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Japan—Economic and Policy Developments

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INTERNATIONAL MONETARY FUND

JAPAN

Economic and Policy Developments

Prepared by a staff team consisting of C. Towe, T. Bayoumi,
R. Dekle and I. Oishi (all APD)

Approved by the Asia and Pacific Department

September 3, 1997

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Japan: Basic Data

Nominal GDP: US$4,600 billion (1996)
Population: 125.7 million (1996)
GDP per capita: US$36,589 (1996)
Quota: SDR 8,241.5 million

	1990	1991	1992	1993	1994	1995	1996
Growth (percent change)							
Real GDP	5.1	3.8	1.0	0.3	0.6	1.4	3.5
Domestic demand	5.2	2.9	0.4	0.1	1.0	2.2	4.5
Private consumption	4.4	2.5	2.1	1.2	1.9	2.0	2.8
Residential investment	4.8	-8.5	-6.5	2.4	8.5	-6.4	13.6
Private plant and equipment	10.9	6.3	-5.6	-10.2	-5.3	3.9	6.6
Government consumption	1.5	2.0	2.0	2.4	2.4	3.5	2.3
Government investment	4.9	4.9	14.5	15.7	2.8	0.7	9.9
Stock building[1]	-0.2	0.2	-0.5	-0.1	-0.2	0.3	-0.1
Net exports[1]	0.0	0.9	0.6	0.2	-0.3	-0.8	-0.9
Saving-Investment (percent of GDP)							
Gross national saving	33.5	34.2	33.8	32.8	31.4	30.7	31.3
Gross domestic investment	32.3	32.2	30.8	29.7	28.7	28.5	29.8
Inflation (percent change)							
CPI	3.1	3.3	1.7	1.2	0.7	-0.1	0.1
GDP deflator	2.3	2.7	1.7	0.6	0.2	-0.6	0.0
Unemployment rate (percent)	2.1	2.1	2.2	2.5	2.9	3.1	3.3
Government (percent of GDP)							
Central government balance	-0.5	-0.2	-1.7	-2.7	-3.5	-4.1	-4.2
General government							
Revenue (percent change)	11.2	5.4	0.9	-2.5	0.8	0.5	3.7
Expenditure (percent change)	10.1	5.3	5.4	7.0	2.9	4.6	6.2
Balance	2.9	2.9	1.5	-1.6	-2.3	-3.7	-4.6
Balance excluding social security	-0.6	-0.8	-2.0	-4.8	-5.1	-6.5	-7.2
Structural balance excluding social security	-1.5	-1.5	-3.0	-3.7	-4.1	-5.1	-6.2
Social security balance	3.4	3.6	3.4	3.2	2.8	2.8	2.7
Money and credit (average percent change)							
M2 plus CDs	11.7	3.6	0.6	1.1	2.1	3.2	3.3
M3	7.0	5.3	3.4	3.9	4.0	3.6	3.3
Domestic credit	9.2	2.9	2.9	0.8	-0.4	1.8	1.4
Bank lending	7.5	4.4	2.5	1.2	0.5	1.3	0.4
Interest rates							
Three-month CD rate (annual average)	7.6	7.2	4.3	2.8	2.1	1.1	0.5
Official discount rate (end-period)	6.0	4.5	3.3	1.8	1.8	0.5	0.5
Balance of payments (in billions of US$)							
Exports, f.o.b.	280.4	308.1	332.5	352.9	386.0	429.4	400.2
Imports, f.o.b.	216.8	212.0	207.8	213.3	241.5	297.2	316.7
Current account balance	35.8	68.4	112.3	132.0	130.6	111.4	65.8
Percent of GDP	1.2	2.0	3.1	3.1	2.8	2.2	1.4
Terms of trade (percent change)	-6.4	10.0	7.4	8.9	7.4	-0.3	-8.4
Change in reserves	-8.9	-8.2	0.7	27.7	25.4	58.7	36.8
Merchandise trade (percent change)							
Export volume	5.6	2.4	1.6	-1.9	1.7	3.2	0.8
Export unit value (US$)	-1.5	7.1	6.3	8.3	7.6	8.6	-7.8
Import volume	5.6	3.8	-0.7	3.8	13.7	12.4	3.4
Import unit value (US$)	5.3	-2.6	-1.0	-0.5	0.2	9.0	0.7
Total reserves minus gold (in billions of US$)	78.5	72.1	71.6	98.5	125.9	183.2	216.6
Exchange rates (annual average)							
Yen/dollar rate	144.8	134.7	126.7	111.2	102.2	94.1	108.8
Real effective exchange rate[2]	100.0	106.7	110.9	135.2	145.4	153.6	130.9

Sources: Nikkei Telecom; WEFA; and staff estimates.

[1]Contribution to GDP growth.
[2]Based on normalized unit labor costs; 1990=100.

I. INTRODUCTION

1. The economic slowdown that followed the bursting of the asset-price bubble in 1990 was unusually deep and prolonged and, even with the pickup of growth in 1996, output still remains well below potential. Nonetheless, developments during the past year have provided encouraging evidence that a solid foundation has been laid for sustained economic recovery. In particular, growth has accelerated sharply, reflecting the supportive stance of macro-economic policies, considerable progress in addressing private sector balance sheet and capital stock imbalances, and the yen's depreciation since mid-1995. The improved economic environment has provided the opportunity for important structural and fiscal policy initiatives that will help the economy adapt to the substantial demographic shifts that are expected to occur in Japan.

2. The recent progress on these fronts is described in the subsequent chapters. **Chapter I** discusses recent economic and monetary policy developments. It suggests that, while growth is likely to be adversely affected in the near term due to the fiscal consolidation measures adopted as part of the FY 1997 budget, the prospects are favorable for continued economic recovery, supported by improved labor market developments and external demand. A declining working-age population, however, will constrain underlying growth over the longer term. Concern regarding the fiscal implications of population aging has helped prompt a shift from fiscal stimulus toward a contractionary fiscal stance in FY 1997 and the adoption of a medium-term deficit reduction strategy. These developments are described in **Chapter III**, which also suggests that a deeper and more accelerated fiscal adjustment than is currently contemplated would help ensure a declining debt ratio over the medium term and could improve the credibility of the commitment to fiscal consolidation, thereby minimizing the adverse impact on aggregate demand.

3. The subsequent chapters focus mainly on structural issues. Balance sheet difficulties of the banking sector have weighed heavily on the economy in recent years. **Chapter IV** reviews the progress that has been made by the banks in reserving against losses, and describes the regulatory and supervisory initiatives in this area. It concludes that, while considerable progress has been made on average, a number of institutions face a large overhang of nonperforming assets, raising questions as to their viability as interest rates rise to more sustainable levels and financial markets are deregulated. **Chapter V** examines the recent progress toward structural reform and deregulation. It described a number of significant measures that have been adopted in recent years, but highlights estimates that suggest that there are substantial additional economic gains that could be reaped from further progress in this area. For example, **Chapter VI** details the government's recent proposals to deregulate financial markets, which, when implemented, are expected to significantly improve the efficiency of the Japanese financial system.

4. On the external front, **Chapter VII** describes recent trade policy developments, noting that trade tensions between Japan and its trading partners appear to have lessened during the

past year, possibly reflecting the increased use of the dispute settlement mechanisms of the World Trade Organization. **Chapter VIII** concludes with a discussion of Japan's official development assistance (ODA) and notes that, while Japan remained the largest provider of ODA in 1996, fiscal constraints are likely to place significant constraints on ODA in coming years.

II. Economic Developments and Long-Run Prospects

A. Output and Price Developments

Output developments

5. The recovery strengthened markedly in 1996 following several years of anaemic growth (Table II.1 and Chart II.1).[1] GDP growth rose to 3½ percent in 1996, compared with 1½ percent in 1995, supported by: (i) the stimulative effects of low interest rates and expansionary fiscal policies; (ii) a rise in confidence following the Kobe earthquake and terrorist attacks in 1995; and (iii) progress in completing capital stock and balance sheet adjustments, which had restrained growth in previous years. Growth in the latter half of the year was also bolstered by the lagged response of external demand to the yen's depreciation since mid-1995.

6. Despite the pickup in activity, growth was uneven in 1996, partly due to special factors. In particular, the 2 percent surge in GDP in the first quarter, and the subsequent stagnation in activity during the second and third quarters, partly reflected the fact that the seasonally adjusted data did not fully take into account the effect of the leap year.[2] Concern regarding E-coli contamination also slowed household consumption of foodstuffs. Growth rebounded by 1 percent in the fourth quarter, owing to the dissipation of these factors, as well as households' efforts to avoid the April 1, 1997 increase in the consumption tax.

7. Growth promises to be similarly unsteady in 1997. GDP rose sharply in the first quarter, increasing by 1½ percent, mainly due to a further surge in consumption ahead of the consumption tax hike. Available data suggest that a substantial portion of this increase will be unwound in the second quarter. While this is expected to be offset in part by a pickup in external demand, overall activity would be expected to slow temporarily, until the effects of the consumption tax have waned.

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[1]Real GDP growth averaged only ¾ percent during 1992–95, following the bursting of the asset-price bubble in 1990, and output had fallen 4¼ percent below potential by 1995. The unusually deep and prolonged slowdown reflected the effects of: (i) capital stock adjustments following overaccumulation during the late 1980s; (ii) the fall in asset prices on household wealth and consumption, and on corporate and financial sector balance sheets; and (iii) the sharp appreciation of the yen on external demand.

[2]The effect of the extra day in February, owing to the leap year, is estimated to have raised GDP growth by ½ percentage point in the first quarter, and to have lowered second-quarter growth by a similar amount. Growth midyear also was slowed by the effect of an outbreak of E-coli contamination on consumption.

Table II.1. Japan: Growth of Real GDP and Demand Components, 1992-97 1/

(Percent change from the previous period)

	1992	1993	1994	1995	1996	1996				1997
						I	II	III	IV	I
Private consumption	2.1	1.2	1.9	2.0	2.8	2.0	-1.0	-0.2	1.2	4.6
Private gross fixed investment	-5.8	-7.6	-2.2	1.3	8.2	2.0	2.5	1.4	2.7	-0.4
Residential	-6.5	2.4	8.5	-6.4	13.6	6.0	5.9	-0.5	4.0	-3.9
Business	-5.6	-10.2	-5.3	3.9	6.6	0.8	1.4	2.0	2.2	0.7
Final private domestic demand	-0.3	-1.4	0.8	1.8	4.2	2.0	-0.1	0.2	1.6	3.2
Government consumption	2.0	2.4	2.4	3.5	2.3	0.8	0.1	1.3	0.6	0.1
Government fixed investment	14.5	15.7	2.8	0.7	9.9	6.5	2.1	-2.0	-7.4	-12.4
Final domestic demand 2/	0.9	0.3	1.1	1.9	4.6	2.3	0.1	0.1	0.6	1.5
Stockbuilding 3/	-0.5	-0.1	-0.2	0.3	-0.1	0.1	-0.2	0.0	-0.1	0.0
Private	-0.5	-0.1	-0.3	0.3	-0.1	0.0	-0.2	0.0	-0.1	0.0
Government	0.0	0.0	0.1	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Total domestic demand	0.4	0.1	1.0	2.2	4.5	2.4	-0.1	0.1	0.5	1.6
Foreign balance 3/	0.6	0.2	-0.3	-0.8	-0.9	-0.3	-0.2	0.2	0.4	0.1
Exports	5.0	1.3	4.6	5.4	2.3	-0.7	0.1	1.6	5.0	0.7
Imports	-0.7	-0.3	8.9	14.3	10.5	2.0	1.8	-0.3	1.8	0.2
Real GDP	1.0	0.3	0.6	1.4	3.5	2.0	-0.3	0.3	0.9	1.6
Memorandum items:										
Government expenditure 4/	7.3	8.5	2.6	2.1	5.9	3.6	1.1	-0.4	-3.4	-5.9
Nominal GDP	2.8	0.9	0.8	0.8	3.6	2.4	-0.4	0.4	0.5	2.2
GDP deflator (1990=100)	1.7	0.6	0.2	-0.6	0.0	0.4	-0.1	0.1	-0.5	0.5
Output gap (percent of potential GDP)	1.3	-1.4	-3.3	-4.2	-3.1	-2.4	-3.2	-3.4	-3.1	-2.3

Sources: Nikkei Telecom; and WEFA.

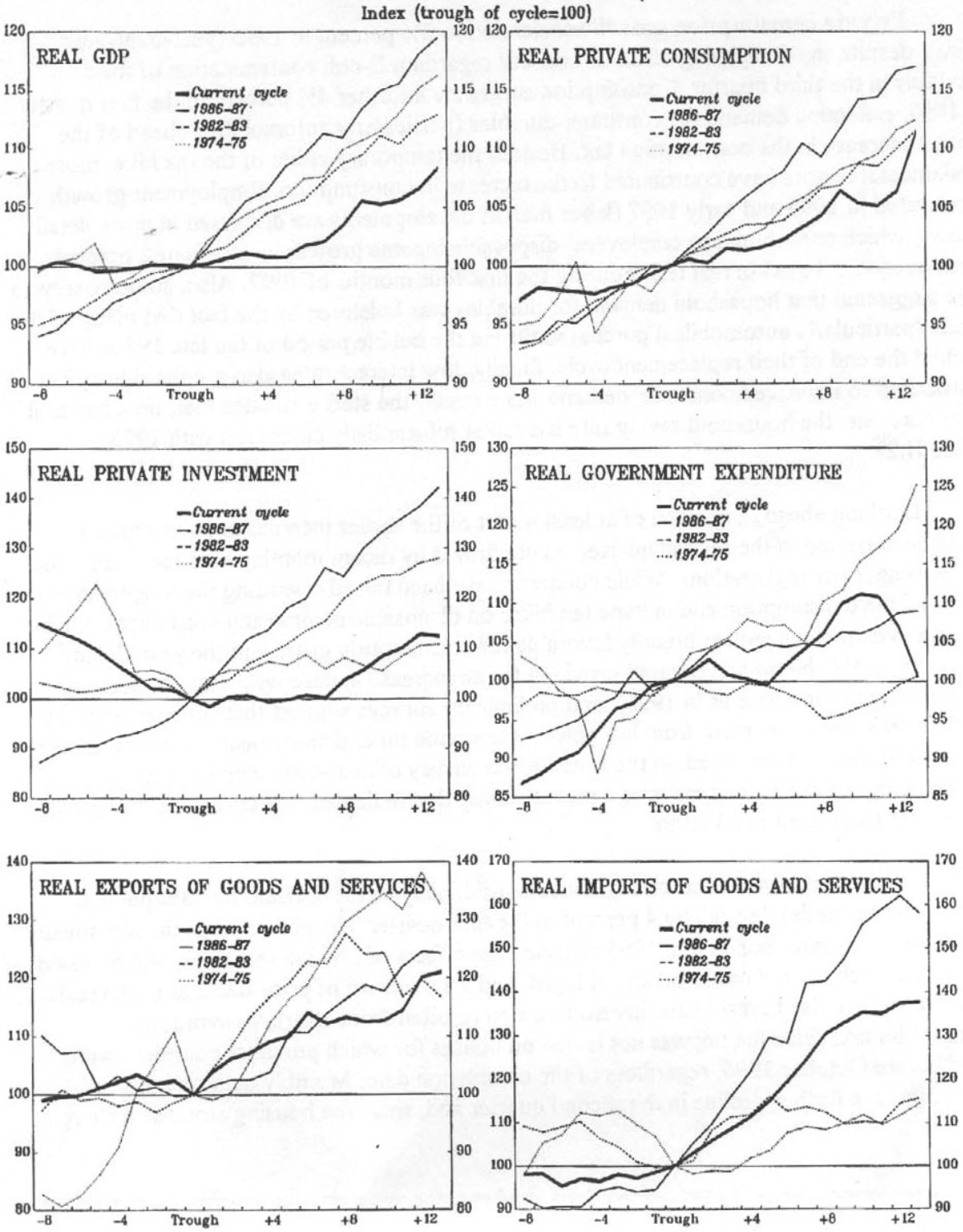
1/ At 1990 prices.

2/ Final private domestic demand is the sum of private consumption, residential investment, and business fixed investment. Final domestic demand is final private domestic demand plus government consumption and investment.

3/ Contribution to real GDP growth.

4/ Government consumption and investment.

CHART II.1
JAPAN
COMPARISON OF FOUR CYCLES 1/
Index (trough of cycle=100)



Source: Nikkei Telecom.
1/ Troughs defined as: 1993Q4 for current cycle; 1987Q2 for 1986-87 cycle; 1983Q2 for 1982-83 cycle; 1975Q1 for 1974-75 cycle.

8. **Private consumption** growth accelerated to 2¾ percent in 1996 (year-over-year basis), despite the dampening effect of concern regarding E-coli contamination of food products in the third quarter. Consumption surged by a further 4½ percent in the first quarter of 1997, reflecting demand for consumer durables (particularly automobiles) ahead of the April 1 increase in the consumption tax. Besides the temporary effect of the tax hike, more fundamental factors have contributed to the increase in consumption. Employment growth accelerated in 1996 and early 1997 (labor market developments are discussed in more detail below), which contributed to employees' disposable income growth in excess of 2 percent (year-over-year basis) in real terms during the first four months of 1997. Also, some observers have suggested that household demand for durables was bolstered by the fact that many of the goods (particularly automobiles) purchased during the bubble period of the late 1980s have reached the end of their replacement cycle. Finally, low interest rates also are thought to have contributed to improved consumer demand. As a result, the staff estimates that, on a national accounts basis, the household saving rate has fallen substantially compared with 1995 (Table II.2).

9. Looking ahead, a reversal of at least a part of the earlier increase in consumption would be expected in the second quarter, as confirmed by recent monthly data for retail sales and passenger car registrations. While concerns have been raised regarding the longer-term impact of the consumption and income tax hikes on disposable income and consumption, labor market developments appear broadly favorable for consumption growth in the year ahead.[3] The spring 1997 *shunto* wage round provided for an increase in base wages of 2¾ percent (the same rate of increase as in 1996), and preliminary surveys suggest that summer bonuses could increase by 3¼ percent from last year. At the same time, employment prospects appear likely to improve further based on the June *tankan* survey of near-term employment expectations, as well as the results of a recent survey that indicated that corporate hiring will increase by 13 percent in FY 1998.

10. **Residential investment** strengthened considerably in 1996, rising by 13¾ percent (year-over-year basis), but fell by 4 percent in the first quarter.The pickup from the historically weak investment rate recorded in 1995 reflected the effects of low interest rates, which raised housing affordability indices to historical highs, and a slowdown of price declines in the real estate sector.The rise in residential investment also resulted from efforts to avoid the consumption tax, since the tax was not levied on houses for which purchase contracts were signed before October 1996, regardless of the completion date. Monthly data on housing starts point to a further decline in the second quarter and, since the housing stock as a share of

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[3]The income tax increases represented a withdrawal of tax measures introduced in 1994, which provided rebates of 15 percent of taxpayers' tax liabilities in June and December, up to a maximum of ¥70,000.

Table II.2. Japan: Saving and Investment Balances, 1991-96

(In percent of GDP)

	1991	1992	1993	1994	1995	1996
Gross national saving	34.2	33.8	32.8	31.4	30.7	31.3
Private sector	24.4	25.0	25.8	25.9	25.9	26.8
Households	8.5	8.6	8.9	9.0	9.0	7.3 1/
Private enterprises	15.8	16.4	16.9	16.9	16.9	19.5 1/
Public sector	9.8	8.8	6.9	5.7	4.8	4.6
General government	9.1	8.3	6.2	5.4	4.1	3.9 1/
Public enterprises	0.8	0.5	0.8	0.3	0.7	0.7 1/
Gross domestic investment	32.2	30.8	29.7	28.7	28.5	29.8
Private sector	25.6	23.3	21.1	20.0	19.9	20.7
Households 2/	5.2	4.8	5.0	5.4	5.0	5.5
Private enterprises	20.4	18.5	16.2	14.6	14.9	15.2
Public sector	6.6	7.5	8.5	8.7	8.6	9.1
General government	5.1	5.6	6.5	6.5	6.4	6.9 1/
Public enterprises	1.5	1.9	2.0	2.1	2.2	2.2 1/
Foreign balance 3/	2.0	3.0	3.1	2.8	2.2	1.4
Saving-investment balances						
Private sector	-1.2	1.7	4.7	6.0	5.9	6.1
Households	3.4	3.8	3.9	3.7	4.0	1.8 1/
Private enterprises	-4.5	-2.1	0.8	2.3	2.0	4.3 1/
Public sector	3.2	1.3	-1.6	-3.0	-3.8	-4.5
General government	4.0	2.7	-0.3	-1.1	-2.3	-3.0 1/
Public enterprises	-0.8	-1.4	-1.3	-1.8	-1.4	-1.5 1/
Memorandum item:						
Real GDP growth	3.8	1.0	0.3	0.6	1.4	3.5

Source: Nikkei Telecom, WEFA, and staff estimates.

1/ Staff estimate.
2/ Residential investment.
3/ Current account balance.

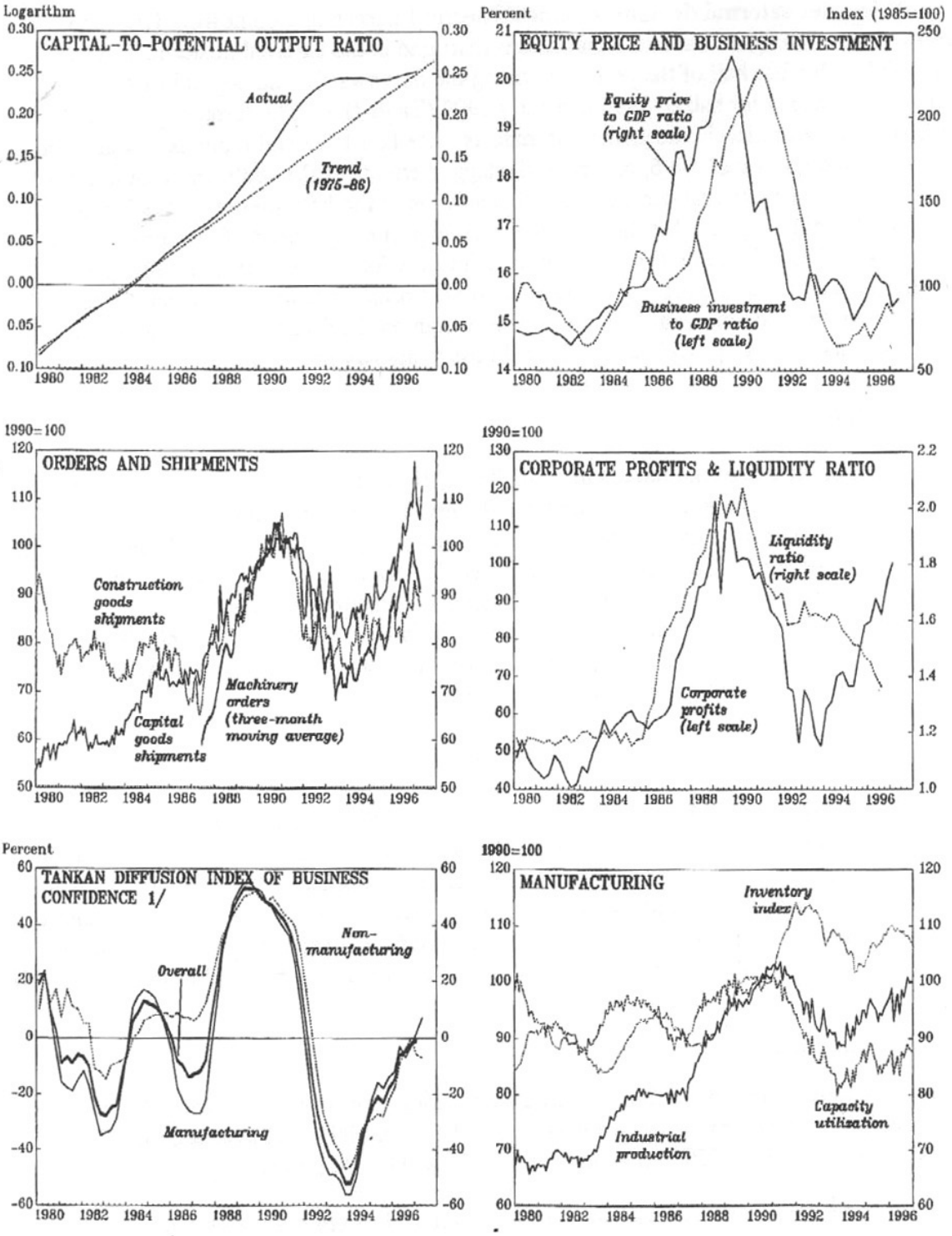
potential GDP still appears modestly above its longer-run trend, residential investment demand may continue to be sluggish in the period ahead, despite low interest rates and increased demand for more modern housing.

11. **Business investment** rose by 6½ percent in 1996 (compared with an increase of 4 percent in 1995), and grew by a further ¾ percent in the first quarter of 1997. By contrast, **inventory adjustments** exerted a small negative contribution of 0.1 percentage point to growth in 1996. The pickup in fixed investment reflected a considerable improvement in business conditions: real interest rates are low, corporate profitability has risen sharply since 1994, and equity prices have been relatively stable during the past several years following the sharp correction that began in mid-1990 (Chart II.2). These factors have contributed to a steady improvement in business confidence, particularly within the manufacturing sector, which benefited from the depreciation of the yen from the historically high levels recorded in early 1995. In addition, the capital-to-output ratio has largely adjusted from the unusually high levels achieved in the late 1980s, at the end of the bubble period (Chart II.2). Deregulation in the telecommunications sector also helped support investment in 1996; restrictions on the personal ownership of cellular phones were removed, which spurred considerable infrastructure investment among providers of cellular telephone services.

12. Prospects for continued strength in business investment appear favorable. Although capital and construction goods shipments have dipped in recent months, the level remains high and machinery orders appear to remain relatively strong. Vacancy rates are relatively low, suggesting scope for improvement in the construction sector. In addition, technological changes, in the face of the upward trend in capacity utilization ratio and the low capital-to-output ratio, should also support investment in equipment. However, a sustained improvement in business investment will depend importantly on the activities of smaller and nonmanufacturing enterprises, whose financial health has generally lagged behind those of other firms.

13. The growth of **government consumption** moderated to 2¼ percent in 1996 (year-over-year basis) from 3½ percent in 1995, and fell to less than ¼ percent in the first quarter of 1997. By contrast, **public investment** outlays jumped by 10 percent in 1996, versus ¾ percent growth in 1995, but fell by 12¾ percent in the first quarter of 1997. The volatility of public investment reflects the impact of the September 1995 stimulus package and outlays related to reconstruction efforts following the Kobe earthquake. While public investment fell from 9¾ percent of GDP in mid-1996 to 7½ percent of GDP in the first quarter of 1997, it remains about 1 percent of GDP above the average recorded during the late 1980s. The sharp first-quarter decline in public investment was larger than most analysts had anticipated, possibly reflecting difficulties in seasonally adjusting the data in the face of the large stimulus packages in previous years, as well as the relatively late approval of the supplementary budget for FY 1996. Nonetheless, recent government fiscal commitments suggest that public investment is likely to be constrained in the period ahead.

CHART II.2
JAPAN
INDICATORS OF BUSINESS INVESTMENT, 1980–97



Source: Nikkei Telecom and WEFA.
1/ Percentage of respondents reporting improving business conditions versus deteriorating.

14. While **net external demand** subtracted nearly 1 percentage point from GDP growth in 1996, the annual figure masks a significant turnaround in the external position. The foreign balance fell in the first half of the year, continuing the downward trend begun in 1993, but the balance rose in the latter half of 1996 and early 1997 (Table II.1). The turnaround resulted from a sharp deceleration in the growth of imports since late 1995 and rapid export growth from the second quarter of 1996, reflecting the lagged effects of the yen's depreciation since mid-1995. While net external demand slowed somewhat in the first quarter of 1997, more recent monthly data suggest that this was due to an import surge ahead of the consumption tax hike, as well as a desire by firms to shift sales into the following fiscal year. Thus, even assuming that structural factors (including an increased preference for imports and effects of shifts in Japanese production abroad) continue to weigh on the foreign balance, net external demand appears likely to provide a significant boost to activity in 1997.

Price developments

15. Deflationary forces moderated in 1996. The CPI inflation rate remained near zero, while the GDP and consumption deflators from the national accounts rose by ¼ percent, after declining in 1995 (see tabulation below). However, this partly reflected the yen's depreciation since mid-1995—the domestic component of the WPI index continued to fall in 1996. Price indices jumped sharply in April, by roughly 1½ percent, reflecting the effect of the 2 percentage points increase in the consumption tax. This was roughly consistent with the experience in 1989, following the introduction of the 3 percent consumption tax, when the CPI inflation rate rose by roughly 2 percentage points.[4]

B. Labor Market Developments

16. The current recovery has been marked by unusually slow employment growth, which has been ascribed to uncertainties about the recovery and the need for industrial restructuring in the face of the sharp appreciation of the yen that occurred during 1993 to mid-1995. As a result, firms have been reluctant to take on full-time employees, especially given the Japanese lifetime employment system and the difficulties that were faced in adjusting the size of labor forces during the recent downturn.[5] As a result, firms have tended to respond to improved

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[4]Based on a simple regression of the monthly core inflation rate on its lags during the previous twelve months and dummies for the April 1989 and the April 1997 tax increases, the effect of the tax was to increase the CPI by 1¾ percent in 1989 and by 1½ percent in 1997.

[5]The Japanese lifetime-employment system is characterized by very high retention rates, low turnover, and relatively steep wage-tenure profiles, particularly among larger firms, which has historically led to relatively stable employment over business cycles. For a discussion, see M. Lutz, "Japanese Labor Market Developments" in *Japan—Selected Issues*, IMF Staff Country Report No. 96/114 (October 1996), pp. 28–68.

demand conditions in 1995–97 by adjusting overtime hours, part-time employment, and bonus payments rather than taking on full-time employees and raising base wages.

Price Inflation

(Percent change of period average from previous year)

	1992	1993	1994	1995	1996	1997	
						Q1	May
CPI inflation	1.6	1.3	0.7	-0.1	0.1	0.6	1.9
Core CPI inflation 1/	2.4	1.3	0.8	0.0	0.2	0.4	2.1
WPI inflation	-1.6	-2.9	-2.0	-0.9	0.7	1.4	2.7
Domestic goods	-0.9	-1.5	-1.7	-0.8	-0.8	-0.2	1.9
GDP deflator	1.7	0.6	0.2	-0.6	0.1	0.0	...
Consumption deflator	1.9	1.2	0.7	-0.5	0.2	0.6	...

1/ Core inflation excludes fresh food, fuel, water, and light.

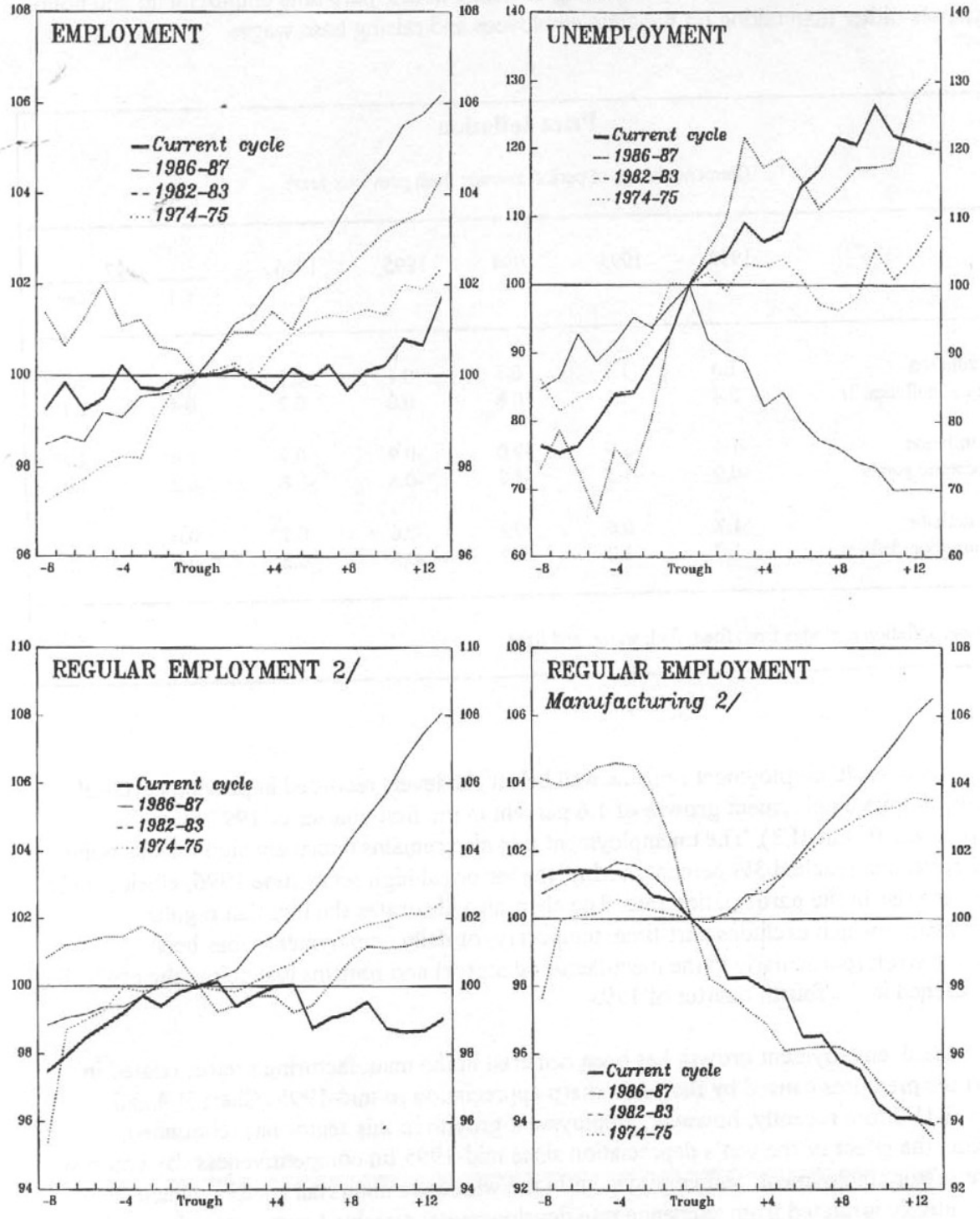
17. As a result, employment remains well below the levels recorded in previous cyclical upturns, despite employment growth of 1.6 percent in the first quarter of 1997 from the previous year (Chart II.3). The unemployment rate also remains unusually high for this point in the cycle, and reached 3½ percent in May, the historical high set in June 1996, albeit mainly owing to a rise in the participation rate. The chart also illustrates the fact that regular employment—which excludes part-time, temporary, or daily employment—has been especially weak (particularly in the manufacturing sector) and remains just below the cyclical peak reached in the fourth quarter of 1993.

18. Weak employment growth has been centered in the manufacturing sector, related in part to the pressures caused by the yen's sharp appreciation to mid-1995 (Chart II.4 and Figure II.1). More recently, however, employment growth in this sector has rebounded, reflecting the effect of the yen's depreciation since mid-1995 on competitiveness. By contrast, service sector employment, and employment in the wholesale and retail sectors, which have been relatively insulated from exchange rate developments, remained comparatively steady in recent years. Employment declines in recent years have also been concentrated within larger

CHART II.3
JAPAN

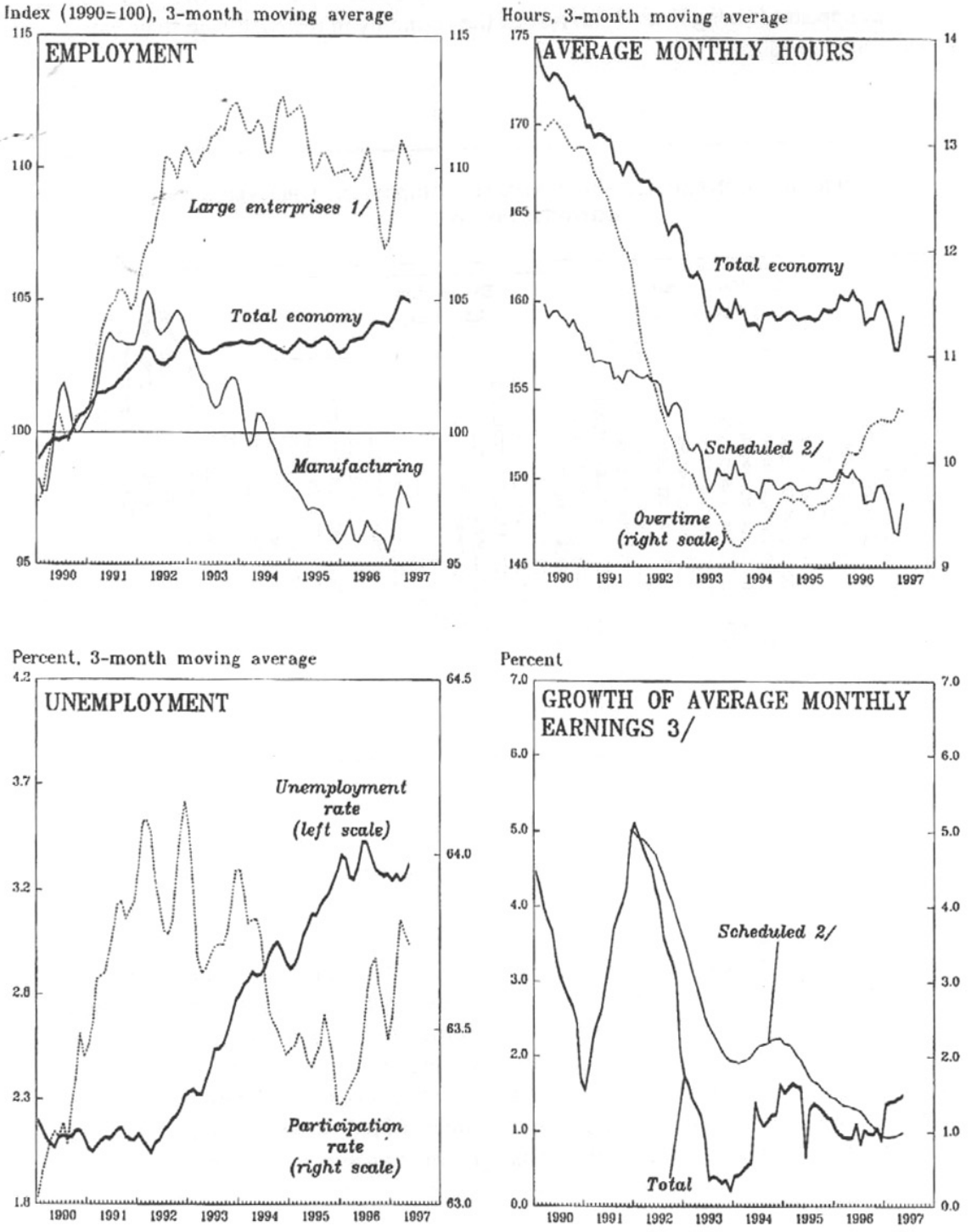
COMPARISON OF FOUR CYCLES 1/

Index (trough of cycle=100)



Source: Nikkei Telecom.
1/ Troughs defined as: 1993Q4 for current downturn; 1987Q2 for 1986-87 downturn; 1983Q2 for 1982-83 downturn; 1975Q1 for 1974-75 downturn.
2/ Regular employment excludes part time, daily, or temporary employment.

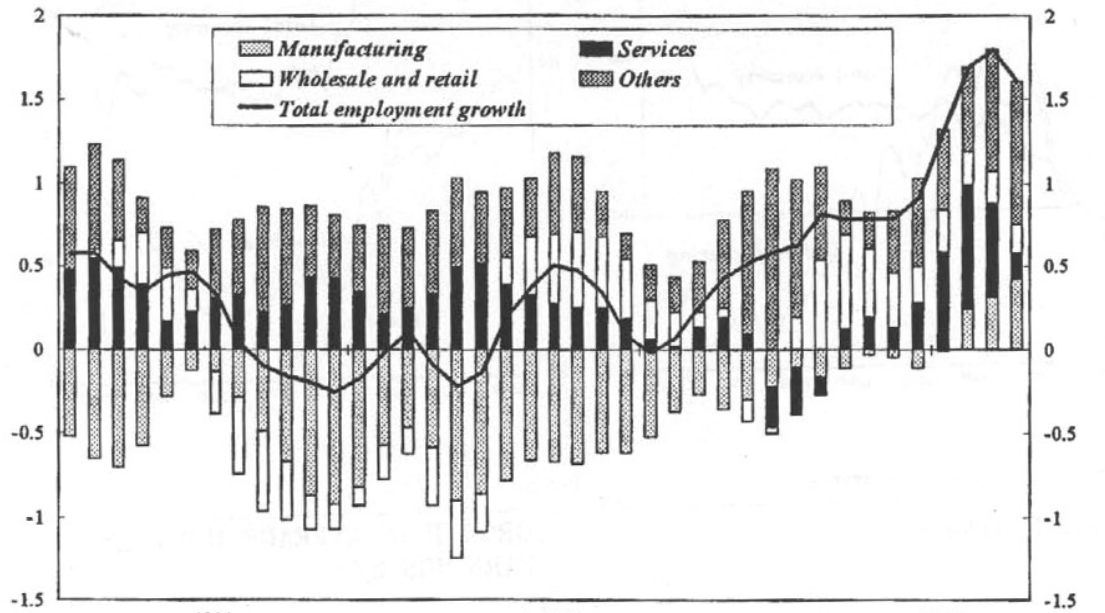
CHART II.4
JAPAN
EMPLOYMENT INDICATORS



Source: Nikkei Telecom and WEFA.
1/ 500 or more employees.
2/ Scheduled hours and wages refer to activities of regular employees during regular hours.
3/ Year-over-year growth of 12-month moving average.

enterprises—defined as enterprises with 500 or more employees—plausibly owing to the fact that these firms appeared to lag behind the rest of the economy in restructuring their work forces in 1991 and 1992.

FIGURE II.1. CONTRIBUTIONS TO NON-AGRICULTURAL EMPLOYMENT GROWTH, 1994-97



19. Uncertainties about the durability of the recovery and the high cost of full-time employees, given the lifetime employment system in Japan, have encouraged firms to respond to the recent pickup in demand by increasing average hours worked and taking on part-time employees. Overtime hours have increased sharply since late 1994, particularly in the manufacturing sector, which has more than offset the effect of recent legislation to reduce the length of the work week (Chart II.4).[6] Reflecting the effects of industrial restructuring, labor productivity growth in the manufacturing sector has grown at an average annual rate of

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[6]Scheduled hours have demonstrated a downward trend in recent decades, reflecting a succession of measures to reduce the work week. Most recently, the Labor Standards Law was revised in 1993, setting a 40-hour work week beginning in April 1994; the application of this standard to small- and medium-sized enterprises was delayed until April 1997.

4¼ percent during 1994–96, and rose by 9 percent in the first quarter of 1997.[7] After a two-year period of stagnation in 1992–93, economy-wide labor productivity growth accelerated to reach 3 percent in 1996, and rose by ½ percent in the first quarter of 1997.

20. Wage growth also appears to have been affected by efforts to avoid permanent increases in labor costs. For example, the four-quarter growth of average monthly cash earnings has risen sharply, reaching 3¼ percent in the first quarter of 1997. However, the growth of scheduled (i.e., base wage) cash earnings has declined steadily since 1990, and was only 1¼ percent in the first quarter of 1997. Thus, the pickup in wage growth has mainly reflected overtime pay and semiannual bonuses, rather than contractual increases in base pay.

C. Financial Market Developments and Bank of Japan Independence

Recent developments

21. The Bank of Japan (BOJ) began to ease monetary conditions in mid-1991 as activity weakened, and by end 1994 the official discount rate (ODR) had been lowered in seven steps from 6 percent to 2 percent (Chart II.5). In the face of continued evidence of a sluggish recovery, as well as the sharp appreciation of the yen, the BOJ lowered the ODR by a further 1 percentage point in April 1995. In July 1995, following the cut in U.S. short-term interest rates and coordinated intervention to resist the appreciation of the yen, the BOJ announced a further easing of monetary conditions consistent with a decline in the overnight call rate of about ½ percentage point to just below the ODR. Signs of continued sluggishness in economic activity prompted a further ½ percentage point cut in the ODR and the overnight rate in September 1995, where they have remained since.

22. While short-term interest rates have been held steady since September 1995, long-term bond yields have been volatile, mainly reflecting changes in market perceptions regarding the strength of the recovery and the prospects for short-term interest rate hikes. Yields rose during the first half of 1996 owing to the strong GDP growth in the first quarter and expectations of a possible tightening by the BOJ. At the same time the Nikkei 225 stock price index rose sharply from the recent low set in June 1995 to reach a five-year high in June 1996. However, incoming data suggested that growth had slowed considerably in the second and third quarters, and bond yields began to fall in mid-1996. With growing fears that fiscal consolidation could impede the recovery, and that financial sector deregulation would erode bank profitability, bond yields fell further in late 1996 and early 1997, setting new historical lows. At the same time, the Nikkei also weakened, and by May had fallen by nearly 25 percent from its 1996 high. In May, however, confidence in the economy's ability to weather fiscal consolidation apparently strengthened, long-term yields rose sharply, and the Nikkei recovered roughly half its earlier losses.

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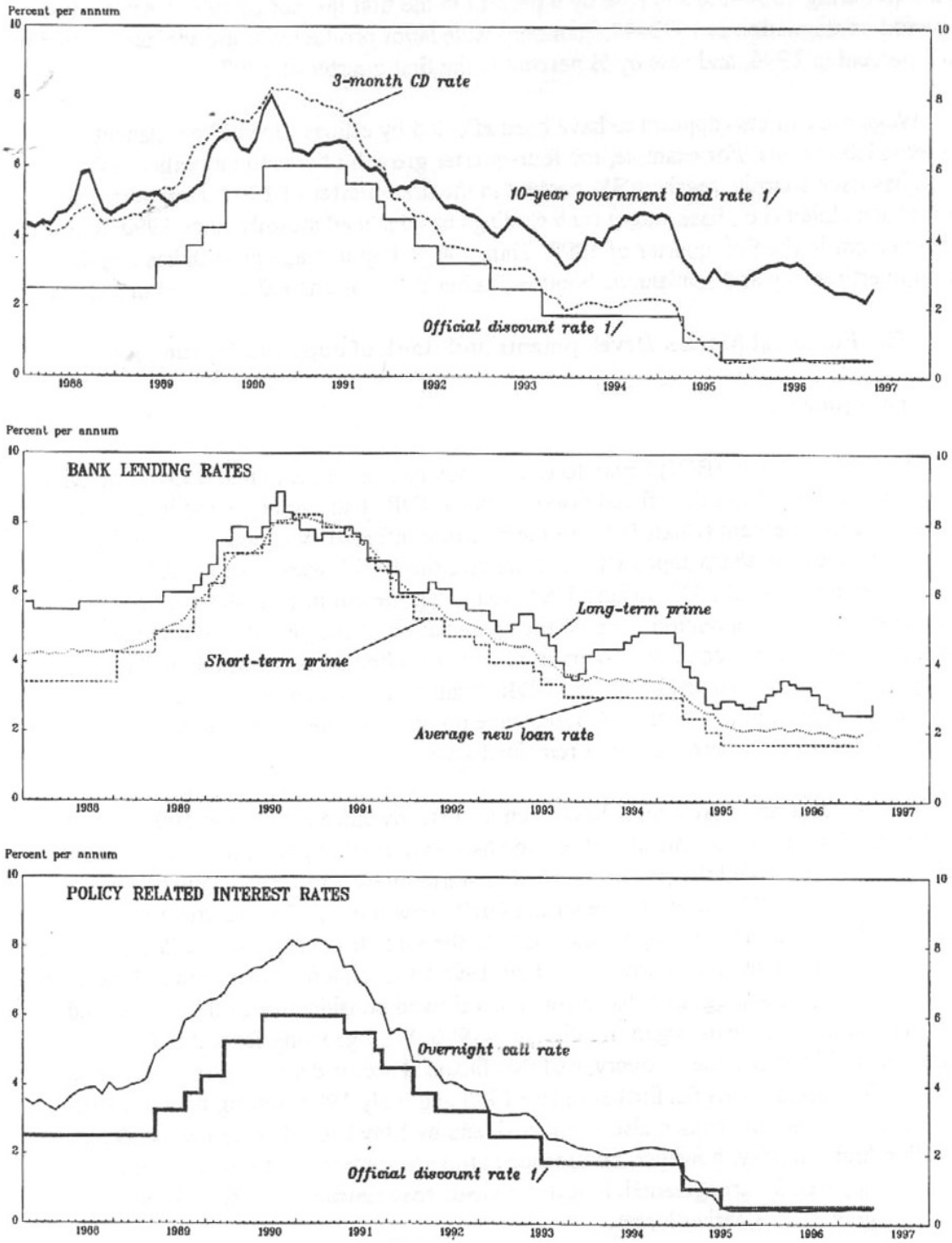
[7]Productivity growth is calculated on the basis of the ratio of output to the product of employment and monthly hours.

CHART II.5
JAPAN
SELECTED INTEREST RATES, 1988-97



Source: Nikkei Telecom and WEFA.
1/ End-period.

23. Overall monetary conditions—as measured by the staff's monetary conditions index (MCI)—tightened considerably from late 1992 to mid-1995, despite the decline in short-term interest rates (Chart II.6).[8] The increase in the MCI was principally due to the sharp appreciation of the yen during this period, but also reflected the fact that falling inflation muted the decline in real interest rates. The rise in the staff's financial conditions index—which also takes into account the effect of fiscal policy and stock market developments—was somewhat less pronounced, reflecting the impact of the stimulative fiscal policies that were introduced during this period. Since mid-1995, however, monetary and financial conditions have eased considerably, again principally due to the depreciation of the yen, but also reflecting the continuation of fiscal stimulus in 1996. During 1997, conditions are expected to tighten somewhat, owing to the fiscal consolidation that was adopted as part of the FY 1997 budget, but to remain relatively stimulative.[9]

Monetary aggregates

24. During 1990–92, the growth of the broader measures of money and liquidity slowed sharply, reflecting the slowdown in overall activity (Chart II.7). However, with the pickup in activity and the decline in interest rates, growth of M2+CDs, the aggregate most closely watched by the BOJ, rose steadily from minus ½ percent (12-month rate) in 1992 to 3¼ percent in 1995, and has remained in the 3 percent range since that time. By contrast, M1 growth accelerated much more sharply during the recovery, rising to over 16 percent in mid-1996, mainly reflecting a substitution into transactions deposits owing to the low interest rate environment. M1 growth slowed in the latter half of 1996 and into 1997, but still remained high at 9 percent in May 1997.

25. Deposits with the Postal Saving system (PSS) have increased sharply as a share of M2+CDs since 1991, reaching 22 percent in early 1997 (Chart II.7). The increase likely reflects the importance that depositors attached to the government guarantee of PSS deposits, given the failures in the rest of the banking sector. PSS deposits also have the advantage of

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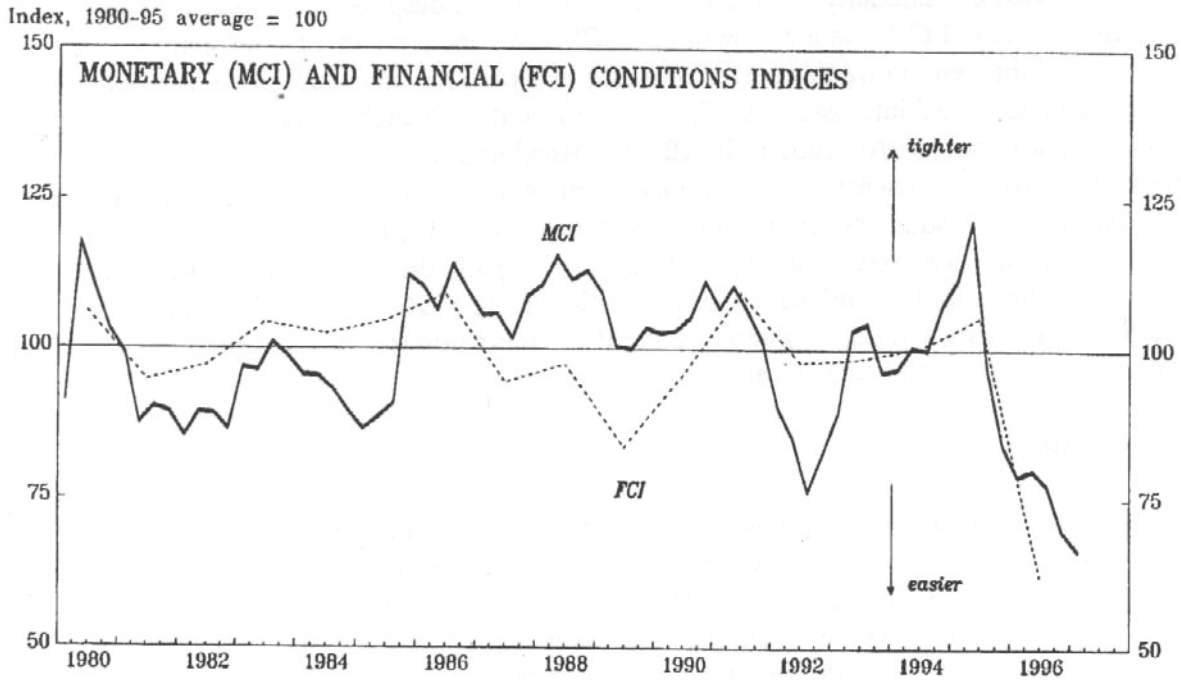
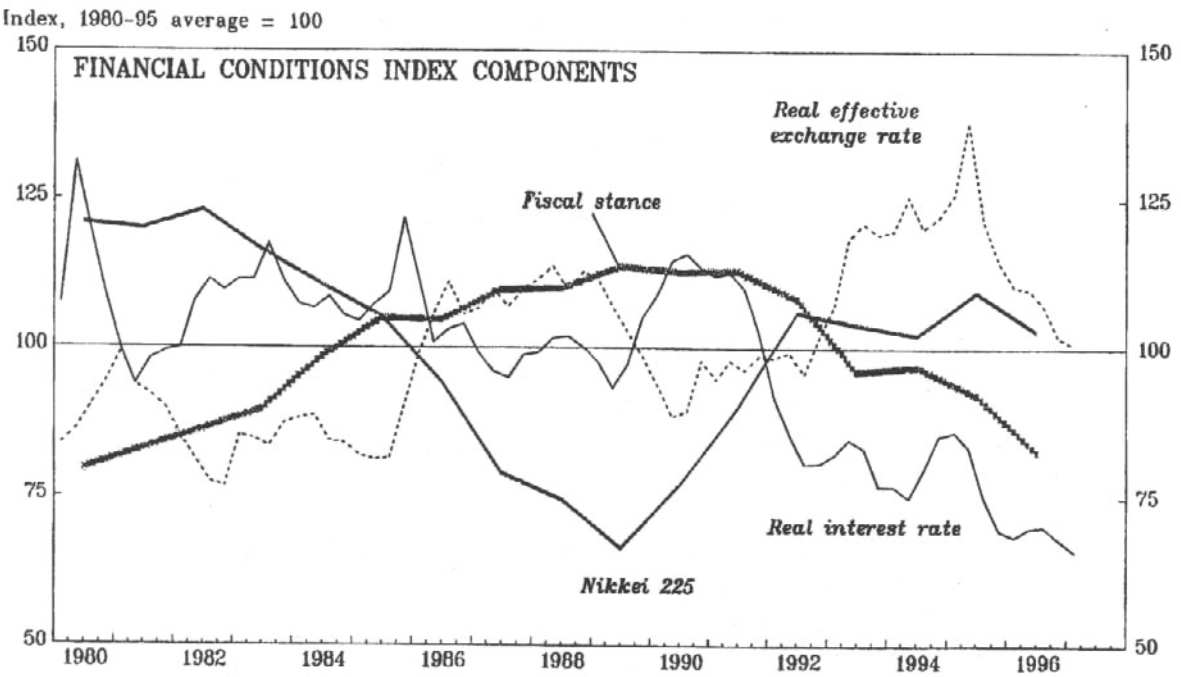
[8]For a discussion, see G. Lipworth and G. Meredith, "Indicators of Monetary and Financial Conditions: A Reexamination," in *Japan—Selected Issues*, IMF Staff Country Report No. 96/114 (October 1996), pp. 192–202. This year's selected issues papers also review the usefulness of the monetary conditions index.

[9]Concerns have been raised that the easing of monetary conditions may have been overstated because of a widening of bank intermediation spreads and a tightening of credit conditions related to a "credit crunch." While this issue is difficult to resolve, staff analysis has suggested that by mid-1996, the spreads between short-term lending rates and the banks' cost of funds had returned to levels that could be explained by "normal" cyclical factors. Moreover, recent *tankan* surveys suggest that banks' willingness to lend has increased sharply since the trough of late 1991.

CHART II.6
JAPAN
INDICATORS OF MONETARY AND FINANCIAL CONDITIONS, 1980-97 1/

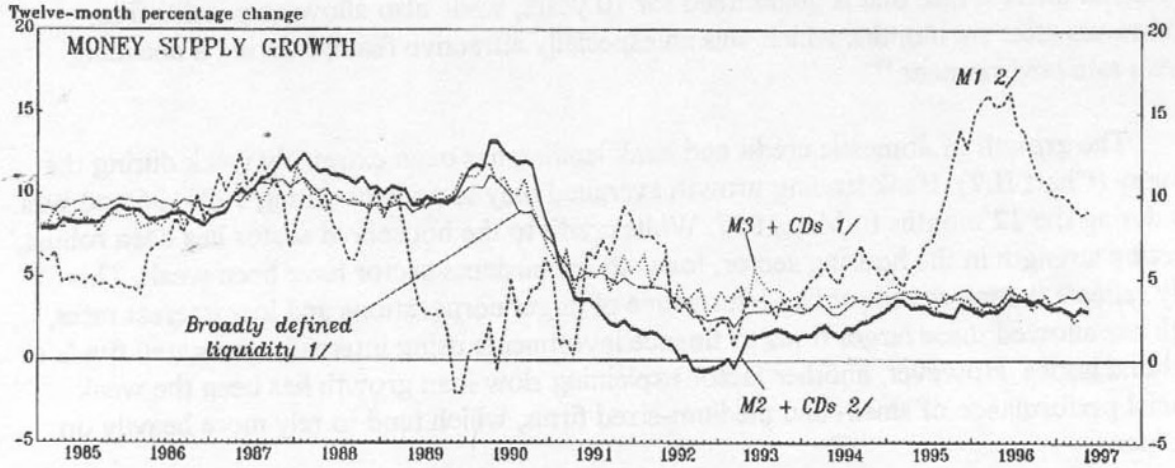


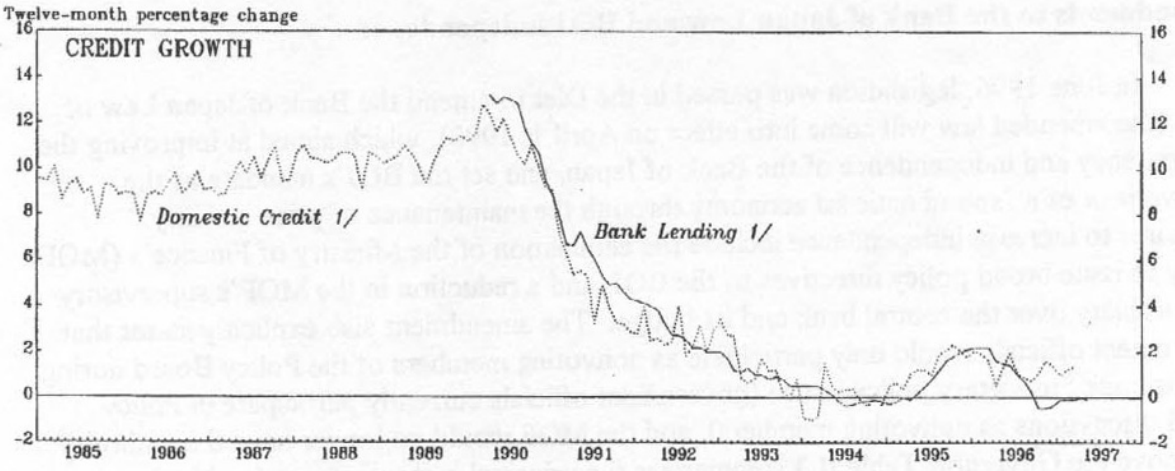


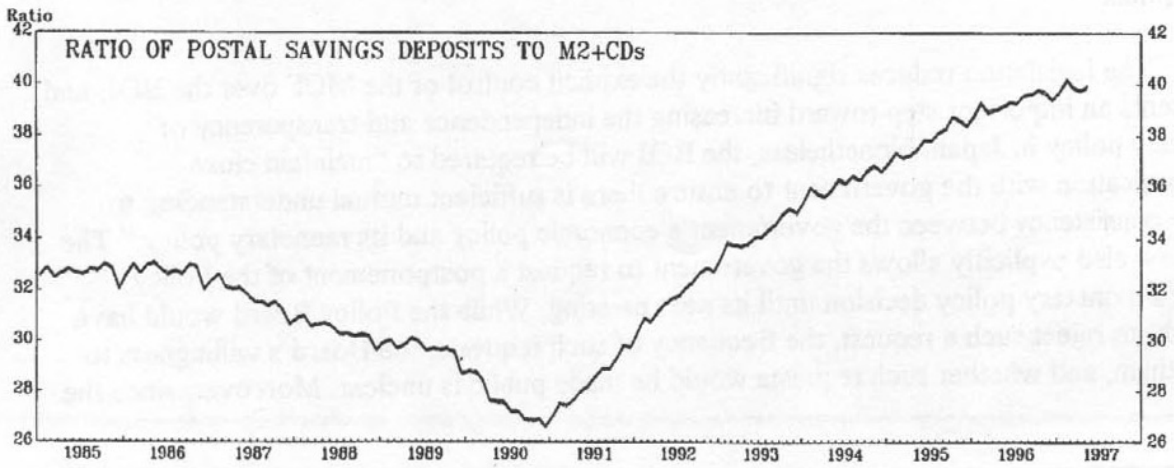
Sources: Nikkei Telecom; and staff estimates

1/ An increase indicates a tightening in monetary and financial conditions. The MCI is a weighted average of changes in the real interest rate and the real exchange rate. The FCI also includes the change in the fiscal stance and the stock price index; this index is presented on an annual basis because quarterly fiscal data are not available.

CHART II.7
JAPAN
MONEY, CREDIT AND POSTAL SAVINGS, 1985-97







Sources: Nikkei Telecom, WEFA, and staff calculations.
1/ End-period.
2/ Period average.

carrying an interest rate that is guaranteed for 10 years, while also allowing penalty-free withdrawals after six months, which was an especially attractive feature during a declining interest rate environment.[10]

26. The growth of domestic credit and bank lending has been extremely weak during the recovery (Chart II.7). Bank lending growth averaged only ½ percent during 1993–96 and was zero during the 12 months to May 1997. While credit to the household sector has been robust, reflecting strength in the housing sector, loans to the business sector have been weak. This partly reflects the improved profit performance of larger corporations and low interest rates, which has allowed these larger firms to finance investments using internally generated funds or new bond issues. However, another factor explaining slow loan growth has been the weak financial performance of small- and medium-sized firms, which tend to rely more heavily on bank loans.

Amendments to the Bank of Japan Law and BOJ independence

27. In June 1996, legislation was passed in the Diet to amend the Bank of Japan Law of 1942 (the amended law will come into effect on April 1, 1998), which aimed at improving the transparency and independence of the Bank of Japan, and set the BOJ's mandate as the achievement of a "sound national economy through the maintenance of price stability." Measures to increase independence include the elimination of the Ministry of Finance's (MOF) ability to issue broad policy directives to the BOJ, and a reduction in the MOF's supervisory responsibility over the central bank and its budget. The amendment also explicitly states that government officials would only participate as nonvoting members of the Policy Board during discussions of monetary policy issues (government officials currently participate in Policy Board discussions as nonvoting members), and the MOF would no longer have the authority to remove the Governor. Table II.3 summarizes the principal measures contained in the amendment.

28. The legislation reduces significantly the explicit control of the MOF over the BOJ, and represents an important step toward increasing the independence and transparency of monetary policy in Japan. Nonetheless, the BOJ will be required to "maintain close communication with the government to ensure there is sufficient mutual understanding to secure consistency between the government's economic policy and its monetary policy." The new Law also explicitly allows the government to request a postponement of the Policy Board's monetary policy decision until its next meeting. While the Policy Board would have the right to reject such a request, the frequency of such requests, the Board's willingness to reject them, and whether such requests would be made public is unclear. Moreover, since the

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[10]For a more detailed discussion of the Postal Saving system, see G. Lipworth, "Postal Savings in Japan," in *Japan—Selected Issues*, IMF Staff Country Report No. 96/114 (October 1996), pp. 135–149.

Table II.3. Amendments to the Bank of Japan Law

Issue	Previous Law	Revised Law
Monetary policy decisions	Finance minister can require that the BOJ delay a change in policy.	Finance minister can request a delay in change in policy until next Policy Board meeting. Policy Board may reject this request.
Policy Board members	Seven: governor, four appointed representatives of various sectors in the economy, and two nonvoting government representatives.	Nine: governor, two vice-governors, and six regular members chosen among experts. Two nonvoting government representatives may attend policy-related meetings and may make a motion to postpone a change in policy.
BOJ executives	Governor, vice-governor, seven directors, and less than two inspectors.	Governor, two vice-governors, six directors, and less than three inspectors
Appointment of bank personnel	Finance minister can order the removal of any bank executive Governor and vice governor appointed by Cabinet. Directors and inspectors appointed by MOF.	Finance minister cannot order the removal of any bank executive. Governor, vice-governors, and Policy Board members appointed by the cabinet with the consent of the Diet, inspectors appointed by the Cabinet.
Publication of the proceedings of the Policy Board	No such system.	Outline released rapidly, minutes released after slight delay.
Reporting to the Diet	Governor reports to the Diet once a year.	Governor reports twice a year.
MOF oversight	MOF empowered with broad authority over all bank operations, can change the bank's articles of incorporation, can demand on-the-spot inspections and reports.	MOF authority to influence bank operations limited to request for a change if there is an infraction of the law or violation of the bank's articles of incorporation. On-the-spot inspections abolished, but MOF can request inspectors to look into such suspected violations and request a report on the results of their investigations on short notice. MOF authorization required to change bank's articles of incorporation and responsibilities (e.g., derivatives new financial products, new capital settlement system, set up branches, offices, agencies). MOF can request information or data regarding BOJ activities "as necessary."
MOF authority over bank's budget	MOF approval needed for all general affairs budgetary actions by BOJ.	General affairs budget outlays which do not affect BOJ's monetary policies approved by MOF (wages, transportation, and telecommunications); if rejected, reasons must be given.

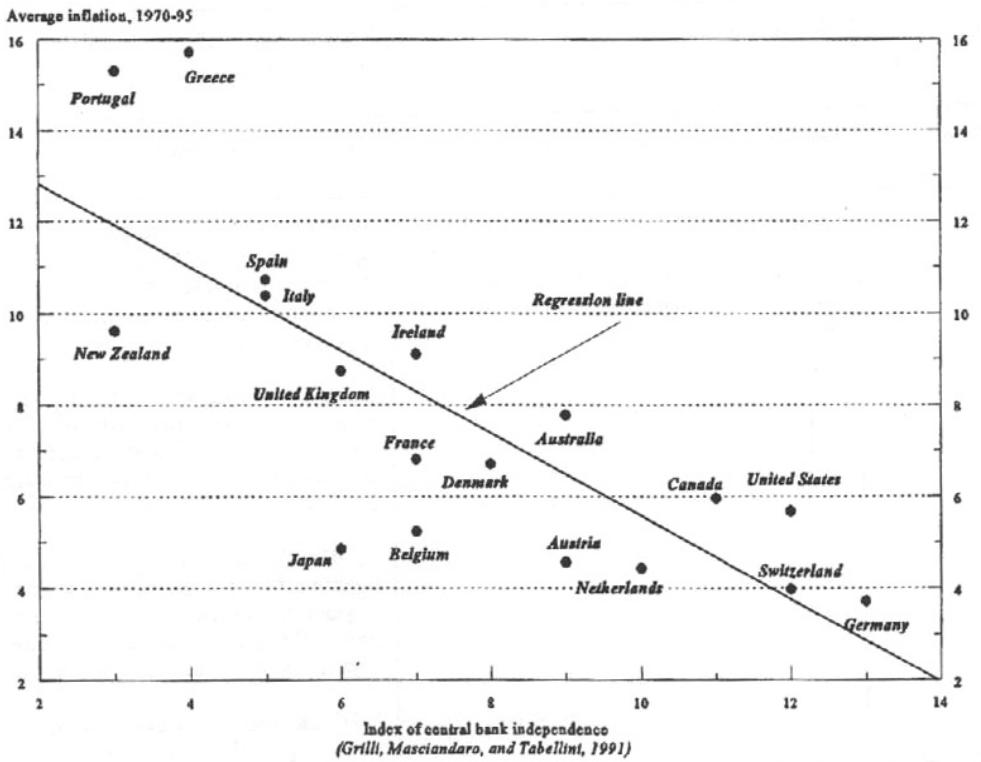
Sources: Merrill Lynch, Japan Economic and Fixed Income Monthly, May 15, 1997; and news reports.

scope and timeliness of the published Board minutes have yet to be decided by the new Policy Board, the degree to which policy transparency will be enhanced also remains to be seen.

29. In addition, while the MOF will no longer have broad authority over the BOJ's budget, it will retain oversight responsibility over most administrative expenses. While the legislation explicitly requires that budgetary disagreements between the MOF and the BOJ be made public by the MOF, there are concerns that the absence of complete budgetary autonomy could impinge on the independence of monetary policy.

30. Cross-country studies of the impact on inflation of central bank independence have tended to consider the BOJ as an outlier. As illustrated in the figure below, taken from the October 1996 *World Economic Outlook*, Japanese inflation has tended to be lower than in many other industrial countries whose central banks would be considered to be relatively

FIGURE II.2. CENTRAL BANK INDEPENDENCE AND INFLATION



independent.[11] Walsh (1996) has suggested that the Japanese experience is less atypical than it first appears when consideration is given to the fact that the overall macroeconomic environment in Japan—including its low unemployment rate—tended to favor low inflation.[12] He also suggests that the historical dominance of a single party in Japan, as well as the dominance of the BOJ by the MOF insulated monetary policy from pressures to inflate the economy.[13] If these conclusions are correct, they would tend to suggest that Japan's enviable inflation record in the past does not necessarily imply a lessened need for greater BOJ independence in the years ahead.

D. Balance of Payments and Exchange Rate Developments

Exchange rate developments

31. After a period of relative stability, the yen appreciated sharply in the period from end-1992 to mid-1995, rising by over 40 percent in nominal effective terms (Chart II.8). The yen's movement during this period was most pronounced against the U.S. dollar, while the yen was roughly stable against the Deutsche mark. The strength of the yen has been ascribed to a number of factors including the cyclical asymmetry between the United States and Japan, which contributed to the sharp decline in Japanese/U.S. interest differentials, and shifts in portfolio preferences of Japanese investors in favor of Japanese assets. Also contributing to the yen's appreciation was a growing perception among market participants that the United States was not averse to a lower dollar, given the large U.S. current account deficit vis-à-vis Japan.[14]

32. The yen's appreciation (and the dollar's weakness) was halted in mid-1995 following concerted intervention by the industrial countries, as well as statements by G-7 officials calling for an orderly reversal of earlier exchange rate movements. The yen subsequently depreciated by about 20 percent between June and January 1996 in nominal effective terms, spurred by the reduction in the Japanese overnight rate in July, a cut in the official discount rate in

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[11]See for example, Vittorio Grilli, Donato Masciandaro, and Guido Tabellini, "Political and Monetary Institutions and Public Financial Policies in the Industrial Countries," *Economic Policy: A European Forum*, Vol. 6 (October 1991), pp. 342–91.

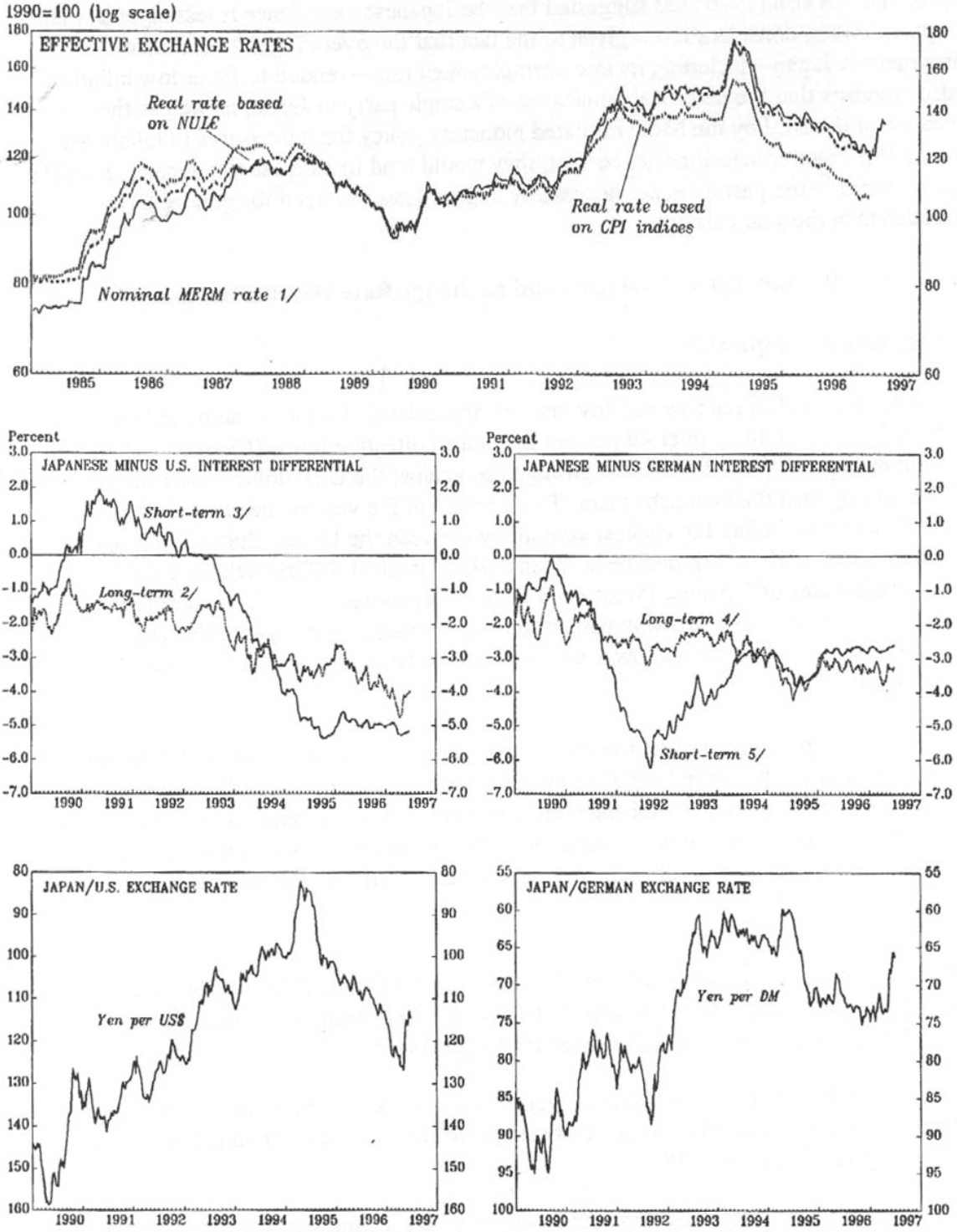
[12]Carl Walsh, "Inflation and Central Bank Independence: Is Japan Really an Outlier?" *Monetary and Economic Studies,* 15(1), Institute for Monetary and Economic Studies, Bank of Japan, (May 1997), pp. 89–118.

[13]His argument is that a single-party system results in a longer time horizon for policymakers and a lesser incentive to inflate the economy to promote employment.

[14]The selected issues papers discuss exchange rate developments from a longer-term perspective.

CHART II.8
JAPAN

EXCHANGE RATES AND INTEREST RATE DIFFERENTIALS, 1985-97



Sources: IMF, Information Notice System; and Nikkei Telecom.
1/ Based on IMF MERM rate.
2/ Japan: ten-year government bond rate; United States: ten-year government bond rate.
3/ Japan: three-month CD rate; United States: three-month CD rate.
4/ Japan: ten-year government bond rate; Germany: ten-year government bond rate.
5/ Japan: three-month CD rate; Germany: three-month interbank rate.

September, as well as the August 1995 announcement of measures to liberalize capital outflows from Japan, which was followed by concerted intervention in support of the U.S. dollar.

33. The yen was roughly stable in effective terms during January-August 1996. However, during the latter half of 1996 and early 1997, the yen again depreciated markedly, and by April 1997 the yen had lost a further 10 percent of its value and stood at roughly the same level as at the beginning of 1993 in nominal effective terms. The yen's weakness partly reflected cyclical disparities between the United States and Japan, which contributed to a marked widening of interest rate differentials in favor of U.S. dollar-denominated assets. More recently, the yen has rebounded strongly, gaining 5¼ percent between April and May 1997, partly owing to a delayed reaction to statements by G-7 Ministers in March that the process of reversing the previous depreciation of the dollar had been completed, and statements by U.S. officials expressing concern regarding the rise in the Japanese current account surplus.

Current account developments

34. The **current account surplus** reached a recent peak of ¥14.7 trillion in 1993, but fell sharply thereafter to ¥7.2 trillion (1.4 percent of GDP) in 1996 (Table II.4 and Chart II.9). This decline was the result of a narrowing of the trade surplus, from ¥15.5 trillion in 1993 to ¥9.1 trillion in 1996, and a rise in the deficit on the services account from ¥4.8 trillion to ¥6.8 trillion during the same period. The drop in the trade surplus was partly offset in 1996 by a sharp increase in net investment receipts, which reflected increases in U.S. interest rates and a rise in Japan's net foreign asset position, which reached ¥103 trillion (21 percent of GDP) at the end of 1996.

35. The decline in the trade surplus partly reflected the effects of the yen's rapid appreciation between 1992 and mid-1995, which slowed export growth relative to import growth, as well as J-curve effects following the yen's correction after mid-1995 (Table II.5). Exports grew only modestly in 1992–96, as export unit values declined and volumes grew moderately.[15] Export volumes were also adversely affected by a slowing of demand in partner countries. The decline in import unit values during this period more closely mirrored the yen's appreciation, and import volumes rose considerably more rapidly than domestic demand.

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[15]Two price indices are published for the trade data. The index based on customs-clearance data is based on a Fisher index or unit value, covering 20 commodity groupings. The Bank of Japan's index is calculated as a Laspeyres, fixed-weight index, and covers 184 items. While the two import price indices have moved together, the BOJ's export price index fell more rapidly during 1990–96 than the customs-clearance index. An explanation may be that the customs index has not accounted for a shift toward higher-value exports, or that the BOJ's index has overweighted goods whose prices are falling sharply.

Table II.4. Japan: Current Account Summary, 1992-97

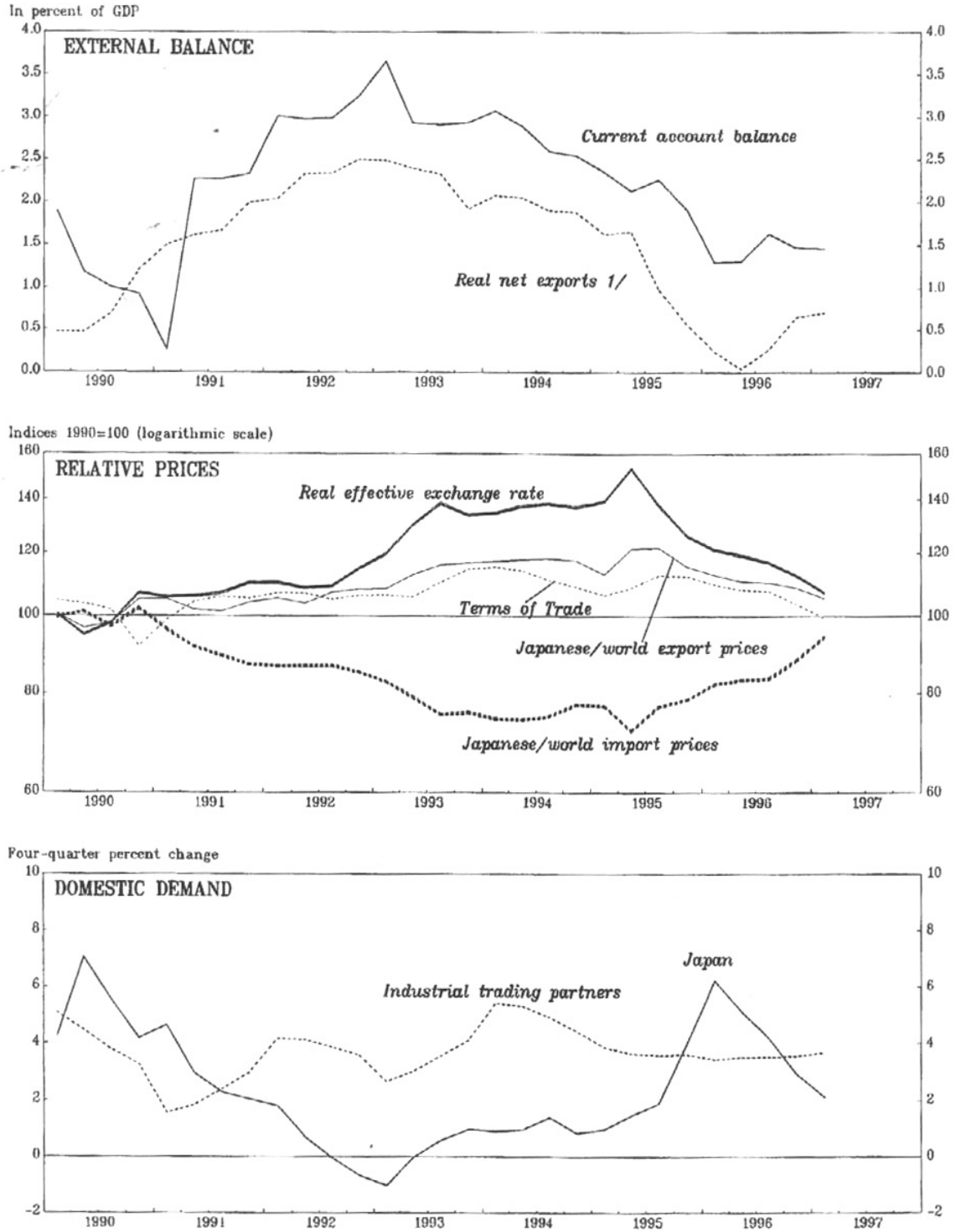
(In billions of yen)

	1992	1993	1994	1995	1996	1996 1/				1997 1/
						I	II	III	IV	I
Current account balance	14,235	14,669	13,343	10,386	7,158	1,924	1,858	1,674	1,677	1,990
Trade balance	15,776	15,482	14,732	12,345	9,097	2,348	2,167	2,152	2,404	2,086
Exports	42,082	39,164	39,349	40,260	43,566	10,510	10,857	10,814	11,388	11,814
Imports	26,306	23,682	24,617	27,915	34,469	8,162	8,690	8,661	8,984	9,728
Services	-5,571	-4,780	-4,898	-5,390	-6,779	-1,533	-1,678	-1,766	-1,802	-1,616
Travel	-2,942	-2,582	-2,776	-3,160	-3,588	-869	-815	-980	-925	-884
Receipts	455	394	355	305	445	96	106	114	129	126
Payments	3,396	2,976	3,132	3,464	4,033	965	921	1,094	1,053	1,010
Transportation	-1,100	-1,103	-1,159	-1,256	-1,307	-328	-303	-367	-310	-302
Receipts	2,338	2,103	2,074	2,123	2,350	577	567	591	615	623
Payments	3,438	3,205	3,233	3,379	3,656	905	869	958	925	925
Other	-1,529	-1,095	-962	-973	-1,884	-336	-561	-419	-568	-431
Receipts	3,416	3,420	3,529	3,730	4,571	1,213	1,030	1,125	1,204	1,434
Payments	4,945	4,515	4,491	4,703	6,456	1,549	1,591	1,544	1,772	1,865
Income	4,513	4,533	4,131	4,157	5,818	1,417	1,583	1,503	1,315	1,905
Investment	4,613	4,622	4,202	4,220	5,818	1,417	1,583	1,504	1,314	1,904
Labor	-100	-89	-72	-63	0	1	-1	-1	1	1
Net transfers	-483	-565	-623	-725	-978	-309	-214	-215	-240	-386
Public	-261	-266	-288	-314	-214	-73	-31	-44	-67	-151
Private	-222	-300	-334	-411	-763	-235	-183	-172	-173	-235
Memorandum items:										
Current account, 2/	14,220	14,647	13,365	10,356	7,163	1,782	1,726	1,808	1,847	1,862
Current account, 3/	14,235	14,669	13,343	10,386	7,158	2,024	1,576	1,729	1,829	2,037
Current account/GDP	3.0	3.1	2.8	2.2	1.4	1.4	1.4	1.4	1.5	1.4
Average exchange rate (Y/$)	126.7	111.2	102.2	94.1	108.8	105.8	107.6	108.9	112.8	121.2

Sources: Nikkei Telecom; WEFA; and staff estimates.

1/ Sum of the seasonally adjusted trade balance and the seasonally unadjusted invisibles balances.
2/ Seasonally adjusted.
3/ Seasonally unadjusted.

CHART II.9
JAPAN
EXTERNAL BALANCE AND ITS DETERMINANTS, 1990-97



Sources: Nikkei Telecom, WEFA, and staff estimates.

1/ Real net exports of goods and services on a national accounts basis.

Table II.5. Japan: Merchandise Trade Prices and Volumes, 1988-97 1/

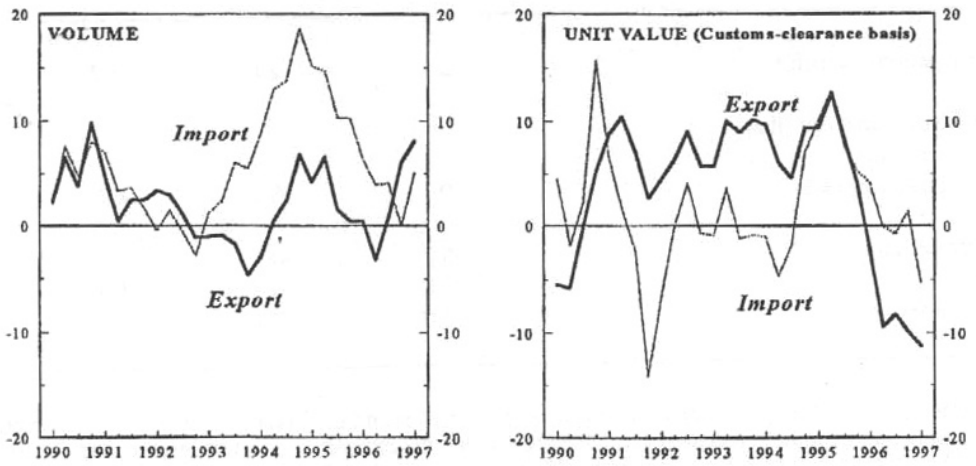
(Percentage change from previous period, yen basis)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997 Q1
Exports	1.9	11.4	9.6	2.2	1.5	-6.5	0.7	2.6	7.7	3.5
Prices										
Customs clearance unit value	-3.3	6.5	3.9	-0.3	0.0	-4.7	-1.0	-0.7	7.0	2.4
Bank of Japan price index	-2.3	4.5	2.1	-5.4	-3.6	-8.0	-2.8	-2.2	6.9	3.4
Difference	-0.9	2.1	1.8	5.1	3.6	3.3	1.8	1.5	0.1	-1.0
Volume										
Value deflated by customs-clearance unit value	5.3	4.6	5.5	2.4	1.6	-2.0	1.7	3.2	0.7	1.1
Value deflated by Bank of Japan price index	4.3	6.7	7.3	8.0	5.3	1.6	3.6	4.9	0.7	0.1
Imports	10.4	20.7	16.8	-5.8	-7.4	-9.1	4.8	12.3	20.4	7.2
Prices										
Customs clearance unit value	-6.3	11.8	10.7	-9.1	-6.9	-12.3	-8.0	-0.3	16.4	3.4
Bank of Japan price index	-4.6	7.6	8.7	-8.2	-6.1	-10.4	-5.5	-0.1	9.6	6.2
Difference	-1.7	4.2	2.1	-0.9	-0.8	-2.0	-2.4	-0.2	6.9	-2.7
Volume										
Value deflated by customs-clearance unit value	17.9	8.0	5.5	3.7	-0.6	3.6	13.8	12.5	3.4	3.7
Value deflated by Bank of Japan price index	15.8	12.2	7.5	2.6	-1.4	1.3	10.9	12.3	9.9	1.0
Terms of trade										
Based on unit values	3.3	-4.7	-6.2	9.7	7.4	8.7	7.6	-0.4	-8.1	-1.0
Based on Bank of Japan price indices	2.4	-2.9	-6.0	3.1	2.7	2.6	2.9	-2.1	-2.4	-2.6
Difference	0.9	-1.8	-0.2	6.7	4.7	6.1	4.7	1.7	-5.7	1.6
Export/import volume										
Based on unit values	-10.7	-3.2	0.0	-1.2	2.2	-5.4	-10.6	-8.3	-2.7	-2.5
Based on Bank of Japan price in	-9.9	-4.9	-0.2	5.2	6.9	0.2	-6.6	-6.7	-8.3	-0.9
Difference	-0.8	1.8	0.2	-6.4	-4.7	-5.6	-4.1	-1.6	5.7	-1.6
Memorandum items:										
World non-oil import volume 2	13.2	10.5	7.8	6.5	10.7	9.1	12.8	11.8	6.7	2.4
Relative export prices (Japan/ world) 3/	3.4	-1.5	-4.9	8.5	6.7	10.6	5.8	1.8	-6.1	-3.6
Real domestic demand	7.4	5.5	5.2	3.0	0.4	0.1	1.0	2.1	4.6	1.6
Import price/wholesale 4/	-5.0	10.1	8.5	-9.9	-6.1	-11.5	-6.2	0.8	17.8	3.3

Sources: Staff estimates derived from Nikkei Telecom, WEFA, and WEO.

1/ Annual price and volume figures are constructed as period averages of underlying monthly data.
2/ Data for trading partners weighted using Japan's export shares.
3/ Japan's export price based on customs-clearance unit value, world export price based on weights using Japan's export shares.
4/ Japan's import price based on customs-clearance unit value.

FIGURE II.3. TRADE DEVELOPMENTS, 1990-97
(Four-quarter percent changes)



36. The tabulation below illustrates the macroeconomic and other factors that have contributed to the decline in the current account surplus to 1996, utilizing simulations of the staff's current account model.[16] The exchange rate's appreciation reduced the surplus in 1995 and 1996 by about 1 percent of GDP (the appreciation's earlier impact had been to raise the surplus, owing to J-curve effects). The other macroeconomic factor that helped to lower the surplus was the (modest) pickup in domestic demand; domestic growth caused the surplus to fall by the equivalent of 1 percent of GDP in 1996. By contrast, however, growth abroad had a larger positive effect on the surplus, reflecting the relatively sluggish pace of activity in Japan.

[16]For a description of the model, see B. Chadha, "External Adjustment in Japan: Recent Developments and the Medium-Term Outlook," in *Japan—Selected Issues*, IMF Staff Country Report No. 96/114 (October 1996), pp. 150–172.

Current Account Simulations

(In percent of actual GDP)

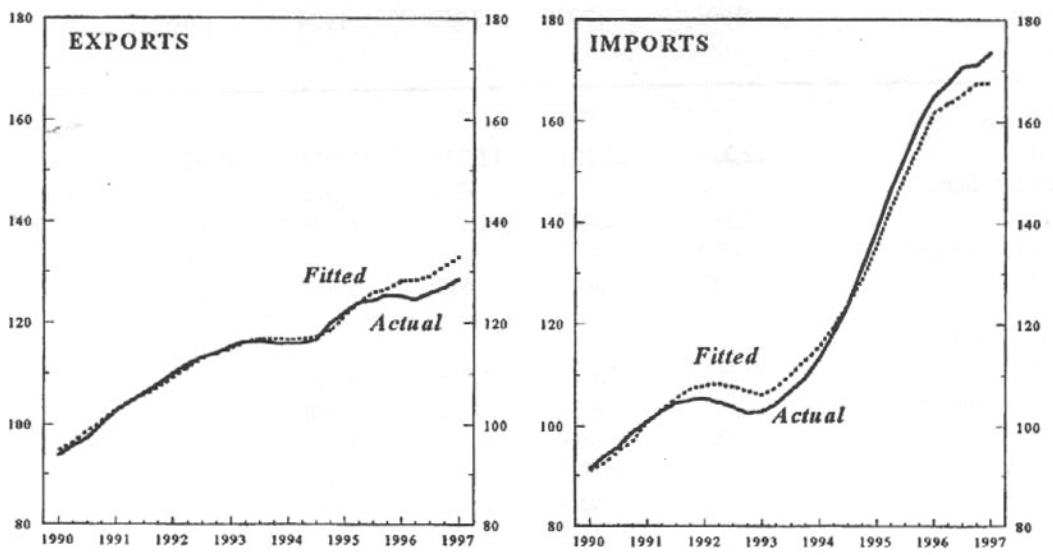
	1992	1993	1994	1995	1996
Actual current account surplus	3.0	3.1	2.8	2.2	1.4
Simulated contribution to surplus from movements in: 1/					
Nominal exchange rate		0.1	0.1	-0.1	-1.0
Prices		-0.1	0.1	0.3	0.1
Domestic demand		-0.2	-0.1	-0.3	-0.9
Foreign demand		0.0	0.4	0.8	1.2
"Structural factors"		0.0	0.1	-0.5	-1.1

1/ The figures represent the difference between the actual surplus and the balance that would have occurred if the respective variable had been held constant at its 1992:Q4 level; the exception was foreign demand (i.e., world imports), which was assumed to grow at roughly half its actual rate. The effect of structural factors was calculated by assuming that the residuals of the behavioral equations were zero in 1993–96.

37. However, the sum of these effects is relatively small, particularly in 1996, suggesting that other, possibly structural, factors may have been at work to lower the surplus. Indeed, simulations of the model, assuming that the residuals were equal to zero over the 1993–96 period, but that the macroeconomic variables equaled their actual values, resulted in a predicted level of the surplus that was 1.1 percent of GDP higher than the actual level of the surplus in 1996. The impact of these structural factors on trade volumes is illustrated in Figure II.4, which compares the actual levels of trade volumes to the levels that would be predicted on the basis of the staff's trade model. As can be seen, export volumes were substantially lower than would have been predicted on the basis of historical trends in 1995 and 1996. Conversely, manufactured import volumes were significantly higher than would have otherwise been expected.

38. Factors that have been cited to explain these trends include: (i) the increased importance of capital goods in Japan's exports and the slowdown in investment among Japan's major trading partners; (ii) the weakness of the global market for integrated circuits that began in late 1995, which adversely affected exports; (iii) the impact of the need to keep pace with technological innovations and a surge in imports related to information technology; and (iv) the slowdown of automobile exports to the United States. In the latter case, overseas production of Japanese automobiles has risen significantly in recent years, suggesting a possible substitution from Japanese production. Indeed, auto exports from Japan to the

FIGURE II.4. MERCHANDISE TRADE VOLUMES
Index 1990=100, four-quarter moving averages)



United States and the European Union have been on a declining trend in recent years, which has moderated Japan's surplus with these regions (Table 11.6).[17]

39. There is also evidence that the shift in Japanese productive capacity overseas has led to so-called "reverse imports," or the import of products made by Japanese companies that had previously been manufactured domestically.[18] In particular, the rapid increase in the share of Japanese production located overseas has increased, from around 6 percent in FY 1991 to around 9 percent in FY 1995, has been associated with a large increase in sales by Japanese manufacturing firms' overseas affiliates to Japan. This phenomenon can be seen in the rapid increase in imports from Southeast Asia as well as other developing countries.

40. More recent data suggest that the decline in the current account surplus halted in mid-1996. Indeed, the balance rose somewhat to ¥8 trillion (annual basis) in the first quarter

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[17]A useful discussion of recent trade developments is contained in the Bank of Japan's November 1996 *Quarterly Bulletin.*

[18]See the selected issues papers for a discussion of the effect of Japanese foreign direct investment on trade flows.

Table II.6. Japan: Regional Trade Flows, 1991-97

(In billions of yen, customs-clearance basis)

	1991	1992	1993	1994	1995	1996	1997 Q1
United States							
Exports	12,324	12,121	11,735	12,036	11,333	12,177	3,456
(percent change)	-5.6	-1.6	-3.2	2.6	-5.8	7.4	16.8
Imports	7,191	6,622	6,163	6,424	7,076	8,631	2,371
(percent change)	-5.2	-7.9	-6.9	4.2	10.1	22.0	13.5
Balance	5,133	5,499	5,573	5,611	4,257	3,546	1,084
European Union							
Exports	7,969	7,923	6,319	5,890	6,600	6,847	1,887
(percent change)	3.0	-0.6	-20.2	-6.8	12.0	3.7	7.8
Imports	4,284	3,964	3,360	3,624	4,580	5,363	1,457
(percent change)	-15.5	-7.5	-15.2	7.8	26.4	17.1	14.7
Balance	3,686	3,959	2,959	2,267	2,020	1,484	430
Other industrial countries							
Exports	3,381	3,224	2,717	2,615	1,995	2,115	574
(percent change)	-5.6	-4.6	-15.7	-3.8	-23.7	6.0	12.7
Imports	4,231	3,816	3,389	3,504	3,351	3,749	1,044
(percent change)	-7.4	-9.8	-11.2	3.4	-4.4	11.9	20.1
Balance	-850	-592	-672	-889	-1,356	-1,633	-470
Southeast Asia							
Exports	12,960	13,217	13,055	14,151	15,905	17,147	4,428
(percent change)	8.5	2.0	-1.2	8.4	12.4	7.8	8.2
Imports	7,927	7,288	6,749	6,944	7,983	9,564	2,558
(percent change)	0.7	-8.1	-7.4	2.9	15.0	19.8	11.0
Balance	5,033	5,928	6,306	7,207	7,922	7,583	1,870
Other developing countries							
Exports	5,574	6,394	6,214	5,806	5,698	6,445	1,736
(percent change)	12.7	14.7	-2.8	-6.6	-1.9	13.1	19.5
Imports	8,216	7,804	7,140	7,609	8,558	10,686	3,148
(percent change)	-5.6	-5.0	-8.5	6.6	12.5	24.9	31.0
Balance	-2,642	-1,410	-926	1,803	-2,861	-4,241	-1,412
Total							
Exports	42,360	43,012	40,202	40,498	41,531	44,731	12,081
(percent change)	2.2	1.5	-6.5	0.7	2.6	7.7	12.3
Imports	31,900	29,527	26,826	28,104	31,549	37,993	10,578
(percent change)	-5.8	-7.4	-9.1	4.8	12.3	20.4	18.4
Balance	10,460	13,485	13,376	12,393	9,982	6,738	1,503

Source: Nikkei Telecom and WEFA.

of 1997, despite the fact that imports surged ahead of the introduction of the consumption tax. Looking ahead, it seems likely that the surplus will rise in 1997, despite the cyclical recovery in Japan, owing to the lagged effect of the yen's appreciation since mid-1995 and the rise in Japan's net foreign asset position (and thus net investment receipts).

Recent capital account developments

41. Private capital outflows have declined steadily in recent years, to a large extent mirroring the drop in the current account surplus (Table II.7). The deficit on the financial account (which includes direct investment, portfolio investment, and other investment) fell from ¥12.8 trillion in 1992 to ¥3.0 trillion in 1996, mainly owing to a decline in the other investment category. Capital outflows related to the buildup of official assets also have been significant, owing to efforts to stem the yen's appreciation, and total reserves (excluding gold) rose from US$72 billion at the end of 1991 to US$217 billion at the end of 1996.

E. Long-Run Growth and Measures of Potential Output

42. The sharp decline in GDP growth in Japan after 1990 has raised concern that the economy has suffered a structural decline in productivity, rather than simply a cyclical slowdown. While this perception may have spurred progress on the deregulatory front, it has also contributed to a pessimistic outlook regarding Japan's future prospects, which may be unwarranted. This issue is examined below, using a simple model of potential output.

43. An often used approach to measuring potential output assumes that output can be approximated as a Cobb-Douglas function of capital, labor, and total factor productivity (TFP), which in logarithmic form can be expressed as:[19]

$$y = \alpha l + (1-\alpha) k + t \qquad (1)$$

where y is the log of GDP, l is the log of the labor input, k is the capital stock, and t is the log of total factor productivity (TFP). The variable α represents labor's share of income. The measure of potential output is then defined by replacing the labor input and TFP by their trend values.

44. The **labor input** is defined as total persons employed, while trend employment is constructed first by applying a Hodrick-Prescott (HP) filter to the total labor force. A trend unemployment rate is constructed by applying the same HP filter to the unemployment rate (the trend unemployment rate is assumed to be 2.5 percent from end-1987). The trend level of employment is then calculated by applying the trend level of the unemployment rate to the

---

[19]Alternative estimates of potential output were discussed in more detail by E. Prasad, "Trends and Cycles in the Japanese Economy," in *Japan—Background Papers*, SM/95/163, Supplement 1 (July 12, 1995), pp. 97–111.

Table II.7. Japan: Capital and Financial Account Summary, 1992-97

(In billions of yen, not seasonally adjusted)

	1992	1993	1994	1995	1996	1996				1997
						I	II	III	IV	I
Current account balance	14,235	14,669	13,343	10,386	7,158	2,024	1,576	1,729	1,829	2,037
Capital and financial account	-12,917	-11,704	-8,992	-6,275	-3,347	1,095	-828	-1,025	-2,589	-3,995
Capital account	-164	-165	-192	-214	-354	-168	-64	-81	-41	-129
Total credit	0	0	0	1	134	31	30	33	39	49
Total debit	164	165	192	215	487	199	94	114	80	178
Financial Account	-12,753	-11,539	-8,800	-6,061	-2,994	1,263	-764	-945	-2,548	-3,866
Direct investment	-1,843	-1,523	-1,761	-2,125	-2,524	-594	-781	-580	-569	-557
Direct investment abroad	-2,192	-1,547	-1,852	-2,129	-2,548	-587	-688	-680	-593	-660
Equity capital	-2,235	-1,671	-1,688	-2,209	-2,029	-508	-589	-422	-510	-690
Other capital	43	124	-164	81	-270	-72	-84	-144	31	208
Direct investment in Japan	349	23	91	4	25	-7	-93	100	24	103
Equity capital	281	8	70	30	-77	-1	-102	44	-18	27
Other capital	68	15	21	-26	24	-29	-3	36	20	43
Portfolio investment	-3,340	-7,762	-2,366	-3,077	-4,514	-2,033	3,050	-3,954	-1,577	-4,105
Assets	-4,339	-6,955	-9,204	-8,004	-12,523	-1,571	-3,260	-3,921	-3,770	-1,848
Equity securities	392	-1,642	-1,415	7	-905	451	-923	-73	-359	332
Debt securities	-4,730	-5,313	-7,789	-8,010	-11,618	-2,022	-2,337	-3,848	-3,411	-2,180
Bond and notes	-4,590	-4,004	-7,004	-8,479	-8,798	-1,523	-1,523	-2,919	-2,834	-1,125
Money market instrument	-61	-1,255	-828	582	-1,303	-59	-510	-527	-207	-438
Financial derivatives	-79	-54	44	-113	-1,517	-441	-304	-402	-370	-618
Liabilities	998	-807	6,838	4,926	8,009	-462	6,310	-32	2,193	-2,257
Equity securities	1,137	2,191	5,199	4,805	5,298	2,629	2,085	129	455	659
Debt securities	-139	-2,997	1,639	121	2,711	-3,091	4,225	-162	1,738	-2,915
Bond and notes	-58	-3,460	-1,373	-920	1,931	-1,340	1,872	-138	1,537	-1,223
Money market instruments	171	522	3,036	1,893	68	-2,067	2,156	-230	209	-2,155
Financial derivatives	-253	-59	-24	-852	712	316	197	206	-8	463
Other investment	-7,570	-2,253	-4,674	-859	4,044	3,890	-3,033	3,589	-402	796
Assets	6,077	1,834	-3,620	-9,789	466	3,945	-1,232	3,077	-5,325	-2,409
Trade and credits	511	576	268	232	110	-49	168	-52	43	40
Loans	7,421	3,315	-1,051	-15,634	-906	2,093	-55	3,785	-6,728	-1,460
Currency and deposits	-1,903	-1,656	-2,691	3,755	5,079	1,811	885	178	2,205	138
Other assets	47	-402	-146	1,858	-3,818	91	-2,230	-835	-844	-1,127
Liabilities	-13,646	-4,087	-1,054	8,931	3,579	-55	-1,801	512	4,923	3,205
Trade credits	34	-99	-157	-28	52	112	-26	-86	51	-2
Loans	-9,358	-1,147	-504	9,758	2,157	-588	-1,213	515	3,442	3,447
Currency and deposits	-4,708	-3,444	-195	-26	807	-99	-5	28	883	-19
Other assets	385	603	-198	-774	564	520	-559	56	547	-222
Net errors and omissions	-1,243	32	-1,765	1,313	132	-799	7	-174	1,097	2,411
Reserve assets	-75	-2,997	-2,585	-5,424	-3,942	-2,320	-755	-531	-337	-454

Source: Nikkei Telecom and WEFA.

labor force. The **capital stock** is constructed by cumulating national accounts data on business fixed investment and residential investment, assuming annual depreciation rates of 10 percent and 5 percent, respectively.[20] As regards **factor shares**, the labor share is assumed to be 65 percent, the share of private fixed capital is set at 26 percent, and the share of residential capital is set at 9 percent, roughly consistent with historical averages.

45. Under these assumptions, an estimate of total factor productivity can be derived from equation (1) above, which is illustrated in Chart II.10. As can be seen actual TFP appears to follow a segmented log-linear trend, with a break in 1973:Q4. In particular, productivity growth is estimated to have been 3 percent up to this date and to have fallen to just under 1 percent thereafter.[21]

46. The choice of the breakpoint was somewhat arbitrary, but corresponded to the results reported by Soejima (1996), who identifies breaks in trend growth of Japanese GDP around this date.[22] The existence of a break in productivity growth in the early 1970s is also a result that has been found for a number of other industrial countries, including the United States. A number of explanations have been proposed for the drop in productivity growth, including the effect of the first oil price shock, a change in the composition of the labor force, a decline in research and development spending or a drop in its productivity, or a shift in the composition of output toward services. In addition, Wolff (1996) presents evidence to suggest that the productivity slowdown also was related to an increase in the average vintage of the capital stock, as well as the effect of slower output growth on innovation.

47. These estimates do confirm a marked slowing of TFP growth during the 1990s. However, the decline is interpreted as cyclical, following the above trend growth in the late

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[20]The capital stock is reduced by roughly 0.4 percent in 1995 as a result of the Kobe earthquake. Adjustments are also made to account for the inclusion of Nippon Telephone and Telegraph and Japan National Railways in the private investment data in 1985 and 1987, respectively.

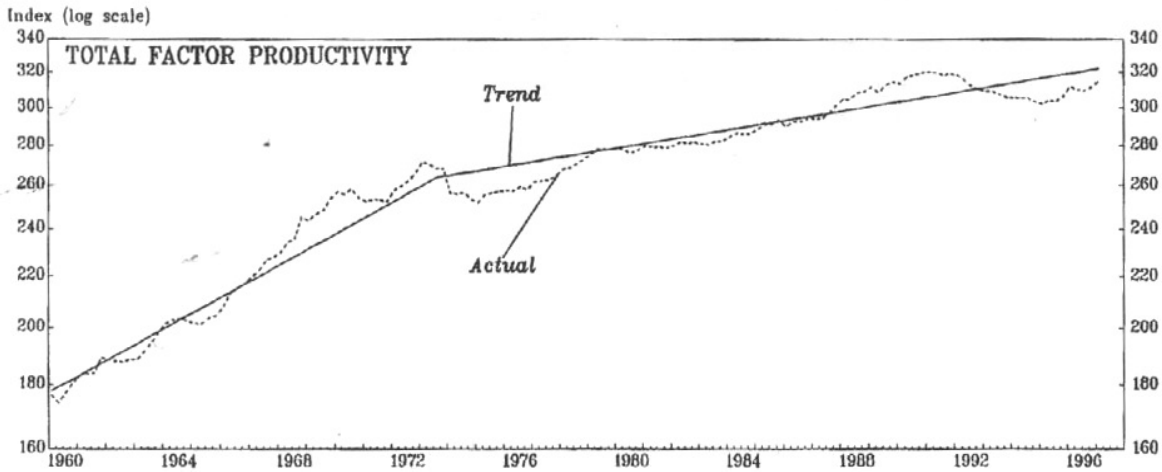
[21]The estimated regression equation was (t-statistics in parentheses):

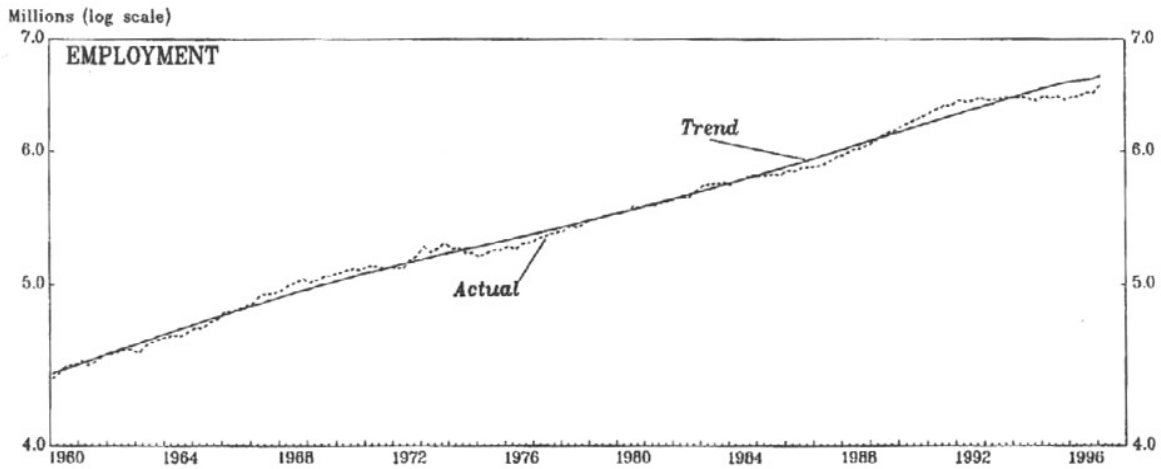
$$t = \underset{(300.06)}{4.89064} + \underset{(35.08)}{0.00719}\ tme1 - \underset{(18.76)}{0.00513}\ tme2, \quad R^2 = 0.96, \text{DW} = 0.10$$

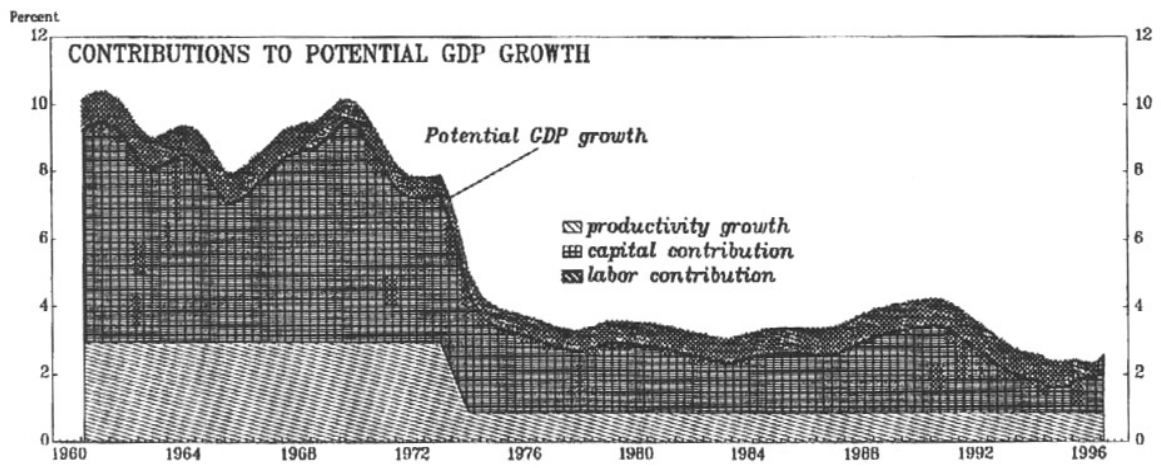
where *tme1* is a time trend and *tme2* equals zero until 1973:Q3 and increases by one each quarter thereafter. The residuals from the regression equation also appeared stationary, providing further confirmation that the hypothesis of a segmented trend was appropriate.

[22]Y. Soejima, "A Unit Root Test with Structural Change for Japanese Macroeconomic Variables," *Monetary and Economic Studies,* 13(1), Institute of Monetary and Economic Studies, Bank of Japan, 1995, pp. 124–156.

CHART II.10
JAPAN
TOTAL FACTOR PRODUCTIVITY, EMPLOYMENT, AND POTENTIAL GDP





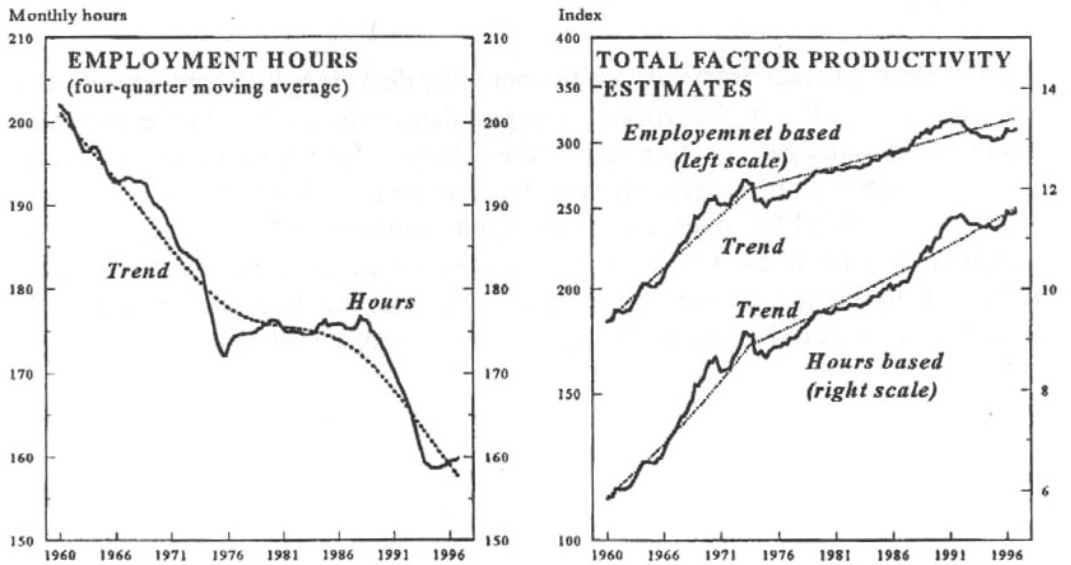


Source: Staff estimates.

1980s. Indeed, TFP growth has exceeded its estimated trend rate since early 1995, as it returns to a cyclically neutral level.

48. One drawback to the calculations described above is that they are based on the assumption that the relevant measure of the labor input is total employment, rather than total hours worked. This issue is especially relevant in the case of Japan, since average hours worked have exhibited a marked downward trend during the 1960s and early 1970s, and again

FIGURE II.5. EMPLOYMENT HOURS AND ALTERNATE ESTIMATES OF TOTAL FACTOR PRODUCTIVITY



during the late 1980s and early 1990s (Figure II.5). The decline initially reflected the move toward a five-day work week and, more recently, legislation requiring a 40-hour work week.

49. However, estimates based on an estimate of total hours worked did not materially change the conclusion that there was a structural break in productivity growth in the early 1970s.[23] As in the earlier case, the hypothesis that TFP followed a segmented trend with a

[23]Total hours was proxied by the product of trend employment (described above) and an estimate (using an HP filter) of trend average hours. Average hours was based on the survey of establishments with 30 or more employees. The results of the regression were:

(continued...)

break in 1973Q4 could not be rejected. Moreover, and somewhat surprisingly, the hours-based estimates suggested almost the same decline in productivity growth—from 3½ percent to 1¼ percent. Finally, the trend value of the hours series was also included as a regressor in the equation, but was not significant, suggesting that the TFP series was not contaminated by the structural shift in hours.

50. These results should be interpreted with some degree of caution given the relatively strong assumptions used to derive the estimates. Nonetheless, they provide encouraging confirmation that the growth slowdown in recent years has not reflected a structural decline in productivity growth, but has mainly been a cyclical phenomenon. This, in turn, suggests the scope for the above trend in the period ahead, as the economy returns to potential and the output gap closes.

51. Nonetheless, growth prospects are tempered by demographic trends, which have already resulted in a decline in the working-age population since 1995. In the absence of a significant increase in the participation rate of the elderly, a falling workforce is expected to slow the rate of potential output growth over the medium term from 2¼ percent in 1996 to about 2 percent by 2002. Moreover, the hours-based estimates of TFP are closer to their trend level than the employment-based measure, since employment hours have been trending downward in recent years. This suggests the possibility that the degree of economic slack might be smaller than would be suggested by an employment-based measure of potential output.

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[23](...continued)

$t = 1.39599 + 0.00830\ tme1 - 0.00543\ tme2, \quad R^2 = 0.98, DW = 0.11$
(91.45) (43.27) (21.20)

III. Fiscal Developments

52. FY 1997 represents a pivotal year for Japanese fiscal policy, as the overall stance has shifted from one of expansion to consolidation. From FY 1992–96, fiscal policy was used to support the economy, and, as a result, the general government balance deteriorated from a surplus of 3½ percent of GDP in FY 1991 to a deficit of 4¼ percent of GDP by FY 1996, owing to cuts in taxes and increases in spending. This year, however, the deficit is projected to fall to about 2½ percent of GDP, reflecting a rise in the consumption tax, the ending of temporary income tax cuts, a drop in government investment spending, and reforms to the system for paying for medical treatment. Plans for further fiscal consolidation have also been announced, including medium-term deficit targets and proposals for additional cuts in spending in FY 1998.

A. Past Fiscal Trends

53. The Japanese fiscal deficit has exhibited large swings, deteriorating through the 1970s, improving through the 1980s, and then deteriorating again through the first half of the 1990s (Chart III.1). While some of these movements reflect cyclical factors, including the effects of the bubble economy during the late 1980s and the subsequent downturn, most of the changes in the deficit have been structural, reflecting active use of countercyclical fiscal policies.

54. In particular, the structural general government balance deteriorated by over 5 percent of GDP between FY 1991 and FY 1996—around two-thirds of the overall fall during this period—reflecting efforts to stimulate the economy. Most of this stimulus, particularly on the spending side, was included in a series of supplementary budgets, culminating in a ¥14 trillion package announced in September 1995 (Table III.1; the impact of past packages on public investment is shown in Chart III.2).[24] As a result of these spending initiatives, government outlays as a share of GDP rose sharply from 31 percent in FY 1991 to 36¼ percent in FY 1996 (the effects of population aging also contributed through an increased social security expenditure ratio). By contrast, tax cuts, which were only partially offset by increases in social security contribution rates, contributed to a drop in the revenue ratio from 34½ percent to 32 percent over the same period (Table III.2 and Chart III.3).[25]

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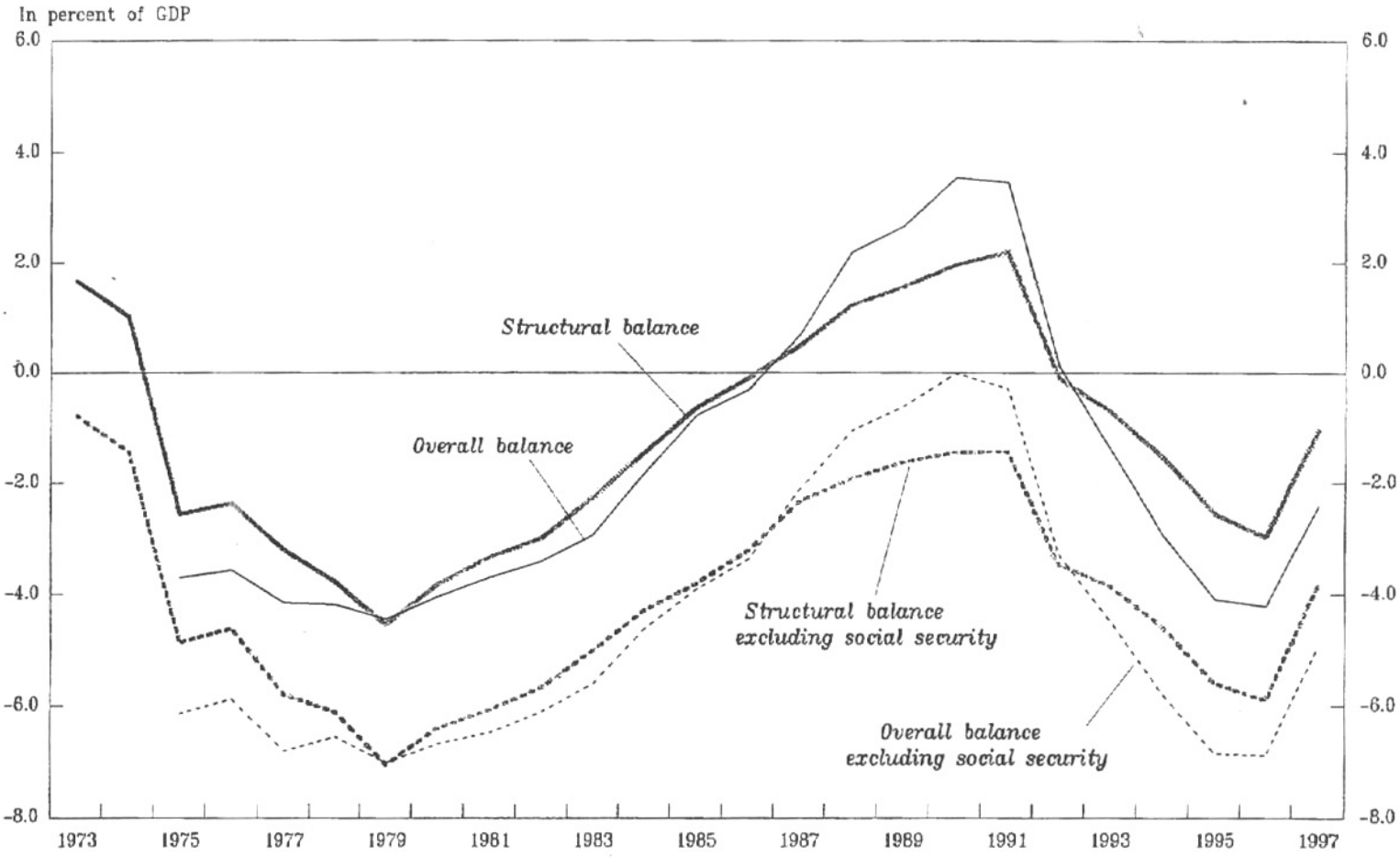
[24]A supplementary budget was announced in December 1996 that included further increases in investment spending, but the measures involved were small and were not explicitly aimed at economic stimulus (small annual supplementary budgets are a normal feature of the Japanese budgetary process).

[25]The most important tax cuts were temporary income tax reductions announced in early 1994. The 1995 tax reform package made part of these reductions permanent (with the loss in revenue to be replaced by a subsequent hike in the consumption tax rate). The remaining temporary tax reductions were initially extended through FY 1995, and then further extended to the end of FY 1996. See *Japan—Recent Economic Developments*, IMF Staff Country Report No. 96/90 (September 1996) and SM/95/163 (July 7, 1995) for more details.

CHART III.1
JAPAN

GENERAL GOVERNMENT BALANCE, FY 1973-97 1/



Sources: Ministry of Finance; Economic Planning Agency; and staff estimates and projections.

1/ The fiscal year is from April to March.

Table III.1. Japan: Summary of Economic Stimulus Packages, 1992–95

(In trillions of yen, unless otherwise indicated)

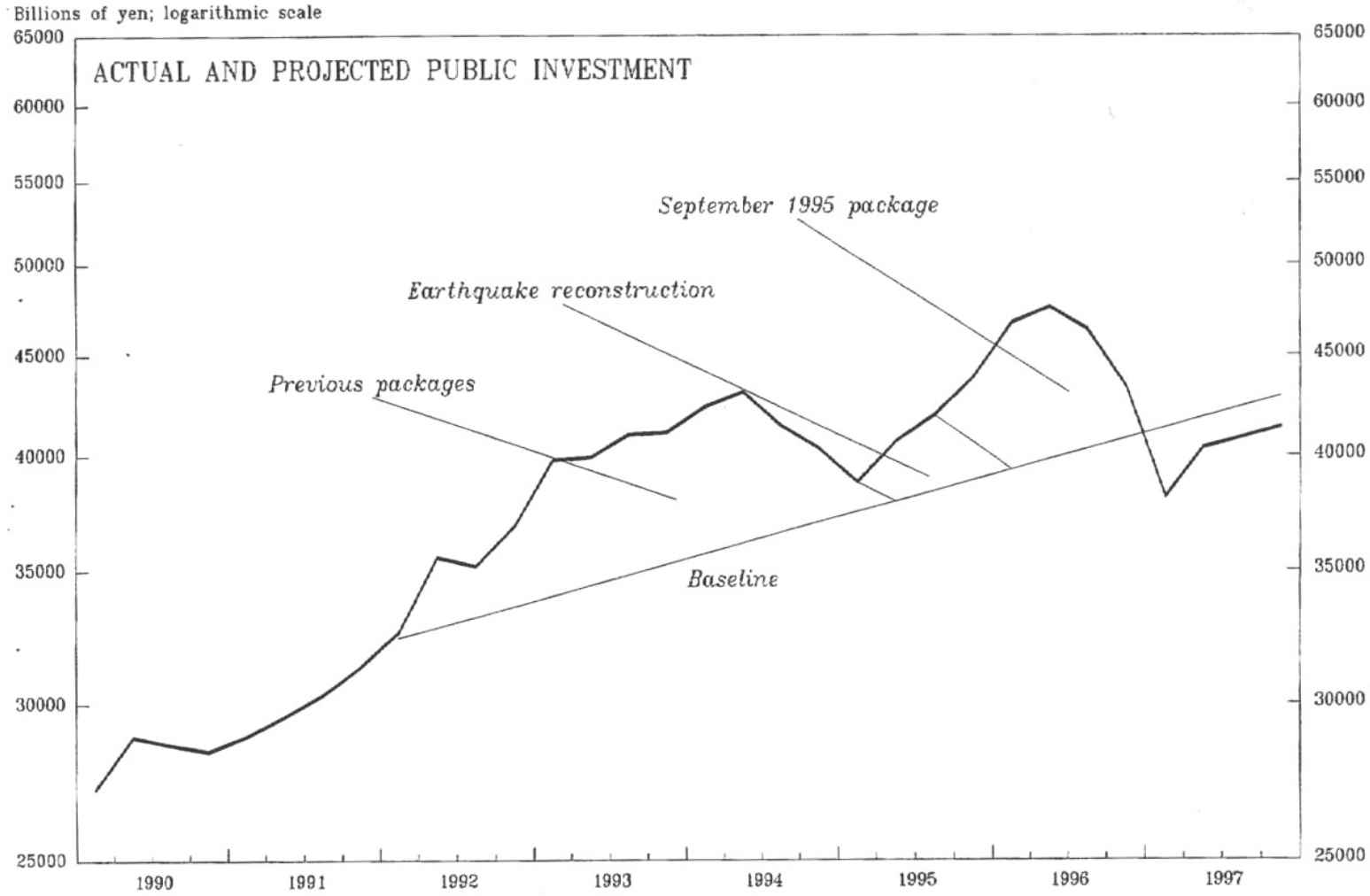
Date Proposed	1992 August	1993 April	1993 September	1994 February	1995 September
Total package	10.7	13.2	6.2	15.3	14.2
(In percent of GDP)	(2.3)	(2.8)	(1.3)	(3.2)	(3.0)
Tax reductions	0.0	0.2	0.0	5.9	0.0
(In percent of GDP)	(0.0)	(0.0)	(0.0)	(1.2)	(0.0)
Public investment 1/	6.2	7.6	2.0	4.0	8.1
(In percent of GDP)	(1.3)	(1.6)	(0.4)	(0.8)	(1.7)
Land purchases	1.6	1.2	0.3	2.8 2/	3.2 3/
(In percent of GDP)	(0.5)	(0.3)	(0.1)	(0.6)	(0.7)
Increased lending by Housing Loan Corporation	0.8	1.8	2.9	1.2	0.5
(In percent of GDP)	(0.2)	(0.4)	(0.6)	(0.3)	(0.1)
Increased lending by government-affiliated financial institutions	2.1	2.4	1.0	1.5	2.4
(In percent of GDP)	(0.5)	(0.5)	(0.2)	(0.3)	(0.5)

Sources: Data provided by the Japanese authorities; and staff estimates.

1/ Includes disaster relief, unidentified land component of public investment, and FILP lending to public corporations for public works.
2/ Includes ¥0.5 trillion of land purchases to be conducted over a five-year period.
3/ Includes ¥0.5 trillion of land purchases by a government-affiliated urban development organization.

CHART III.2
JAPAN

PUBLIC INVESTMENT PROFILE, 1990-97 1/



Sources: Ministry of Finance; Economic Planning Agency; and staff estimates and projections.

1/ The baseline shows the path from increasing investment by 5% per annum. It implies investment spending of 560 trillion yen between FY1995 and FY2004, the period of the government's medium-term investment plan.

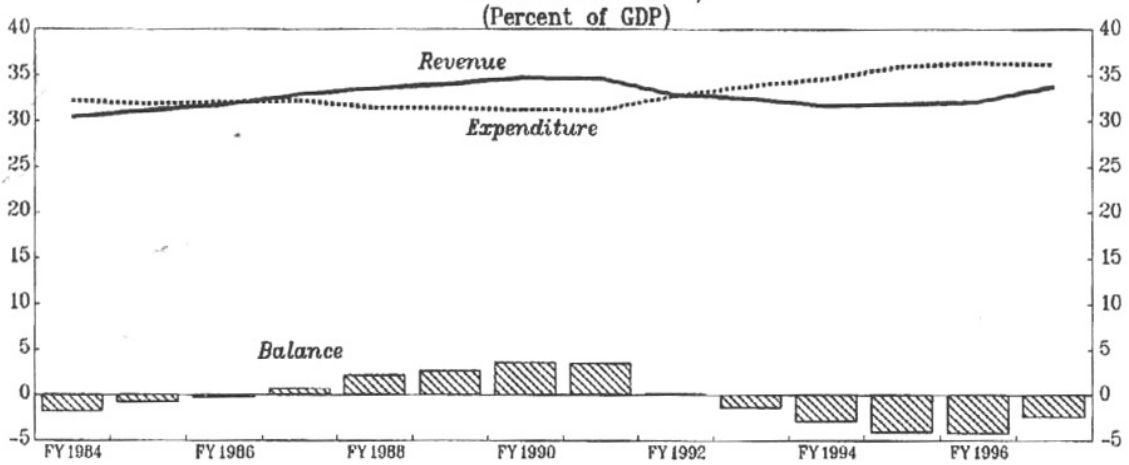
Table III.2. Japan: General Government Balances, FY 1989-97 1/

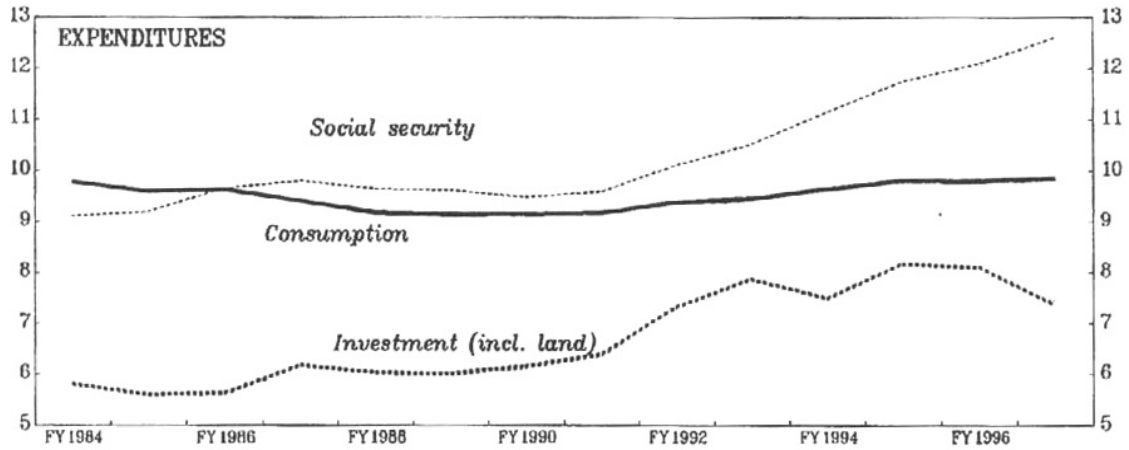
	1989	1990	1991	1992	1993	1994	1995	Est. 1996	Proj. 1997
				(In billions of yen, fiscal years)					
Revenues									
General government	136,744	150,208	157,696	153,182	154,702	151,593	155,663	161,828	175,886
Central government	60,112	65,846	67,498	62,236	64,020	60,839	59,883	59,643	64,960
Local government	55,375	59,292	62,169	62,283	60,955	60,104	62,045	63,444	66,430
Social security	53,346	58,134	62,839	65,111	67,001	69,319	73,211	76,896	81,390
Expenditures									
General government	126,046	134,878	141,899	152,616	161,396	165,713	175,612	183,065	188,539
Central government	64,991	67,247	68,451	72,303	77,600	78,368	80,350	80,841	80,692
Local government	52,952	57,943	62,532	67,578	68,781	70,359	75,046	76,956	76,445
Social security	40,193	42,753	45,728	49,183	52,290	55,655	59,692	63,422	68,297
Balances									
General government	10,698	15,329	15,797	567	-6,694	-14,120	-19,949	-21,237	-12,653
(Excluding social security)	-2,456	-52	-1,315	-15,361	-21,405	-27,784	-33,469	-34,711	-25,746
Central government	-4,879	-1,401	-952	-10,067	-13,580	-17,529	-20,468	-21,198	-15,732
Local government	2,423	1,349	-362	-5,295	-7,826	-10,255	-13,001	-13,512	-10,015
Social security	13,154	15,381	17,111	15,928	14,712	13,664	13,519	13,474	13,093
				(In percent of GDP)					
Revenues									
General government	34.0	34.7	34.6	32.9	32.5	31.6	31.9	32.1	33.8
Central government	15.0	15.2	14.8	13.4	13.4	12.7	12.3	11.8	12.5
Local government	13.8	13.7	13.6	13.4	12.8	12.5	12.7	12.6	12.7
Social security	13.3	13.4	13.8	14.0	14.1	14.5	15.0	15.3	15.6
Expenditures									
General government	31.4	31.2	31.1	32.8	33.9	34.6	36.0	36.3	36.2
Central government	16.2	15.6	15.0	15.5	16.3	16.4	16.5	16.0	15.5
Local government	13.2	13.4	13.7	14.5	14.4	14.7	15.4	15.3	14.7
Social security	10.0	9.9	10.0	10.6	11.0	11.6	12.2	12.6	13.1
Balances									
General government	2.7	3.5	3.5	0.1	-1.4	-2.9	-4.1	-4.2	-2.4
(Excluding social security)	-0.6	0.0	-0.3	-3.3	-4.5	-5.8	-6.9	-6.9	-4.9
Central government	-1.2	-0.3	-0.2	-2.2	-2.8	-3.7	-4.2	-4.2	-3.0
Local government	0.6	0.3	-0.1	-1.1	-1.6	-2.1	-2.7	-2.7	-1.9
Social security	3.3	3.6	3.8	3.4	3.1	2.9	2.8	2.7	2.5
Structural balance 2/	1.6	2.0	2.2	-0.1	-0.7	-1.5	-2.6	-3.0	-1.0
(Excluding social security)	-1.6	-1.4	-1.4	-3.5	-3.9	-4.6	-5.6	-5.9	-3.8

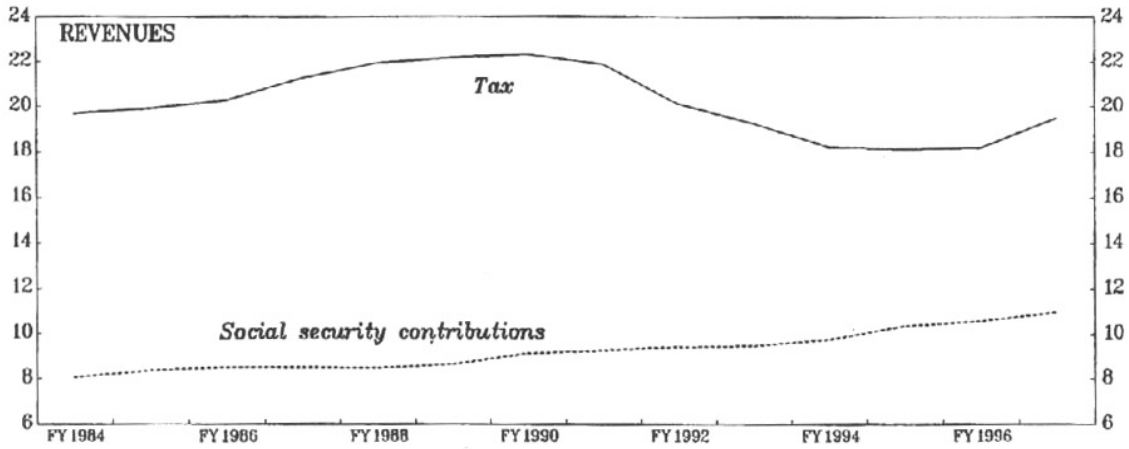
Sources: Economic Planning Agency, Annual Report on National Accounts, 1996; and staff estimates and projections.

1/ The fiscal year begins on April 1.
2/ In percent of potential GDP.

CHART III.3
JAPAN
GENERAL GOVERNMENT EXPENDITURES AND RECEIPTS
FY1984-FY1997 1/
(Percent of GDP)







Sources: Economic Planning Agency, Annual Report on National Accounts; and staff estimates.

1/ Figures for FY 1996 and FY 1997 are staff estimates.

55. Reflecting fiscal stimulus at both levels of government, the balances of the central and local governments both deteriorated from near zero in FY 1990 to significant deficits by FY 1996, with the fall in the central government balance being the larger of the two (Table III.2 and Chart III.4). The social security surplus has also fallen in recent years, due to the fiscal pressures caused by population aging, which have offset higher contribution rates. Finally, increased investment by public enterprises, also aimed at stimulating the economy, led to a deterioration in their balance in the early 1990s, so that the overall deficit of the public sector rose by more than its general government counterpart (Table III.3).

56. The experience of the early 1990s illustrated the strengths and weaknesses of the current fiscal structure. The speed at which fiscal packages were implemented allowed fiscal stimulus to be provided in a timely manner. Based on staff estimates that the underlying fiscal multipliers in Japan are about one-half for taxes and transfers and unity for government consumption and investment spending, fiscal policy added around 3 percent of GDP to aggregate demand between FY 1990 and FY 1996 (see tabulation below).[26] However, the lack of accounting transparency and well-defined medium-term objectives for policy has contributed to uncertainty about the timing and magnitude of the fiscal consolidation that is now required (see Box III.1).

Sources of the Deterioration in the Structural Balance: FY 1991–FY 1996

(Percent of potential GDP)

	Change in Structural Balance	Impact on Aggregate Demand
Taxes and fines	-3½	1¾
Government investment	-1	1
Net other factors	-¾	¼
Total	-5¼	3

[26]See G. Lipworth and G. Meredith, "Indicators of Monetary and Fiscal Conditions: A Reexamination" in *Japan—Selected Issues*, IMF Staff Country Report No. 96/114 (October 1996).

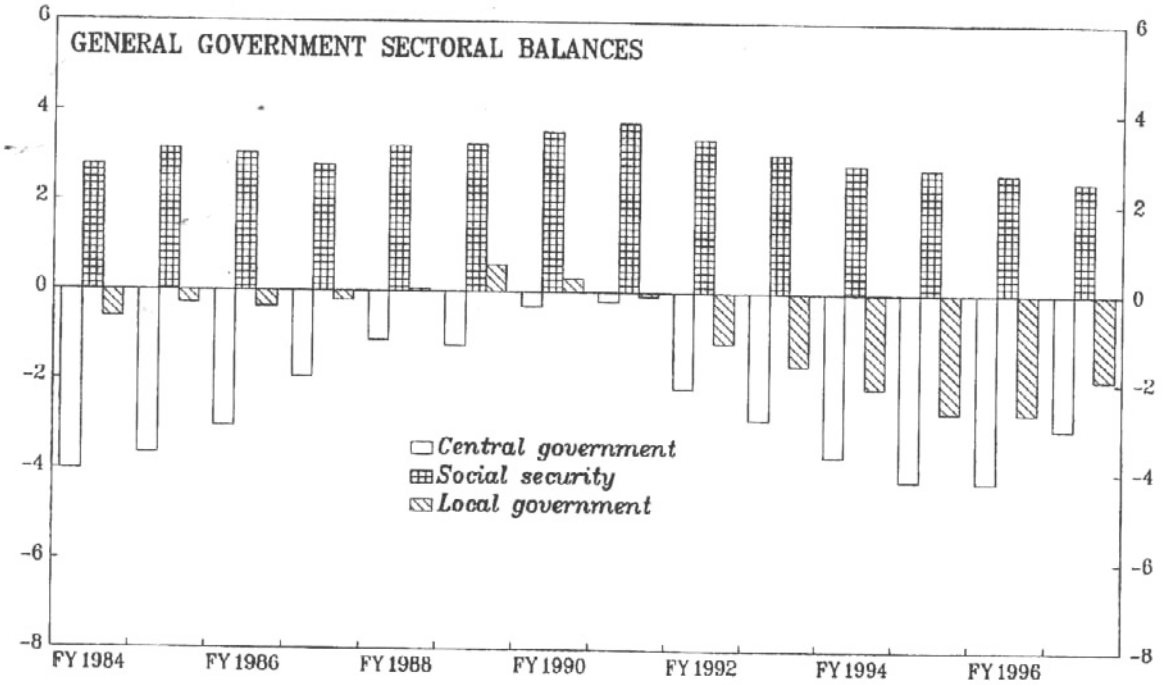
CHART III.4

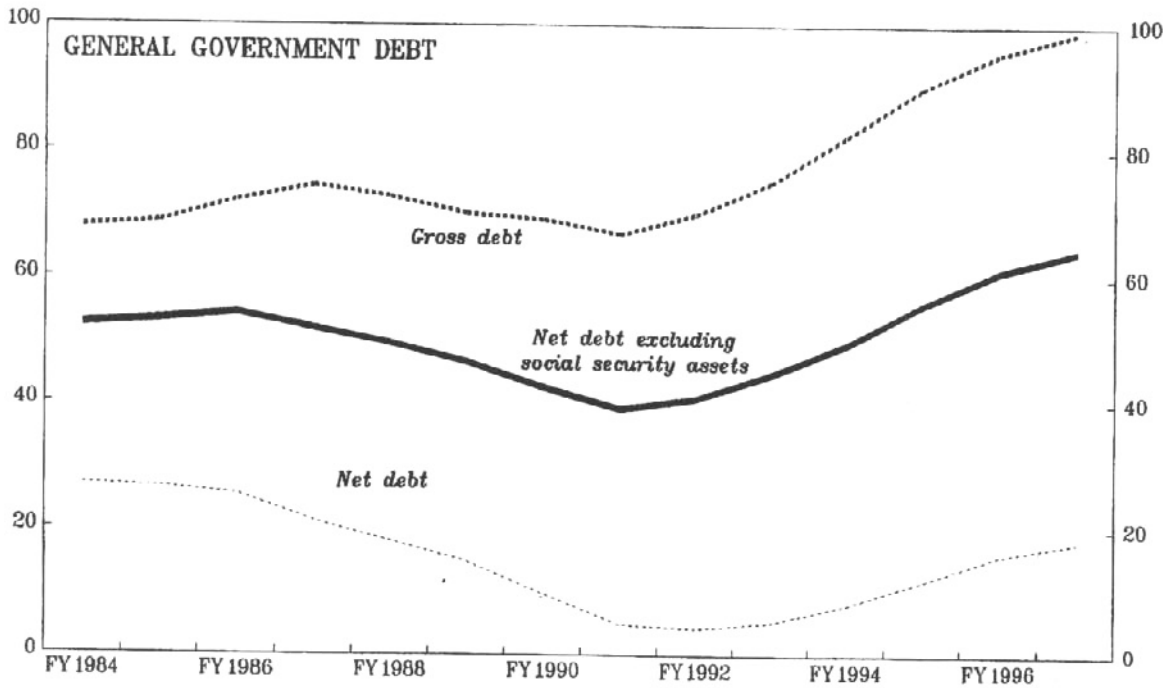
JAPAN

GENERAL GOVERNMENT FISCAL INDICATORS

FY 1984-97 1/

(Percent of GDP)





Sources: Economic Planning Agency, Annual Report on National Accounts; and staff estimates.

1/ Figures for FY 1995, 1996 and 1996 are staff estimates.

Table III.3. Japan: Public Sector Balances, FY 1988-95

	1988	1989	1990	1991	1992	1993	1994	1995
				(In billions of yen, fiscal years)				
Saving 1/	29,931	38,521	44,469	44,932	41,595	33,016	26,247	...
General government	28,272	33,695	38,420	41,495	39,169	29,447	25,983	18,797
Public enterprises	1,659	4,827	6,049	3,436	2,426	3,569	264	...
Investment	28,499	29,541	32,720	35,324	41,143	46,814	47,251	47,278
General government	22,689	23,735	26,078	28,289	32,332	37,081	37,051	36,676
Gross fixed capital formation	18,860	19,808	21,614	23,229	26,474	30,777	31,335	30,860
Land acquisition	3,829	3,928	4,465	5,060	5,858	6,304	5,716	5,816
Public enterprises 2/	5,810	5,806	6,642	7,035	8,811	9,733	10,200	10,603
Balance	1,432	8,980	11,749	9,608	452	-13,798	-21,004	...
General government	5,583	9,959	12,342	13,207	6,837	-7,634	-11,068	-17,879
Public enterprises	-4,152	-979	-593	-3,599	-6,385	-6,164	-9,936	...
				(In percent of GDP)				
Saving 1/	8.0	9.6	10.3	9.8	8.8	6.9	5.5	...
General government	7.6	8.4	8.9	9.1	8.3	6.2	5.4	3.9
Public enterprises	0.4	1.2	1.4	0.7	0.5	0.8	0.1	...
Investment	7.6	7.4	7.6	7.7	8.7	9.8	9.9	9.8
General government	6.1	5.9	6.1	6.2	6.9	7.8	7.7	7.6
Gross fixed capital formation	5.0	5.0	5.0	5.1	5.6	6.5	6.5	6.4
Land acquisition	1.0	1.0	1.0	1.1	1.2	1.3	1.2	1.2
Public enterprises 2/	1.6	1.5	1.5	1.5	1.9	2.0	2.1	2.2
Balance	0.4	2.2	2.7	2.1	0.1	-2.9	-4.4	...
General government	1.5	2.5	2.9	2.9	1.5	-1.6	-2.3	-3.7
Public enterprises	-1.1	-0.2	-0.1	-0.8	-1.4	-1.3	-2.1	...

Source: Economic Planning Agency, Annual Report on National Accounts,1996.

1/ Includes capital consumption allowances and capital transfers (net) of the general government. For public enterprises, data on capital tr are not available.

2/ Includes inventory accumulation. Data on land acquisition are not available.

Box III.1. Transparency in Fiscal Management

The transparency of Japanese fiscal policy is analyzed in the chapter "The Japanese Fiscal System and Fiscal Transparency" in the selected issues paper. It provides an overview of the fiscal system, including the relationship between the fiscal accounts used by the government for budgetary purposes (notably the general account of the central government) and the national accounts fiscal data, as well as an analysis of the debts of the Japan National Railways Corporation. The paper finds that fiscal transparency is reduced by three characteristics of the system.

- **Japan's fiscal system is highly fractured**, involving a large number of different accounts with little consolidation. The budget for each account is generally treated independently from other accounts within the system. The term "the budget" generally refers to the general account of the central government, but this covers only part of overall government spending. Separate budgets are submitted for other government accounts, in particular the Fiscal and Investment Loan Program (FILP), whose spending is around two-thirds of the size of the general account. The fractured nature of the government's fiscal operations makes it difficult to analyze the overall impact of fiscal measures for public finances.

- The current system lacks a regular cycle for **medium-term expenditure planning** and for articulating fiscal targets. The government is currently in the process of providing such controls and targets, but only for the specific purpose of achieving fiscal consolidation over the next few years. Integrating these reforms into the underlying budgetary system, so that budgets are planned on a multi-year basis in order to attain well-defined medium-term targets, could provide a more favorable environment for maintaining fiscal rectitude over the long term.

- **The government's involvement in financial intermediation**, through collecting postal savings and providing the proceeds to the Fiscal and Investment Loan Program (FILP), creates a large potential fiscal liability. This is because the returns to investors are guaranteed by the full faith and credit of the government, but the investments are inherently risky. The example of the Japan National Railways Settlement Corporation, whose net debts are estimated at over ¥20 trillion (4 percent of GDP), provides an example of how such loans, when combined with an inefficient public corporation, can generate significant fiscal costs. The government has recently formed a commission to look into the future of the FILP.

B. FY 1996 and FY 1997 Budgetary Operations

57. The **FY 1996 initial general account[27] budget** was broadly cyclically neutral, thereby maintaining the significant fiscal support for the economy embodied in stimulus measures taken in previous years.[28] It projected a deficit of ¥21.0 trillion, some ¥1.6 trillion (0.3 percent of GDP) lower than the revised deficit for FY 1995, which incorporated the large September 1995 stimulus package (Table III.4).[29] Spending would be reduced from 15.5 to 15.0 percent of GDP between FY 1995 and FY 1996, reflecting the unwinding of the temporary spending increases in the September 1995 stimulus package, while revenues were projected to fall from 11.6 to 10.8 percent of GDP over the same period (Table III.5).[30]

58. No explicit stimulus packages were implemented in FY 1996. However, a modest **supplementary budget** for FY 1996 was formulated in December 1996, and approved by the Diet in February 1997 (see tabulation below). Additional spending of about ¥2.7 trillion (0.5 percent of GDP) was announced, including measures associated with the Kobe earthquake, disaster relief preparations, and additional national debt repayment. In total, the additional spending for public investment was about ¥1.4 trillion (0.3 percent of GDP). Given that the supplementary budget was only passed in February 1997, most of the extra spending is expected to occur in FY 1997.

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[27]The central government's general account is the most important fiscal account. It receives almost all national tax revenues (although not social security contributions), and disburses a significant proportion of government spending. See "The Japanese Fiscal System and Fiscal Transparency" in the accompanying selected issues papers for a fuller description of the general account and its relationship to other government account and to national income account definitions of government sectors.

[28]The budget was not passed until mid-May, requiring a provisional budget for the first 50 days of the fiscal year (the fiscal year starts on April 1). The delay was due to the inclusion of a controversial disbursement of funds to the Deposit Insurance Corporation, as a part of the resolution of the *jusen* problem.

[29]The initial budget is that proposed by the government at the start of the fiscal year. The revised budget, available at the end of the fiscal year, incorporates any intervening supplementary budgets. The settlement data, available only with a considerable lag, reports final outcomes.

[30]For more details of the FY 1996 budget, see *Japan—Recent Economic Developments*, IMF Staff Country Report No. 96/90 (September 1996).

Table III.4. Japan: Central Government General Account Budget, FY 1992–97

(In billions of yen, fiscal years)

	1992	1993	1994	1995			1996		1997
		Settlement		Initial	Revised	Settlement	Initial	Revised	Initial
Expenditures	70,497	75,102	73,614	70,987	78,034	75,939	75,105	77,771	77,390
Social security	12,756	13,346	13,603	13,924	14,548	14,543	14,288	15,000	14,550
Public works	9,671	13,684	13,208	9,240	14,216	12,795	9,618	11,218	9,745
Defense	4,589	4,602	4,638	4,724	4,734	4,720	4,846	4,849	4,948
Official aid	893	950	985	1,035	1,028	1,034	1,072	1,079	1,089
Foodstuff control	349	308	261	272	272	269	271	310	269
Transfer to the special account for industrial investment, etc.	205	177	163	1,281	1,281	1,241	172	172	172
National debt service 1/	14,628	13,714	13,422	13,221	12,857	12,820	16,375	16,084	16,802
(Interest payments)	(10,808)	(10,608)	(10,706)	(11,651)	(11,279)	(10,708)	(11,703)	(11,098)	(11,682)
Transfer of local allocation tax to local government	14,204	13,950	12,069	13,215	12,302	12,302	13,604	13,945	15,481
Revenues	57,942	60,022	57,220	58,387	55,393	56,585	54,057	54,480	60,665
Taxes and stamp duties	54,445	54,126	51,030	53,731	50,681	51,931	51,345	51,736	57,082
Miscellaneous	3,497	5,896	6,190	4,656	4,712	4,654	2,712	2,744	2,863
Deficit	12,556	15,080	16,393	12,600	22,641	19,354	21,048	23,291	16,725
Financing	12,556	15,080	16,393	12,600	22,641	19,354	21,048	23,291	16,725
Bond issues	9,536	16,174	16,490	12,598	22,032	21,247	21,029	22,368	16,707
Deficit-financing bonds	0.0	0.0	4,144	2,851	5,532	4,807	11,998	11,661	7,470
Construction bonds	9,536	16,174	12,346	9,747	16,500	16,440	9,031	10,707	9,237
Others									
Carried over surplus	1,475	-1,660	-97	2	609	-1,894	19	924	18
Carry in	2,443	969	2,629	2	609	2,725	19	924	18
Carry out	-969	-2,629	-2,725	0	0	-4,619	0	0	0
Transfer from the settlement adjustment fund	1,545	566	0	0	0	0	0	0	0
Memorandum items:									
In percent of GDP									
Expenditures	14.9	15.8	15.4	14.5	16.0	15.5	15.0	15.5	15.0
Revenues	12.3	12.6	11.9	12.0	11.3	11.6	10.8	10.9	11.8
Deficit	2.7	3.2	3.4	2.6	4.6	4.0	4.2	4.6	3.2
Bond financing	2.0	3.4	3.4	2.6	4.5	4.3	4.2	4.5	3.2
Deficit financing bonds	0.0	0.0	0.9	0.6	1.1	1.0	2.4	2.3	1.4
Public works	2.0	2.9	2.8	1.9	2.9	2.6	1.9	2.2	1.9

Source: Data provided by the Japanese authorities.

1/ Includes repayments of principal and running costs.

Table III.5. Japan: Tax Receipts of the Central Government General Account, FY 1992–97

	1992 Settlement	1993 Settlement	1994 Settlement	1995 Initial	1995 Revised	1995 Settlement	1996 Initial	1996 Revised	1997 Initial
				(In billions of yen, fiscal years)					
Individual income tax	23,231	23,686	20,418	21,350	19,564	19,515	19,338	18,995	20,882
Corporate income tax	13,714	12,138	12,363	13,726	12,714	13,735	13,548	13,986	14,432
Taxes on goods and services	10,378	10,778	11,218	11,665	11,433	11,372	11,611	11,711	15,522
Of which									
Consumption tax	(5,241)	(5,586)	(5,632)	(5,980)	(5,748)	(5,790)	(5,948)	(6,048)	(9,813)
Liquor tax	(1,961)	(1,952)	(2,113)	(2,172)	(2,172)	(2,061)	(2,111)	(2,111)	(2,063)
Gasoline tax	(1,563)	(1,627)	(1,813)	(1,850)	(1,850)	(1,865)	(1,875)	(1,875)	(1,956)
Tobacco tax	(1,020)	(1,030)	(1,040)	(1,038)	(1,038)	(1,042)	(1,040)	(1,040)	(1,062)
Custom duties	915	881	908	897	897	950	968	968	1,093
Stamp revenue	1,571	1,599	1,752	1,762	1,762	1,941	1,925	2,121	2,019
Other	4,636	5,044	4,371	4,331	4,311	4,418	3,955	3,955	3,854
Total tax and stamp revenue	54,445	54,126	51,030	53,731	50,681	51,931	51,345	51,736	57,802
				(Percentage change) 1/					
Individual income tax	-13.2	2.0	-13.8	4.6	-4.2	-4.4	-0.9	-2.7	9.9
Corporate income tax	-17.4	-11.5	1.9	11.1	2.8	11.1	-1.4	1.8	3.2
Taxes on goods and services	4.2	3.9	4.1	4.0	1.9	1.4	7.9	3.0	32.5
Total tax and stamp revenue	-9.0	-0.6	-5.7	5.3	-0.7	1.8	-1.1	-0.4	11.7

Source: Data provided by the Japanese authorities.

1/ Percentage changes calculated relative to most recent data of previous year.

Summary of FY 1996 Supplementary Budget

(In trillions of yen)

Public investment	1.4
Measures for Kobe earthquake	0.3
Other disaster relief	0.2
Emergency counter measures for preventing disasters	0.6
Measures related to the Uruguay Round Agriculture Agreement	0.3
Local allocation tax grants	0.3
National debt repayment	0.3
Other measures	0.7
Total	2.7

59. Overall expenditures at the general government level are estimated to have risen to 36.3 percent of GDP in FY 1996 from 36.0 percent in FY 1995. As general government revenues only rose marginally, the general government deficit edged up from 4.1 to 4.2 percent of GDP. Excluding social security, the deficit is estimated to have remained unchanged in relation to GDP, at 6.9 percent of GDP.[31] The equivalent structural deficits deteriorated by more, however, largely reflecting the impact of the September 1995 stimulus package on underlying FY 1996 spending (Table III.2).

60. The **FY 1997 general account budget** represents a significant move toward fiscal consolidation. The budget projects a reduction in the general account deficit from an initial total of ¥21.0 trillion (4.2 percent of GDP) in FY 1996 to ¥16.7 trillion (3.2 percent of GDP) in FY 1997 (Table III.4).[32] This reduction largely reflects revenue gains from the April 1

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[31]The rationale for excluding social security is that this surplus is specifically earmarked to help pay for Japan's rapidly aging population, and will be eroded as aging progresses. Hence, excluding the social security surplus abstracts from this intertemporal element in the government accounts. On the other hand, changes in the government surplus *including* social security is a better measure of the short-term impact of fiscal policy on the economy.

[32]It is customary to compare initial budgets with the equivalent initial budget of the previous year, largely because the timing of the spending incorporated in intermediate supplementary

(continued...)

increase in the consumption tax rate from 3 percent to 5 percent and the elimination of ¥2 trillion in temporary income tax cuts.[33] General account revenues were projected to rise to 11.8 percent of GDP in the FY 1997 budget from 10.8 percent of GDP in FY 1996, while expenditures were projected to stay constant as a ratio to GDP.

61. While overall nominal expenditures were projected to rise by 3 percent, discretionary expenditures (i.e., total spending excluding national debt payments and local allocation tax grants), were envisaged to rise by only 1.5 percent. These totals reflected austerity across the board:

- **ODA expenditures** were projected to rise by 2.1 percent to ¥1.2 trillion (0.2 percent of GDP).

- Spending on **public works**, which has expanded rapidly in recent years due to fiscal stimulus measures, would also rise by only 2.1 percent. At the same time, the allocation of public works spending across different types of projects remained stable (Table III.6).[34]

- **Social security expenditures** (central government grants to the social security system) were projected to rise by only 1.8 percent. This reflected plans to raise the cost of health services to individuals in May 1997 (see Box III.2), thereby lowering government transfers. The proposals for medical reform were passed by the Diet and will be implemented in September 1997.

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[32](...continued)
budgets is often uncertain.

[33]The FY 1997 budget tax hikes represents a culmination of the 1995 tax reform package. The package provided temporary support to the economy through permanent and temporary income tax reductions, and shifted part of the personal tax burden from direct to indirect taxes as the loss in revenues from the permanent income tax breaks were replaced by a later rise in consumption taxes.

[34]Lack of flexibility in the allocation of public works spending is widely believed to lead to significant inefficiencies within the program.

Table III.6. Japan: Allocation of Public Works Expenditure of Central Government General Account, FY 1992–97

	1992	1993	1994	1995	1996 Revised	1997 Initial
	Actual					
	(In percent, fiscal years)					
Erosion and flood control	16	17	17	15	16	16
Road improvement	26	27	26	6	26	28
Port, harbor, and airport improvement	7	7	7	7	7	8
Housing	12	11	12	12	15	13
Environment facilities	16	16	17	15	16	18
Agricultural production	13	13	13	13	14	13
Forestry roads and water supply for industrial use	3	3	3	3	4	4
Disaster relief	6	5	5	8	3	1
Total	100	100	100	100	100	100

Source: Data provided by the Japanese authorities.

Box III.2. Medical Care Reform Proposals

As part of the FY 1997 budget, the government proposed a series of reforms to the public health care system. The most important proposals were:

- **Salaried workers.** Copayments for medical expenses were to rise from 10 percent to 20 percent.

- **Those aged over 70.** The aged were to be charged ¥500 per outpatient visit (up to a maximum of four times per month), rather than a flat fee of ¥1,020 per month. Inpatient care charges were to rise from ¥710 per day to ¥1,000 per day in FY 1997, to ¥1,100 in FY 1998, and to ¥1,200 in FY 1999.

- **Prescriptions.** Costs of medicines are currently included in the overall cost of treatment. The plan envisioned charges of ¥15 per prescription drug per day.

- **The premium rate** for government health insurance for small- and medium-sized companies was to be raised from 8.2 percent to 8.6 percent.

These proposals would have raised **private sector health costs** by about ¥1.5 trillion in FY 1997 and reduced government subsidies by about ¥380 billion. However, as the health system is operated on a pay-as-you-go basis, the long-term reduction in government health costs would equal the increase in payments by individuals (except for any changes in overall health spending).

The proposals created considerable political controversy, which resulted in a dilution of the original plans. In particular:

- The reforms have been **postponed** to September 1997.

- **Prescription costs** have been limited depending on the category and the number of drugs being taken.

- The **premium rate** for small- and medium-sized businesses has been raised to 8.5 percent rather than 8.6 percent.

All of these changes have reduced the increase in individual copayments, and hence raised government transfers to the social security system.

- The most rapid increase in projected spending in the initial budget comes from **tax allocation grants to local governments**, which were estimated to rise by 13.8 percent. This reflected an increase in the proportion of tax revenues allocated to local governments, implemented as part of the consumption tax hike.[35]

- Expenditures for **national debt service** (repayment for government bond and interest payments) were projected to increase by 2.6 percent.

62. In line with the general account budget, the **Fiscal Investment and Loan Program** (FILP) budget was also contractionary (Table III.7). FILP spending (excluding portfolio investment) was budgeted to fall by 3 percent from the initial FY 1995 level, which is only the second decrease in FILP spending since its establishment, although the level of spending remains significantly above its FY 1990 level.[36] Funds for public financial institutions declined considerably, reflecting lower demand for FILP funds due to low market interest rates and thus a shift to commercial lenders.

63. The **local finance plan**[37] for FY 1997 envisaged growth in total government expenditures of only 2.1 percent. Local tax revenues are projected to grow by 9.6 percent, reflecting the introduction of the local consumption tax and the termination of the temporary cut of the individual inhabitants tax. Transfers from the central government are budgeted to grow by 1.7 percent. As a result of the rise in tax receipts, local government borrowing is projected to decrease by 6.4 percent from FY 1996.

64. The staff estimates that the **general government deficit** in FY 1997 will fall to 2.4 percent of GDP, its lowest level since 1993, while the deficit excluding social security is

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[35]Tax grants to local governments from consumption tax revenues were raised from 24 percent of the total revenue of consumption tax to 29.5 percent.

[36]The Japan National Railway Settlement Corporation (JNRSC) is budgeted to receive ¥0.9 trillion from the FILP, slightly lower than the level provided in FY 1996. Given the already large net debt of the JNRSC, it is unclear how these loans will be repaid. Net debt of the JNRSC is over ¥20 trillion (4 percent of GDP). The JNRSC debt problem is discussed in the accompanying selected paper, "The Japanese Fiscal System and Fiscal Transparency."

[37]The local government finance plan represents an estimation of the total expenditure and revenue of all local governments (i.e., prefectures and municipalities) made by the Ministry of Home Affairs. It provides a projection of local government spending, but is not legally binding. The relationship between central government and local authorities is discussed in D. Mihaljek, "Intergovernmental Relations and Local Public Finance in Japan," in *Japan—Selected Issues*, IMF Staff Country Report No. 96/114 (October 1996).

Table III.7. Japan: Fiscal Investment and Loan Program (FILP), FY 1992–97

(In billions of yen, fiscal years)

	1992	1993	1994	1995			1996		1997
		Actual		Initial	Revised	Prel. Actual	Initial	Revised	Initial
Sources of funds	48,086	55,404	50,324	48,190	55,083	52,941	53,725	54,092	56,157
Trust Fund Bureau	40,192	45,982	39,172	36,693	43,195	42,405	41,910	42,400	45,551
Postal savings	(14,012)	(12,825)	(13,760)	(10,000)	(...)	(16,393)	(10,000)	(...)	(11,700)
Welfare and national pensions	(7,853)	(7,413)	(6,921)	(7,380)	(...)	(7,730)	(6,920)	(...)	(7,300)
Repayment and other	(18,328)	(25,743)	(18,492)	(19,313)	(...)	(18,283)	(24,990)	(...)	(26,551)
Industrial investment special account	72	99	83	66	81	77	65	65	64
Postal life insurance fund	6,024	6,977	8,457	8,182	8,186	7,229	8,650	8,477	7,542
Government-guaranteed bonds and borrowing	1,799	2,346	2,612	3,250	3,620	3,229	3,100	3,150	3,000
Uses of funds 1/	48,086	55,404	50,328	48,190	55,083	45,114	53,725	54,092	56,157
Purchase of government bonds	1,956	2,946	0.0	0.0	2,958	2,851	4,600	4,976	4,800
FILP	46,130	52,458	50,324	48,190	52,125	42,263	49,125	49,116	51,357
Portfolio investments 2/	(9,660)	(9,175)	(8,450)	(7,950)	(7,950)	(7,950)	(8,591)	(8,591)	(12,030)
General FILP	36,470	43,283	41,874	40,240	44,175	34,313	40,535	40,525	39,327
Central government projects (special accounts)	(1,104)	(1,130)	(866)	(854)	(961)	(930)	(807)	(856)	(755)
Government nonfinancial enterprises	(10,996)	(11,230)	(10,573)	(9,521)	(9,864)	(8,678)	(9,374)	(9,379)	(8,753)
Government financial agencies	(17,756)	(22,244)	(23,048)	(22,240)	(23,145)	(14,628)	(21,273)	(20,760)	(20,888)
Of which Housing Finance Corporation	(6,865)	(9,981)	(12,141)	(10,269)	(11,150)	(4,970)	(10,910)	(10,910)	(10,647)
Local governments	(6,223)	(7,966)	(6,996)	(7,250)	(9,830)	(9,703)	(8,730)	(9,180)	(8,600)
Other	(392)	(713)	(391)	(375)	(375)	(373)	(350)	(350)	(331)
Memorandum items:									
Increase in General FILP (In percent) 3/	19.8	18.7	-3.3	-3.9	5.5	-18.1	18.1 4/	18.1 4/	-3.0 5/
General FILP as a percent of GDP 3/	7.7	9.1	8.7	8.2	9.0	7.0	8.1	8.1	7.6

Source: Ministry of Finance.

1/ Difference between "sources of funds" and "uses of funds" reflects short-term off-program investments of the Trust Fund Bureau.

2/ Reflects the funding of the "lend-back" system under which the postal savings system, public pension funds, and the postal life insurance fund receive funds for portfolio management on their own account.

3/ Excludes portfolio investment.

4/ Compared with preliminary outturn of the previous year.

5/ Compared with revised plan of the previous year.

also projected to fall to 4.9 percent of GDP from 6.9 percent of GDP (Table III.2).[38] Total revenues in FY 1997 are estimated to rise to 33.8 percent of GDP from 32.1 percent in FY 1996, due to increases in tax revenues and a scheduled increase in the medical care premium rate. Total expenditures are estimated to fall slightly as a ratio of GDP, to 36.2 percent of GDP from 36.3 percent of GDP in FY 1995.

C. Plans for Future Fiscal Consolidation

65. The Japanese Government has also formulated plans for further fiscal consolidation after FY 1997. In December 1996, as part of the budget process, the cabinet approved a set of guidelines for future consolidation, including FY 2005 deficit targets for the general government (excluding social security) and the central government's general account. In March 1997 the targets were brought forward to FY 2003, and the guidelines were further refined and were announced as the "five basic principles" of fiscal structural reform. These principles are:

- The general government deficit excluding social security should be reduced to no more than 3 percent of GDP by FY 2003, and the issuance of deficit-financing bonds for the general account of the central government should be curtailed by the same date.

- The fiscal years 1998–2000 will be known as the "Special Reform Term." Concrete quantitative targets will be set for major expenditures.

- General account discretionary expenditures (defined as overall spending less debt service and local allocation tax grants to lower levels of government) will be lower in FY 1998 than they were in FY 1997.

- All multiyear spending programs (such as the basic plan for public investment) will be subject to "drastic" reductions. No multiyear spending programs with new fiscal expenditure implications will be made.

- Fiscal policy will be conducted so as to ensure that the sum of taxes, social security contributions, and the deficit does not exceed 50 percent of national income.

66. A Fiscal Reform Council, chaired by the Prime Minister, was formed to oversee fiscal consolidation plans for the FY 1998 budget and beyond. The council made its recommendations to the MOF at the end of May, and draft spending cuts were announced in June aimed at ensuring that general account discretionary spending will be lowered in FY 1998 compared with FY 1997. The announced changes for major spending categories are: increases in social

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[38]The structural deficit of the general government is projected to fall to 1.0 percent of GDP from 3.0 percent of GDP in FY 1995, while the structural deficit excluding social security is projected to fall by 2.1 percent of GDP to 3.8 percent of GDP.

security transfers, which would have risen by ¥800 billion without measures, will be lowered to ¥300 billion through medical and pension reforms; public works spending is to be cut by ¥630 billion (7 percent) in FY 1998; ODA spending is to be cut by ¥110 billion (10 percent); defense spending is to be held flat or reduced in nominal terms; and the growth in science spending is to be limited to 5 percent or less. The FY 1998 spending plan for local governments is also to be reduced compared to the FY 1997 plan.

67. The government also announced plans to cut two multiyear spending programs. The ten-year ¥630 trillion government investment plan for FY 1995–2004 is to be extended by three years, and public works spending in FY 2000 is planned to be 15 percent below its FY 1997 level. The current ¥25.2 trillion, five-year defense plan is to be trimmed by ¥920 billion, and defense spending is to either stay constant or fall in nominal terms over the next three years.

68. The government also announced in June 1997 that it was planning to review the public pension and health systems so as to achieve a better balance between social security burdens and benefits, partly in response to the long-term commitment to keep the sum of taxes, social security contributions, and the deficit to below 50 percent of national income.[39] Current pension plans envisage a very large future increase in pension contribution rates. For example, the contribution rate for Welfare Insurance (the main public pension scheme covering private sector employees), which was 14.5 percent in 1994, is currently projected to rise to more than 34 percent by 2025, even with the changes envisaged in the 1994 pension plan.[40] Similarly, private sector contributions for health care will rise over time to help pay for increases in health spending as the population ages, particularly in the light of current plans to increase health care copayments.

D. The Economic Impact of Fiscal Consolidation

69. Current plans envisage a shift toward significant fiscal consolidation over the next few years. The implications of such consolidation for Japan's underlying fiscal position are analyzed below by looking at the impact on debt dynamics over the medium term. Next, the possible effect on growth is considered.

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[39]The current ratio is estimated to be slightly under 40 percent of national income.

[40]See K. Okamura, "Japan's Medium- and Long-Term Fiscal Challenges" in *Japan—Selected Issues*, IMF Staff Country Report No. 96/114 (October 1996) for more details on the pension reform. The main provisions to limit expenditures are a gradual increase in the retirement age from 60 to 65 and a switch to indexing pension payments by the rate of increase in wages net of taxes, rather than gross wages.

Debt dynamics

70. The top panel of Chart III.5 shows the paths for general government net debt under three alternative scenarios: (i) no fiscal consolidation in FY 1998 or beyond, (ii) achieving the government's FY 2003 target for the general government (excluding social security) deficit, and (iii) a more ambitious plan that would cut the primary deficit by 1 percent of GDP per annum over the next four fiscal years (FY 1998–2001). Under the first scenario, the ratio of net debt to GDP rises rapidly in the absence of further consolidation measures, illustrating existing fiscal pressures. Even assuming adherence to the authorities' fiscal program, net debt would continue to grow as a share of GDP, albeit at a diminishing rate. By contrast, under the more stringent scenario, the debt ratio would level off and begin to fall, before stabilizing in the long-run due to the fiscal pressures created by population aging.

71. Calculating the path for gross debt requires an assumption about the behavior of financial assets. Assuming that the ratio of financial assets (excluding social security) to GDP rises at roughly the same rate as in the historical period, the projected paths for gross debt look very similar to that for net debt, except that the initial debt ratio is about 30 percent of GDP higher (Chart III.5). Different assumptions about the path for financial assets, however, would produce different paths for gross debt.[41]

72. In contrast to the case for the general government deficit (excluding social security), the authorities' target for the general account stabilizes the ratio of general account bonds to GDP over the forecast period (Chart III.6). Comparing the authorities' target for the general account with that for the general government, it is clear that the deficits fall in a similar manner, but that the large gap that has built up over the last few years between the two deficits would not be significantly reduced. The continuation of this gap explains why the ratio of nonsocial security general government net debt to GDP does not stabilize, while the equivalent general account ratio does.[42]

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[41]For example, if the nominal value of financial assets is assumed to remain unchanged over the projection period, the authorities' deficit path would stabilize the level of gross general government debt to GDP by the end of the period. However, this would require a fall of 5 percentage points in the ratio of general government financial assets to GDP, and an accompanying fall in property income receipts.

[42]Interestingly, the reduction in the general government deficit (excluding social security) in the 1980s consolidation period was significantly larger than the reduction in the general account deficit. Indeed, between FY 1988 and FY 1991 the general account deficit was larger than its general government counterpart (Chart III.6).

CHART III.5
JAPAN

ILLUSTRATIVE NET AND GROSS DEBT PATHS, 1997-2003

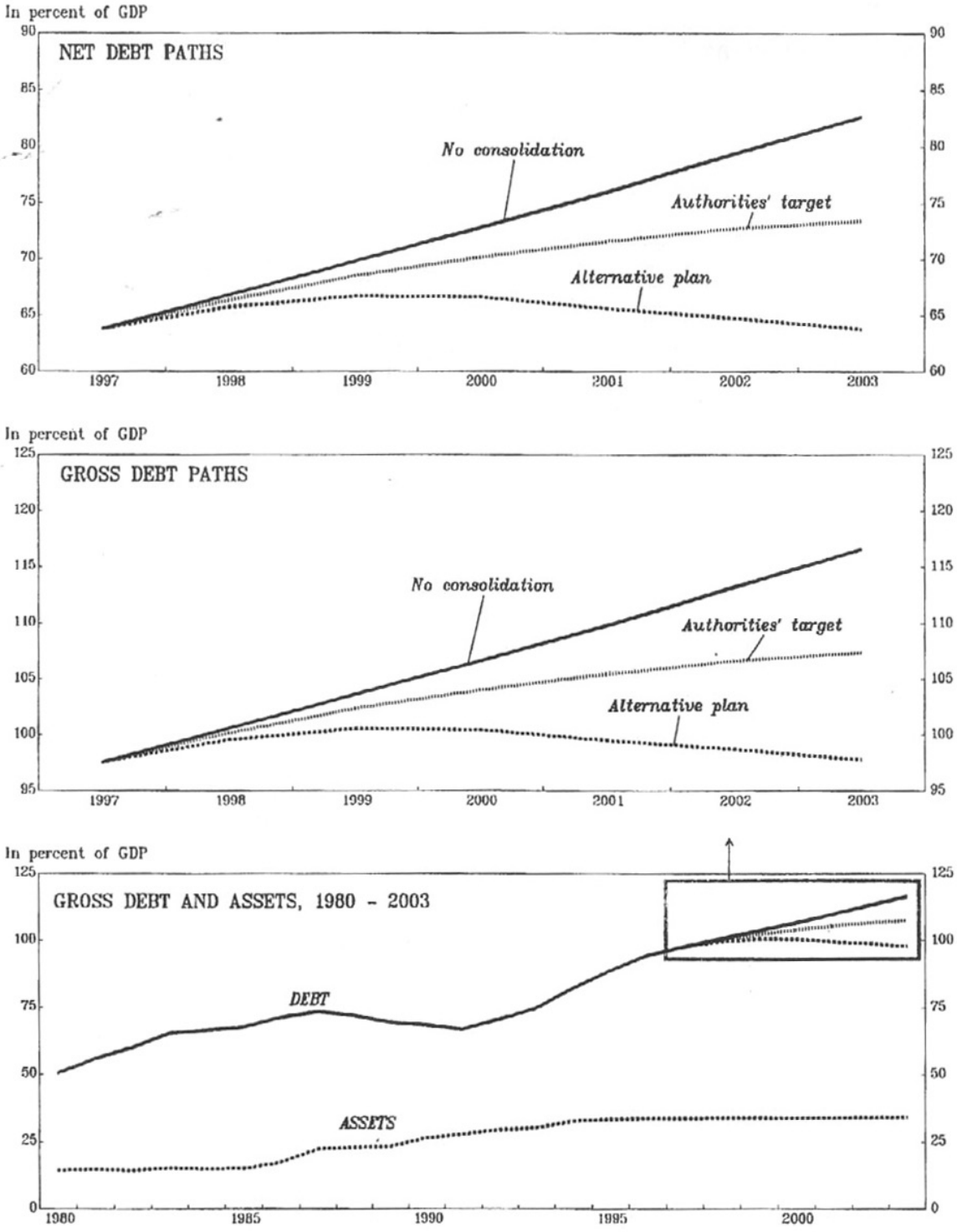
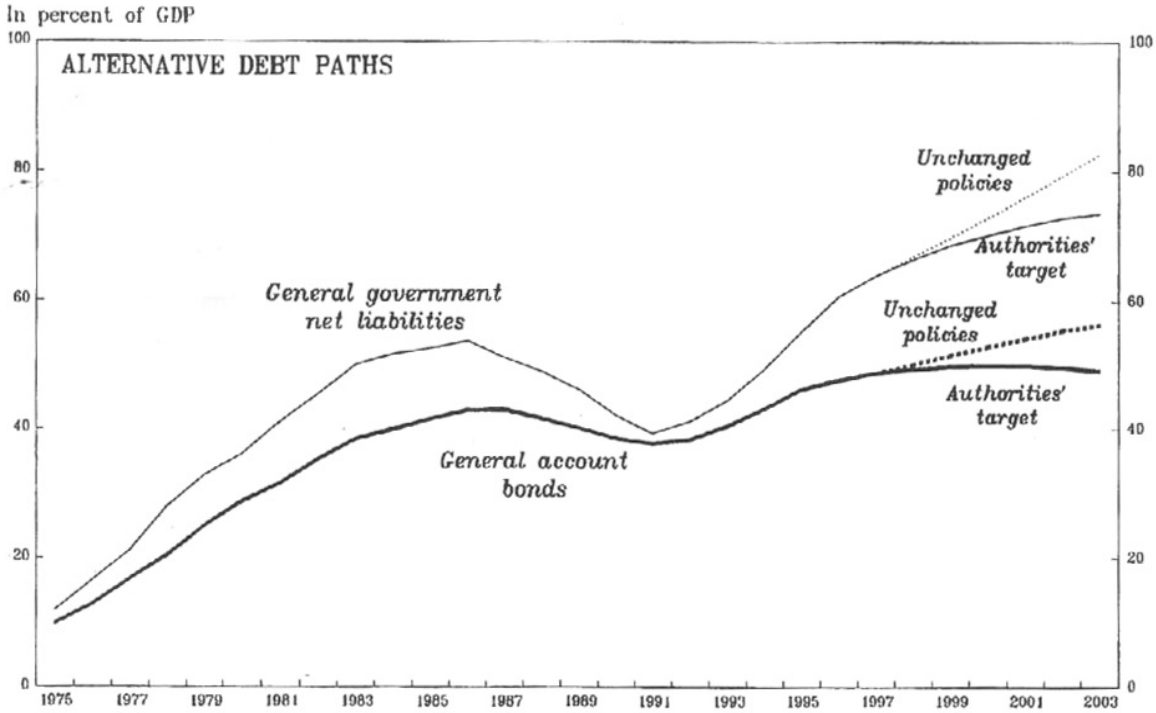
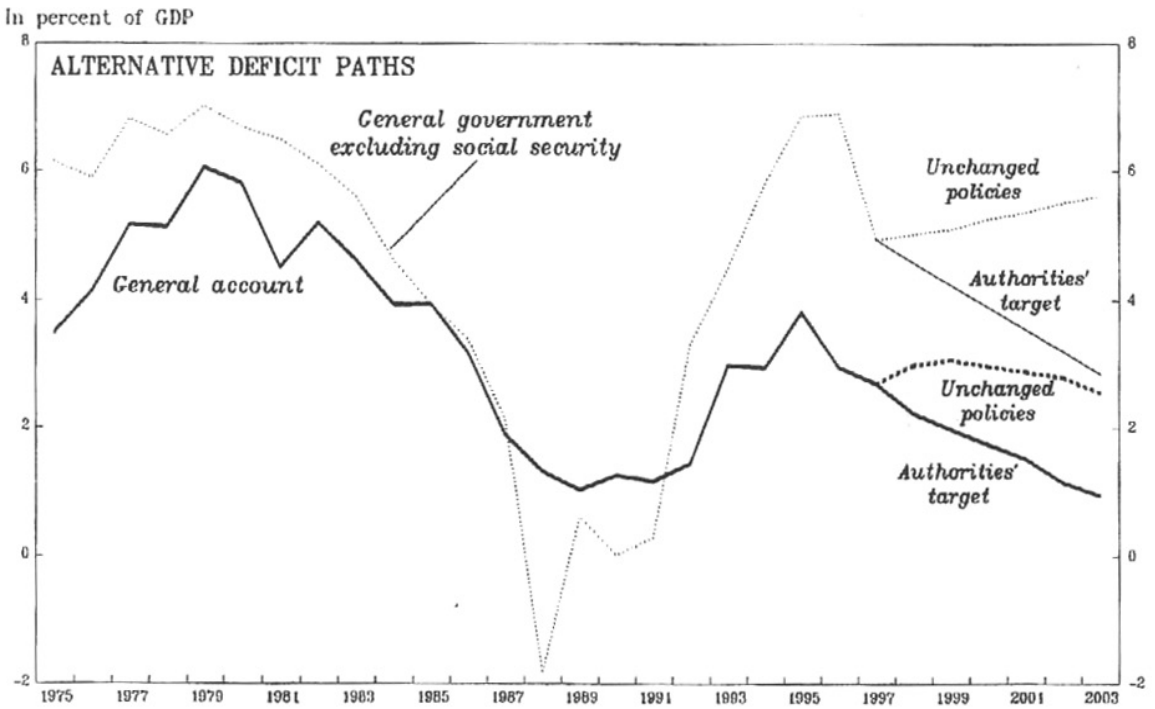


CHART III.6
JAPAN

ALTERNATIVE PATHS FOR DEBT AND DEFICITS, 1975-2003





Economic effects of future fiscal consolidation

73. To consider the macroeconomic impact of fiscal consolidation, simulations were performed on a version of the Japanese sector of MULTIMOD.[43] The model incorporates forward-looking behavior in asset markets, in that exchange rates and wealth are calculated using forward-looking expectations. As a result, future policy actions can influence current consumption, investment, and net exports.

74. The simulations assume that the primary deficit is cut by 1 percent per annum over the next four years, with half of the deficit reduction coming from expenditure restraint and half from increased revenues, compared to a baseline in which no consolidation occurs from FY 1998 onwards (so that the structural deficit rises to 5¾ percent of potential GDP by FY 2002). By way of comparison, the government's target for consolidation implies a reduction in the deficit of slightly under ½ percent of GDP per annum over the next six years, or roughly half of the adjustment assumed below.

75. To illustrate the importance of expectations on the macroeconomic effects of fiscal policy, two sets of results are reported. The first assumes that policy is fully credible, so that the public fully anticipates the consolidation path. The second set of results assumes that the public fails to anticipate the additional fiscal measures imposed each year until they actually occur.

76. Chart III.7 shows the results from each simulation, measured as a deviation from the baseline with no consolidation. In the credible scenario, the anticipated benefits of future consolidation (which does not start until 1998) cause a depreciation of the real exchange rate in 1997 and a small decline in the real long-term interest rate. These factors, together with the increase in wealth due to expectations of lower taxes in the longer run, generate an increase in real GDP. Output remains above the baseline path in 1998, as the stimulus to the private sector from anticipated future consolidation dominates the negative impact of the current fiscal contraction. Output then falls slightly below the baseline for the remainder of the consolidation period, before recovering in 2002.

77. The noncredible scenario has significantly larger short-term output losses than its credible counterpart. There is no boost to real GDP in 1997 in anticipation of future consolidation, and real GDP is about ¾ percent lower than in the baseline over the first three years of consolidation—almost exactly the loss that would be expected from the static multipliers used by the staff. Output losses are higher than in the credible scenario because, with no expectation of additional future tax cuts, the response of the private sector is muted, and the real exchange rate depreciates less. These scenarios illustrate the potential benefits

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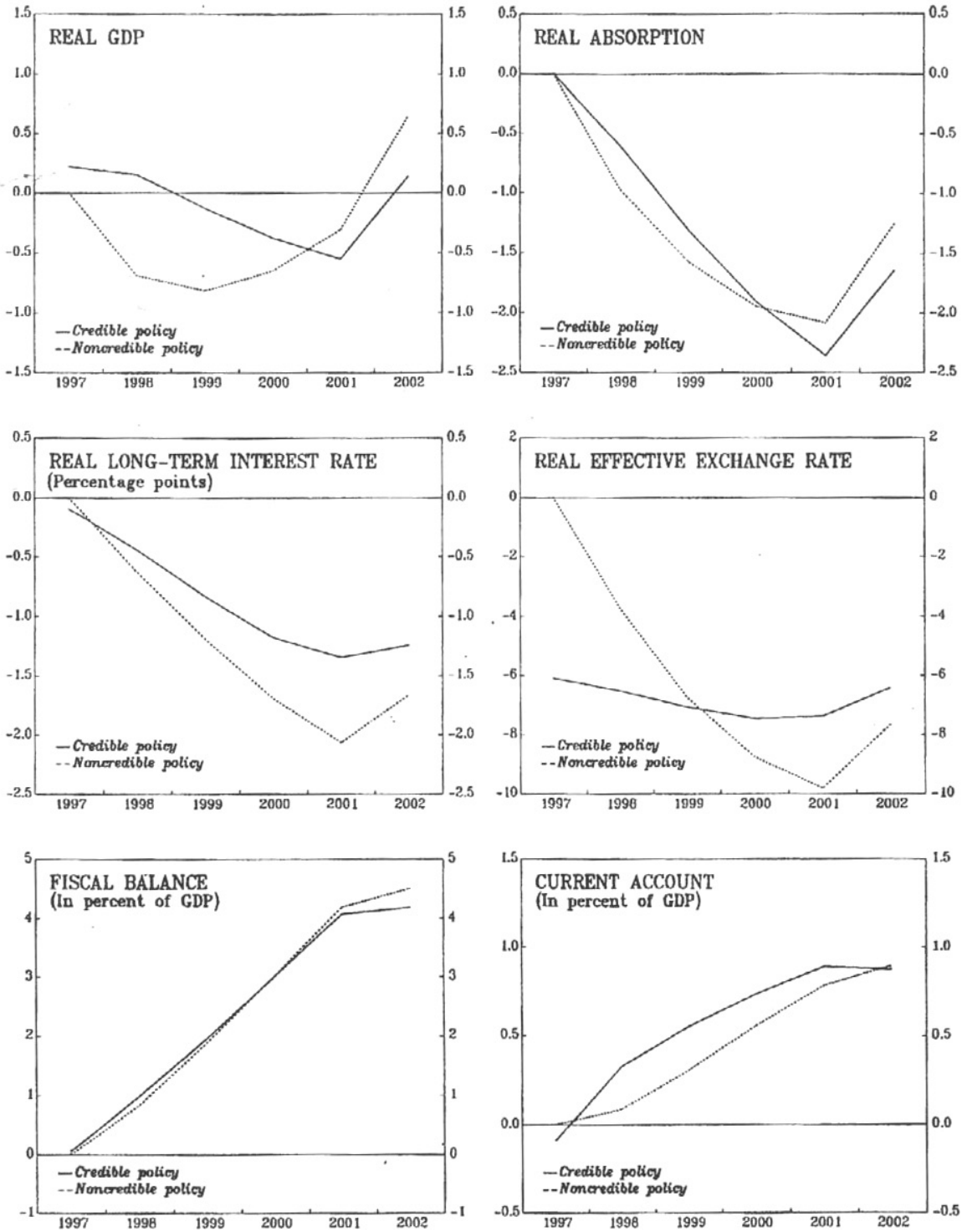
[43]For more details on the methodology see the accompanying selected issues paper "The Yen—Past Movements and Future Prospects."

CHART III.7
JAPAN
FISCAL SIMULATION RESULTS
(Percent deviation, shock minus control, unless otherwise indicated)



from announcing (and following) a credible path for fiscal consolidation, as anticipation of the future benefits of such actions would reduce the short-term impact of output.

78. These results have some similarities with recent work looking at the experience of economies which have gone through significant fiscal consolidations over the last two decades,[44] which tends to indicate that the effect of fiscal consolidation on real output is smaller when the fiscal adjustment is large and is oriented toward expenditure cuts. One possible interpretation of this effect, which is consistent with the results reported here, is that these consolidations are more successful because they engender an expectation of further fiscal measures in the future, and that these expectations boost private demand.

E. Administrative Reform

79. In November 1996, the government announced six areas for reform in order to improve Japan's long-term economic prosperity. They were administrative reform, financial system reform (the "Big Bang"), structural reform, social security reform, reform of the fiscal system, and education reform.[45] Administrative reform is aimed primarily at increasing the efficiency of public administration, and a number of panels and committees were formed in late 1996 and early 1997 to prepare proposals.

80. The **Administrative Reform Committee (ARC)**, which was established by the cabinet in November 1996, is charged with developing a framework for restructuring government ministries and public corporations. The ARC is headed by Prime Minister Hashimoto, and comprises academics, business people, and other nongovernment representatives. It is expected to submit its recommendations to the Prime Minister by end-1997. A bill covering related laws will then be submitted to the ordinary Diet session in 1998.

81. The reorganization of government ministries is not expected to start until 2001. However, reforms of public corporations are expected to occur sooner. Indeed, in June 1997 the cabinet approved the abolition of five government-affiliated corporations by end-1999, the abolition of three additional corporations after 1999, and the privatization of a further three corporations. Details and exact legislation are in the process of being formulated by the government. Plans include scrapping the Housing and Urban Development Corporation, the Employment Promotion Projects Corporation, and the Pension Welfare Service Public Corporation, and privatizing the Power Reactor and Nuclear Fuel Development

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[44]This issue is discussed in more detail in Chapter III of the May 1996 *World Economic Outlook* (International Monetary Fund), which also provides the relevant references.

[45]Structural issues are discussed in Chapter V; financial reforms are discussed in Chapter VI.

Corporation.[46] The Japan Agricultural Land Development Agency will also be liquidated in 1999, to coincide with expected revisions to the Agriculture Basic Law, with a section of the agency to be transferred to the Forest Development Corporation.

82. In addition, in response to an initiative by Prime Minister Hashimoto, the MOF formed a new subcommittee in February 1997 to study the reform of the FILP, which currently funds government investment projects, largely using Postal Savings deposits and public pension system surpluses. The new panel, which is expected to discuss a wide range of issues, including the appropriateness of letting the FILP manage Postal Savings and insurance funds, is expected to prepare options for the reform of the FILP by the end of 1997.

83. In this regard, the Ministry of Posts and Telecommunications released an analysis in June 1997, which suggested that the postal system would run combined annual losses of ¥60 billion if privatized (compared to current profits of ¥660 billion).[47] According to the study, some 90 percent of post offices would lose money on mail delivery, and up to 60 percent would record losses from running postal savings, in part because they would have had to pay deposit insurance premiums and other charges. While metropolitan offices would likely be profitable if privatized, those in less-populated regions would have larger losses. These considerations illustrate the potential problems—both economic and political—for radical reform.

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[46]No decisions has yet been made on how to handle the Pension Welfare Service's fund management division, currently saddled with more than ¥1 trillion in cumulative losses.

[47]A detailed description of the Postal Saving system is given in "Postal Savings in Japan" in *Japan—Selected Issues*, IMF Staff Country Report 90/114 (October 1996).

IV. Banking Sector Developments

84. Important progress has been made over the past year in addressing the difficulties in the Japanese banking sector. Plans were implemented to liquidate the insolvent *jusen* (housing loan corporations), and three financial laws were enacted in June 1996 to strengthen regulators' discretionary powers to take prompt corrective actions (PCA) to prevent failures, to declare distressed banks insolvent, and to resolve failed banks by using the enhanced deposit insurance system.[48] The authorities have also dealt with a number of smaller institutions in an expedient and transparent manner. These steps, together with the aggressive write-offs of problem loans in FY 1995, contributed to growing market sentiment that the worst of the banking sector's difficulties were over.

85. Concerns regarding the health of the banks' balance sheets, however, reemerged in late 1996 owing to a drop in equity prices and concern in the market that the proposed "Big Bang" financial reforms would negatively affect profitability. The ensuing funding difficulties of some of the major banks led to the announcement in early April that two of the weaker major banks would be restructured, with NCB receiving substantial support from the public sector.

A. Size of the Problem

86. The Ministry of Finance (MOF) releases figures on problem loans in the financial sector on a biannual basis, based on a survey of individual institutions.[49] These data, revised as of end-March 1997, place total problem loans at ¥28 trillion (about 6 percent of GDP) (Table IV.1). Private analysts typically arrive at a much higher figure. For instance, IBCA, a U.K.-based bank rating agency, places total problem loans at ¥69 trillion (14 percent of GDP). Some of the difference, however, reflects the accounting treatment of past loan write-offs. In particular, private analysts typically construct a "gross" figure based on the original book value of various loans that have been written down. The amount written off is then treated as a "reserve" against gross problem loans. It should also be noted that Japanese criteria for accounting for problem loans are less stringent than those in the United States, and the adoption of U.S. criteria would imply a larger estimate of the total problem (Box IV.1).

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[48]For a description of the *jusen* issue, see *Japan—Recent Economic Developments*, IMF Staff Country Report No. 96/90 (September 1996). The PCA measures are scheduled to be implemented starting in April 1998.

[49]Problem loans include nonperforming loans (loans to borrowers that have legally been declared bankrupt and loans on which interest has not been paid for 180 days), and restructured loans (loans on which interest rates have been reduced to below the official discount rate prevailing at the time).

Table IV.1. Japan: Estimates of Problem Loan Held by Deposit-Taking Institutions[1]

(In trillions of yen)

	Official	IBCA
Problem loans[2]	27.9	69.1
(In percent of loans)	3.9	9.7
(In percent of GDP)	5.7	13.5
Major banks	16.4	40.0
Regional banks	5.3	14.5
Cooperatives	6.1	14.6
Estimated unrecoverable loan losses[3]	17.0	49.3
Major banks	9.8	30.0
Regional banks	3.3	11.0
Cooperatives	4.0	8.3
Loan loss reserves[4]	12.3	35.4
Major banks	8.1	26.2
Regional banks	2.4	6.2
Cooperatives	1.9	3.0
Estimated uncovered losses	4.7	13.9
(In percent of GDP)	0.9	2.7
Major banks	1.7	3.8
Regional banks	0.9	4.8
Cooperatives	2.1	5.3
Memorandum item:		
Net operating profits (average of FY 1992–96)	6.7	6.7
Major banks	3.7	3.7
Regional banks	1.7	1.7
Cooperatives	1.4	1.4

Sources: Ministry of Finance; and IBCA.

[1]Official: End-March 1997.
IBCA: major banks, end-March 1997; for other institutions, end-September 1996.
[2]Official: loans to borrowers in bankruptcy, loans over six months overdue and loans restructured at interest rates below the official discount rate (currently ½ percent).
IBCA: official problem loans, loans to *jusen*, original loan principal sold to the CCPC, problem loans of affiliated banks, and loans to customers for support.
[3]Official: 66 percent of nonperforming and 33 percent of restructured loans.
IBCA: loans to *jusen* plus 75 percent of remaining problem loans.
[4]Official: specific reserves.
IBCA: specific reserves, losses already recorded on loan sales to the CCPC, *jusen* loans, and other direct charge-offs.

Box IV.1. Japanese and U.S. Criteria for Problem Loan Disclosure

Japanese and U.S. criteria for disclosure of problem loans differ in the following respects:

- In Japan, nonperforming loans are defined as those loans to borrowers in bankruptcy and those loans on which interest has not been paid for six months (restructured loans are also counted as nonperforming loans). In the United States, a loan is nonperforming when based on current information and events, it is probable that a creditor will not be able to collect all amounts due according to the contractual terms of the loan agreement.

- U.S. banks are generally not allowed to lend new money to problem borrowers, to capitalize interest, to accrue interest beyond 90 days, or to buy collateral in excess of its true value, and to transfer problem loans to unconsolidated affiliates.

- In Japan, restructured loans are defined as those loans on which the interest rate has been reduced to below the official discount rate. In the United States, the definition of restructured loans is broader. Such loans include those whose terms have been modified, because of a deterioration in the financial conditions of the borrower, to provide for a reduction in either interest or principal.

- In the United States, balance sheets are consolidated and include the problem loans of affiliates, but in Japan the accounts are unconsolidated.

- In the case of one major Japanese bank, which is listed on the New York Stock Exchange and discloses problem loans according to U.S. criteria, problems loans at end-March 1996 were 32 percent higher by U.S. criteria than by Japanese criteria.

87. As an example, banks have sold about ¥13 trillion of loans to the Cooperative Credit Purchasing Company (CCPC), taking a write-off of ¥8 trillion.[50] IBCA considers the original value of these loans to represent problem loans, but treats the amount written off as a reserve against future losses. Collectively, accounting differences of this type explain about

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[50]The CCPC is an asset liquidation company established by banks and the government in January 1993 to take over the banks' nonperforming loans at a discount on their face value (based on the estimated market value of the collateral) and enable them to take tax-deductible write-offs on the losses (see *Japan—Recent Economic Developments*, IMF Staff Country Report No. 96/90 (September 1996)). While the CCPC has facilitated the write-down of problem loans, it has only liquidated a small portion of the collateral associated with these loans. Until the collateral is sold, the banks retain contingent liabilities. As of end-April 1997, ¥13.6 trillion in loans had been sold to the CCPC at an average discount of 60 percent, while the CCPC had sold only ¥0.8 trillion of the collateral (Table IV.2). As a result, the banks had contingent liabilities of ¥4.6 billion to the CCPC, although this figure is likely to be substantially reduced as further collateral is realized.

¥25 trillion of the gap between the IBCA and the official figures. Beyond this, there are more fundamental differences in definition. IBCA, for instance, includes estimates of loans to borrowers to which the lending bank is extending help, as well as recapitalized loans and loans that have been restructured at above the official discount rate.

88. While the scale of the problem is clearly large, Japanese banks have in recent years made significant progress in provisioning for potential loan losses. The ultimate loss on problem loans is likely to be substantially less than the gross amount of bad loans, since not all problem loans will be unrecoverable, and banks have accumulated significant reserves against losses.[51] Official and IBCA estimates of irrecoverable losses that are not covered by loan loss reserves, (i.e., *uncovered losses*), are about ¥4.7 trillion (0.9 percent of GDP) and ¥13.9 trillion (2.7 percent of GDP), respectively (Table IV.1).

89. Assuming that recent levels of operating profits are sustained, remaining uncovered losses of the overall banking sector, on average, should be completely provisioned for in the next few years. However, as described below, many individual banks, including the weakest of the major banks, appear to face more severe difficulties.

B. Framework for Resolving Failed Institutions

90. In order to make the resolution mechanism for financial institutions more explicit and to establish a rules-based supervisory framework, the authorities have recently enacted several laws and have created a new financial supervision agency. Three financial laws were enacted in June 1996, which aimed at bolstering the supervisory and deposit insurance systems:

- A law concerning the assurance of sound banking management, including: allowing the authorities to require prompt corrective actions (PCA) to prevent failures and problems in financial institutions, based on objective criteria such as capital-adequacy ratios; applying mark-to-market accounting principles to trading accounts; and strengthening the auditing of cooperative-type financial institutions.[52]

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[51]Officially, 66 percent of nonperforming and 33 percent of restructured loans are assumed to be unrecoverable.

[52]Although the details of Japan's prompt corrective action standards have not yet been released, they appear to be somewhat more lenient than those applied in the United States. For example, under Japanese PCA standards, regulators may close a bank if the bank's capital-asset ratio falls below zero, whereas in the United States, the threshold is 2 percent.

Table IV.2. Japan: Business Results of Cooperative Credit Purchasing Company (CCPC), FY 1993–97

(In billions of yen)

	Number of Transactions	Face Value	Price	Discount (In percent)	Value of Recoveries
FY 1993	1,891	3,838.3	1,778.9	53.6	30.2
FY 1994	3,077	4,038.0	1,591.0	60.6	141.5
FY 1995	3,154	3,577.5	1,182.0	70.0	260.9
FY 1996	1,425	1,444.8	409.5	71.6	381.2
1996					
April	26	26.3	6.6	75.0	24.8
May	18	14.0	4.4	68.6	23.9
June	45	75.3	22.3	70.4	28.8
July	50	57.4	15.6	72.8	31.6
August	38	61.5	17.4	71.7	26.9
September	547	548.1	158.0	71.2	35.0
October	36	49.4	12.7	74.3	25.6
November	6	18.5	4.0	78.4	27.2
December	26	108.2	28.1	75.0	46.2
1997					
January	73	75.3	16.8	77.7	22.7
February	92	47.1	15.1	67.9	32.6
March	468	363.8	108.4	70.2	55.9
April	18	40.2	6.4	84.1	18.8
Total	9,794	13,620.4	5,420.2	60.0	831.6

Source: Data provided by the Japanese authorities.

- A law providing procedures for reorganizing financial institutions by: enabling the regulators to initiate corporate reorganization or bankruptcy procedures for financial institutions; and empowering the Deposit Insurance Corporation (DIC) to act as the agent of depositors.

- Amendments to the deposit insurance law, including: increasing the deposit insurance premium fourfold to 0.048 percent; charging an additional premium of 0.036 percent for the following five years to establish special funds for depositors of ordinary financial institutions and credit cooperatives to extend financial assistance beyond the insurance payments limit. The legislation also provided a government guarantee to the DIC to borrow from the Bank of Japan and/or private financial institutions through the Special Account for Credit Cooperatives through end-FY 2000, which meant that all credit cooperative deposits, including those beyond the insurance payments limit (i.e., deposits in excess of ¥10 million), are effectively "insured" by the government until March 2001. Notwithstanding the fact that this government guarantee strictly applies to only credit cooperatives, the authorities have stressed that all bank deposits would be protected for the next five years.

91. In addition, in June 1997, the Diet enacted legislation to create a new financial supervision agency, the Supervisory Agency for Financial Entities (SAFE). The new agency will report directly to the Prime Minister's Office, and will take over the inspection and supervision of financial institutions from the MOF in June 1998. The MOF, however, will retain responsibility for setting policy and drafting legislation for the financial sector. The SAFE will oversee the activities of most domestic financial institutions, including banks, securities firms, life insurance companies, agricultural and workers' cooperatives, and nonbanks. The oversight of agricultural and workers' cooperatives and nonbanks will be shared with the Ministries of Agriculture, Labor, and Trade and Industry, respectively.

92. The resolution of troubled banks will be an important function of the new agency. Banks failing to meet prompt corrective action criteria would be worked out, or if necessary, closed. However, while the new agency would have sole discretion to close banks, this discretion would be limited to institutions without large-scale depositors (i.e., deposits beyond the DIC insurance payments limit of ¥10 million). The closure of a bank with such depositors would require, indirectly, the permission of the MOF. As mentioned, deposits beyond the insurance payments limit are covered by funds in the "special accounts" of the DIC in the form of special financial assistance. This extension of special financial assistance requires MOF approval.

C. Resolving the Difficulties of the Major Banks

93. Until FY 1996, the strategy for resolving problems among the major banks was to encourage them to use their operating profits to gradually write off bad loans.[53] In addition, the banks were permitted to make tax-deductible loan-loss provisions, including by selling

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[53]Major banks include city banks, long-term credit banks, and the trust banks.

their nonperforming loans to the CCPC. However, FY 1996 was marked by increased differentiation among banks of their ability to resolve their problems in a timely manner. Increased doubt by markets about the ability of the weaker banks to grow their way out of problems led to increased risk premia and the announcement that Nippon Credit Bank and Hokkaido Takushoku Bank would be restructured.

The major banks' FY 1996 results

94. As shown in the following tabulation, aggregate net operating profits (*gyomu-juneki*) of the major banks continued to be strong in historical terms, registering ¥4.6 trillion in FY 1996, down slightly from a record ¥4.8 trillion in the previous year. The continued strength was primarily attributable to robust net interest revenue due to the favorable interest rate environment. Net interest revenue rose by 9 percent from FY 1995, while non-interest revenue sagged by 32 percent, primarily due to the fall in net profits on investment bonds.

Results for Major Banks
(In trillions of yen, except where indicated)

	March	
	1996	1997
Nonperforming loans	13.1	13.2
Restructured loans	8.8	3.2
Loans for customer support	3.8	2.9
Specific loan-loss reserves	9.1	8.1
Hidden reserves	16.5	8.8
Total loans	391.9	395.3
Risk-weighted capital ratio (in percent)	9.1	9.0
Net operating profits	4.8	4.6
Of which		
Net interest income	6.7	7.3
Net gains/losses on securities	3.4	3.5
Loan loss provisions and write-offs	11.0	6.1
Net income	-3.6	-0.1

Sources: IBCA; and Ministry of Finance.

95. With the Nikkei 225 stock price index falling to 18,003 at end-FY 1996 from 21,406 at end-FY 1995, banks' hidden reserves (i.e., the unrealized capital gains on stocks) fell to ¥8.8 trillion from ¥16.5 trillion. To partially offset the effect of these losses on their capital positions (45 percent of hidden reserves may be counted as Tier 2 capital), a number of banks generated capital gains by selling some of their remaining low-book value equities, thereby realizing a ¥3.5 trillion profit on their equity holdings. Since banks repurchased most of these

shares at a higher book value, the exposure of their balance sheets and their income to the stock market has increased.[54]

96. Banks' loan-loss charges amounted to ¥6.1 trillion in FY 1996. Part of these charges were covered by net operating profits and capital gains on the sale of equity. As a result, the major banks recorded an aggregate net loss of ¥0.1 trillion, well below the net losses of ¥3.6 trillion recorded in FY 1995.

Capital adequacy of the major banks

97. Given the small aggregate net loss for the major banks, Tier 1 capital was roughly stable at 4.7 percent at end-FY 1996, compared with FY 1995.[55] With the fall in equity prices lowering hidden reserves, the major banks' average Tier 2 capital ratio fell to 4.3 percent at end-FY 1996 from 4.6 percent at end-FY 1995. Of Tier 2 capital, the share of subordinated debt jumped to 74 percent from 64 percent. Thus, banks total capital ratios fell slightly to 9.0 percent from 9.1 percent at end-FY 1995.

Resolving the difficulties of Nippon Credit Bank and Hokkaido Takushoku

98. On April 1, Nippon Credit Bank (NCB), the smallest of Japan's long-term credit banks, announced a major restructuring plan. This announcement followed the downgrading of NCB's obligations by Moody's to junk bond status, which meant that NCB found it extremely difficult to roll over its maturing debentures.[56] The restructuring plan called for the immediate write-off of loans to three nonbank affiliates, which were to be liquidated, staff cuts of more than 20 percent, the sale of property (including NCB's head office in Tokyo and other domestic retail outlets), and withdrawal from international operations. In order to maintain an adequate capital base, the bank would issue new equity to the New Financial Stabilization Fund (NFSF), city banks, long-term credit banks, and life and casualty insurance

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[54]Banks are required to charge unrealized capital losses on their securities against income. If banks realize capital gains on their securities holdings by repurchasing them at a higher price, their reported income becomes more dependent on stock market variations, as they would suffer valuation losses if the market falls below cost.

[55]Tier 1 capital consists of shareholders' funds plus minority interests in subsidiaries minus proposed distributions. Tier 2 capital consists of general loan loss reserves, subordinated debt, and 45 percent of "hidden" reserves.

[56]The long-term credit banks are required to fund themselves by issuing long-term (chiefly five- year) debt instruments.

companies, amounting to ¥290 billion.[57] In spite of these actions, NCB would fall below the 8 percent BIS capital adequacy guideline.

99. At the same time, Hokkaido Takushoku Bank, the smallest of Japan's city banks, announced plans to merge with a regional competitor, Hokkaido Bank; sharply reduce personnel and operating expenses; and close overseas operations.

100. The announcements appear to have helped confirm the authorities' commitment to supporting the major banks and reassured markets. However, concerns have been expressed that the NCB restructuring did not provide a framework for resolving the difficulties of other major commercial banks and have placed an ad hoc responsibility on healthy institutions to support their weaker counterparts.

D. Resolving the Difficulties of the Smaller Financial Institutions

Recent bank failures[58]

101. Of the smaller financial institutions, four credit cooperatives and one regional bank failed during FY 1996, bringing the total of failed credit cooperatives and regional banks to eleven and three, respectively, since the onset of the recent banking sector problems.[59] In all cases, depositors have been protected and shareholders were required to write off their claims on the failed banks. In addition, the closures have involved the extensive use of DIC funds, and in the case of Hanwa bank, Bank of Japan (BOJ) loans under Article 25 have been extended (see Box IV.2).

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[57]The NFSF was established by the BOJ and the commercial banks. Of the ¥290 billion, ¥80 billion would come from the NFSF.

[58]Small banks can be divided into regional banks and cooperative financial institutions. There are two types of regional banks, the first and second tier regional banks; and three types of cooperative institutions, *shinkin* banks, workers' cooperatives, and credit cooperatives. The first tier regional banks, *shinkin* banks, and agricultural cooperatives are relatively healthy.

[59]The four failed credit cooperatives were Sanyo, Kenmin-Daiwa, Sanpuku, and Hanshin-Rohdoh. The failed regional bank was Hanwa.

Box IV.2. Article 25 of the Bank of Japan Law

- Under Article 25 of the Bank of Japan Law, and subject to approval of the MOF, the BOJ may take any action considered necessary to maintain the stability of the financial system.
- Since the onset of banking sector problems, the BOJ has periodically invoked Article 25 in lending and in injecting capital. Most of the loans were used to pay the depositors of failed institutions, and the BOJ is expected to be repaid by the DIC once the institutions are resolved. Indeed, the BOJ has already been reimbursed in full for loans to Cosmo Credit, Kizu shinkin bank, and Hyogo Bank.
- BOJ funds have been used to provide direct support for depositors of failed institutions, and to capitalize the Resolution and Collection Bank (RCB) and the New Financial Stabilization Fund (NFSF).
- Over the past two years, the BOJ has made allowances amounting to ¥780 billion in FY 1995 and ¥430 billion in FY 1996, to cover, inter alia, losses from bad loans and fluctuations in exchange rates and government bond prices.

102. The Hanwa bank resolution was important in that it was the first failed regional bank to be liquidated. The institution was closed, its problem assets were transferred to the Deposit Insurance Corporation, and collection will be handled by the Resolution and Collection Bank (RCB).[60] In contrast, the two regional banks that failed previously, Hyogo and Taiheiyo, were ultimately recapitalized with the help of other commercial banks—the old "convoy" system—and survived as going-concerns, although under new names.[61]

[60]The RCB was established in September 1996 to facilitate the disposal of failed credit cooperatives during the next five years. Since then, the assets of all failed credit cooperatives have been transferred to the RCB, with the exceptions of Yuai and Fukui-ken-Daiichi.

[61]Hyogo and Taiheiyo became Midori and Wakashio banks, respectively.

Table IV.3. Japan: Bank of Japan's Accounts, FY 1993–96

(In billions of yen)

	FY 1993	FY 1994	FY 1995	FY 1996
Total revenues	2,732.1	1,939.8	2,322.5	2,632.5
Total expenses	974.5	894.9	1,610.8	1,489.3
Of which				
Transferred to allowance for losses	114.1	8.3	779.9	432.8
Net income	1,757.6	1,044.8	711.8	1,143.2
Appropriations of net income:				
Transfers to legal reserve	87.9	52.2	35.6	57.2
Transfers to general reserve	17.6	10.4	7.1	11.4
Dividends	0.0	0.0	0.0	0.0
Payments to Japanese government	1,652.2	982.1	669.0	1,074.6
Total capital 1/	2,624.4	2,532.0	2,016.4	2,685.6
Of which				
Legal reserve	1,005.3	1,065.8	1,131.1	1,156.3
General reserve	859.9	872.0	885.1	890.2
Specific reserve	0.0	0.0	0.0	0.0
Equity	0.1	0.1	0.1	0.1
Net income	759.0	593.9	0.0	638.9

Source: Bank of Japan, *Annual Review*, various issues.

1/ End of year.

Small bank failures and the DIC

103. Private analysts believe that several second-tier regional banks and many credit cooperatives are insolvent. The disposal cost of these institutions is estimated by market participants to be anywhere from ¥750 billion (less than ¼ percent of GDP) to ¥8½ trillion (over 1½ percent of GDP). The MOF estimates that the recent increases in DIC premia would generate a total DIC income of around ¥2½ trillion over the next five years. Disposal costs at the low end could therefore be covered by DIC funds, while losses at the high end may require as much as ¥6 trillion (1¼ percent of GDP) of additional funds.

104. These funds could be provided to financial institutions either via direct budgetary outlays by the central or local governments or via the BOJ. As mentioned, the recent amendment to the deposit insurance law has legislated the use of public funds to resolve problems at credit cooperatives if there is a shortage of funds at the time of the closing of the "special accounts" after six years. A notable provision of the law is that the government can guarantee the borrowing of the "special accounts," which opens the door to the systematic use of public money. In addition, the DIC can borrow up to ¥2 trillion from the BOJ and private financial institutions.[62]

[62]This includes ¥1 trillion from the BOJ to the General Account, and ¥1 trillion from the BOJ and private financial institutions to the two special accounts.

V. Structural Reform and Deregulation

105. The Japanese Government has actively pursued structural reform in recent years with the objectives of promoting market access, reducing price differentials from those abroad, and raising consumer welfare. The beneficial economic effects of these reform initiatives, particularly in the retail and telecommunications sectors, are beginning to become apparent. More recently, two packages of deregulation measures were approved by the cabinet in the first half of 1997, which include significant deregulation of the transportation and electricity generation sectors, as well as further deregulation in the area of telecommunications.

106. Until recently, the basic policy intentions for deregulation and structural reform were developed with reference to the reports of two advisory groups. The suggestions of the first group, contained in the 1986 Maekawa report, were ambitious and wide ranging. However, without a mechanism for ensuring that the recommendations of the report generated policy initiatives, many of the proposed reforms have not been implemented. A more recent set of objectives was initiated by the Advisory Group for Economic and Structural Reform, which issued the Hiraiwa report in December 1993.

107. With these reports as a backdrop, successive Japanese governments have implemented a number of deregulation packages. Policy initiatives in the early 1990s included an overhaul of land taxes, reforms to the distribution system, and continuing moves toward financial market reform. More recently, the government announced several packages containing large numbers of measures. Three such packages containing a total of 1,382 items were announced in 1993 and 1994. In March 1995, the government unveiled a five-year Deregulation Action Plan (DAP) covering 1,091 items, and the implementation period was shortened to three years shortly thereafter. Under the umbrella of the DAP, further deregulation packages containing 1,797 and 2,823 items were announced in March 1996 and March 1997, respectively.[61]

108. The measures included in these recent packages have often overlapped and differed widely in scope. While some items have been very specific, others have only designated areas for further review and have lacked detail. This diversity, which has often made it difficult for outside commentators to assess the impact of the announced measures, reflects the decentralized nature by which the measures have been chosen. While the Prime Minister's Office coordinates these efforts, the main responsibility for proposing and implementing measures rests with individual ministries. In addition, the fact that deregulation in Japan has sometimes been in response to pressure from other countries may have created a desire to be seen to be doing more each year, and hence an emphasis on the number of measures proposed.

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[61]Comprehensive details of each of the specific measures, including the timetable for completion, are available in Japanese.

109. The DAP also contained an important administrative change, namely the formation of the Administrative Reform Committee (ARC). This committee, comprised of academics, business people, and other non-government representatives, was established as a way of setting an agenda for reforms, and makes its recommendations directly to the Prime Minister. The deregulation subcommittee of the ARC, which will be disbanded with the rest of the ARC in December 1997 under current plans, provides a mechanism through which plans for deregulation generated by various panels can be turned into concrete initiatives, thereby reducing the problems of moving from proposals to action. Such a role is particularly important currently, as the Hashimoto government has formed a large number of blue ribbon panels as part of its drive to ensure a rapid pace of deregulation.[62] In many respects, the deregulation subcommittee would seem to be an obvious conduit for organizing and prioritizing the recommendations from these panels, and thus turning such recommendations into actions.

110. The government has not announced a successor to the DAP, in part because it was felt that any extension of the DAP would provide ministries with an excuse to delay reforms. However, the importance that the government gives to structural reform was underlined by the announcement of a further reform package in May of this year, less than two months after the final DAP package.

A. Recent Policy Initiatives

111. During 1994 there were deregulation initiatives in a number of areas. Rules on the operations of large retail stores were eased and large stores were permitted to acquire liquor licences. Sales of cellular telephones were allowed (previously only leases were permitted) and international satellite communications were opened to foreign firms. Gas charges and rules defining large-lot users were deregulated, interest rates on demand deposits were liberalized, and commercial banks were allowed to participate in securities business through subsidiaries. Initiatives in 1995 and 1996 included: abolition of the Oil Products Import Control Law, which restricted imports to companies with refinery and storage facilities; alignment of the system of standards, certification, and labeling with international norms; improving customs clearance for imports; simplifying inspection rules for automobiles; reducing restrictions on the importation of building materials; relaxation of pension fund management rules; deregulation of cellular telephone service rates; and changes to the foreign exchange rules for companies.[63]

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[62]Such panels include the Action Plan Committee of the Economic Council, which reports to the Prime Minister, and the Committee on Foreign Exchange and Other Transactions, which reports to the Finance Minister.

[63]Further details can be found in *Japan—Recent Economic Developments*, IMF Staff Country Report No. 96/90 (September 1996).

112. The package of measures approved by the cabinet in March 1997 involved significant reforms in the areas of transportation, telecommunications, and finance (the "Big Bang" initiative is covered in Chapter VI on the financial system):

- **Transportation.** The government announced plans to eliminate the supply-demand adjustment system for civil aviation by the end of FY 1999 and for taxis and buses by the end of FY 2001. The supply-demand adjustment system limits the numbers of flights, taxis, and buses in a particular sector or region to demand (as perceived by the government). The ending of these restrictions is expected to encourage new entrants and to significantly increase competition.

- **Telecommunications.** Restrictions on foreign equity holdings in telecommunications companies, except Nippon Telegraph and Telephone (NTT) and Kokusai Denshin Denwa (KDD), are to be abolished, as are similar restrictions on cable TV companies.

- **Other initiatives.** Some restrictions on the size of condominiums in big cities were lifted, and the government announced plans to review the Large Scale Retail Stores Law by the end of FY 1997, to look into whether to accept lawyers with degrees from other countries by the same date, and to review the possibility of allowing companies to enter into agricultural management by the end of FY 1998.

113. The package of measures approved by the cabinet in May 1997 were designed to increase Japanese companies' competitiveness by cutting the cost of energy, distribution and telecommunications. The package included the following proposals:

- **Energy sector.** The government expects to implement a two-stage cut in electricity charges, the first in 1998 and the second in 2000. Numerical targets will be set for curbing peak loads of electricity demand. (Such peak loads are reported to be a major reason for the high costs of electricity in Japan, as they require costly new investment in power plants). The government will also produce specific plans within a year to increase competition in the power generation industry by creating a level playing field between existing utilities and new industry entrants. Press reports indicate that consideration will also be given to separating the financial accounts for power-generation and power-distribution services, so as to increase transparency and efficiency in the power generation sector.

- **Distribution.** The government is committed to ending all demand-supply restrictions in this sector by 2001. The deadline for reviewing the Large Scale Retail Store Law was also moved forward from end-March 1998 to end-December 1997.

- **Telecommunications.** The plan calls for telecommunications costs to be reduced to an internationally competitive level by 2001, in part by promoting competition through reviewing methods for setting fees.

- **Other sectors.** The plan identifies 15 strategically important business sectors (including distribution and telecommunications) that, it estimates, could create an extra 7.4 million jobs by 2010. However, the proposals for deregulating these sectors generally lack specifics or refer to pending reports from official commissions. In addition, regulations on joint-research activities between national universities and private businesses were reduced, plans to amend the Anti-Monopoly Law to allow more flexibility in corporate mergers and to review the corporate tax system were announced, and constraints on securities firms' ability to handle unlisted securities were reduced so as to allow more capital to flow into new businesses.

114. In addition to these two packages of measures, progress has also been made on structural reform in several other areas during the year. The first is the abolition of the ban on holding companies.[64] Proposals to end the ban on nonfinancial holding companies by January 1998 have recently been passed by the Diet, although holding companies would still be banned if: (a) the assets of the holding company exceeded ¥15 trillion (3 percent of GDP); (b) if the company owned a large-scale financial company and other companies not engaged in finance; or (c) the company owns businesses with a high degree of influence over interrelated fields. In addition, the Anti-Monopoly Act would also apply to any holding companies. Ending the ban on financial holding companies requires separate legislation, which is still being prepared by the Ministry of Finance. This legislation will probably be submitted to the Diet during the fall, with the aim of having the bans on financial and nonfinancial holding companies lifted at the same time.

115. There is, however, concern that the ban on holding companies may not be effective without reform of the corporate tax system. Currently, taxes are levied on companies on an unconsolidated basis. In the absence of moves to allow companies to have their tax assessed on a consolidated basis, there will be little financial incentive for the creation of holding companies. The proposed breakup of NTT into three smaller companies, a long-distance carrier and two local providers covered by a single holding company, is a good illustration of this point in that NTT was given tax incentives that lowered the tax liabilities of the three new companies under the new holding company arrangement.

116. In the labor market, bills to reduce job discrimination against women and to remove measures limiting overtime and late night work for women have recently passed the Diet. In addition, the government also announced earlier this year a review of Japan's Labor Standard Law. The Law, enacted in 1947 to protect workers' rights, has been criticized for perpetuating labor market rigidities. Press reports indicate that consideration will be given to increasing the number of industries qualifying for the discretionary wage system (where employers do not have to calculate wages on an hourly basis), to extending the permissible maximum number of daily and weekly work hours (including overtime) from the current

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[64]A holding company is a company which owns a number of subsidiary enterprises.

10 hours and 52 hours, respectively, to allowing temporary work contracts of longer than one year, and to obliging employers to spell out working conditions when a contract is signed.

117. Opinions on whether the impetus for structural reform will strengthen or weaken over the new few years remain divided. There is a concern amongst some commentators that the impetus for reform may diminish as economic recovery takes hold. As the sense of economic crisis wanes, this argument goes, the perceived need to fundamentally reform the economy will likewise diminish. On the other hand, many commentators argue that the current government is genuinely committed to structural reform, which implies that the impetus for further measures is likely to continue as the economy recovers. Indeed, there is an argument that the recovery may make it easier to carry out such reforms, as prosperity will make the short-term economic costs caused by structural reforms easier to bear. In addition, deregulation measures in one area often generate pressures for measures in other areas. For example, the plan to breakup Nippon Telephone and Telegraph (NTT) into three separate companies by 1999, finalized late last year, required that the ban on holding companies also be lifted by this date.

118. Any diminution of the impetus toward structural reform would be unfortunate. Recent work by the Economic Planning Agency (EPA), which indicates that past deregulation has provided tangible economic benefits over the last few years, illustrates the potential gains from such policies. Analyses of the current situation uniformly indicate that significant economic gains from deregulation remain to be exploited. Indeed, a recent analysis by the OECD across the five major industrial countries indicates that Japan has the most to gain from deregulation in five major sectors of the economy. These estimates of the economic gains from deregulation are discussed further below.

B. Estimates of the Economic Benefits of Deregulation

119. Deregulation remains an important policy issue in Japan. As such, it has attracted a significant amount of analysis, focusing on the potential economic gains from reducing the level of regulation in the economy. Table V.1 shows an estimate of the extent of regulation across a range of industrial sectors in 1965 and 1990. With the important exceptions of manufacturing and real estate transactions, regulation remained the norm in most areas of Japanese industry, at least as of 1990.

120. The impact of **past deregulation** was analyzed recently in an EPA report. It contains two approaches to estimating the average gains to the economy from 1990–95 of existing deregulation efforts. The first looks at the impact on aggregate demand across different economic sectors, with separate estimates of the impact on consumption, investment, and GDP.[65] The second approach estimates the gains to deregulation by calculating the fall in manufacturers' costs, calculated by multiplying the fall in price by output of the industry.

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[65]The values for GDP utilize estimates of the impact on imports.

Table V.1. Regulatory Coverage by Industry 1/

Industry	Share of Industry Covered by Regulation 1965	1990
	(In percent)	
Agriculture, forestry, and marine produces	85.7	87.1
Mining	100.0	100.0
Construction	100.0	100.0
Manufacturing	23.4	14.1
Wholesale and retail	...	...
Finance, insurance, and stockbroking	100.0	100.0
Real estate	2.6	7.5
Transport and communications	98.8	97.3
Electricity, gas, water and heat supply	100.0	100.0
Services (including education, health, and welfare)	72.8	55.6
Government services	...	...
Other	...	...
Total	47.8	41.8

Source: Seiji Shimpo and Fumihara Nishizaki, "Measuring the Effects of Regulatory Reform in Japan: A Review," Discussion Paper No. 74, Economic Research Institute, Economic Planning Agency (March, 1997).

1/ The existence of legislation in any form in a given industry (classified according to input-output tables) is considered to represent regulation throughout the industry. Deregulation under the relevant legislation therefore does not necessarily alter the fields subject to regulation. Where legislation applies to only a certain field, all added value in that field is considered to be subject to regulation. Where a legislation cannot be defined by the classifications in the input-output tables, it is disregarded in the calculation.

121. The starting point for both calculations involves estimating how much deregulation has lowered prices in specific sectors of the economy. To calculate the impact on demand, these price changes are combined with demand elasticities to estimate the induced change in real consumption. Estimates of the impact of deregulation on investment and imports are then added so as to gauge the impact on GDP. The estimate of the reduction in costs—and hence the gain to production from deregulation—multiplies the reduction in price by the output of the industry. As GDP can be calculated either from the demand side or the production side, these two calculations should produce similar estimates of the economic benefits from deregulation.

122. Table V.2 reports the results by broad industrial sector. Focusing first on the estimates of the impact of deregulation on demand, the results indicate that deregulation increased consumption by ¥4.7 trillion (1 percent of GDP) and GDP by ¥7.3 trillion (1½ percent of GDP) on average in each year during 1990–95. To the extent that the gains from deregulation have risen over time, the benefits in 1995 would be larger than the average over 1990–95.

123. The demand calculations indicate that the benefits from deregulation have been heavily concentrated in a limited number of industries. The retail sector is responsible for over half of the estimated increases, with benefits of ¥3.9 trillion (¾ percent of GDP). Another sector with significant increases in real demand is telecommunications, where the benefits are estimated to be ¥2 trillion. Finally, significant benefits are estimated to have been produced by financial deregulation in capital markets.[66]

124. In addition to this estimate of the benefits from past deregulation, there are a number of estimates of the **potential gains from future deregulation** on the Japanese economy. A recent study by the OECD is particularly useful in this regard, as it compares performance across five industries for five major industrial nations, including Japan.[67] The study found that, in Japan, deregulation had the potential to raise labor productivity by 10–25 percent and capital productivity by 10–40 percent in all of the industries that were studied. The potential long-run gain to GDP from deregulation was estimated to be 6.4 percent of Japanese GDP, the largest gain amongst the five countries.[68] As the data from the study relate to the early

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[66]The alternative calculations, based on costs reductions, show similar benefits for telecommunications and finance. They provide no estimate for the benefits to the retail sector, but do estimate significant savings for power generation and petrochemicals.

[67]The industries were electricity, airlines, road transportation, telecommunications, and distribution. The other economies were the United States, Germany, France and the United Kingdom.

[68]The estimated long-term gains were 0.9 percent of GDP for the United States, 5.4 percent for Germany, 4.8 percent for France, and 3.5 percent for the United Kingdom.

Table V.2. Impact of Deregulation on Demand and Costs 1/

(In billions of yen)

	Demand			Reduction in Costs
	Consumption	Investment	GDP	
Retail 2/	2,990	917	3,907	...
Telecommunications	1,285	707	1,992	1,231
Finance 3/	0.0	701	701	640
Power generation	...	...	...	952
Petrochemicals	...	...	...	874
Other	426	271	583	914
Total	4,701	2,596	7,282	4,621

Source: EPA. See text for details.

1/ Average annual impact during 1990–95.
2/ Net of impact on small retail stores.
3/ Convertible bonds and commercial paper.

1990s, some of these gains may have already been realized, but significant benefits from further deregulation in these sectors clearly remain.

125. In addition to studies which focus on particular industries, there have also been a number of estimates of the potential impact of economy-wide impact of deregulation, whose results are summarized in Table V.3.[69] Generally, these studies have started from an estimate of how much deregulation will reduce the price differential between Japan and other major industrial countries, notably the United States. Estimates of the potential increases in GDP range from 2.3 to 18.7 percent, with the smaller results generally incorporating assumptions about import liberalization and hence the leakage of some of the increase in demand abroad.

126. Most of these studies are static, and do not consider the speed at which these increases in GDP might be realized. An exception is the OECD report discussed above, which estimates that about half of the gains from deregulation could occur within five years. A recent EPA study looking at eight sectors of the economy estimated that recent deregulation proposals could increase real GDP growth over FY 1998–2003 by 0.9 percent per annum.[70] However, as noted earlier, many of the stated proposals are not supported by concrete measures.[71]

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[69]See Seiji Shimpo and Fumihira Nishizaki, "Measuring the Effects of Regulatory Reform in Japan: A Review," Discussion Paper No. 74, Economic Research Institute, Economic Planning Agency. They also provide details of several sector-specific studies.

[70]"Economy-Wide Effects of Economic Structural Reforms in Japan: FY 1998–2003," EPA (June 1997). The eight sectors are finance, telecommunications, transportation, energy, land and housing, health care and welfare, and the labor market.

[71]An earlier study by the Japan Committee for Economic Development estimated that comprehensive deregulation could raise growth in Japan by one percent per annum during 1993–2000. Another EPA study, again looking at the impact of comprehensive reforms, found that deregulation could increase GDP growth by 1¼ percent per annum during FY 1995–2000. In this EPA study, the impact of regulatory reforms were incorporated directly by changing the coefficients on technical progress, based on interviews with business people, rather than through estimates of price differentials, and hence reflect a somewhat different methodological approach from most of the other estimates reported in the section.

Table V.3. Potential Effects of Overall Deregulation 1/

(In percent)

	Period Considered	Change in Differential Between Japanese and Foreign Prices	Reduction in Domestic Prices	Increase in GDP
Static Analysis				
Nakatani (1994)	1992	-50	-16.5	9.4
Nakakita (1994)	1992	-100 1/	-22.0 1/	8.2
Japan Research Institute (1993)		-100		2.6
Smith (1994)		-50	-20.0	2.3
Daiwa Research Institute (1994)	1992	-100 2/		10.0
Economic Planning Agency (1994)	1992	-20 3/		8.0
Japan Center for Economic Research (1995)	1992	-100 4/		18.7

Source: Seiji Shimpo and Fumihara Nishizaki, "Measuring the Effects of Regulatory Reform in Japan: A Review," Discussion Paper No. 74, Economic Research Institute, Economic Planning Agency (March, 1997).

1/ Regulated sectors only.

2/ The relative labor productivity of the nonmanufacturing sector to the manufacturing sector in Japan is increased to that of the level in the United States. Assuming that the markups over labor costs in both countries are the same and that the exchange rate is in equilibrium, this implies a 100 percent elimination of price differentials between Japan and the United States.

3/ For those sectors in which labor productivity is lower than in the United States., such productivity is reduced by 20 percent geometrically over 5 years.

4/ Relative unit labor cost in the nonmanufacturing sector to the manufacturing sector is reduced to that of the United States, which implies the price differentials are reduced to 0.99.

VI. The "Big Bang" Financial Reforms

127. In late 1996, the government announced its commitment to a wide-ranging reform of Japan's financial markets—the so-called "Big Bang" reform. The objectives of the program is to ensure that Japan's financial market is based on market principles ("free"), is transparent and rules-based ("fair"), and has legal, accounting, and supervisory regimes consistent with international norms ("global"). The main aim of the measures is to make the Tokyo financial market comparable in scale and in the variety of financial services offered to those of New York and London. In June 1997, advisory panels issued their final reports, which contained recommendations of specific measures and a proposed timetable for their adoption. Some of the measures have already been legislated, others are expected to be approved by the Diet next year.

128. The announcement of the "Big Bang" reforms was motivated by concern that regulations and high transactions costs were causing Tokyo to lose market share to other financial centers, including Hong Kong and Singapore. For example, monthly stock market turnover in Tokyo is now only one-fifth of that in New York, compared to near parity in the early 1990s. The number of foreign companies with a Tokyo stock exchange listing also has nearly halved from the peak in 1992. There was concern that Tokyo's role as an international financial center and the role of the yen could be further eroded by the European Monetary Union, and the creation of the Euro.

129. A second motivation for the reform initiative was concern that the return on Japanese household assets, valued at ¥1,200 trillion, has been too low to support the needs of a rapidly aging population. Analysts estimate that the real return on Japanese household financial assets could be as much as 1½ to 2 percentage points lower than in the United States. Low rates of return have partly reflected cyclical factors, but also the fact that Japanese households have been unable to fully take advantage of high yields abroad, given restrictions on foreign remittances and pension fund investment activity.

130. A third motivation for reform was the fact that the profitability of Japanese financial institutions has been low by international standards. During 1985–94, the average return on assets for Japanese banks was 0.5 percent, compared to about 1.7 percent for Canadian, U.K., and U.S. banks. There has been concern that oligopolistic behavior in the financial system has stifled incentives to innovate and create new financial products, which has meant that the growth in fee income has been relatively modest.

131. Recently, several advisory panels to the Ministry of Finance released detailed timetables for specific steps in the "Big Bang" initiative.[72] These proposals, which are listed in

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[72]The five panels that drew up the reports were the Committee on Foreign Exchange and Other Transactions, the Business Accounting Council, the Securities and Exchange Council, (continued...)

Box VI.1, call for expanding competition by allowing the banking, securities, and insurance sectors to compete in each other's markets; by removing government control over their operations; and by lowering the barriers to new entrants. The measures also call for lowering transactions costs and allowing financial companies more freedom in offering new products and services.

132. Some of the more important proposals include:

- **Amendment of the Foreign Exchange Law:** The Foreign Exchange Law was amended by the Diet in May 1997, to take effect in April 1998. The amendment has eliminated the authorized foreign exchange bank system, which required all foreign exchange transactions to be conducted through authorized banks. Japanese households and firms will be permitted to remit funds to foreign-based financial institutions without pre-notifying the authorities.[73]

- **Removal of fixed commissions on stock transactions:** Presently, only commissions on stock transactions over ¥1 billion are freely determined. Starting in April 1998, commissions on equity transactions over ¥50 million will be freed, and by end-April 1999, fixed brokerage commissions would be eliminated on stock transactions of all sizes.

- **Allowing banks to sell equity mutual funds and securities companies to offer cash management accounts:** Presently, banks are prevented from selling mutual funds. After the removal of the restrictions, households will be able to buy equity mutual funds from banks. Households will also be able to open equity-linked accounts at securities firms, and use these accounts to settle transactions (which are not considered exchange transactions under the Banking Law).

- **Removal of the ban on financial holding companies:** The revision of the Anti-Monopoly Law, which was passed by the Diet in June 1997, and the associated revision of the financial laws in the coming fall, will allow the establishment of financial holding companies, which have been banned since the Second World War. Bank holding companies will be permitted to own other financial firms such as securities, insurance, and leasing companies. However, bank holding companies will still be prohibited from owning commercial entities.

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[72](...continued)
the Financial System Research Council, and the Insurance Council.

[73]Banks will still be required to notify the authorities of their foreign transactions on an ex post basis.

Box VI.1. "Big Bang" Financial Reform Proposals

Financial liberalization is expected to take place in stages. The following measures would be implemented in FY 1998:

- Amend the Foreign Exchange Law to enable Japanese companies and individuals to obtain foreign exchange without notifying the authorities or using authorized foreign exchange banks.
- Remove fixed commissions on stock transactions above ¥50 million.
- Allow banks to sell mutual funds.
- Allow securities companies to offer asset management accounts, which would have characteristics similar to those of bank deposits.
- Remove current restrictions on over-the-counter derivatives.
- Permit financial holding companies, which would pave the way for commercial banks owning other financial institutions.
- Abolish the 5:3:3:2 pension asset management rule.

In FY 1999, the following measures are expected to be implemented:

- Review the securities transactions tax and the structure of capital gains taxes.
- Allow the securities subsidiaries of banks to engage in all aspects of the securities business, including underwriting, sales, and trading on equity transactions.
- Allow commercial banks to issue bonds.
- Introduce a defined-contribution corporate pension system—pension benefits will be tied to contributions and investment performance.
- Require companies to adhere to "mark-to-market" accounting principles; presently firms are required to disclose only realized profits and losses.

Finally, in FY 2001:

- Permit banks and insurance companies to enter each other's businesses through subsidiaries.

- **Removal of restrictions on securities derivatives and asset-backed securities:** Derivatives and options will be allowed to be traded over-the-counter and on the stock exchanges. Banks will be authorized to trade derivatives over-the-counter, but they will be prevented from receiving or delivering the underlying asset. Exemptions from certain articles in the civil and the commercial code will be granted for asset-backed securities.

- **Abolishing the 5:3:3:2 rule:** Pension fund management will be further liberalized, by scrapping the 5:3:3:2 asset management rule for all fund managers.[74] The rule requires that 50 percent *or more* of the funds total assets must be invested in domestic bank deposits, bonds, and loans; 30 percent *or less* in stocks; 30 percent *or less* in foreign-currency denominated assets; and 20 percent *or less* in real property.

- **Reviewing the securities transactions tax and the structure of capital gains taxes:** Presently, all securities transactions are subject to a tax ranging from 0.12 percent to 0.21 percent of the value of the transaction. This tax will be reviewed and possibly eliminated. The capital gains arising from stock transactions are taxed at a lower rate (20 percent) than the standard capital gains tax rate (50 percent); the capital gains tax system also is expected to be reviewed, with a view toward eliminating the discrepancy between the two rates.

- **Allowing commercial banks to issue bonds:** Presently, unlike long-term credit banks, commercial banks are prohibited from issuing bonds. Allowing commercial banks to issue bonds will make these institutions less dependent on deposits, and will further blur the distinction between commercial and long-term credit banks.

133. The "Big Bang" liberalization measures are anticipated to promote consolidation in the financial industry, particularly by encouraging the restructuring of some major banks with weak balance sheets and small banks with weak local retail franchises. The fact that commercial banks and foreign firms will be able to perform asset management functions previously reserved for the trust banks, and the re-emergence of holding companies, should promote consolidation among financial institutions under the holding company umbrella. The removal of fixed commissions also may force small- and medium-sized brokerages to fold or to merge with large securities firms.

134. The liberalization also is expected to raise the efficiency of the financial system. As the variety of financial products offered at the retail level increases, the share of household assets held as deposits should fall from the current 60 percent, which is high by international norms. Corporations are expected to raise their share of direct financing, as foreign investment banks compete with Japanese institutions in offering innovative corporate financing alternatives.

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[74]The 5:3:3:2 rule had earlier been relaxed only for fund managers meeting certain criteria.

135. In addition, linkages between Japanese financial institutions, especially with those in need of capital and foreign managerial expertise, and foreign firms are expected to increase (e.g., the recent alliances between Bankers Trust and Nippon Credit and between Barclays and Hokkaido Takushoku). New types of financial businesses, both domestic and foreign, are expected to emerge, including derivatives-trading firms, foreign exchange trading houses, and mutual and hedge fund companies.

136. An important issue that still needs to be resolved is the government's role in intermediating between borrowers and lenders. In particular, a group affiliated with the Economic Planning Agency, and many private sector observers, have recommended that the Postal Saving system be privatized. The Postal Saving system pays no taxes and deposit-insurance premia, which, it has been argued, give the system unfair advantages over private banking institutions.[75] The group also recommended that the government financial institutions associated with the Fiscal Investment and Loan Program (FILP) be reformed, arguing that lending from these institutions often does not go to economically viable projects and distorts financial markets. Adding impetus to FILP reform, the ruling Liberal Democratic Party announced in early July that several large government-owned financial institutions will be merged by March 2000. Specifically, there will be mergers between the Japan Development Bank and the Hokkaido and Tohoku Development Bank, and the Export-Import Bank and the Overseas Economic Cooperation Fund. Significant downsizing is expected to accompany the mergers.

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[75]See Lipworth, Gabrielle, "Postal Saving in Japan," in *Japan—Selected Issues,* IMF Staff Country Report No. 96/114 (September 1996).

VII. Developments in Trade Policies

A. Overview

137. Over the past year, trade tensions between Japan and other countries appeared to lessen, possibly reflecting an increased use of the dispute settlement mechanisms of the World Trade Organization (WTO) as well as the successful resolution of a number of bilateral trade disputes, especially with the United States. Some of the major developments are summarized below.

B. Multilateral Trade Issues

138. Japan continues to implement its commitments under the **Uruguay Round agreement** (Table VII.1). In agriculture, the agreement included commitments in three areas: market access, domestic support, and export subsidies. Japan had already achieved the targeted cut in domestic support (of 20 percent from the 1986–88 base period) by 1992, through reductions in administrative prices and a product limitation program, and Japan did not have export subsidies. Thus, the principal impact was in the area of market access, where Japan's commitments consisted of three elements. First, all agricultural products (except rice) that were previously subject to quotas (27 products on a 4-digit Harmonized System basis, including wheat, barley, dairy products, beans, peanuts, starches, raw milk, and pork) were to be tariffied. Second, tariffs for all agricultural products except rice were to be cut by an average of 36 percent during the six-year implementation period. This would imply a reduction in tariffs from 14.5 to 9.3 percent on a simple average basis (excluding the products to be newly tariffied) (Table VII.1). Third, while rice was exempted from tariffication, Japan committed to provide minimum access equivalent to 4 percent of domestic consumption in 1995, rising to 8 percent by 2000.

139. For industrial goods, Japan committed to lowering its tariffs by 61 percent over the zero-to-fifteen implementation period (basically five years), bringing industrial duties to an average level of 1.5 percent—among the lowest in the world (Table VII.1). Duties will be eliminated altogether on 10 product groups (pharmaceuticals, construction equipment, medical equipment, steel, beer, furniture, farm equipment, whiskey and brandies, pulp and paper, and toys). In line with the Uruguay Round agreement, Japan aims to eliminate all voluntary export restraints (VER) during the four-year period allowed for phasing out grey-area measures, except the limitation on exports of automobiles to the European Union, which is to be eliminated upon expiry in 1999. Beyond industrial and agricultural goods, Japan committed to cut tariffs on wood products by one-half and to reduce tariffs on fisheries by one-third.

140. Japan's implementation of its Uruguay Round commitments has been accelerated in the context of agreements within the **Asia Pacific Economic Cooperation (APEC)** forum. In 1995, APEC member countries adopted "the Osaka Action Agenda" to achieve free and open trade and investment by 2010 for industrialized countries, and by 2020 for developing

Table VII.1. Japan: Outline of Tariff Changes Under the Uruguay Round

1. Number of Items (Harmonized 9-Digit System)

	Offer
Agricultural products	about 1,500
Wood products	about 140
Fishery products	about 250
Industrial products	about 6,700
Total	about 8,500

2. Tariff Reductions (in percent)

	From Agreement Base 1/	From Applied Rate 2/
Agricultural products	36	...
Wood products	50	30
Fishery products	33	29
Industrial products	61	33

3. Average Tariff Rates (in percent) 3/

	Base Rate	Applied Rate in 1993	Applied Rate in 1996	Post Uruguay Round in 2000
Agricultural products	14.5	11.9	11.1	9.3
Wood products	2.0	1.4	1.3	1.0
Fishery products	6.1	5.7	5.0	4.1
Industrial products	3.8	2.2	2.0	1.5

Source: Data provided by the Japanese authorities.

1/ Offer rate relative to the base rate (in 1986–88).

2/ Offer rate relative to the applied rate (in 1993).

3/ Simple average for agricultural products and a trade-weighted average (in 1988) for other products. Newly tariffied products are excluded from agricultural products in the calculation.

counties in the region. The Osaka Action Agenda required each member country to draw up an Individual Action Plan (IAP) in 1996, setting out voluntary actions that the member would take to liberalize and facilitate trade and investment. In this context, Japan announced in November 1995 a plan to accelerate tariff reduction under the Uruguay Round on 697 items, including textiles, chemicals, steel, and nonferrous metals. The tariff cuts were accelerated by approximately two years on an applied rate basis, and tariff rates originally scheduled to be applied in January 1998 were applied in April 1996.

141. During the **Ministerial meeting of APEC in November 1996 in Manila**, Japan submitted a comprehensive IAP, aimed at trade and investment facilitation. This included tariff reduction measures, as well as deregulatory measures in areas such as commodity standards and telecommunications. Examples of the measures that were included were: a closer alignment with international standards of the JIS (Japanese Industrial Standard), the JAS (Japanese Agricultural Standard), and technical regulations under the Electrical Appliance and Material Control Law; the abolishment of provisions preventing the establishment of excess telecommunication facilities; and the review of the market access restrictions for basic telecommunications carriers to further facilitate the participation of new entrants to the market.

C. Major Bilateral Trade Issues with the United States

142. Bilateral trade disputes between Japan and the United States in recent years have tended to be governed by the **Japan-U.S. Framework Agreement**, which was announced in July 1993. A key goal of the Framework, which covers not only structural and sectoral issues, but also macroeconomic policies, was to increase access and sales of foreign goods and services through market-opening and macroeconomic measures. Under this agreement, four priority areas for increased access were identified—government procurement, automobiles and parts, insurance, and the promotion of competition and competitiveness. More recently, in June 1997 an Enhanced Initiative on Deregulation and Competition Policy was announced, which called for high-level consultations under the Framework to review deregulation policies in the areas of telecommunications, housing, medical devices/pharmaceuticals, and financial services.

143. In September 1994, agreements were reached under the Framework on the procurement of telecommunications and medical equipment by the Japanese government and its agencies, and on foreign access to the Japanese insurance market. An "understanding" was also reached on increased foreign access to the Japanese flat-glass market, which was later made more specific. In January 1995, agreement was reached on providing greater foreign access to Japan's financial services market. Finally, an agreement in the area of the automobile and automobile parts sector was reached in June 1995 following a U.S. deadline to impose punitive tariffs on the imports of luxury models of Japanese cars (which prompted a Japanese complaint to the WTO).

144. The 1991 **semiconductor** agreement, which set a target of a 20 percent market share for foreign-made chips by end-1993, expired in July 1996.[76] While the United States sought renewal of the agreement, Japan argued that there was no reason to extend or renew the agreement since its objectives had been fully achieved (e.g., the market share for foreign-made chips has been over 20 percent since 1993). Japan further argued that increases in cross-border and joint production had rendered the notion of identifying the nationality of purchased semiconductors by the capital affiliation of the manufacturer meaningless. In August 1996, Japanese and U.S. semiconductor industries agreed to create the "Semiconductor Council" as a private forum to promote international cooperation. European and Korean industry groups joined the Council, and the first annual meeting was held in April 1997, where producer groups agreed to cooperate in the areas of standardization, protection of environment and safety, and intellectual property protection. At the governmental level, the Japanese and U.S. governments released a joint statement in August 1996, which included an agreement to hold the "Global Governmental Forum on Semiconductors" to discuss issues related to semiconductors. The first Forum was held in December 1996 with the EU and Korea, where it was agreed to pursue policies consistent with international trade rules.

145. Disputes regarding the **insurance sector** reflected the interpretation of a 1994 accord on the pace of liberalization and deregulation of the so called "third" sector (an area between life and casualty insurance, including hospitalization and injury insurance), where U.S. firms have occupied a large market share. The 1994 accord stated that deregulation of the "third" sector should only take place after life and nonlife insurance markets were sufficiently deregulated.

146. In April 1996, Japan implemented the revised Insurance Business Law which allowed life and nonlife insurance companies to enter each other's spheres through the establishment of subsidiaries. The United States contended that allowing subsidiaries of major Japanese insurance companies into the "third" sector at this point violated the 1994 agreement. Japan countered that the new insurance law represented substantial and meaningful deregulation of the life and nonlife insurance sectors, satisfying the precondition for liberalization of the "third" sector.

147. Japan and the United States reached an agreement on this dispute (called "supplementary measures") in December 1996 after bilateral talks. The contents of the agreement are summarized as follows. First, with the exception of deposit-type casualty insurance, and medical and cancer insurance, nonlife subsidiaries of life insurance firms will be permitted to enter a part of the third sector (i.e., casualty insurance) from January 1997. Second, from September 1997, insurers may set auto insurance premiums according to the policyholders' age, gender, area of residence, driving record, and mileage. Moreover, auto and fire insurance premiums would be wholly liberalized by July 1998. Third, domestic life insurers and life insurance units of Japanese casualty firms would be able to sell medical and

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[76]The agreement on paper products also expired in April 1997.

cancer insurance from January 2001 (consistent with the "Big Bang" financial services deregulation initiative). However, this would be conditional on confirmation that deregulation measures in the auto and fire insurance area had been completed in July 1998. While this agreement is expected to promote the competition in the auto and fire insurance area, the "third" sector would not be liberalized until 2001.

148. In May 1995, Kodak filed a petition with the U.S. trade representative (USTR) under Section 301 of the U.S. Trade Act, alleging that a Japanese **film** producer (Fuji) had engaged in practices that had impeded Kodak's entry into the Japanese consumer photographic film and paper market. The Japanese Government has maintained that Kodak's access to the domestic Japanese market should not be discussed at a governmental level, since there had been no government intervention in the film market. In June 1996, the United States filed a complaint with the WTO against Japan's trade practices in the consumer film and paper market. The WTO established a panel in December 1996 to adjudicate the dispute. The panel is expected to issue its initial ruling in the fall of 1997.

149. In other areas, a dispute on Japanese seaport services was settled in April 1997. In February 1997, the U.S. Federal Maritime Commission announced sanctions against Japanese **ocean freight operators**, effective April 14, 1997, alleging that there were restrictions on foreign firms' use of Japanese ports. The Japanese and the U.S. governments subsequently reached an agreement in April 1997 (before the imposition of the sanctions), which required Japan to grant licenses to foreign stevedoring and port operations firms within four months after applications were made. Japan also agreed to examine the abolishment of the prior consultation system between labor and management on harbor operations.

150. In April 1997, the United States requested consultations with Japan under the auspices of the WTO, alleging that Japan prohibited the importation of each variety of a product requiring **quarantine treatment** until the quarantine treatment has been tested for that variety, even if the treatment has proved to be effective for other varieties of the same product. Japan argued that it was necessary to examine products on a variety-by-variety basis since the effects of insect-killing agents differ depending on varieties. The United States also requested consultations with Japan in June 1996 (and again in September 1996) on the issue of the **Large-Scale Retail Store Law**. Japan contends that the Law does not discriminate against foreign retailers and thus is not in contravention of the WTO.

D. Major Bilateral Trade Issues with the European Union

151. There have been no major bilateral trade disputes between Japan and the EU over the past year. However, in 1995, the EU, subsequently followed by the United States and Canada, alleged that Japanese taxes on distilled liquors resulted in effective discrimination against imports, such as whiskeys and brandies, and requested consultations with Japan under Article 22 of the GATT 1994. Since they were unable to reach a mutually satisfactory resolution, the EU requested the Dispute Settlement Body (DSB) to establish a panel, and in

November 1996, the DSB adopted the panel report that the Japanese system of taxes on distilled liquors discriminated against imported liquor. In response, Japan revised its Liquor Tax Laws, narrowing the gaps between taxes on domestically produced "shochu" and other distilled liquors. Although the EU was satisfied with the revision, the United States argued that the pace of revision, which would be completed by 2001, was not quick enough and the issue was sent to the WTO for arbitration. In February 1997, the WTO arbitrated that the transition period should be no longer than 15 months.

152. In January 1997, the European Communities (EC) requested consultations with Japan under the auspices of the WTO, arguing that restrictive tariffs on the import of **pork** and processed pork products were in contravention of the 1994 GATT. Japan has contended that these safeguard measures were permitted under the Uruguay Round agreements. The EC also requested consultation with Japan under the auspices of the WTO in March 1997 in respect of a procurement tender published by the Ministry of Transport of Japan to purchase a **multi-functional satellite** for Air Traffic Management. The EC contended that the specifications in the tender were not neutral but referred explicitly to U.S. specifications. Japan argued that the tender was based on procedures under the Government Procurement Agreement of the WTO.

E. Other Issues

153. In November 1996, Japan, with the EU and the United States, lodged complaints with the WTO against Indonesia, claiming its efforts to promote a domestic automobile industry discriminated against their producers. The WTO has established a dispute settlement panel to examine the issue.

VIII. Official Developments Assistance (ODA)

154. Since 1978, Japan has taken several initiatives to stimulate the flow of financial resources to developing countries, with the most recent being the "Funds for Development" initiative, which targeted the provision of $120 billion in funds over the 1993–97 period. The program consists of $70 billion in untied official development assistance (ODA) funds (grants, technical assistance, yen loans, and subscriptions and contributions to multilateral lending institutions) and $50 billion in non-ODA, untied funds (including loans from the Export-Import Bank of Japan and international trade insurance).

155. As a result of these initiatives, Japan's ODA to developing countries increased from $9.1 billion in 1990 to $14.5 billion in 1995, and Japan became the world's largest donor nation, although the ratio of ODA to GNP fell slightly during this period (from 0.31 percent in 1990 to 0.28 percent in 1995; Table VIII.1). In 1996, while the dollar amount of Japan's ODA decreased by 35 percent to US$9.4 billion (0.20 percent of GNP), Japanese ODA still represented about 17 percent of total ODA of all DAC countries, and Japan remained the largest donor nation, as in the previous five years. Three main factors contributed to the decline in ODA in 1996: (i) the yen's depreciation lowered the dollar amount of ODA; (ii) grants to international financial institutions were delayed; and (iii) loan repayments by borrowers were higher than expected. In contrast to the decline in actual ODA disbursements, the FY 1996 ODA budget provided for a 3.5 percent increase (in yen terms) over FY 1995 and a further 2.1 percent increase is budgeted for FY 1997.

156. Japan's ODA is well diversified regionally. While Asia receives the bulk of Japan's bilateral aid—about 54 percent of the total in 1995—Africa (12½ percent), Latin America (11 percent), and the Middle East (7 percent) are also major recipient areas. As of 1995, Japan was still leading donor in over 50 countries, not only in Asia but also in parts of Africa. The allocation of Japan's aid is governed by the ODA charter that was adopted in 1992, which outlines four principles for foreign aid. They stipulate that Japan must pay close attention to: environmental concerns; restraint in military expenditures and weapons development; democratization and basic human rights; and the fostering of market-oriented economies.

157. The process of untying Japan's ODA loans started in the 1970s and accelerated in response to other countries' criticisms of Japan's large trade surplus. In 1978, the Japanese Government announced, in a joint communique with the United States, its intention to increase the ratio of untied loans. In FY 1995, 98 percent of Japan's ODA loans were untied.

158. However, the share of grants (including grant aid, technical cooperation, and financial contributions to international organizations, etc.) to total ODA spending by Japan (on a commitment basis) is relatively low, standing at 47 percent in 1995 compared with the DAC average of 77 percent. Moreover, the grant element—which indicates the concessionality of a loan, in the form of the present value of an interest rate below the market rate over the life of a loan—stood at 79 percent in 1995, compared with the DAC average of 91 percent.

159. There have been several recent proposals for the reform of Japan's ODA from both public and private sectors. The Ministry of Foreign Affairs set up a panel comprised of academics and business people in April 1997 to discuss ways to improve the quality of Japan's ODA and to propose a program for the overall reform of ODA toward the twenty-first century. The panel is expected to release its final report by end-1997. While only about two-thirds of the government's Funds for Development initiatives for 1993–97 had been committed as of the end of 1996, Japanese ODA spending is likely to be placed under pressure given fiscal constraints. In a recent cabinet decision, the government announced plans to cut annual ODA budget outlays by at least 10 percent in FY 1998, and to end its practice of setting medium-term targets for ODA.

Table VIII.1. Japan: Net Flow of Financial Resources to Developing Countries and Multilateral Agencies, 1990–96 1/

	1990	1991	1992	1993	1994	1995	1996
				(In billions of U.S. dollars)			
ODA	9.1	11.0	11.2	11.3	13.2	14.5	9.4
Bilateral	6.8	8.9	8.4	8.0	9.6	10.4	8.2
Multilateral	2.3	2.1	2.8	3.2	3.7	4.1	1.2
Other official flows	3.4	2.6	3.3	3.8	3.2	5.5	...
Private flows 2/	6.2	11.1	1.5	0.6	11.8	22.0	...s
Grants by private voluntary agencies	0.1	0.2	0.2	0.2	0.2	0.2	...
Total resource flows	18.7	24.7	16.2	15.9	28.5	42.3	...
				(In percent of GNP)			
ODA	0.31	0.32	0.30	0.27	0.29	0.28	0.20
Total resource flows	0.63	0.74	0.44	0.40	0.60	0.80	...

Source: Data provided by the Japanese authorities.

1/ Calendar years, Development Assistance Committee basis.
2/ Private flows represent flows at market terms to countries on the Development Assistance Committee list of aid recipients.