ЕВРОПЕЙСКИ ПАРЛАМЕНТ PARLAMENTO EUROPEO EVROPSKÝ PARLAMENT EUROPA-PARLAMENTET
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Policy Department A.: Economic and Scientific Policy and Quality of Life Unit

Japan

Economic Policy Review

Briefing Note

ECON 2007-21 **PE 385.671**

Only published in English.

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Manuscript completed in October 2007.

The opinions expressed in this document do not necessarily represent the official position of the European Parliament.

Japan

Economic Policy Review

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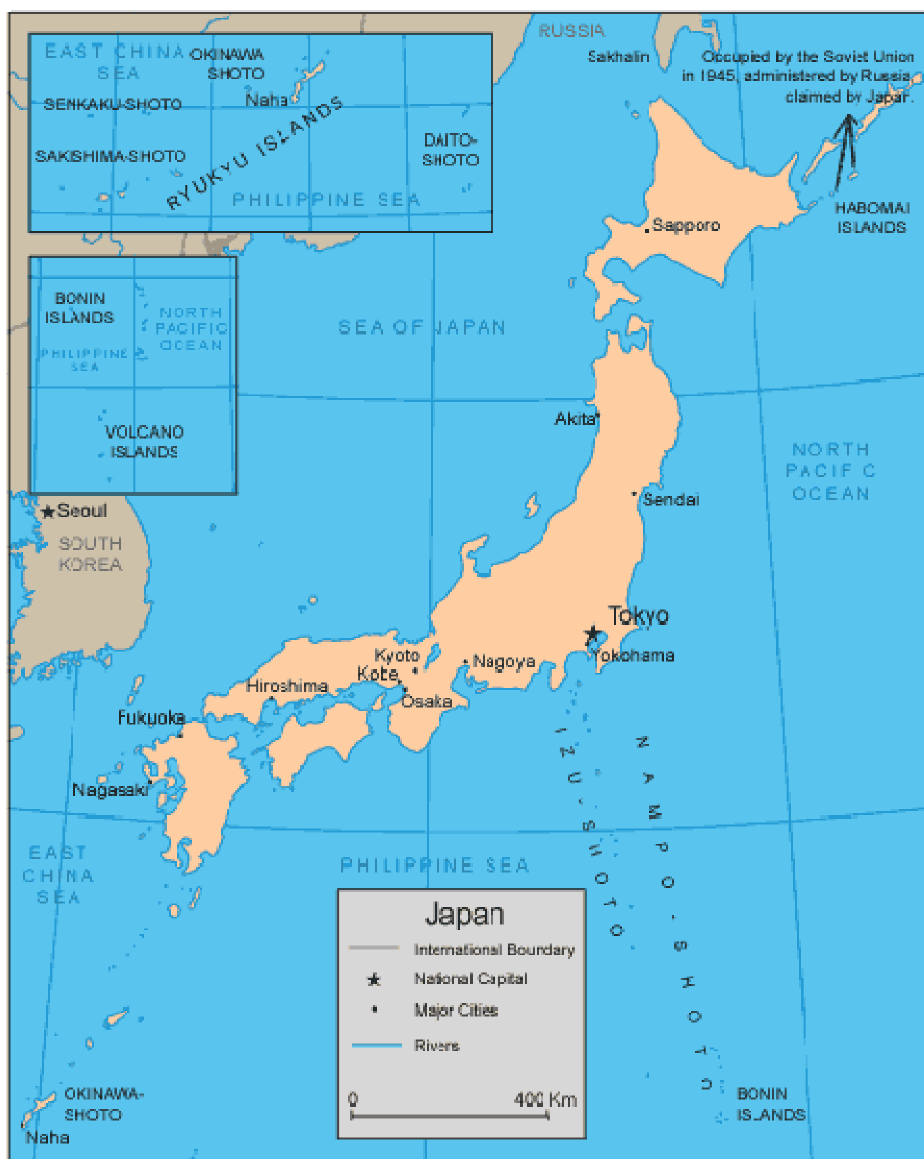

Source: Oxford Analytica

Area: 377.9 (in 1000 sq. km)

Population: 127,8 million as of October 2006

Ethnic groups: Japanese 99%, others 1% (Korean 511,262, Chinese 244,241, Brazilian 182,232, Filipino 89,851, other 237,914) (year 2000)

Religions: Shinto and Buddhist 84%, other 16% (including Christian 0.7%)

Monetary Unit: Yen (¥), 1 EUR = 165.7 JPY (ECB data of 16/10/2007)

OECD Short-term Economic Projections

	2004	2005	2006	2007	2005		2006		2007	
					1st half	2nd half	1st half	2nd half	1st half	2nd half
Demand and output (volumes)										
Consumption										
Private	1.9	2.1	1.7	1.6	3.0	2.6	1.4	1.5	1.7	1.7
Government	2.0	1.7	0.8	0.9	2.4	1.4	0.6	0.5	0.9	1.2
Gross fixed investment	1.1	3.3	2.3	1.3	5.4	3.9	1.5	2.5	1.1	0.6
Public[2]	–8.6	–6.0	–4.1	–4.0	–0.2	–1.2	–5.6	–4.0	–4.0	–4.0
Private residential	1.9	–0.7	3.4	0.7	–4.0	3.4	4.6	1.2	0.6	0.5
Private non-residential	4.9	7.7	4.1	3.1	10.0	5.7	3.0	4.9	2.7	2.0
Stockbuilding[3]	–0.2	0.1	0.0	0.0	0.5	–0.3	0.2	0.0	0.0	0.0
Total domestic demand	1.5	2.4	1.7	1.4	4.0	2.3	1.4	1.6	1.4	1.3
Exports of goods and services	13.9	7.0	12.3	9.0	4.2	13.8	13.0	9.5	9.0	8.7
Imports of goods and services	8.5	6.3	4.9	4.2	4.5	7.9	4.0	3.7	4.4	4.5
Net exports[3]	0.8	0.2	1.1	0.9	0.0	0.9	1.4	1.0	0.8	0.8
GDP	2.3	2.6	2.8	2.2	3.9	3.2	2.7	2.5	2.2	2.1
Inflation and capacity utilisation										
GDP deflator	–1.2	–1.3	–0.6	0.5	–1.7	–1.3	–0.8	0.4	0.5	0.7
Private consumption deflator	–0.7	–0.8	–0.1	0.7	–1.1	–0.5	–0.1	0.5	0.7	0.8
CPI[4]	0.0	–0.3	0.7	0.8	–0.1	–0.4	1.2	0.6	0.8	1.0
Core CPI[4]	–0.4	–0.3	0.4	0.8	–0.5	0.1	0.3	0.6	0.8	1.0
Unemployment rate	4.7	4.4	4.0	3.5	4.4	4.4	4.2	3.9	3.6	3.3
Output gap	–1.9	–0.8	0.5	1.2	–1.2	–0.4	0.2	0.7	1.1	1.4
Memorandum items:										
Net government lending[5]	–6.3	–5.2	–5.2	–4.7						
Net primary balance[5]	–4.9	–3.9	–3.7	–3.0						
Gross debt[5]	168.1	172.1	175.2	177.3						
Net debt[5]	82.2	86.3	89.7	92.0						
Current account[5]	3.7	3.6	4.3	5.5						

1. Assuming an exchange rate of 113.5 yen to the dollar – the level on 4 May 2006 – and the price of Brent oil at $70. All growth rates are at an annual rate relative to the preceding period.
2. Including public corporations.
3. Contribution to GDP growth.
4. Compared to the same semester of the previous year. The core CPI is the OECD definition, which excludes both food and energy.
5. Per cent of GDP.

Source: OECD, *OECD Economic Outlook*, No. 79 (May 2006).

1. Executive Summary

The current report aims to provide an assessment of the Japanese economy focussing on macroeconomic issues and financial services.

The list of policies analysed is by no means exhaustive, but attempts to reflect the remit of the European Parliament's ECON Committee.

Political Brief

Following the loss of its majority in the election to the House of Councillors in July, the LDP's fear of losing the next election in the House of Representatives is immense. It will try to regain the public's confidence by addressing the voter concerns that led to its recent election defeat. Particular efforts will be made to resolve such domestic issues as the scandal in which the state admits to having lost around 50m pension records, economic disparities between cities and rural areas, and misuse of political funds. Mr Fukuda and his new government will have to strike a difficult balance between appeasing the rural electorate and repairing the country's fiscal position.

Recent Economic Development

The economy continues to grow at a good pace. Measured in year-on-year terms, real GDP grew by 2.7% in the first quarter of 2007 but preliminary reports for the second quarter of 2007 had to be revised downwards together with the contributions to growth from government investment and household consumption. Overall, the downturn in the second quarter seems to be transitory and should be reversed in the second half of 2007.

Mild deflation continues to be a problem. For 2007, consumer prices are now forecast to remain flat. Inflationary pressures are expected to build gently over the next few years.

The August financial crisis in the US sub-prime mortgage market caused the yen to appreciate and had adverse effects on the Japanese stock market and the country's economic outlook. The impact of these developments has yet to be seen, but the recent events could bring more disappointing economic growth results for another quarter or two.

Monetary Policy

The volatility in global financial markets since August and the subsequent cuts in the US federal funds rate have altered expectations regarding the speed at which that the Bank of Japan will tighten monetary policy. It is no longer expected that the interest rate will be raised before the end of 2007. Concerns about the US economy might further dissuade the Bank of Japan (BoJ) from tightening aggressively in 2008. In 2009, however, the pace of tightening is expected pick up.

Fiscal policy

The budget deficit in Japan in 2006 was about 5.2%. The gross public debt stock stands at approx. 170% of GDP, with an increasing tendency.

The government projects to stabilize the debt ratio by the early 2010s, an effort not entirely certain to work out. Spending restraint will be an important factor in achieving this. However, spending cuts are made more difficult by increasing ageing pressures laying more intensely on Japan than in any other OECD country. Therefore, revenue increases through tax hikes may become necessary. This should be modestly possible as Japan has a relatively low revenue/GDP ratio (30%) in international comparison (EU average 45%).

The fiscal problem Japan is facing today mainly stems from the aftermath and handling of the depression in the 1990s on one hand, and from above average ageing pressures on the other.

Banking and Securities

Financial Reform started with interest rate liberalisation in the 1970s and this continued in the 1980s.The ‘big bang’ of the mid- to late-1990s saw foreign exchange controls removed (albeit still with some requirements for reporting transactions) and banks, brokerages and insurance companies allowed some freedom to operate in each others' areas. The range of financial products that banks could deal in was expanded and insurance companies were permitted to do a certain amount of foreign exchange business.

Further liberalisation of the operating environment for financial institutions has now become an official priority for a number of reasons. Leading banks and brokerages have returned to quite robust health following a period in the 1990's of clearing up bad loans portfolios.

Japan has begun to place higher priority on the development of financial and other services, in order to counteract an expected decline in manufacturing output as production shifts offshore and the workforce ages. There is an official desire to strengthen financial institutions so that they will not be vulnerable to foreign takeover once rules on inward mergers and acquisitions are relaxed later this year.

Conclusion: A second wave of rationalisation is coming to the Japanese financial system, this time involving securities houses, although the banking sector, which has already undergone extensive restructuring, will be integrally involved in the reorganisation of the sector. It will continue to be so as Japan moves closer to a ‘universal banking’ model of financial intermediation.

Insurance

The formerly highly regulated Japanese insurance sector passed through a period of liberalisation and deregulation during the last decade. An **overall reform** revised the legal basis for the business laid down in the **Insurance Business Law of 1996**. Due to this liberalisation and changes of the market the industry is suffering from negative growth since then.

New entrants from non-financial sectors and direct selling players are challenging traditional non-life insurers. The gradual entry of foreign life insurance companies to the Japanese market, demutualisation as well as the removal of the prohibition on the reciprocal entry between non-life and life insurers have changed the life insurance market. Insurance distribution requires authorisation. Recently distribution became more diversified and new channels such as bank assurance and internet based insurance sales compete with traditional agent shops.

The insurance sector as part of the entire financial system is supervised by the **Financial Services Agency** (FSA) which was established in 2000. The FSA cares for safeguarding the stable and smooth functioning of the financial sector as well as consumer protection (depositors, policyholders and investors). In addition, the Ministry of Finance covers the administration of the reinsurance scheme as well as earthquake insurance.

Policyholders' protection is provided through firstly early warning measures based on a solvency margin ration carried out by the FSA. Secondly the two (life and non-life) policyholders protection systems arrange for financial aid to take over a failed insurance company.

2. General Overview[1]

Political structure

Japan is a constitutional monarchy with a parliamentary government.

Executive

The head of government is the Prime Minister, who is designated by the Diet (parliament) and appoints the cabinet (government). Traditionally, the leader of the majority party or coalition becomes Prime Minister, a change in party leadership thereby signalling a new PM and cabinet.

Legislature

The Diet consists of two chambers, the House of Representatives and the House of Councillors. The House of Councillors consists of 242 members and the House of Representatives of 480 members. Councillors are elected for six-year terms, with half of the House coming up for election every three years. Representatives are elected every four years, 300 to single-seat constituencies, with the remaining 180 being elected by proportional representation in 11 regional blocs. Both houses are directly elected by universal suffrage. The House of Representatives is constitutionally superior to the House of Councillors, having the power to overrule the upper house in the selection of the Prime Minister, in passing the national budget and in approving international treaties.

2.1 Political Background

Except for an 11-month period in 1993/94, post-war Japan has been governed continuously by the Liberal Democratic Party (LDP) or coalitions dominated by it. One consequence of this situation is that the rivalry of factions within the party largely replaces the usual competition between majority and opposition. Although no longer able to govern alone, the LDP continues to dominate the political landscape. It currently governs in a formal coalition with New Komeito (which is itself closely allied to a large lay-Buddhist organisation, Soka Gakkai). The parties differ on many key policies, such as defence and fiscal reform. The LDP is also internally divided on policy, particularly on radical economic reform introduced by former Prime Minister Koizumi, much of which directly threatens the vested interests of the party's old guard.

The largest opposition party, the Democratic Party of Japan (DPJ), has too few parliamentary seats to be able to challenge the LDP on its own in the lower house, however, it is the biggest party in the upper house since the elections in July and now commands a majority there. The party's unity is uncertain - it was formed from the original DPJ and the fragments of its predecessor as largest opposition party, Shin Shinto (New Frontier Party), and embraces a correspondingly wide range of ideologies, both left- and right-wing. It currently has ten or so internal groupings, agitating for issues as wide-ranging as preserving the "peace" constitution and promoting policies for urban voters. The party's weakness has forced it to look for allies in other opposition parties in order to bolster its parliamentary support. The recruiting into government of the third-largest party, New Komeito, by the LDP has, however, depleted the opposition ranks.

[1] This section is based on DGExPo/B/PolDep/Note/2007_112, Country Briefing Japan.

Composition of the Diet *(number of women members in parentheses)*

Party	House of Representatives as of 8 June 2006	House of Councillors as of 29 July 2007
LDP	292 *(26)*	84 *(12)*
New Komeito	31 *(4)*	21 *(5)*
Government Total	323	105
DPJ and 'Club of Independents'	113 *(10)*	115 *(21)*
Japanese Communist Party	9 *(2)*	7 *(1)*
Social Democratic Party	7 *(2)*	5 *(1)*
People's New Party, New Party of Nippon and Group of Independents	6 *(-)*	4 *(1)*
Independents	20 *(1)*	6 *(2)*
Vacant seats	2	-
Total	480	242

Electoral calendar:

The last general election for the lower house was in September 2005; the next election must be held by September 2009, but is expected for 2008 already. The last election for (half the seats of) the upper house was on 29 July 2007; the next one is scheduled for July 2010.

2.2 Current Political Situation[2]

In policy and budgetary decisions this spring, the government of Prime Minister Abe backed down from its initial promises to redeploy tax revenue away from the construction industry and towards healthcare for the elderly, and from its previously declared intention to deregulate and liberalise parts of the agricultural market. The conservative factions and like-minded bureaucrats have clearly clawed back some of the ground that they lost during the Koizumi era. An attempt by Mr. Abe to gather internal support by readmitting into the LDP several "rebel" former MPs who had opposed Mr. Koizumi on the privatisation of the postal services also backfired, causing a far greater uproar in the media and public opinion than expected.

Also, with an eye on this July's elections, the government postponed discussion of an increase in the sensitive consumption tax despite a general consensus in political circles that such an increase is overdue. It appears that Mr. Abe had chosen to postpone any controversial domestic decisions until after the July vote and concentrated instead on his foreign policy profile and the defence issue to get votes. This strategy was risky, as the electorate may well have cared more strongly about the economy, especially the noticeable increase in inequality among a population once famous for its (perceived) homogeneity of living standards, than about reinterpreting the past or enhancing Japan's role in the world.

The government's approval ratings have slumped. While the country's first unified local elections held on 22 April brought no major shift in the main parties' standing, the LDP lost its majority in the Upper House in the July elections from which Mr. Abe emerged a vulnerable figure. Losses are also likely in the Lower House elections widely expected for the second half of 2008, as the LDP's current seats there were won in 2005 at the height of Prime Minister Koizumi's popularity.

[2] Sources include: Economist Intelligence Unit; Comments and contributions from the Policy Department External Policies are gratefully acknowledged.

The backbenchers in the LDP blamed Mr. Abe for their discomfiture and wanted sooner or later to replace him. The opposition DPJ, meanwhile, felt encouraged by its victory at the polls and was determined to frustrate every initiative of Prime Minister Abe in order to force him to call an election to the House of Representatives while voters were still angry with his government. Seemingly never-ending attacks on Mr Abe and members of his government by the press and the public prosecutor's office were a further sign of Abe's weakness. In a cabinet reshuffle in August Mr Abe attempted to remove the likely targets of the public prosecutor from his government and regain the initiative. The LDP factions were happy to claw back some of the power that they used to enjoy when they received offices in the cabinet, while the prosecutors continued to harry the government hinting at the possibility of action against Abe himself. Abe decided to stake his career on the fate of a single measure: renewing the anti-terror law.[3]

In early September Mr Abe publicly reiterated his determination to get the anti-terror law through parliament. Returning from the Asia-Pacific Economic Cooperation (APEC) summit held in Sydney on 8/9 September where he had reportedly promised the US president, that he would succeed in renewing the law, Abe opened the extraordinary parliamentary session devoted to passing the law on 10 September. In the afternoon of 12 September, however, a sullen and apparently ill Mr Abe stunned Japan by publicly announcing his retirement.

Within a day this announcement, the leaders of the LDP's biggest factions had all come out in support of Yasuo Fukuda, who had served as Mr Koizumi's chief cabinet secretary and enjoyed a reputation for efficient government and moderate foreign policy. On 23 September Mr Fukuda was elected as new party president of the LDP, and on 25 September he was officially announced as Japan's new prime minister. The public reaction to the LDP's choice is yet to be seen, but will be crucial to the survival of the LDP as the dominant party in Japanese politics.

Following the loss of its majority in the election to the House of Councillors in July, the LDP's fear of losing the next election in the House of Representatives is immense. It will try to regain the public's confidence by addressing the voter concerns that led to its recent election defeat. Particular efforts will be made to resolve such domestic issues as the scandal in which the state admits to having lost around 50m pension records, economic disparities between cities and rural areas, and misuse of political funds. Mr Fukuda and his new government will have to strike a difficult balance between appeasing the rural electorate and repairing the country's fiscal position.

The DPJ may seem to be in the ascendant, but it has yet to establish its credentials as an alternative party of government. Formed in 1998 through the merger of several small opposition parties, the DPJ is a young entity, and this is the first time that it has been the biggest party in the upper house. In order to maintain momentum, the DPJ will have to clarify its policy platform.

The next election to the lower house is due by September 2009, but is likely to be called earlier, in the second half of 2008, as the lower house rarely serves a full term. The opposition parties, led by the DPJ, are pressing for elections as early as the end of this year in order to capitalise on the government's low poll results, and can be expected to keep the pressure up in the coming months, possibly even by resorting to a motion of censure.

[3] This law allows the Self-Defence Force (Japan's de facto military) to stay in the Indian Ocean and provide support to the allied forces in Afghanistan. The law needed to be renewed before 1 November. Representatives of the US government had declared on several occasions that the renewal was essential to US-Japanese relations and that the DPJ should come to an accommodation with the LDP on this score. The DPJ refused to co-operate. Abe's government resigned itself to the fact that the only way to pass the law would be to use the LDP's 2/3 majority in the lower house to override a veto. Controversial at the best of times in consensus-oriented Japan, such a strategy by Mr Abe, who was already unpopular, would have offended the Japanese electorate even more.

3. General Economic Situation

3.1 Background[4]

Historically, Japanese companies have relied on bank financing (with big corporations having their own banks) rather than on equity and bond issuance, and employees at big firms tended to stay throughout their careers. Another striking feature of the economy is that it consists of two distinct tiers: first, the large and powerful multinational companies, many of which have become global household names in the past three decades; and second, the plethora of small, often family-owned enterprises. This two-tier structure has been cited as one of the reasons for the dynamism of some parts of Japanese industry, as smaller companies provide the flexibility and innovation that is often lacking in larger enterprises.

Manufacturing, dominated by the electronics and car industries, has been the mainstay of the economy since the 1960s and today accounts for just over 20% of current-price GDP. After huge success in penetrating international markets, export-oriented sectors have suffered in recent years from the strength of the yen, prompting a wave of outward direct investment to low-cost countries, in particular those in Asia. Japan is the world's largest maker of machine tools, exporting much of that output to the US and South Korea. It is also one of the world's most important iron and steel makers, although in production terms, Nippon Steel was overtaken by Arcelor and Mittal even before their merger.

Japan exhibits little openness to foreign trade: As a proportion of current-price GDP, the value of two-way foreign trade in 2005 stood near 23%, contrasting with around 65% for Germany and 64% for China. Japan's lack of openness to trade largely stems from official and unofficial restrictions on merchandise imports, which remain in place to protect less efficient industries such as textiles, food, and pulp and paper, despite pressure from the US and other important trading partners. This failure to open to foreign trade has often been cited as one of the reasons for the persistence of structural problems in the economy, and especially of the poor productivity of companies operating in the non-tradable sector.

Despite Japan's recent economic problems and the poor quality of some of its infrastructure, the material affluence of ordinary Japanese people is generally high, as shown by high rates of ownership of consumer durables and sophisticated electronic goods. At around US$36,000 at market exchange rates, Japanese GDP per capita is also among the highest in the world.

3.2 From post-war economic miracle to the woes of the 90s[5]

"Japan poses a problem for economists, because this sort of thing isn't supposed to happen."

Paul Krugman (May 1998)

World War II wiped out many of the gains Japan had made since 1868 when the then government first opened the country to Western commerce and influence. As Japan's post-war economic development began, a well-disciplined and highly educated work force set out to rebuild the country.

The early post-war years were devoted to rebuilding lost industrial capacity and by the mid-1950s, production matched pre-war levels. Since post-war Japan was no longer governed by a military-dominated government, the economy recovered its lost momentum and surpassed the growth rates of earlier years. Between 1953 and 1965, GDP expanded by more than 9 percent per year. The "Golden Sixties", the second decade associated with the Japanese economic miracle, where under way.

In the mid-1960s the economy opened itself to international competition in some industries. Products such as cars, ships and machine tools assumed new importance. Growth rates moderated to about 8 percent and evened out between the industrial and service sectors between 1970 and 1973.

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[4] This section is based on DGExPo/B/PolDep/Note/2007_112, Country Briefing Japan.

[5] Source include: Country studies of the Federal Research Division (Library of Congress); Wikipedia; Economist Intelligence Unit; Takatoshi Ito, Frederic Mishkin: Two decades of Japanese monetary policy and the deflation problem, NBER working paper 10878.

Japan faced a severe economic challenge in the mid-1970s. The world oil crisis in 1973 was a shock since Japan had become virtually dependent on foreign oil. The country experienced a decline in industrial production and severe price inflation. The recovery that followed the first oil crisis revived the optimism of most business leaders. Many energy-intensive industries successfully reduced their dependence on oil during the late 1970s and 1980s and enhanced their productivity. Advances in semiconductors in the late 1970s and 1980s led to new growth industries in consumer electronics and computers and to higher productivity in already established industries. As a result, the energy efficiency of manufacturing was increased and knowledge-intensive industries expanded. The service industries also grew in an increasingly post-industrial economy.

Structural changes, however, were unable to stop the slowing of growth as the economy matured in the late 1970s and 1980s with annual growth rates of between 4 to 6 percent. For a country with few domestic resources and in an environment of high oil prices, such rates, however, were remarkable.

Despite further rises in oil prices in 1979, the strength of the Japanese economy was apparent. It grew without the double-digit inflation that other industrial nations endured. Japan experienced slower growth in the mid-1980s, but a demand-sustained boom of the late 1980s revived many troubled industries.

Complex economic and institutional factors affected Japan's long period of post-war growth:

- Japan's pre-war experience provided several important legacies (e.g. a vital commercial sector in burgeoning urban centres, a relatively well-educated elite, a sophisticated bureaucracy, a pool of experience labour).
- The level and quality of investment that persisted through the 1980s: Investment in capital equipment was kept at high rates throughout.[6] In the 1970s and 1980s, Japan improved its industrial base through technology licensing, patent purchases, and imitation and improvement of foreign inventions. Industry stepped up research and development.
- Japan's labour force with its availability, literacy and reasonable wage demands contributed significantly to economic growth. As population growth slowed and Japan became increasingly industrialized in the mid-1960s, wages rose significantly. But union cooperation generally kept salary increases within the range of productivity gains.
- High productivity growth: For this, the highly skilled and educated work force, extraordinary savings rates and accompanying levels of investment as well as the low growth of Japan's labour force were major factors.
- Japan has also benefited from economies of scale. Many industrial enterprises consolidated to form larger, more efficient units.[7]
- Japanese corporations developed growth-oriented strategies such as product diversification, the adding of plant and human capacity ahead of demand, seeking market share rather than quick profit.
- The United States occupation of Japan (1945-52) resulted in the rebuilding of the nation and the creation of a democratic state. A variety of measures during the occupation contributed to the economy's later performance.
- The economy benefited from foreign trade because it was able to expand exports rapidly enough to pay for imports of equipment and technology without falling into debt.

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[6] Rate attained 20% of GNP during the 1950s, more than 30% of GNP during the late 1960s and 1970s, around 20% during the 1980s.

[7] Before World War II, large holding companies formed wealth groups, or zaibatsu, which dominated most industry. The zaibatsu were dissolved after the war, but keiretsu – large, modern industrial enterprise groupings– emerged.

In the decades after World War II, Japan had implemented stringent tariffs and policies to encourage the people to save. With more money in banks, loans and credit became more easily available, and with large trade surpluses, the yen appreciated against foreign currencies. This allowed Japanese companies to invest in capital resources much more easily than their competitors, which made goods cheaper and widened the trade surplus further. And, with the yen appreciating, financial assets became very lucrative.

Asset prices started to rise around 1982 with the rise accelerating from 1985 to 1986. Rises were relatively moderate in the early stage and two years 1985/86 even coincided with a recession caused by the appreciation of the yen. The bubble saw skyrocketing land and stock prices, roughly lasting from 1986 to 1990. Speculation was inevitable, particularly at the Tokyo Stock Exchange and in the real estate sector. Additionally, banks granted increasingly risky loans. The bubble episode was thus characterized by a substantial increase in asset prices, overheating of the economy and an increase in money supply and credit. The bubble eventually had to burst. The time after the bubble's gradual collapse is known as the "lost decade" in Japan.

Views differ as to when the bubble began to burst. Stock prices peaked at the end of 1989 while land prices peaked around 1990. The year-on-year growth rate of money supply peaked in April and May 1990, and the economy peaked in February 1991.

The easily obtainable credit that had helped create the bubble continued to be a problem for several years. Correcting the credit problem became even more difficult as the government began to subsidise failing banks and businesses. With Japan's economy driven by high rates of reinvestment, the crash hit particularly hard. Investments were made increasingly out of the country, and Japanese manufacturing firms lost much of their technological edge. As Japanese products became less competitive overseas, the low consumption rate began to bear on the economy, causing a deflationary spiral.

The Japanese economy then became stagnant for more than ten years. The average growth rate from 1993 to 2003 was just above 1%. Since 1998, the inflation rate was negative. Due to virtually zero growth and deflation, Japanese nominal GDP had shrunk by 4% from 1997 to 2002.[8]

Many problems describe contributing factors explaining the “lost decade”. The burst bubble and the non-performing loans problem are often blamed for the poor performance in the early stage of the stagnation. Slow policy responses to the non-performing loan problem resulted in the banking crisis of 1997-98. Slow structural reform in regulated sectors is another problem for the Japanese economy, which did not benefit from ICT advances that fuelled the US economy. But, in the eyes of many economists, the most likely cause for deflation in Japan is a failure of monetary policy.[9]

The economic stagnation of the 1990s and early 2000s eventually led to a range of reforms, including the deregulation of various industries, recapitalisation of the banking system and progressively more ambitious corporate restructuring. In 2003, the economic recovery finally got under way.

3.3 Recent Economic Performance[10]

GDP development

The economy continues to grow at a good pace. Measured in year-on-year terms, real GDP grew by 2.7% in the first quarter of 2007. In early September the government revised its preliminary report for the second quarter of 2007. The latest data show that, rather than growing at 0.1% as originally indicated in the government's preliminary estimate, GDP actually shrank quarter on quarter by a seasonally adjusted 0.3% in real terms. The contributions to growth from government investment and household consumption were revised downwards. The critical factor in this first economic contraction since the fourth quarter of 2004 was a sharp and unexpected decline in corporate investment. Business investment which, together with exports, has been one of the pillars of Japan's robust economic performance in the past three years has now contracted for two quarters in succession.

[8] Data from the Library of Congress, Federal Research Division.

[9] For a more detailed look at the conduct of monetary policy see chapter 4.1.

[10] This section largely draws on the Economist Intelligence Unit Country Report Japan (October 2007).

Overall, the downturn in the second quarter seems to be transitory and should be reversed in the second half of 2007.

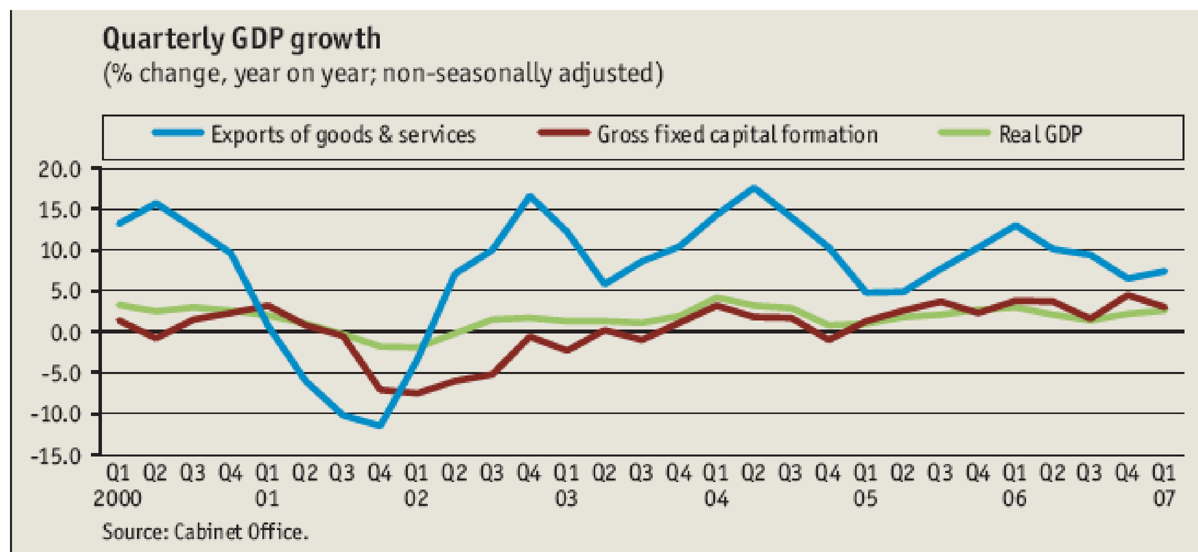


Figure 1 Quarterly GDP Growth 2000-2007

Through most of the now five-year-old recovery the biggest sources of growth were net exports, predominantly sales either directly or indirectly to the US and China, and corporate investment in plant and equipment. Thus the recovery depends heavily on the external environment, and the possibility of a slowdown in the US or China is a real threat to the Japanese economy. If the US would fall into a recession this would severely damage Japan's export industries, discourage corporate investment and undermine household confidence in a manner that almost inevitably would curtail consumption, raising the likelihood of a recession in Japan.

Household spending on new housing and consumption could reduce the Japan's dependence on foreign demand. But there is a dilemma behind this simple observation: Japan's savings rate is extraordinarily high and plays a powerful role in the country's economic performance. Since the collapse of the asset-price bubble, Japan has been awash with capital, interest rates have remained low and corporate investment very high.

The increase in productive capacity, together with the weakness of household consumption implies that the country must export a great deal of its industrial output and that the government must provide a significant degree of budgetary stimulus. Economists long expected the solution to the problem of excess savings (or, from an alternative standpoint, inadequate demand) to come with the retirement of the post-war baby-boom generation: When those people left the workforce, their savings would collapse and their consumption expand.

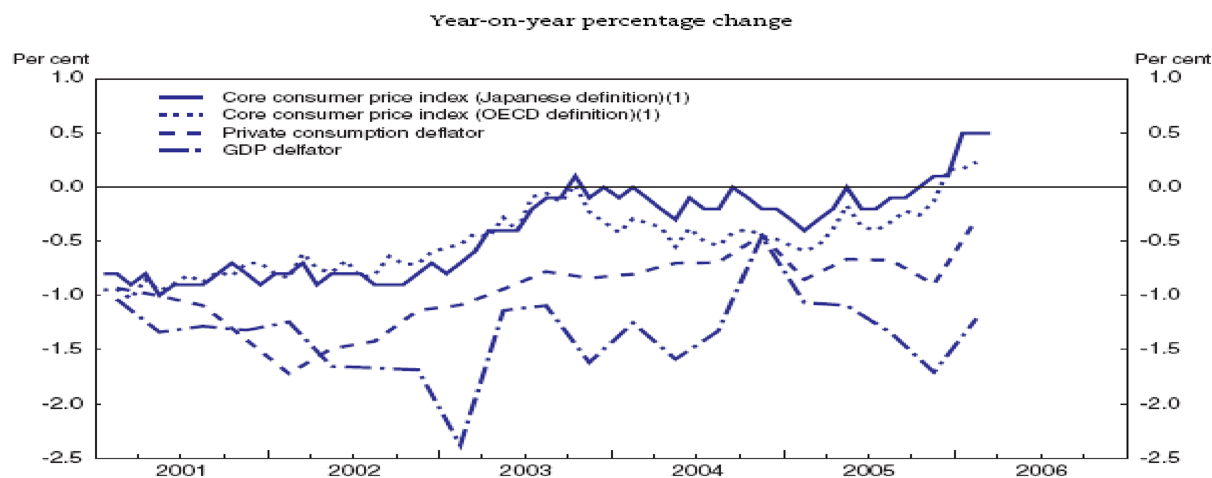
However, consumption has not risen significantly even after five years of GDP growth and the cresting of the wave of retirement. Most observers would attribute this lack of responsiveness to the failure of wages to strengthen, which in turn stems from companies using more and more part-time and temporary staff. Also, the dismantling of the traditional lifetime employment model may not be as significant in attenuating wage increases as the longer-term trend towards younger workers as firms replace their older, more expensive staff with a younger workforce willing to accept lower levels of compensation. This trend is likely to persist. Consumption may therefore remain weak for many more years. Thus, Japan might continue to suffer from an excessively high saving rate and consequently remain dependent for economic growth on a combination of government deficits and expansion in net exports. This pattern, together with the growing receipts from existing overseas investments, also virtually guarantees that the Japanese current account will continue to run a large surplus.

Some government reports, however, provide grounds for optimism. In the first three months of 2007 private consumption showed renewed strength after this component of GDP was basically stable in late 2005 and early 2006.

Inflation (Deflation)

The persistence of mild deflation is a cloud on the horizon. Given that deflation considerably damaged the economy, undermining corporate profitability and the solvency of the banking system, the Japanese economy and in particular the Bank of Japan (BoJ) has eagerly awaited the return of price inflation. The BoJ also needs inflation to raise interest rates in a manner that asserts its institutional independence from the political authorities curtails speculation in asset markets and discourages the yen carry trade.

Developments, however, have disappointed. The BoJ had predicted the consumer price index (CPI) for 2006/07 to show an increase of 0.6% relative to the preceding year, but actual growth was just 0.1%. Since official methods of calculating prices moderately overstate inflationary trends, this means that the prices for households were in fact still falling.



1. Japanese core CPI excludes fresh food only, while the OECD core CPI excludes food and energy products.
Source: OECD Economic Outlook 79 database, Ministry of Internal Affairs and Communications and Cabinet Office.

Figure 2 Year on year percentage changes in consumer prices.

The latest monthly data offer further evidence of this development. Largely owing to a stabilisation (for the observed period) of the prices of oil and other commodities in international markets, but also to reductions in domestic mobile phone charges, personal computers, flat-screen televisions and other leisure goods, the CPI registered slight year-on-year declines in each of the first four months of 2007. This means, firstly, that Japan has not exorcised the spectre of deflation. Secondly, the recent CPI figures emphasise the extent to which the country continues to depend on international demand, as inflationary pressures within Japan are not robust enough to keep prices rising.

It is also remarkable that wholesale prices are moving upward even as retail prices fall. This means that margins at Japanese firms are coming under pressure. The ever rising cost of raw materials cannot be passed on to the customers which might be one of the reasons why companies continue to cut their payroll expenses so aggressively, and hence prevent wages from improving significantly.

For 2007, consumer prices are now forecast to remain flat. Inflationary pressures are expected to build gently over the next few years, with price rises estimated to be around 0.5% in 2008 and 0.8% in 2009. Capacity constraints are starting to kick in and companies are also reporting labour shortages. Above-trend economic growth, coupled with good news on land prices, should also help to put upward pressure on consumer prices in 2008. Sustained GDP growth in 2009 is expected to continue to exert mild inflationary pressure on the economy.

Exchange rates[11]

The August financial crisis in the US sub-prime mortgage market caused the yen to appreciate and had adverse effects on the Japanese stock market and the country's economic outlook.

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[11] It should be noted that from the point of view of the Japanese economy the exchange rate to the US dollar is of significantly higher importance than that to the euro due to the high dependency of Japan on exports to the US market and to China. Therefore, much literature focuses on the JPY/USD relation.

The first of these dynamics became evident when global investors started selling off their positions in Asia's local markets as their confidence weakened following the crisis and the subsequent tightening of credit conditions. This caused the yen to appreciate sharply against the US dollar, thereby imposing big losses on numerous Japanese individual investors who had bought foreign-denominated stocks and bonds. Meanwhile, and partially independently, the sale of assets caused a 16.4% decline in the Nikkei 225 at the height of the crisis in a single week during 12-18 August. The impact of these developments has yet to be seen, but the recent events could bring more disappointing economic growth results for another quarter or two.

It is now assumed that the BoJ will not raise interest rates in 2007 and not until the second quarter of 2008. However, the yen is expected to further appreciate against the US dollar. As the yen rises, most of the remaining yen carry trade is likely to unwind, leading to a substantial backflow of funds into Japan. This is expected to contribute to a strengthening of the yen in 2008-09, not only against the US dollar but also against the euro.

3.4 A closer look at yen carry trades[12]

Some recent capital outflows from Japan involve yen carry trades, the practice of borrowing in yen at low cost to invest in higher-yielding non-yen instruments. A widening of interest rate differentials, coupled with low volatility, has raised incentives for such trading. To the extent that these positions are leveraged, there is a risk of a disorderly unwinding. Such was the case in October 1998, when the U.S. dollar fell by almost 15 percent against the yen. While the effects on the real sector were minimal, the unwinding of short positions by hedge funds and large financial institutions led to a rapid drying up of liquidity. This resulted in unprecedented price disconnects and market seizures.

While there are no data on the outstanding size of carry trade positions, the indirect evidence from the possible sources of funding suggests that carry trades have been limited to date. This is the view of the IMF. However, most press cuttings seem to advocate the opposite opinion.

The Times wrote on 17 August 2007 in connection with the recent financial market turmoil:

The yen carry trade — a "cheap money" borrowing ploy that may have financed investment in global risk assets worth hundreds of billions of pounds — is in danger of imploding.
Currency experts said that yesterday's acute rise in the yen, particularly against sterling, the euro and the New Zealand and Australian dollars, was an "absolute" signal that the yen carry trade was unwinding — a consequence of the equity market turmoil spilling out from America's sub-prime lending crisis.
The yen carry trade ... is thought by some to be the core of the massive worldwide liquidity pool that is now contracting so violently.
The official interest rate in Japan, as set by the Bank of Japan is just 0.50 per cent, far cheaper than the price at which money has been readily available to borrow elsewhere. The carry trade has, for nearly a decade, exploited the near-zero interest rates at which money can be borrowed in Japan.
Although no firm data is available, many believe that the yen carry trade is the core support for strong markets everywhere — from energy and commodities to fine wine and property.
Certain emerging market economies with high interest rates, such as Turkey, may owe much of the strength of their currencies to investors who have sold borrowed yen to finance large positions in them.
"The scale of today's movements in the yen," said Tokyo Mitsubishi's Derek Halpenny, citing an across-the-board flight from risk, "are clear evidence of a sudden liquidation of carry positions by hedge funds."
He added that central banks have generally viewed the carry trade as a source of widespread mispricing of risk. But while central bankers may welcome some form of minor correction to that mispricing, the current turmoil will be a matter of grave concern. Hedge funds, believed to be the biggest users of the carry trade, have over the past two days become forced buyers of the yen as their overall positions have been squeezed by crashing stocks around the world.
Obliged to pay back the yen they have borrowed to buy shares — assets that are now worth substantially less than they were a week ago — carry trade investors have been forced to sell yet more stocks. The rising yen has also created margin crises for those who used borrowed Japanese currency to finance asset purchases in currencies that have now dived against the Japanese currency.
The unwinding carry trade presents many risks, which include the possibility that some highly leveraged funds might not have enough collateral as market conditions worsen.

Although large, most bank credit is extended to US and EU-based affiliates of Japanese firms. Also, according to the IMF, lending to financial centres (where many hedge funds are domiciled) has risen

[12] Sources include: IMF Country Report No. 07/281, Japan: Selected Issues.

only modestly, suggesting a small role for either hedge funds or banks in financing carry positions from this channel.

Foreign banks are active borrowers in short-term markets, but market commentators believe much of this funding is for yen-yen transactions (such as yield curve arbitrage) that have no impact on the exchange rate. The short-term nature of this financing also limits the impact on the yen.

The notional stock of contracts in the yen swap markets[13] is smaller than US dollar and euro positions. The IMF comes to the conclusion that the amount outstanding has changed little since 2004, suggesting these markets have played only a small role in carry trades. Borrowers may not be able to pay off loans quickly, or may be worried about the impact on their credit ratings from a default – so it is not clear that problems with these loans would spark a rapid or disorderly unwinding. Instead, adjustment would likely be protracted.

In the view of the IMF the recent, sharp rise in margin trading[14] may actually reflect structural factors. (Transaction fees are lower on margin deposits than foreign currency deposits at banks.) Furthermore, the IMF believes that "the average account sizes are small (reportedly around $6,000), and losses could easily be absorbed by most investors. Finally, conventional foreign currency deposits have fallen faster than the rise in margin accounts, potentially offsetting any affect of margin trading on the yen."

Even though the short-yen positions of non-commercial traders have tracked movements in the yen-U.S. dollar exchange rate well, it is not clear if this market is representative. First, traders must self-report whether they are “non-commercial” – and not all of these traders are speculators. Recent data suggest to the IMF that these positions could be used to hedge currency risk in Japanese stock trades. Second, only a small amount of foreign exchange trading goes through these markets.

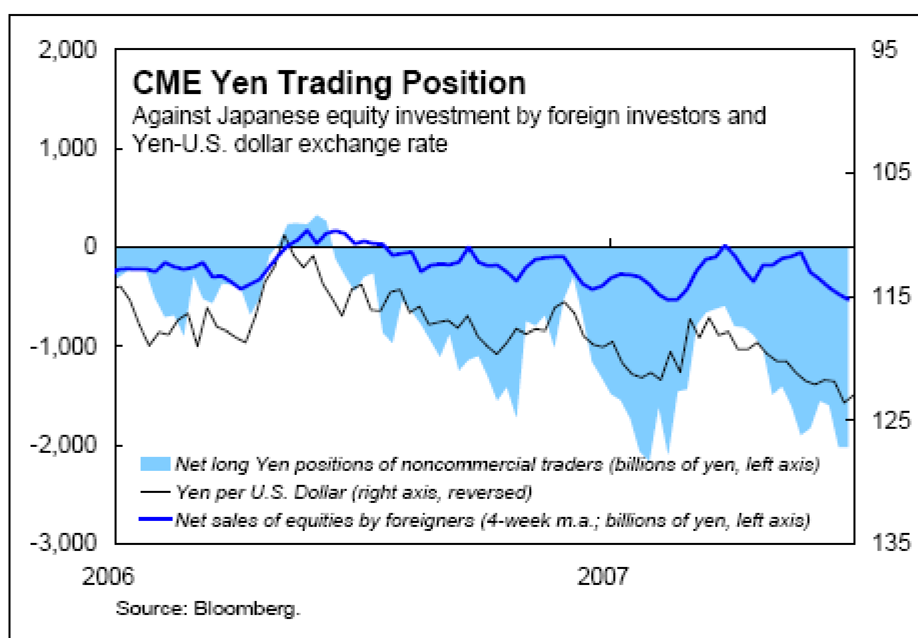

Figure 3 CME Yen Trading Position From: IMF Country Report 07/281, Japan: Selected Issues. Non-commercial short-yen positions at the Chicago Mercantile Exchange (CME) are cited by some as an indicator of speculative yen carry trades. Market commentary suggests that the global short-yen position is around ten times that in the CME.

In light of the considerable uncertainties surrounding the size of the carry trade, it is difficult to draw conclusions about its significance. The wide range of estimates on the carry trade reflects a diversity of views regarding which market is the “best” indicator, and market sizes differ greatly – from around USD 100 billion to nearly USD 2 trillion. The IMF sees limited evidence of a yen carry trade in any

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[13] It is possible to take advantage of Japanese interest rates without borrowing in yen. Banks serve as an intermediary between counterparties in the yen swap market (who are long in yen) and borrowers (who take on currency risk in exchange for low interest rates). Reportedly, these transactions have risen in Europe and Asia, but there are no data. However, some have pointed to the large stock of yen currency swaps as a risk.

[14] Margin trading allows investors to leverage deposits in margin trading accounts (up to 10–20 times) to take currency positions in the foreign exchange market. The actual leverage is unknown, but appears to be smaller.

one funding market, and therefore regards it as likely that the stock of leveraged trades is closer to the lower end of most estimates.

Furthermore, the maturation of markets over the past decade gives additional comfort to the IMF regarding the adjustment process: "First, interest rate differentials are expected to narrow gradually, so market participants have ample opportunity to unwind positions. Second, the long-side of the carry trade appears to be spread across a number of currencies (while in 1998, it was narrowly concentrated on the U.S. dollar), suggesting that any adjustment may involve less movement in the dollar-yen rate[15]. Third, global macro hedge funds are less important at present, and hedge funds have shown flexibility in unwinding their positions, thanks to better risk management techniques. Fourth, the investor base in Japan is more diversified – and holdings remain heavily concentrated in yen assets – adding stability to the financial landscape. Finally, financial markets are in general deeper than a decade ago and better able to absorb asset price volatility. That said, there is still a possibility that an unwinding of carry trades could have a harmful effect in shallower or less liquid markets."

[15] The press, by the way, expects major effects on the Australian and in particular on the New Zealand dollar. (Footnote added by the author.)

4. Economic Policy Areas

4.1 Monetary policy[16]

When the asset price bubble emerged, the BoJ expressed concern at a relatively early stage over inflationary pressure and the adverse effects of excessive monetary easing. From the second half of 1987 when asset prices rose rapidly and economic expansion became increasingly certain, the Bank explored the possibility of monetary tightening, but could not present an argument that was regarded as sufficiently convincing.

Protracted monetary easing is cited as a reason[17] behind the emergence of the bubble. In fact, from the 1980s major countries, including Japan, saw a high correlation between rising asset prices and the expansion of credit. In considering the relationship between the emergence of the bubble and monetary policy, one can identify three sub-periods.

1. Plaza Agreement (September 1985) to spring 1987: promotion of monetary easing to counter the recession caused by the rapid yen appreciation after the Agreement.
2. Summer 1987 to spring 1989: The BoJ could not easily shift to monetary tightening (in a low inflation environment it was difficult to advocate tightening), resulting in the then lowest official discount rate being maintained for a prolonged period. At the same time, the Bank maintained a framework of window guidance with regard to the lending activities of commercial banks.
3. Spring 1989 onwards: The BoJ finally reversed its policy towards monetary tightening. But it took a considerable time for these hikes to have visible effects on money supply and asset prices.

The revised Bank of Japan law became effective on 1 April 1998. It is a state-of-the-art modern central banking law. The central bank is given a single mandate of price stability, and there is no mention of aggregate demand or full employment as part of its objective.

Institutional independence is guaranteed in the sense that Governors as well as Policy Board members will not be dismissed unless physically or mentally incapacitated; their terms of appointment are five years; government officials attend Board meetings only as non-voting members.

Monetary policy decisions are made by majority vote at the Monetary Policy Meetings of the Policy Board. The law states that members of the Policy Board are appointed on the basis of their expertise. The Board is composed of nine members: the Governor, two Deputy Governors and six experts on monetary affairs and economics.

The transparency of monetary policy decision-making was greatly enhanced under the new law. Under the old regime, there was no disclosure of minutes or transcript. The Monetary Policy Board was revamped in the appointment criteria. In April 1998, the Bank under the new law started to announce the decision on the day of meeting and the Governor gives a press conference on the decision within a few days. Detailed minutes are publicly disclosed several weeks after the meeting, and the meeting minutes in about a month and a half. It was decided that the transcript would be disclosed in later years.

[16] Sources include: Paul Krugman: Japan's Trap; Okina et al: The Asset Price Bubble and Monetary Policy: Japan's Experience in the Late 1980s and the Lessons; Muto: Recent Conduct of Japanese Monetary Policy; Ito: Japanese Monetary Policy: 1998-2005 and beyond.

[17] Other reasons: intensified bullish expectations, certain taxation and regulation issues and weak mechanisms to impose discipline. See Okina et al: The Asset Price Bubble and Monetary Policy: Japan's Experience in the Late 1980s and the Lessons.

As the economy slid into deflation in the wake of the banking crisis, the BoJ had in front of it the task of getting the economy out of this deflation and what is regarded by some economists as a "liquidity trap".[18] Several key monetary policy decisions between 1998 and 2006 have to be considered to follow the path of developments. When the Bank of Japan first started to fight deflation, it was more tentative than decisive. The then Governor Hayami even repeatedly suggested that he regarded deflation as not necessarily a bad thing and that aggressive monetary policy might not be called for.

Zero Interest Rate Policy (ZIRP)

After statistics showed negative growth in Japan for several quarters and deflation was getting worse, the BoJ adopted the zero interest rate policy (ZIRP) which was declared to be continued “until deflationary concerns are dispelled”. However, the precise definition of this exit clause was not clarified. Several studies could show that the Bank of Japan should have eased quite aggressively in the early stages of the bursting of a bubble, i.e. before 1995, as by that time the effectiveness of conventional policy instruments had become weak.

After the zero interest rate was introduced in the spring of 1999, the economy started to recover. The worldwide IT stock price rally boosted confidence and stimulated consumption and investment. The mood became bright by the end of 1999. GDP growth rate rose into positive territory in the second quarter of 1999. Inflation also showed some signs of increasing (but remained negative) in the spring of 2000.

When Governor Hayami and some Board members started to suggest in spring 2000 that ZIRP might be terminated soon, many economists and government officials questioned the basis for such a decision. The economy was only on a fragile recovery path, and the internal and external environment were deteriorating, as the IT stock bubble had burst. However, the BoJ pushed the agenda.

In the Monetary Policy meeting on 11 August 2000, the attending government officials went as far as – based on a clause in the Bank of Japan law – submitting a motion to delay the voting on the interest rate hike by one month. This is the maximum resistance and show of displeasure that the government can make against the independent central bank. The delay motion was voted down and the motion for an interest rate hike passed.

What followed confirmed the fears of the critics of the Banks decision. The recession started two months after the interest rate hike, and CPI inflation turned sharply negative. Economic conditions deteriorated towards the end of 2000. The interest rate had to be reversed only seven months later.

Quantitative Easing (QE)

In this situation the BoJ Board members started to explore ways to stimulate the economy.

The official discount rate was cut from 0.5% to 0.35% and the so-called lombard-type lending scheme was introduced.[19] In the Monetary Policy meeting of 28 February 2001, the official discount rate was cut to 0.25%, and the policy interest rate was cut from 0.25% to 0.10%. However, these changes did not have any impact on the market.

The BoJ made a substantial policy change in the meeting of 19 March 2001 when it was decided that the policy instrument would be switched from the interest rate to current accounts at the Bank of Japan, the sum of required and excess reserves, and that excess reserves would be maintained. The banks would place excess funds in the Bank of Japan account that bears zero interest. By implication, the zero interest rate would result.

The change of instrument was a radical move towards quantitative easing. It had the psychological effect that the BoJ was seen as having become more serious about exploring ways to fight deflation.

[18] A liquidity trap occurs when the economy is stagnant, the nominal interest rate is close or equal to zero and the central bank is unable to stimulate the economy with traditional monetary policy tools. In this kind of situation, people do not expect high returns on physical or financial investments, so they keep assets in short-term cash bank accounts or hoard rather than making long-term investments. This makes recession even more severe.

[19] This means capping the interbank rate at 0.35% for anyone who has collateral.

The decision of 19 March 2001 was also accompanied by a more explicit condition on when QE would end: "The new procedures for money market operations continue to be in place until the consumer price index (excluding perishables, on a nationwide basis) registers stably 0% or an increase year on year." This was new in two respects: First, it was clearly stated that the CPI (excluding fresh food) was the index to watch. Second, the new exit condition was much clearer in that the numerical condition was mentioned. However, the definition of "stably" was defined remained ambiguous.

The BoJ also announced in March 2001 a decision to increase the amount of monthly government bond purchases. This decision was a reaction to calls for additional measures even at the zero interest rate. Purchasing assets that are riskier than short-term government paper would help asset reallocation in the economy, so that the private sector would take more risk.

The economy remained weak in 2001. The growth rate was negative for four consecutive quarters and the inflation rate remained about –1% from early 2001 to early 2003. The Bank of Japan tried several steps to enhance QE. It increased the target amount of current account balances as well as the purchase of government bonds in several steps. Also, the official interest rate was reduced to eventually stand at 0.10% in September 2001.

A new Governor and two Deputy Governors were appointed in March 2003. Governor Fukui was keen on building a better relationship with the government and was skilful in communicating to the public his commitment to fight deflation. He also argued that he would be patient before terminating quantitative easing.

QE was a signal that the BoJ would continue monetary easing. Since it would take time to reduce liquidity without disruption, the BoJ was committed to easing and ZIRP into the future by providing excess reserves. It was called the policy "duration effect" in Japan. Therefore, the more excess reserves, the stronger the commitment.

In October 2003, the conditions for exiting QE were clarified. Notably, the meaning of "stably" was defined: the backward-looking inflation rate had to be on average at zero or above and the forward-looking inflation rate had to be forecast by the Board members to be at zero or above.

As signs of economic recovery became clearer, ending QE became a popular topic in 2005. Starting in April 2005, some Board members proposed lowering the target amount for current account balances at the BoJ. The market started to expect the Bank to end QE and raise the interest rate by the summer of 2006. High GDP growth rates and strong profit figures of major corporations gave support to the view that deflation would end soon.

The BoJ finally terminated QE on 9 March 2006. The Bank switched the policy instrument from the target for current account balances to the interest rate. However, since the excess reserves could not be brought down to zero at once without disruption to the financial market, ZIRP had to continue for several months.

There was one other twist to this exit. The BoJ finally disclosed its "understanding" of price stability as interpreted by the Policy Board members. The range was disclosed to be 0-2% measured by CPI inflation.

The volatility in global financial markets since August and the subsequent cuts in the US federal funds rate have since altered expectations regarding the speed at which that the BoJ will tighten monetary policy. Interest-rate spreads have narrowed, rather than widened as previously expected. The GDP growth estimate for the second quarter of 2007 was revised downwards by the government in early September. The BOJ last raised its target for the overnight call rate by 25 basis points to 0.5% on 21 February 2007, and pressure on the central bank to increase the rate again has subsequently lessened. For this reason, together with the GDP data revisions, it is no longer expected that the interest rate will be raised before the end of 2007.

Concerns about the US economy might further dissuade the BoJ from tightening aggressively in 2008. In 2009, however, the pace of tightening is expected pick up, with quarterly increases taking the overnight call rate to 2% by the end of 2009.

4.2 Fiscal policy and Ageing

Status quo

The budget deficit in Japan in 2006 was about 5.2%. The gross public debt stock stands at approx. 170% of GDP, with an increasing tendency.

The government projects to stabilize the debt ratio by the early 2010s, an effort not entirely certain to work out. Spending restraint will be an important factor in achieving this. However, spending cuts are made more difficult by increasing ageing pressures laying more intensely on Japan than in any other OECD country. Therefore, revenue increases through tax hikes may become necessary. This should be modestly possible as Japan has a relatively low revenue/GDP ratio (30%) in international comparison (EU average 45%).

The fiscal problem Japan is facing today mainly stem from the aftermath and handling of the depression in the 1990s on one hand, and from above average ageing pressures on the other.

Legacy of the depression in the 90s

In the midst of the liquidity trap of the 90s, the government attempted to reinvigorate the economy throughout this time with spending programmes, without much success. Together with the ageing component this helped to push up spending from around 30% of GDP in 1990 to just under 40% by 2002. By 2006, this figure has been consolidated to just above 36%. At the same time, notwithstanding modest improvements between 2002 and 2006, revenues broadly stagnated between 1992 and 2006 at around 30% of GDP.

Budget balance

Reflecting this imbalance, the budget deficit reached a peak in 2002 with 8.2% of GDP, up from a surplus of 0.8% in 1992 (see Table X). Spending cuts and economic expansion have helped to bring the deficit down since then, now (2006/2007 estimate) revolving around 5%, with modestly decreasing outlooks until 2010, hopefully stabilising at around 4.5% (OECD estimations). Since 2002, the government has succeeded to reduce the deficit by an average of 0.6% of GDP p.a.

	1992	2002	2005	diff 92-02	diff 92-05
Revenue *Selected Items*					
Direct taxes households	7,8	5,2	5,1	*-2,6*	*-2,7*
Direct taxes business	4,7	2,9	3,2	*-1,8*	*-1,5*
Indirect taxes	7,8	8,5	8,5	*0,7*	*0,7*
Social sec. Contributions	8,5	10,6	10,6	*2,1*	*2,1*
Total revenue	33,3	30,9	30,7	*-2,4*	*-2,6*
Expenditure *Selected Items*					
Govt. Consumption (wages)	5,9	6,8	6,1	*0,9*	*0,2*
Social sec. Payments	7,2	11,1	11,4	*3,9*	*4,2*
Fixed capital formation	5,4	4,8	3,6	*-0,6*	*-1,8*
Interest payments	3,5	3,1	2,7	*-0,4*	*-0,8*
Total expenditure	32,6	39,0	36,9	*6,4*	*4,3*
Budget balance	0,8	-8,2	-6,2	*-9,0*	*-7,0*
Primary budget balance	1,9	-6,7	-4,9	*-8,6*	*-6,8*

Table 1: Changes in government revenue and expenditure since 1992 (in % of GDP)(OECD)

Revenue

On the revenue side, direct tax revenues have significantly decreased over the last 15 years due to the economic depression, while indirect tax revenues have modestly increased. Furthermore, most notably, the social security contributions have slightly increased as % of GDP.

All in all, however, the revenue to GDP ratio decreased by 2%-points between 1992 and 2005, to approx. 30%. In international comparison, Japan raises a very low ratio of its already low total absolute level of taxes from taxes on goods and services (indirect), and a relatively high share from corporate taxes. For the next years, an increase in the consumption tax is expected, from its current very low level of 5% (the Japanese version of VAT). In the medium term, the tax bases in personal and corporate taxes may also be broadened as they are currently quite narrow.

Expenditure

Between 1992 and 2002, expenditures rocketed mainly due to social security outlays in the midst of the depression. While this development has been reversed since 2002, there still remains a considerable imbalance between expenditures and revenue. While government consumption has remained relatively stable, the stark increase in social security outlays has for small parts been compensated by decreasing public investment and interest expenditures. The latter has been facilitated by the extremely low interest rate levels in Japan.

Public debt

The implications of this fiscal deterioration are visible in the debt stock. The public debt to GDP ratio in Japan is presumably the biggest fiscal policy challenge in the near future, having reached levels higher than anything ever recorded in OECD country history. The following graph shows this evolution since 1980.

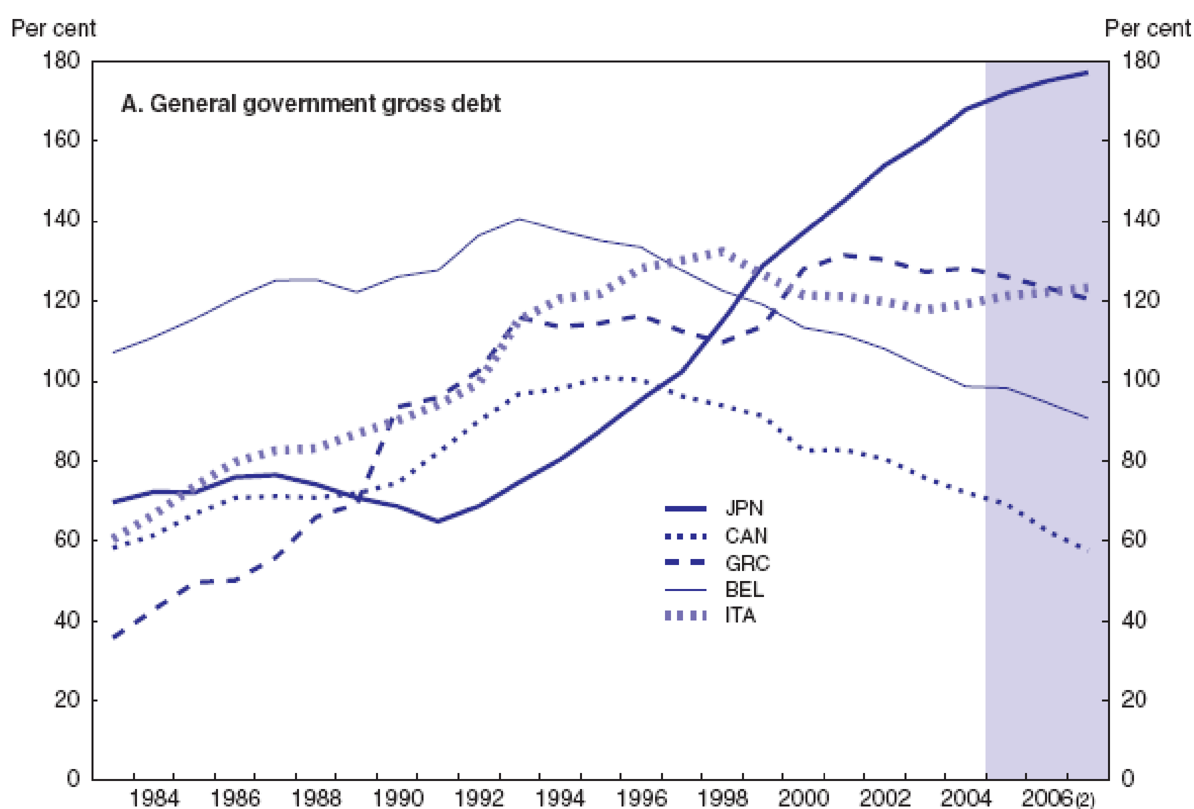

Figure 4: OECD Country comparison with large public debt ratio. Source: OECD Economic Survey 2006

The above figure puts Japan in comparison to other highly indebted OECD economies (Canada, Greece, Belgium, Italy). While the Japanese debt stock is the largest by far, what is remarkable in addition is that only Italy has also recently displayed a growing trend in the debt stock (albeit more modest than that of Japan). All other economies have embarked on more or less successful paths to decrease the debt stock in the new millennium.

The situation in Japan is even worse than above when off-budget items such as state pension obligations and liabilities of the Fiscal Investment and Loan Programme (FILP, a state credit programme) are taken into consideration. However, counting in the financial assets of the government, the net debt ratio is not quite as bad (at 86% of GDP).

Stopping the upward trend in the trend ratio requires that nominal GDP grow at least as fast as the stock of government debt. As the latter has far outstripped the former in Japan with average annual growth of 7.3% and 0.5% respectively since 1997, stabilizing the debt stock remains a challenging task. Low interest rates have facilitated the management of the debt overhang until now, an advantage which is now vaning as the rates are on the rise again. As the projections of the primary deficit are dependent on the level of interest rates that are on rise again, the surplus that the primary budget needs to achieve becomes larger and larger in order to stabilize the debt stock. The Japanese government projects a positive primary balance by 2010. This by itself is already very difficult to achieve, given the current deficit of 3,7% in the primary deficit. Moreover, this on its own is a necessary but not sufficient condition to stabilize the debt stock.

Ageing pressures

Government estimates suggest that as the population is ageing, social security outlays, including pensions, as a proportion of GDP will rise from around 20% currently to more than 35% by 2025. More old people and fewer workers will put pressure on the public finances.

In 2004 the pension system was reformed which marked a fundamental shift from the past system where benefits were largely determined by the income needs of the elderly. Under the reformed system, the benefits will be determined under a combined flat-rate and earnings-related scheme by macroeconomic indexation and fall accordingly (to below 50%) in the course of the coming years. The contribution rate, on the other hand, is scheduled to increase from 13,6% in 2004 to 18,3% in 2017.

Fiscal policy outlook – modest tax increases in sight

The government is expected to cut spending aggressively in order to limit the budget deficit to less than 2.5% of GDP in 2008/09. However, pressure on the public finances will remain intense due to increasing social expenditure. On August 6th 2007 the government released a revised fiscal forecast suggesting that it will only just bring the primary budget into balance in 2011/12. The mixed medium-term economic outlook and the rapid ageing have forced the government to give serious consideration to active measures on the revenue side, e.g. a partial reversal of income tax cuts that were implemented in 1999. Other possible measures include lowering the minimum tax threshold, which is high by international standards, broadening the corporate tax base and raising the consumption tax from the current rate of 5% to 7%. The consumption tax hike is most likely to be the first of these measures to be implemented. However, the timing remains uncertain (between 2009 and 2011).

Reasons for careful optimism

Although the current fiscal policy stance is by no means glorious and especially the gross debt burden is at record levels, there are mainly three reasons to expect that Japan may find its way out of this imbalance: firstly, the net public debt figure is not quite as bad as the gross (170%). The net debt ratio, taking into account the considerable financial assets the Japanese public sector is holding, runs at mere 86%. (On the other hand, even this ratio is still the 4th largest among OECD countries, and on a rising trend.) Secondly, the central bank has also accumulated a significant stock of assets as a result of their quantitative easing policy. Thirdly, and possibly most importantly, the size of the government budget in GDP in Japan is still very low in international comparison, and there should therefore be some scope for both tax rate and tax base increases as in fact planned (as argued above). However, these hikes should be modest in size so that they do not jeopardize the economic recovery and growth prospects.

4.3 Labour market

The employment rate stands at 70% (2006), which is somewhat higher than the OECD average of 66%. From a peak of 5.5% in 2002 and 2003, the unemployment rate gradually dropped, levelling off at 4% from November 2006 to March this year, before declining to just 3.8% in April. This is the lowest figure in a decade.

Although the Japanese labour market did experience some shrinking in the depression of the 90s, the above suggests that unemployment was nevertheless never really the central problem in Japan.

The Japanese labour market is traditionally considered fairly rigid and hierarchical. The market has most recently become more flexible though. An important explanatory factor behind the recent decrease in unemployment is that the situation has improved for women, the elderly and young people. Nevertheless, for those “marginal” groups, the situation still remains less than satisfactory, especially from the point of view of employment stability.

The recent weakening of the life-time employment system has hit exactly the youth and women, who now at relatively high shares have to bear with part-time contracts in temporary employment, outside the well-protected permanent employment realm. The temporary workforce now account for almost one-third of Japan’s workforce. This trend has also depressed wages throughout the recovery.

Employment in Japan has also become more responsive to labour costs, mainly due to increased competition in Asia and international production chains/networks. This has lead to firms gaining more incentives to hire in temporary contracts, thus further worsening the duality in the labour market.

Moreover, Japan has witnessed a strong decrease in its national wage share, from some 75% of GDP in 1980 to 61% of GDP in 2005. This depicts a slower wage growth than labour productivity growth for the whole period and also exemplifies how Japan has moved into more capital intensive production in the light of increasing competition.

Ageing labour supply

Ageing is the main future challenge to the labour market as well. The retirement of the post World War II baby boom generation is set to kick of in 2007. The workforce is already old today. In 2004, according to the Ministry of Land, Infrastructure and Transport, 62% of workers in the industry were aged over 40 and just over 6% were aged 65 or over. One result of this situation may be a change in government policy to encourage foreign workers to come to Japan, although given the country’s high level of cultural homogeneity such a move could prove unpopular with voters.

5. Financial Services

5.1 Reform of Financial Services

Liberalisation Drive

Japan has undertaken financial system reform in a series of stages in recent decades.[20] These have liberalised considerably the environment in which domestic and foreign financial institutions operate, but they have not matched the pace of reform in the United States and the United Kingdom, where banks and brokerages, for example, enjoy more freedom than in Tokyo:

- Interest rate liberalisation in the 1970s and 1980s helped start the reform process in Japan.
- The 'big bang' of the mid- to late-1990s saw foreign exchange controls removed (albeit still with some requirements for reporting transactions) and banks, brokerages and insurance companies allowed some freedom to operate in each other's areas.
- The range of financial products that banks could deal in was expanded and insurance companies were permitted to do a certain amount of foreign exchange business.

From 2000, banks were permitted to form holding companies, wherein they could conduct securities business via subsidiaries specially established for the purpose. Nevertheless, these holding companies were required to establish strict firewalls between banking and securities business, and regulators ensured that such firewalls were observed.

For as long as Japanese banks and other financial institutions remained in a generally distressed condition, after the collapse of the bubble economy in 1990, residual restrictions were not regarded as a reform priority. More pressing issues included the need to maintain solvency and avoid systemic financial problems.

However, further liberalisation of the operating environment for financial institutions has now become an official priority for a number of reasons:

- Leading banks and brokerages have returned to quite robust health.
- Japan has begun to place higher priority on the development of financial and other services, in order to counteract an expected decline in manufacturing output as production shifts offshore and the workforce ages.
- There is an official desire to strengthen financial institutions so that they will not be vulnerable to foreign takeover once rules on inward mergers and acquisitions are relaxed later this year.

The cabinet-level Council on Economic and Fiscal Policy (CEFP) is considering reforms that will affect banks and brokerages, pushing for a further liberalisation of financial services and the creation of a financial community in Tokyo emulating that in London. Among other implications, the proposed reforms would give bank-affiliated brokerages access to wealthy depositors at the parent bank, for marketing investment products. A large part of Japan's JPY 1,400 trillion (USD 11.8 trillion) of household savings is held at banks, and high-net-worth individuals increasingly want to diversify their portfolios, especially into foreign securities.

At the same time, another official panel is examining a plan to expand the role of the Tokyo Stock Exchange (TSE) beyond stock trading and into commodities and financial derivatives. Demand for such products is growing as local investors become more sophisticated, and business is bypassing the TSE for exchanges outside Japan.

Structure

Current restrictions have helped shape the structure of Japan's financial institutions. While eleven former 'city' banks have been merged into three so-called 'mega banks', the structure of the securities industry has changed far less. One of the former 'big four' securities houses, Yamaichi, failed in the 1990s, but Nomura (the largest) and Daiwa remain independent, while Nikko is currently the subject of a takeover bid by Citigroup.

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[20] Nomura Capital Market review 2007; IMF country report August 2007, Goldman Sachs Global Economic Paper December 2006, FSA Japan.

The only one of these securities firms to enjoy freedom to access bank depositors is Daiwa, via a jointly owned company, DaiwaSMBC Securities, which it established with one of the mega-banks, Sumitomo Mitsui Banking Corporation. All three mega-banks have their own securities subsidiaries, but firewalls restrict their access to bank depositors. Independent securities houses (with the exception of Daiwa) have no access to bank clients.

Proposed reforms

If the proposed reforms are enacted, which appears likely given the degree and level of support they enjoy, banks in Japan will be free to offer their broking subsidiaries access to their depositor base, a freedom which independent securities houses will not enjoy. This could feasibly lead Nomura to seek banking partner, while Daiwa Securities could move closer to SMBC Japan's myriad smaller brokerages might also seek individual or joint alliances with banks.

Nikko/Citigroup Takeover changes securities industry: The takeover battle for Nikko is over and Citigroup now owns Nikko the third largest broker exchange. The deal follows a JPY 920bn (USD 7.9bn) tender offer in June that gave Citigroup majority control over Nikko Cordial. Citigroup's acquisition of Nikko Cordial, following an accounting scandal that threatened to lead to the broker's de-listing, catapults the US bank to a leading position in Japan's securities market at a time when the country is expected to see a big shift of household savings into investment assets. It gives the US bank an extensive distribution network in the world's second largest economy and access to a broad corporate customer base. Nikko Cordial has 109 retail outlets throughout Japan and assets in custody of JPY 40, 000bn. The acquisition comes as Japan has significantly strengthened investor protection rules, by requiring financial services providers to ensure that retail investors, in particular, are sufficiently aware of the risks of the products they invest in.

Those supporting changes are not calling for complete abolition of firewalls and brokerages. Accordingly, Japan would almost certainly retain Article 65 of its Securities and Exchange Law, which maintains formal separation of banking and securities business.

Nor will Japan adopt European-style 'universal banking', which allows banking and securities business, including securities underwriting, to be carried out under one roof, virtually without restraint. As a result, residual separation of functions might remain something of a grey area in Japan, with so-called 'administrative guidance' exercised in addition to statute law.

Those urging changes in the law have asked the government to revamp the Securities and Exchange Surveillance Commission (SESC) to protect investors and ensure free market competition and management discipline. They have argued that the SESC should be able to impose financial penalties on a wider range of malpractices and in larger amounts than currently allowed, with effect from 2008.

Tokyo Stock Exchange

Meanwhile, if the plan for the Tokyo Stock Exchange being examined by the panel within the Financial Services Agency is adopted, the government would encourage other exchanges—such as the Tokyo Commodity Exchange, the Tokyo Grain Exchange and the futures-trading Tokyo Financial Exchange—to operate under the Tokyo Stock Exchange's umbrella.

In February 2007, the Tokyo Stock Exchange and the London Stock Exchange formally announced that they would work towards an alliance that will add to an expanding mosaic of mergers and collaboration agreements among exchanges around the world. A month earlier, the TSE announced a similar alliance with the New York Stock Exchange. The ability to trade in commodities and financial derivatives would render the TSE a more equal partner in such alliances.

Competitive pressures

None of the securities houses or banking groups is yet able to compete equally on a global basis with leading US and European banks, or with others from Asia, such as HSBC. In part, this is due to capital constraints on the part of the Japanese brokerages:

- **Nomura exception?** Nomura is something of an exception, in that it has generated abundant revenues from brokerage commissions over many years. Nomura spent more than JPY100 billion (USD 828.5 million) to acquire a major US electronic brokerage and invest in a large hedge fund at the end of last year. However, even Nomura has been the subject of merger speculation with a Japanese bank, from time to time. However Nomura has just received a setback due to their US subsidiary's exposure in the US sub-prime sector.[21]
- Foreign inroads. While Nomura and Daiwa SMBC have preserved a virtual monopoly of capital-raising activities that involve wealthy Japanese institutions investors—such as in the 'public offering without listing' market—foreign investment banks such as Goldman Sachs have been able to make major inroads into M&A business in Japan. Foreign financial institutions are also competing strongly with Japanese securities firms in sales of investment trusts and other financial products.
- Technical innovation. Further pressures are being exerted on Japanese securities houses by the need to install advanced trading systems matching those used by competitors from overseas. Without the large commissions they enjoyed before deregulation of brokerage rates, and facing erosion of their margins also from online stock trading, securities houses are hard pressed to afford the technological innovation needed to compete effectively in global markets.

Late developer

A further constraint is the fact that Japan came relatively late to the idea of financial holding companies where banking and securities activities could be carried out efficiently under one roof, albeit with regulatory firewalls to prevent conflicts of interest arising. An investment banking 'mentality' was slow to develop and financial innovation suffered as a result. Bankers thought mainly in terms of loan income and brokers in terms of income generated from stock commissions. The two groups were slow in coming together to develop new financial products and sources of fee-income from financial services.

The post-war ban on financial holding companies was lifted several years ago, but at that time Japanese banks were generally too preoccupied with dealing with non-performing loans left over from the collapse of the bubble economy to give attention to investment banking activities. With the recovery of the banking system and the slimming down of eleven former city banks into just three mega-banks, attention is now turning toward integrating banking and securities activities and the need to develop globally-competitive investment banks.

Building scale

Size is a key element and this is the context in which the Mizuho Securities and Shinko Securities merger has been conceived. Both firms have historical ties with the Industrial Bank of Japan (IBJ). Mizuho Corporate Bank took over much of the IBJ's work after the IBJ merged with two other banks to form the Mizuho Financial Group. It was Mizuho Corporate Bank that took the initiative in engineering the merger between the two brokerages.

Completed merger

The merger is scheduled to be completed by January 2008 and Shinko Securities, which has a stock exchange listing, will serve as the vehicle to absorb the unlisted Mizuho, though the merged company will be known as Mizuho Securities. Mizuho financial group is expected to retain around 60% of the new company's equity.

The merged company is considering acquiring a US investment bank, a move which appears to be determined more by the need to buy outside expertise than simply a desire to achieve greater size. One of the problems that Japanese brokerages have had in competing internationally is their relative deficit of knowledge on sophisticated financial techniques and products. This is now being overcome, to some extent, through acquisitions of companies and personnel overseas.

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[21] 15 October 2007: Reuters news: Nomura booked pre-tax losses of 74 billion yen at its US unit due to exposure to the sub prime mortgage market.

Nevertheless, the reluctance on the part of Japanese financial institutions to cede top management positions to foreign nationals is still a barrier to the full internationalisation of these institutions.

Smaller-scale rationalisation

Rationalisation of the securities industry and banking industries in Japan is not confined to the largest institutions. Tokai Tokyo Securities, a medium-sized brokerage, and regional bank Yamaguchi Financial Group agreed recently to explore a possible joint venture in securities broking. This would mark the first time that a regional financial institution and a brokerage had entered a comprehensive business alliance with the aim of creating a joint venture, even though Japan's regional bank sector is in the midst of a wave of consolidation.

Conclusion: A second wave of rationalisation is coming to the Japanese financial system, this time involving securities houses, although the banking sector, which has already undergone extensive restructuring, will be integrally involved in the reorganisation of the sector. It will continue to be so as Japan moves closer to a 'universal banking' model of financial intermediation.

5.1.1 New role for the CEFP?

The CEFP met for the first time on October 4th since Prime Minister Yasuo Fukuda took office. Fukuda asked the panel to draw up within the year a plan for bolstering regional economies, a policy seen as crucial to ensuring the ruling coalition's victory in the next general election. However, it is the Cabinet Secretariat, not the CEFP that will be charged with actually configuring the plan. Regarding reforms to the social security and tax systems, Economic and Fiscal Policy Minister Hiroko Ota said after the CEFP meeting that the panel will discuss a structure in which basic pensions will be fully financed with tax revenue, something that the opposition Democratic Party of Japan is pressing for.

But Fukuda has called for the establishment of a joint panel comprised of government officials and ruling party lawmakers to discuss social security and tax system reform, and it is unclear how responsibilities will be divided between this panel and the CEFP. Officials close to the prime minister have said that no measures will clear the Diet unless the ruling coalition gets involved in negotiations.

Under the governments headed by former prime ministers Junichiro Koizumi and Shinzo Abe, the CEFP played a central role in setting policy on reforms. But this may be changing now because the ruling coalition lost control of the upper house, which means that there are no guarantees that the CEFP's decisions will pass in the Diet. Some have suggested that the CEFP should give up on spearheading policy initiatives and go back to playing the role of an advisory panel.

As former Prime Minister Abe overhauled the cabinet, he also terminated the post of economic and fiscal policy adviser. This may help clarify the CEFP's role as the main engine for formulating economic policies.

But a senior Finance Ministry official said policy-setting power will "shift to consultative talks between the ruling and opposition parties" now that the ruling coalition has lost control of the upper house. Neither the CEFP nor the government alone can set policies.

5.2 Banking

Japanese banks can be divided into 4 segments-City banks, Regional banks, tier two Regional banks and Trust banks. City banks operate as commercial banks offering banking services to corporate customers. Trust banks specialise in asset and wealth management and also in mortgages. Regional banks focus mainly on retail banking in specific regional areas. More than 80% of their customers are SME's.

These can be divided roughly between 12 major, internationally oriented banks and the more than 100 smaller regional banks. Performances vary significantly across the sectors. Regional banks in particular appear to be less cost efficient compared to City and Trust banks. Overall Japanese profitability is low compared to other advanced countries. Banks recorded high net profit levels in fiscal year 2006, but this was largely due to one-time reversals of loan loss allowances.[22] .

[22] Bank of Japan, 2007

After City banks with 32.8%, Regional banks have the second largest market share in deposits and loans with 25%. Trust banks and City banks have the highest return on assets (ROA). Regional banks and tier 2 Regional banks have poor ROA reflecting poor asset quality and low diversification of products although their cost structures are lower than European banks.[23]

Japanese banks would benefit from greater product diversification and further deepening of the capital markets. Corporations rely less on capital markets for their need while retail customers hold a larger share of their wealth in bank deposits. Asset-backed securities and real-estate investment trusts have been growing recently. However if we compare the level of risk taking of Japanese banks to other countries, banks in the UK and the US show a higher degree of risk taking.[24]For Japanese Regional banks, their results compare well against Spanish and German savings banks in terms of efficiency, but less well in terms of cost and revenue.[25]

Recently, Moody's investor service reported that Japanese banks were still facing a difficult environment for growth as the core profitability of their loan portfolios has not improved. There are no changes to the business models such as changing the scale of corporate credit concentration which is of a quality that needs to improve for risk absorption to become more efficient.[26]

5.3 Insurance

5.3.1 Non-life Insurance

5.3.1.1. General Situation

The most dramatic change to occur in the Japanese (non-life) insurance industry over the past decade was **market liberalisation and deregulation**. The Japanese insurance industry had been regulated by the government since 1948. Regulatory authorities had exercised influential control over the industry in order to keep it sound and stable by ensuring overall uniformity in terms of products and pricing. In response to changes taking place worldwide, the insurance industry undertook **overall reform in 1996**, when the Insurance Business Law (IBL) was totally revised and the Japanese market first experienced competition. Therefore, liberalisation and deregulation of the non-life insurance industry remain major and ongoing challenges for Japanese insurers.

The industry has suffered from ongoing negative growth since 1997 as a result of liberalisation and maturing of the market. **Stagnant growth in the core businesses** of non-life insurers is a major challenge. In particular, net premiums from auto insurance, which account for about 50% of total premium income, have been declining.

While the growth rate has recently been negative for traditional insurers, there are market players who have achieved remarkable increases in premium income, i.e**. entrants from non-financial sectors and direct-selling players**. In 2004, new entrants showed a 53.1% income increase over the previous year, while direct-selling players achieved an increase of 16.7%. The direct markets and new entrants from the non-financial industry do not present an immediate threat to conventional insurers, given their still small premium income and 3% market share, but their influence will steadily increase, reflecting diversification of their clients' values and lifestyles.

5.3.1.2 Market Data[27]

- A total of 26 domestic and 22 foreign insurers are operating. As of 1.12.2006, a total of **48 general insurance companies** were operating in Japan; a total of 26 companies were licensed as domestic insurers, including 4 foreign capital domestic insurers, while 22 companies were licensed as foreign insurers.

[23] Japanese Bankers Association.
[24] IMF Country report August 2007.
[25] IMF Country report August 2007.
[26] Thomson Financial 11 October 2007.
[27] Data taken from The General Insurance Association of Japan, Fact Book 2005/2006, General Insurance in Japan, p 2, 4 and 5.

- Both ordinary **profits** and net profits for 2006 showed an **increase** and amounted to JPY 483.6 billion and JPY 306.3 billion respectively. Ordinary profits for fiscal year 2005 increased by JPY 74.5 billion and amounted to JPY 483.6 billion compared with ordinary profits of JPY 409.1 billion in the previous year, due to a decrease in claims for natural disasters in the said year. Net profit after tax registered JPY 306.3 billion, an increase of JPY 47.7 billion from JPY 258.6 billion in the previous term.
- The **loss ratio decreased** by 3.0 percentage points to 60.6% due to the decrease in the amount of net claims paid for natural disasters. The **operating expenses ratio improved** by 0.5 percentage point to 32.1% reflecting the belt-tightening efforts of companies to achieve further rationalisation of their operations.

5.3.1.3 Earthquake and Dwelling Risks

By the "Law concerning Earthquake Insurance" in 1966, **Earthquake Insurance on Dwelling Risks** was introduced to the market. The policy provides coverage for losses of or damage to residential buildings or household effects caused by fire, destruction, burying or washing-away following an earthquake, volcanic eruption, or a tsunami following an earthquake or volcanic eruption.

The subject for Earthquake Insurance on Dwelling Risks is dwelling houses (houses used as residence exclusively or partially) and household effects (movables for domestic living) and is undertaken with fire insurance policies. The insured amount of Earthquake Insurance on Dwelling Risks is set between 30% and 50% of the insured amount of fire insurance. The upper limits are JPY 50 million for dwelling houses and JPY 10 million for household effects.

Due to a spate of earthquakes in the past few years in the nation and abroad, **people's awareness against earthquake risks has been growing**. According to the Non-Life Insurance Rating Organisation, 40.3% of the fire insurance policyholders, who took out the policy including renewal contracts in 2005, obtained Earthquake Insurance on Dwelling Risks policy.

Since the likelihood of catastrophic losses following an earthquake is high, the aggregate limit of indemnity is shared among all private insurers and the government, who are liable under the excess of loss reinsurance cover arranged through the Japan Earthquake Reinsurance Company.

5.3.1.4 Distribution

The non-life insurance distribution system in Japan is agency, brokerage and direct distribution by officers or employees of insurance companies. Agents and brokers must be registered with the Prime Minister in accordance with the IBL (Officers and employees of insurance companies are not required to be registered in order to solicit insurance contracts.).

5.3.2. Life Insurance

5.3.2.1 General Situation

The number of stock companies has almost doubled over the past decade, contrasting starkly to the 1960s where only four stock companies were registered with the Life Insurance Association of Japan (LIAJ).[28] This surge can be mainly attributed to the **drastic revision to the IBL in 1996**. As the revised IBL included the introduction of a **demutualisation scheme** which allows a mutual insurance company to be converted into a stock insurance company, it prompted several existing mutual companies to demutualise.

The **removal of the prohibition on the reciprocal entry** between two insurance sectors paved the way for non-life insurance companies to newly join the life insurance market through establishing a subsidiary stock company (or vice versa) as well. And the **gradual entry of foreign life insurance companies** in the Japanese market was another important factor.

[28] Information given in this chapter mainly bases upon the report Life Insurance Business in Japan 2005/2006 by The Life Insurance Association of Japan (LIAJ). As of the end of March 2006 there were 38 life insurance companies members of the LIAJ, see report, p. 2 and list of memeber companies on p. 32 following.

On the back of the revitalisation of the entire life insurance industry due to a recovery in the stock market, the trend for mergers and acquisitions in the industry has settled down for the time being. Meanwhile, the trend in diversifying distribution channels has accelerated as a result of **business and marketing alliances** in the life Industry itself as well as across different industries. The major alliances which took place on or after April 2005 are as follows:

- Business alliance between Dai-ichi Mutual Life Insurance Company and IBJ Leasing Co., Ltd.,
- Marketing alliance between Asahi Mutual Life Insurance Company and Sonpo 24 Insurance C., Ltd.,
- Marketing alliance between Asahi Mutual Life Insurance Company and AXA Life Insurance Co., Ltd.,
- Marketing alliance between Mitsui Life Insurance Co., Ltd. and AXA Life Insurance Co., Ltd.[29]

The **total value of individual insurance policies in force decreased for the ninth consecutive year** as of the end of the fiscal year 2005[30]. The insurance market for mortality risk is still experiencing difficulties. At the same time, third-sector insurances, including medical care insurance, remain strong on the back of a declining birth-rate and a growing proportion of elderly people, and there is fierce competition between the life and the non-life insurance sectors. Sales of variable annuity insurance and other foreign-currency products with high returns expected have been steadily increasing and are mainly distributed by bank assurance.

5.3.2.2 Market Data[31]

- 38 life insurance companies have been operating in 2005. New contracts for individual insurance decreased by 11.4% to JPY 80,739 billion compared to the previous fiscal year.
- Individual insurance contracts in force at the end of 2005 amounted about JPY 1,070 trillion, a modest decrease of 3.7% towards the previous year.
- Premium revenues increased overall by 5% to JPY 29,242 billion, due to the favourable business outcomes of individual annuity insurance and third sector products such as medical insurance.
- As interest rates remained low, the dividend income generated from stocks as well as from other investment income increased on the back of a recovering stock market. Retained earnings were also further increased.

5.3.2.3 Distribution

Tied sales agents have long been the linchpin of the life insurance sales activities in Japan. After peaking at approximately 440 thousand in 1990, the number of agents continued to shrink, and in 2005 fell slightly below 260 thousand. Meanwhile, the number of sales representatives at agencies has been on the rise since it sharply swelled more than twofold in 2002, when Japanese banks started selling individual annuity products subsequently to the partial lifting of the ban on bank assurance in October of the same year.

Bank assurance is now gradually being allowed and the complete clearance of bank assurance is planned by the end of fiscal year 2007. Formerly, major life insurance companies expressed concerns about banks taking advantage of their standing to make high-pressure sales to their loan customers. However, the **major life insurance companies launched bank assurance as a new distribution channel** on the back of measures to avoid the negative effects of such sales, which were implemented as sales regulations to loan customers in July 2005. As shown by the favourable sales of individual annuity insurances by bank assurance after the removal of the prohibition in October 2002, insurance companies are seeking to further reinforce their strategies for this channel.

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[29] The Toa Reinsurance Company, Japan's Insurance Market 2006, p. 37.
[30] For the life insurance sector the fiscal year runs from April 1st to March 31st of the calendar year.
[31] The Toa Reinsurance Company, Japan's Insurance Market 2006, p 38.

However, while they are able to establish a completely new distribution channel in the form of bank assurance, insurance companies are concerned about the negative impact on existing channels such as their sales staffs and agencies. Recently, distribution channels were further diversified, as insurance agent shops as well as internet based insurance sales have become available alongside bank assurance.[32]

5.3.3 Insurance Supervision

5.3.3.1 The Financial Services Agency

The **Financial Services Agency (FSA)**[33], established in 2000, is responsible for ensuring stability of Japan's financial system. This means to safeguard a stable and smooth operation of the financial sector through planning and policymaking concerning the financial system, inspection and supervision of private sector financial institutions, and surveillance of securities transactions. The second important issue is consumer protection i.e. protection of depositors, insurance policyholders and securities investors. The main tasks are:

- Planning and policymaking concerning the financial system,
- inspection and supervision of private sector financial institutions, including banks, securities companies and insurance companies, as well as market participants, including securities exchanges,
- establishment of rules for trading in securities markets,
- establishment of business accounting standards and others concerning corporate finance,
- supervision of certified public accountants and auditing firms,
- participation in activities of international organizations and bilateral and multilateral fora on financial issues to develop internationally consistent financial administration and
- surveillance of compliance of rules in securities markets.

The FSA is composed of four departments. **The Insurance Business Division of the Supervisory Bureau** is responsible for the supervision of life and non-life insurance companies, including foreign insurance companies, insurance holding companies, the Policyholders Protection Corporations, non-life insurance agents, life insurance solicitors, insurance brokers, and non-life insurance rating organisations. The Examination Office within the Insurance Business Division is responsible for the examination of the statement of life and non-life insurance business including the method of operations, general policy conditions, the basis of working out premiums and underwriting reserves.

The FSA also calls for advisory councils to the Commissioner, such as the Financial System Council, the Compulsory Automobile Liability Insurance (CALI) Council, and the Business Accounting Council. These Councils shall, at the request of the Commissioner of the FSA, etc., discuss possible ways and means to improve the financial and accounting system, including the business affairs, administration, and future direction of the financial system and matters related to CALI business. The members of each council are drawn from academic circles, the mass media, consumer groups, etc.

In addition to the FSA the **Ministry of Finance** (Financial System Stabilisation Division) covers tasks like the administration of the reinsurance scheme for earthquake insurance on dwelling risks organized jointly by the government and private insurers, as well as policy planning, research and study relating to the management of financial crises, and supervision of the Deposit Insurance Corporation.

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[32] The Toa Reinsurance Company, Japan's Insurance Market 2006, p. 46.

[33] See also brochure about the FSA available at http://www.fsa.go.jp/en/about/pamphlet.pdf.

5.3.3.2 Policyholders Protection

As part of a scheme to protect policyholders' interests, the following measures have been introduced:

- early warning systems based on the solvency margin ratio, whereby the supervisory authority can require an ailing insurance company to improve its business operation and
- the setting up of two policyholders protection corporations to deal with the possible insolvency of an insurance company.

5.3.3.2.1 Early Warning Measures

In 2003, the FSA revised its administrative guidelines and introduced off-site monitoring and **early warning measures** in addition to the early remedial actions introduced in April 1999. An insurance company will be considered in sound condition if the **solvency margin ratio**[34] is 200% or more. If the ratio falls below 200%, the supervisory authority shall take early remedial action on the basis of the provisions of the IBL and its Enforcement Ordinance. Prior to the early remedial action, off-site monitoring and early warning measures will be taken when the Commissioner deems it necessary in order to improve the management of an ailing company which still maintains its solvency margin ratio at more than 200%.

Early detection and early remedy of managerial problems is the key to rehabilitating unhealthy insurance companies. The FSA has introduced **off-site monitoring** in order to grasp the insurance company's management condition by collecting a continuous flow of financial statements and risk information reports from insurance companies. The collected data is stored and analysed. Giving feedback on the results of the analysis and having interviews with the management of the company, the FSA urges the insurance company to carry out remedial plans independently.

The IBL provides for early remedial action based on solvency margin ratio as a measure to secure the soundness of an insurance company's management. Even an insurance company which does not fall under the scope of early remedial action shall be required to make continuous efforts to maintain and improve the soundness of its business. The FSA will take the following **preventive measures** to assure an early remedy of the management:

- remedial Measure for Profitability,
- remedial Measure for Credit Risk,
- remedial Measure for Stability and
- remedial Measure for Cash Flow.

5.3.3.2.2 Policyholders Protection Corporation System

The "**Life Insurance Policyholders Protection Corporation of Japan**" (PPCJ) and the "**Non-life Insurance Policy-holders Protection Corporation of Japan**"[35]. were both established 1998 for the protection of insurance policyholders by an amendment of the IBL.

Their task is to provide financial aid to a reliever insurance company, which takes over a failed insurance company, and to undertake the insurance contracts of a failed insurance company when reliever insurance companies do not appear. With the partial amendment of the IBL enforced in June 2000, the scope of the Corporations' business and methods of their financial aid have been expanded.

[34] See Annex 1, calculation model taken from The General Insurance Association of Japan, General Insurance in Japan, Fact Book 2005-2006, p. 68; a comparable one for life insurance companies can be found in The Life Insurance Association of Japan: Life Insurance Business in Japan 2005/2006, p. 39.

[35] See The General Insurance Association of Japan, General Insurance in Japan, Fact Book 2005-2006, p. 69.

This includes the establishment of a subsidiary "bridge-insurance company" funded by the corporation to take over the insurance contracts of a failed insurance company, and to provide loans to insurance companies that have to stop paying claims due to temporary cash-flow problems. In addition, by the amendment of the Law concerning Special Rules for Reorganisation Procedures of Financial Institutions effective in June 2000, company reorganisation procedures shall also be applicable to insurance companies, and the reorganisation of failed insurance companies will proceed more smoothly.

In accordance with the provisions of the IBL, **all life insurance companies**[36] **and all general insurance companies operating in Japan**, including foreign insurers and one specific corporation (the Society of Lloyd's), have joined the corporations. However, professional reinsurers, etc. are excluded.

The corporations carry out the following types of business operations:

- to provide financial aid to a reliever general insurance company to which the insurance contracts of an insolvent general insurance company are transferred,
- to undertake the insurance contracts of an insolvent general insurance company, and to administer and/or deal with the insurance contracts, when reliever general insurance companies do not appear,
- to establish a subsidiary ("bridge-insurance company") of the corporation to take over the insurance contracts of an insolvent general insurance company, when reliever general insurance companies do not appear. The corporation shall administer the business operations of the bridge-insurance company,
- to provide loans to the members of the corporation in the event that they have to stop claims payment to their policyholders due to temporary cash-flow problems,
- to provide loans to certain policyholders, etc., of an insolvent general insurance company within the amount equivalent to claims incurred. This is when the insurance company has stopped claims payment due to the issuance of an order to suspend its business operations by the supervisory authority,
- to purchase policyholders' rights on insurance claims filed with an insolvent general insurance company.

The corporations are usually financed by contributions from the member insurance companies. Nevertheless, in the event that an insurance company fails and its insolvency cannot be covered solely by the contributions of the member companies, and if that occurs before the end of March 2009, there is a possibility that the corporations would be financed by a subsidy from the government.

5.4 Securities

There are three separate sections within the TSE market; the first (for the blue chips) and second (for companies with lower trading volumes) and the 'mothers'(venture capital- growth and emerging stocks, which was established in November 1999)

Indices

The TSE has introduced free float indices as well as the existing market capitalisation-weighted indices from November 2005

Traded Instruments

. Stocks, Bonds and derivative products(futures, equity options) are traded on the TSE; the TSE operates under a continuous auction system, where buy and sell orders interact directly with each other and placed under the time priority ruling (a selling/buying order with the lowest/highest price takes precedence over others at the same price. TSE is therefore a order-driven market with no market makers. All TSE listed products have been traded via computer systems since April 1999; there is a

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[36] Excluding organisations as Kampo, the insurance operated under Japan Post and Kyosai, cooperative societies that also provide insurance services, see The Life Insurance Association of Japan, Life Insurance Business in Japan 2005/2006.

daily price limit to avoid wild fluctuations and also a special bid or asked quote posted by TSE in order to balance the price. These two measures work as emergency breaks. Derivatives are traded and reported through the CORES-FOP system (computer assisted order routing and execution system for futures and options).[37]

Clearing and Settlement

In January 2003, the Japan Securities Clearing Corporation, the first registered clearing organisation licensed under the Securities and Exchange Law in Japan started as a unified clearing organisation offering central counterparty services to equities and fixed income products traded on all Japanese stock markets; In February 2004, it offered the same for derivative products. Brokerage commission have been liberalised since end 1999.

Currently the TSE is working to straight through processing (STP).TSE has also announced it will adopt risk management measures in order to avoid adverse effects resulting from hazards such as natural disasters.

The biggest IPO to date has been for Sony Financial Holdings beginning of October raising close to USD 3 bn. Compared to a total of listings in Japan for the first nine months of 2007 totalled USD 2.2 bn for 94 deals against USD 10.4 bn for the same period in 2006.[38]

Samurai Bonds are bonds that are issued in Yen to Japanese investors by foreign companies. Analysts believe that the Japanese bond market has been the source of about USD 30bn of emergency fundraising since the sub prime mortgage crises started. Traders predict that the record for Samurai bonds will be broken this year as the amount of Samurai bonds raised by non Japanese companies in September 2007 was 6x that of September 2006.[39]

Deutsche bank has been the latest in raising USD 1.3 bn in three tranches of Samurai bonds. This is the second Samurai bond this year for Deutsche after a first issue in March this year; The latest offering are believed to be new bonds not expected to repay old Samurai bonds. Citigroup raised USD 2 bn and it is rumoured JP Morgan Chase and Bank of America are also seeking funds.[40] Japanese markets have been hit much less by the global credit crises as Japanese companies have been less exposed as they were still recovering from their bad loans when the CDOs developed overseas.

[37] The handbook of World Stock Exchanges 2007.
[38] Wall Street Journal 12 October 2007.
[39] Global Banking News 1 October 2007.
[40] Reuters 13 September 2007.

6. IFRS/IAS

IASB

On the 8th of August Ikuo Nishikawa chairman of the Accounting Standards board of Japan (ASBJ) and Sir David Tweedie, Chairman of the IASB jointly announced an agreement known as the 'Tokyo Agreement' in order to accelerate convergence between Japanese GAAP and IFRS, a process that started in March 2005.

By 2008 the two boards will seek to eliminate major differences between Japanese GAAP and IFRS as defined by the July 2005 report by CESR. Remaining differences will be removed by the 30th of June 2011.

Both boards will establish working groups led by directors to lead discussions.[41] The IASB has one Japanese board member, Mr Tatsumi Yamada who was appointed in January 2001, joining from PWC Japan and also a member of the executive committee of the IASC.

On 27 and 28 September 2007 the first meeting since the Tokyo Agreement was held. The objectives were to review the convergence programme, focussing on major projects such as segment reporting, intangible assets, special purpose entities and business combinations. Furthermore arrangements for the ASBJ to input its views into the IASB current work programme were also reviewed.

As a reminder the European Commission extended the deadline on restatement for a further two years in October 2006, following recommendations from the European Parliament. Under these measures, third country issuers are not subject to restatement obligations until 31 December 2008 if:

- the financial information contains an explicit and unreserved statement that it complies with IFRS;
- or the financial information is prepared in accordance with Canadian GAAP, Japanese GAAP or US GAAP; or
- the financial information is prepared using a third-country GAAP in relation to which the following conditions are met:
    - the third country authority responsible for that GAAP has made a public commitment to converge it with IFRS; and that authority has established a work programme which demonstrates progress towards convergence before 31 December 2008; and
    - the issuer provides satisfactory evidence to the relevant competent authority demonstrating that the conditions in the above two points have been met.

The measures also require the Commission Services to adopt, through comitology, a definition of equivalence and an equivalence mechanism before 1 January 2008.

[41] IASBJ.

ANNEX I

Solvency Margin Ratio:

In addition to the reserves to cover claims payments and payments for maturity-refunds of savings type insurance policies, etc., it is necessary for general insurance companies to maintain sufficient solvency in order to provide against risks which may exceed their usual estimates. The solvency margin ratio means the ratio of "solvency margin of general insurance companies by means of their capital, reserves, etc." to "risks which will exceed their usual estimates", as calculated below.

$$\text{Solvency Margin Ration (\%)} = \frac{\begin{array}{l}\text{Solvency Margin, i.e. the total amount}\\ \text{of accumulation such as capital (fund),}\\ \text{reserves, etc. prepared for risks which}\\ \text{exceed usual estimates.}\end{array}}{\begin{array}{l}\text{Total of risks which exceeds usual}\\ \text{estimates x ½}\end{array}} \times 100$$

The solvency margin ratio is one of the indices which the supervisory authority utilizes in order to judge the management soundness of a general insurance company. It is understood that problems concerning the management soundness of a general insurance company will not arise if the ratio is 200% or more. The detailed formula of the calculation of the solvency margin ratio is as follows:

$$\text{Solvency Margin Ratio (\%)} = \frac{\text{The sum total of Solvency Margin}}{\left\{\sqrt{(\text{General Insurance Risk})^2 + (\text{Assumed Interest Rate Risk} + \text{Asset Management Risk})^2} + \text{Business Administration Risk} + \text{Catastrophe Risk}\right\} \times 1/2} \times 100$$

→ Solvency margin is calculated as follows:

1. Total Equities
2. Reserves for Fluctuation in Value of Investment
3. Reserves for Catastrophic Risk
4. Allowance for Bad Debts
5. 90% of Latent Profit on Stock (100% of Latent Loss on Stock)
6. 85% of Latent Profit on Land (100% of Latent Loss on Land)
7. Reserves for Dividend to Policyholders of Mutual Insurance
8. Underwriting Reserves (excess amount)
9. Reserves for Loss of Commodity and Securities Transactions
10. The sum total of Deposit, Carried in Capital and Surplus.

plus 11. The Equivalent Amount of Tax Effect of Taxable Reserves
minus 12. Differed Assets

→ The risks mentioned in the denominator are defined as follows:

1. Insurance Risk
   a. General Insurance Risk: risk of occurrence of claims which exceed underwriting reserve.
   b. Catastrophic Risk: risk of loss caused by natural catastrophes such as earthquake, storm, flood, etc.
2. Assumed Interest Rate Risk: risk of not being able to secure the assumed interest rate, which forms the basis of calculation for underwriting reserve.
3. Asset Management Risk: This risk means the total of the following risks:
   a. Risk of fluctuation in value, etc.: risk of occurrence of loss caused by excessive changes in the capital value or interest rate (evaluation based on market value).
   b. Credit Risk: risk of occurrence of loss caused by bad debts or default (evaluation based on market value).
   c. Risk arising in a Subsidiary Company, etc.: risk of occurrence of loss caused by the failure of investment in a subsidiary company or a related company.
   d. Derivative Transactions Risk: risk of occurrence of loss caused by transactions of futures, options and swap, etc.
   e. Reinsurance Risk & Recovery of Reinsurance Risk: risk of occurrence of loss caused by the lack of underwriting reserve or outstanding claims reserve and the recovery of reinsurance.
4. Business Administration Risk: risk of occurrence of loss beyond anticipation in business administration.