, something that macroeconomic conditions make almost impossible, while eschewing the methods that were tried and found inadequate in 1946 but could work, with suitable modifications, today.

The MOF has not dealt as forthrightly with today’s banking crisis as it did in the late 1940s, because the MOF for a long time refused to admit its existence. The MOF thought it could control outcomes, and did not realize early enough that it had lost control
of land prices. But today, since the MOF has found itself unable to bid up land prices to bail out problem banks, the MOF is finally forced to admit the existence of the problem. Financial institutions are in crisis because they followed the lead of the MOF.

As long as the financial institutions were successful, no one objected to MOF controls, but now that financial institutions are in trouble, a systemic problem has emerged. The current crisis cannot be ascribed to any specific policy. The Diet cannot be blamed, as it has not set any policy that led to the crisis. The MOF can be held morally accountable, and can be criticized for benign neglect, but it is not legally culpable. Although in actual fact the MOF is tactically responsible for its licenses, the accepted fiction—TATEMAE in Japanese—is that each institution is theoretically responsible for its own well-being.

MOF has done whatever possible to meet its past commitments with resources it currently commands, plus those from the institutions it licenses. Many of its commitments are not legally binding, and, with the exception of postal saving, the full amount of bank deposits in excess of ¥10 million are not necessarily guaranteed by any legislation. With the exception of deposits at credit unions, no legal provisions allow taxpayers funds to be diverted to support deposits before the following legislature. The public knows this, and they are hoarding money and shifting deposits from weaker banks to stronger ones.

The government introduced rescue measures permitting the use of tax funds to support the banking system just before the fiscal year ended in March 1998. Hereofore, MOF did not want to do so because it feared discussion in the Diet. Rescue measures would have involved open acknowledgment of the purpose and source of government funds used to effect the measures, and MOF worried it might have been obliged to explain any decisions involving taxpayer funds to the public and the Diet. These concerns led the MOF and its allies in the LDP to ask the Diet for amounts inadequate to solve the problem; rescue measures were voted without provoking serious debate. The measures provided ¥1.3 trillion for capital infusion to bolster equity of solvent banks and ¥1.7 trillion for the Deposit Insurance Corporation to support deposits of all banks. Accordingly, the government bought preferred stocks and subordinated debts in the amount of ¥1.8 trillion to augment equity capital of larger banks in time for the fiscal period ended March,
1998. But the amounts were too small to contain the banking crisis and now we face another crisis involving a few large banks.

The government has the legal and financial wherewithal to support even the biggest banks, if it so wishes. Japanese accounting requirements are sufficiently opaque to permit even the weakest banks to maintain the pretense of solvency. The government has the legal right to use a further ¥1.2 trillion to augment bank capital and stabilize the banking system, at least for the time being; if not permanently. But the government has not done so. The reason may be that the MOF has lost public support and fears being held responsible for the crisis. The MOF has the duty and obligation to implement whatever is needed to stabilize the financial system, whatever the risks to its prestige, in the same way that good firemen incur personal risk in fighting fires. But alas, in Japan, our firemen are bystanders.

The Real Big Bang

Once companies and banks are allowed to fail, and once creditors start losing money, then finally we can expect to see ruined creditors turn to judicial remedies and political protests. Only then will meaningful disclosure be forced upon companies. The accounting system will be forced into a radical overhaul that shows a realistic picture of corporate financial health, as investors and creditors who have lost money attempt to recover damages from those responsible.

Historically in the Japanese system, the resources available to management of large, well-connected corporations were not expected to trade; they were to be maintained permanently. Such resources included bank loans, interlocking shareholdings, land holdings, lifetime employees, and customer-supplier relationships. Since these resources were never traded and were always protected, the result was mismatches between causes and results, between risk and return, fundamentals and share prices, cash flow and land prices, employee contributions and wages, values and prices. It is important to understand, however, that the system depends upon the US market as the buyer of last resort. This will not be the case in the future; the US cannot maintain this role forever. When the US can no longer act as buyer of last resort, the Japanese system will stop functioning. What is slowly prying open the Japanese markets to imports is not so-called "liberalization", but a secular rise over the
past quarter century in the value of the yen. Because of the closed nature of the Japanese system, the yen will have to rise extraordinarily high before all obstacles to imports are finally swept away. Once imports begin to pour into the Japanese market, manipulation by bureaucrats of demand and supply no longer functions, resulting in lowered prices and profits.

To date, important players in protected industries have been supported by a strong safety net. If an insider needed to generate profits, it was allowed to sell land or stocks to other insiders. Buyers paid unreasonably high prices because they relied on their ability at some point if necessary to sell at unreasonably high prices. Insiders would not lay off workers as long as they could generate unrealized capital gains. Therefore, the real adjustment process will only start when opportunities for such gains have disappeared. If the government is serious about “Big Bang”, it needs to lower asset prices, or allow them to fall, thus conveying the message that lay-offs and factory closures will be permitted. Declines in asset prices will function as a genuine wake-up call for the Japanese economy. But there is no reason why cash flow, apart from changes in asset prices, should not remain intact. Subsequent restructuring plus sales of unnecessary assets should bring in additional cash, which can be used to reduce debt, and many companies will thus see their viability improve markedly.

Of course, the closure of factories and termination of employment will trigger substantial losses, for the original value of these investments has never been recovered by an adequate stream of profits. Japanese corporations have never paid much attention to profits in the first place, and this is why many of them are still burdened with indebtedness. In order to remain viable, companies will need to reduce unprofitable investments, including interlocking shareholdings and unused land. Historically, such assets were never to be sold outright, and instead were to be held permanently by the corporation and its affiliates. If profits were needed, they were created by sales of assets with the profits coming from the difference between market and book values. But these assets were bought back by the company itself or by other insiders, and it is this practice that supports asset prices and keeps them out of reach of outsiders such as foreigners and ordinary Japanese. If and when a major company in Japan, forced by cost pressures, decides to leave this system by selling such assets in the open market and laying off
its workers, that will be the genuine Big Bang. As asset prices and wage rates fall to reasonable, market-driven levels that permit companies to generate profits, unprofitable and inefficient companies will be squeezed out of business. Credit risks will become a reality, and the overall profitability of the economy will rise as unprofitable players exit the market.

With a nearly fully intermediated financial system in Japan, corporate losses will end up being borne by financial institutions. Thanks to blanket deposit guarantees, the government is expected to pick up the losses, and hopes to ameliorate the cost by generating inflation, thereby transferring wealth from personal financial assets to banks. But this is very difficult to achieve in current conditions.

A full markdown of assets in the Japanese system will result in severe loan losses, which will wipe out a large portion of the equity of the private banking system. It is reasonable to assume that one third of the nation’s deposits will be converted into securities and investment trusts by individual investors, and this will be the fastest growth area for individual financial assets. This in turn should foster a genuine securities market, where securities are actively traded, and strong players are distinguished from the weak, which will force the inefficient into bankruptcy. Mutual back scratching among insiders, such as interlocking share-ownership, may cease to exist, but it remains to be seen whether transactions among insiders will completely disappear, or the shrinkage in Japan’s pool of deposits will weaken the ability of insiders to help each other financially.

In the future, Japanese institutions will be forced to compete in open markets. They will no longer be able to determine prices by cozy negotiations among themselves, with bureaucrats, and with favored customers. It is not the government’s reforms that will bring this about, it is the waves of change crashing over Japan from the outside world. That is the real big bang.
V. Conclusion

The eyes of the world are now on the Obuchi administration: will it act to solve the banking crisis? Paradoxically, the flurry of measures being introduced and discussed points to the lack of any genuine resolve by the current government (or its predecessors) to take the measures necessary to solve the problem. The fact is that the government already has the authority and resources to solve the problem.

The MOF has absolute power over Japan’s financial institutions thanks to a licensing system that accords licensees the status of little more than subordinate, quasi-public institutions. Japan’s financial institutions are subject to administrative law but, to all intents and purposes, are subject neither to the civil nor criminal laws that rule private life. In other words, within its area of jurisdiction, the MOF enjoys a concentration of power that permits it to make the law, to interpret its meaning, and to administer the financial system without any external judicial review. The Financial Supervisory Agency (FSA) was recently created to assume MOF’s responsibilities for bank examination and securities market oversight but, for all its statutory independence, the FSA is very much a creature of the MOF.

Whether the Diet passes new laws or not, the MOF can implement any measures it deems appropriate within its domain. In fact, if the MOF really wanted to implement reforms, it could have done so
already. There are several reasons why the government continues to postpone doing anything serious.

• The MOF fears the consequences of admitting the size of the funding required to solve the problem, and the tax increases such funding would entail. Its licensees created huge financial bubbles in the economy and have suffered large actual and potential losses as a result. In order to quiet public concerns, the MOF implicitly guaranteed deposits at licensed financial institutions. The newly introduced measures calling for prompt corrective action to solve the crisis by MOF or FSA could, if implemented realistically, entail financial commitments approaching ¥100 trillion. These amounts could cause the LDP to lose the next Lower House election, putting the cabinet into the hands of opposition parties that could seek to curtail MOF's power.

• MOF's absolute power in its domain rests on the presumption that its policies could only benefit its licensees and their borrowers. Those who have benefitted from MOF policies have not seriously opposed the ministry, even if they now have growing doubts over the funding requirements necessary to bail out the financial system. However, large implied tax increases could provoke adamant opposition to any attempt by the ministry to implement a far-reaching solution. Thus, any MOF program that results in widespread wealth reduction is fraught with peril for the ministry.

• MOF and the government could suffer a severe loss of faith in attempting to solve the financial crisis using the regular legal framework (e.g., bankruptcy laws, the civil code and the like) rather than by administrative fiat. Two examples can be cited:
  — It has been suggested that the government should bail out the Long Term Credit bank of Japan (LTCB) by infusing tax money to augment its equity capital. This would require stating that LTCB is solvent, something the MOF should have done some time ago. However, many now doubt that LTCB is any longer solvent; its share price has gone down dramatically, suggesting the bank is in serious trouble. If LTCB is indeed bankrupt, the current banking law does not allow the government to use tax money to bail it out. But the MOF has publicly committed both
inside and outside Japan to prevent LTCB from collapsing. The failure to do so would shock the world.

— On the other hand, if LTCB should collapse, the Deposit Insurance Law does not have explicit provisions for the Deposit Insurance Corporation to guarantee bank debentures with tax money. LTCB, like the other two long-term credit banks, relies predominantly on bank debentures for funding. The government might be embarrassed to find bank-debenture holders unprotected legally. As recently as last year, MOF adopted new asset valuation regulations under the Banking Law that allow bank debentures issued by LTCB (along with Japanese government bonds and debentures of the other long-term credit banks) to be treated as risk free. MOF has done nothing but encourage licensed Japanese financial institutions to hold LTCB debentures.

Beyond the specific circumstances of the current crisis, there are a number of important considerations that argue against action by the MOF.

- Under the LDP regime, the government does not control the bureaucracy but instead gives carte blanche to the bureaucracy. Organizational rearrangements of the kind being discussed today are just wasteful exercises. Their real purpose is to preserve the core of the system intact while making a show that things are changing.

- The MOF has, for a century or more, hoarded important information on the banking system. Official records on the crises of the 1930s or the 1940s are not available; precluding scholarly studies of the past that could be of use in coping with present challenges. A few years ago, the MOF published a book on the banking system of the postwar period, but intentionally avoided discussing the crisis immediately after the war.

- The MOF survived Japan's defeat in 1945 with its institutional power intact. The occupying military authorities at GHQ could not change the financial system. They lacked the necessary understanding.

It appears that at present, the only way to achieve genuine reform is takeover of the Diet by opposition parties that would then
attempt to impose genuine political control over the bureaucracy. To do this, the Diet will have to revoke the MOF’s ability to appoint a substantial number of elected officials as vice ministers, thereby helping to force the MOF to become publicly accountable.

In the meantime, and despite the risks that the financial crisis represents to its institutional standing and prestige, the MOF is obliged under the current legal framework to implement the best available measures to settle the financial crisis. For good or for ill, there exists greater institutional memory in Japan for coping with financial threats to the prosperity and safety of the country than at the MOF. Nor do outsiders, including LDP representatives, have access to information on what is happening in the financial system other than that made available by MOF officials. Accordingly, there is no point in arguing in the Diet for new measures, systems or institutions to solve problems that are not understood.

If and when the MOF takes the measures necessary to resolve the crisis, we may see a day of reckoning. A bureaucracy that has never admitted small mistakes could be held accountable for one horrendous mistake. This would send a clear message that the long neglect of political mechanisms necessary to control the bureaucracy at all levels and in all sectors has had a very high cost for Japan.
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