

Emergency Countermeasures to Deflation

February 27, 2002

On February 13, Prime Minister Koizumi directed ministries concerned to formulate emergency countermeasures to deflation, based on the understanding that "while deflation has a varied background, the resolution of the immediate financial problems is indispensable to overcoming deflation." The government's responses to this direction are summarized in this document.

The government shall continue to implement specific and effective measures in a bold and flexible manner in response to any changes in economic and financial conditions. In particular, with regard to the disposal of non-performing loans which presently stands as a top-priority issue, actions shall be taken to achieve concrete progress in line with the ongoing process of special inspections, thereby solidifying the prospects for an early resolution of the so-called "non-performing loans problem." Meanwhile, the government shall stand ready to take any and all necessary measures to prevent a financial crisis.

Overcoming deflation will require the government and the Bank of Japan to act in unison. Therefore, we turn to the Bank of Japan with the request that it act with due audacity in implementing monetary policy.

1. Promoting the Disposal of Non-Performing Loans

(1) Rigorously implementing special inspections

- Borrowers, whose poor performances may wield an important impact on the financial health of financial institutions, shall be

subjected to rigorous inspections and actions through the process of special inspections.

- The process of special inspections shall continue through the end of March 2002. Upon completion, their results shall be promptly summarized and announced.
- Major banks shall be required to publish financial statements promptly following the end of March 2002, which appropriately reflect the outcome of special inspections and the resulting status of the disposal of non-performing loans.

(2) Further accelerating the disposal of non-performing loans

- Major banks shall be required to take the following actions.
 - * In line with the outcome of special inspections, with regard to troubled corporations, necessary measures shall be taken such as promptly formulating corporate restructuring plans that are acceptable to the market and resorting to legal procedures for corporate re-organization or disposal.
 - * The disposal of non-performing loans shall be accelerated through selling the assets to the Resolution and Collection Corporation (RCC) and actively utilizing corporate reconstruction funds.

(3) Actively purchasing assets by the RCC

- The Deposit Insurance Corporation and the RCC shall actively purchase non-performing loans using various means, including the assets-in-trust method and utilization of corporate reconstruction funds. Furthermore, a "headquarters for the promotion of the asset purchase" (tentative name) shall be established in the RCC in order to actively engage in the Article 53 acquisitions.

- The Deposit Insurance Corporation and the RCC shall set appropriate prices in purchasing non-performing loans in view of the recent revision to the Financial Reconstruction Law whereby non-performing loans are to be purchased at market prices. As a provision against possible secondary losses, collection profits generated by the Article 53 acquisitions shall be appropriated to a fund (Market-Price Acquisitions Fund) to be utilized for the effective implementation of acquisitions at market prices.
- The Deposit Insurance Corporation and the RCC shall fine-tune their use of the Article 53 acquisitions scheme in order to ensure the smooth purchase of non-performing loans. For this purpose, meetings shall be held to exchange views with the financial businesses sector.
- The RCC shall fundamentally strengthen its organizational and personnel structures so that it can become more actively engaged in the purchase of non-performing loans, corporate revitalization and other operations. For this purpose, financial institutions will be asked to dispatch personnel with seasoned knowledge of related functions to the Corporation.

(4) Promoting the establishment of corporate reconstruction funds

- Several corporate reconstruction funds are scheduled to be launched by the end of March 2002 through the participation of major banks, the Japan Policy Investment Bank and private investors. The establishment of these funds will further accelerate the process of corporate reconstruction and the disposal of non-performing loans.

2. Stabilizing the Financial System

(1) Ensuring the stability of the financial system in preparation for the introduction of payoff system

- The soundness of financial institutions shall be ensured through appropriate inspection and supervisory measures in order to avoid destabilizing the financial system due to failure of financial institutions following the introduction of payoff system.

[Note] Administrators shall be dispatched to failing financial institutions, which face difficulties to continue their businesses, to undertake the transfer of assets and businesses to receiving organizations (52 cases during FY 2001). For financial institutions lacking in financial strength, early correction measures shall be taken requiring the implementation of recapitalization and other necessary measures prior to the introduction of the payoff system.

- Liquidity risk shall be monitored more intensively in order to obtain a clear view of fund-shifting and other developments immediately before and after the introduction of the payoff system. For this purpose, close contact shall be maintained with the Bank of Japan.

(2) Avoidance of financial crisis

- Should financial institutions experience funding difficulties due to rumors, the Bank of Japan will be requested to take all necessary measures to maintain the soundness of banking sector, such as by providing the ample liquidity.
- Should the risk of financial crisis arise at any time, and should it be judged necessary in light of the relevant laws and ordinances, any and all necessary measures shall be implemented, including capital reinforcement, thereby ensuring the stability of the financial system.

3. Market-Related Measures

(1) Stronger short selling regulations

To restore investors' confidence in the stock markets, various measures shall be taken in addition to those recently implemented. Specifically, more thorough and stronger actions shall be taken in the regulation, supervision and surveillance of short-selling activities.

[1] Comprehensive measures related to short selling (since December 21, 2001)

- Regulatory response
Applying short-selling regulations to margin transactions (mandatory disclosure and confirmation of short-selling transactions). (Enforced on February 20)

- Surveillance response
The Securities and Exchange Surveillance Commission has issued two recommendations for disciplinary action since December 2001. Rigorous surveillance activities will be continued.

- Supervisory response
Disciplinary administrative actions have been taken against three securities companies for violations of short selling regulations since December 2001. Rigorous disciplinary action will continue to be taken as needed.

[2] Reviewing margin and securities-loan transactions (since February 1, 2002)

In response to excessive margin transactions, stock exchanges and securities finance companies have issued "warnings to the market" while raising "rates on securities loans".

- Reviewing standards for warnings issued by securities finance companies. (Implemented on February 7: 17 issues [Feb. 6] --> 31 issues [Feb. 21])

- Reviewing standards for designating issues requiring daily disclosure of outstandings of margin transactions. (Implemented on February 20: 7 issues [Feb. 19] --> 18 issues [Feb. 20])
- Raising lending rates on securities loans under the institutional securities loan system through securities finance companies. (Implemented on February 18)
 - * Raising minimum lending rates on warning issues (minimum bidding charge of ¥0.05 per share).
 - * Increasing the maximum range of lending-rate hikes during emergencies (4 times --> 10 times).

[3] Reviewing regulations concerning short selling (announced on February 8, 2002)

In view of various cases in which short-selling regulations have been circumvented, price regulations on short selling shall be reinforced. (The principle of "prohibiting short selling at prices below the latest market price" shall, as a rule, be revised to "prohibiting short selling at prices at or below the latest market price.") (Scheduled to be implemented on March 6)

[4] Forthcoming initiatives

- Strengthening further the surveillance of violating short-selling regulations by the Securities and Exchange Surveillance Commission
 - * Rigorous surveillance of violating short-selling regulations shall be implemented by means of detailed examination of short-selling transactions and thorough inspection of securities companies.

* Surveillance systems shall be fundamentally reinforced in both quantitative and qualitative terms, primarily through appointing private-sector experts. In FY 2002, the number of staff shall be increased by about 50 per cent (i.e. 61 persons).

- **Strengthening the response of the Tokyo Stock Exchange to short selling**

In line with "Responses to Short Selling" announced on February 19, the following actions shall be implemented: securities companies shall be asked to report on their internal control systems concerning short selling (Feb. 25); stock-price surveillance shall be strengthened in the examination system of transactions in the markets; cooperation will be strengthened with overseas self-regulatory organizations regarding transactions by non-residents; and tie-up will also be reinforced with Japan Securities Finance Co., Ltd. regarding margin transactions (consultations to start on Feb. 27).

- **Reviewing Stock Exchange standards for raising collateral requirements on margin transactions**

Standards for raising collateral requirements on margin transactions shall be reviewed to facilitate raising the guarantee deposit rate (currently 30 per cent) on individual issues (Scheduled to be implemented on March 4).

- **Further reviewing stock certificate procurement costs for institutional margin transactions**

The stock exchanges and securities finance companies will be requested to review their terms of lendings to securities companies and others in order to ensure an appropriate distribution of cost burdens between the buying and selling sides in margin transactions. This request will be issued and announced on February 26.

(2) Actively utilizing the Bank Equity Purchasing Corporation

- The Bank Equity Purchasing Corporation was established on January 30 and started purchase operations financed by a special account on February 15. (Government prepared guarantee facilities of ¥2 trillion for FY 2001, which will also be made available for FY2002.) On February 19, the banking sector was urged to actively utilize the Corporation.

(3) Expanding the eligibility of ETF products

- Eligible indices for ETF (exchange traded funds) shall be expanded by the end of March 2002 so that ETFs linked to industry stock indices can be issued.

4. Countermeasures for Credit Crunch

(1) Ensuring the smooth flow of funds to small- and medium-sized enterprises

[1] Actively utilizing the guarantee system of loan collateralized by trade receivables

The guarantee system of loan collateralized by trade receivables was launched in December 2001 so that the framework of physical-collateral dependent indirect financing should be reformed and the flow of funds to small- and medium-sized enterprises could be smoothed. The following measures shall be implemented to vigorously promote the utilization of the guarantee system.

- Government ministries and agencies shall cooperate to promptly eliminate restrictive contract clauses prohibiting the transfers of receivable accounts owed by the central and local governments and by major corporations.

- The Financial Services Agency shall encourage private financial institutions to more actively utilize this system.
- The Ministry of Economy, Trade and Industry shall urge credit guarantee corporations to promote the active utilization of this system.
- More thorough public relations activities shall be promoted.

[2] Ensuring the smooth flow of funds provided by private financial institutions

- In addition to conventional forms of financing against real estate collateral, new lending initiatives shall be promoted to further ensure the smooth flow of funds to sound small- and medium-sized enterprises. Such lending initiatives will utilize financial know-how previously unavailable to financial institutions, such as the launching of uncollateralized and non-guaranteed business lending facilities featuring speedy decisions on financing.
- Private financial institutions shall be urged to utilize the newly expanded and reinforced safety-net guarantee systems provided by credit guarantee corporations to further ensure the smooth flow of funds to small- and medium-sized enterprises.

[3] Steadily implementing and expanding Safety-net guarantees and lending

Approximately ¥140 billion was provided by the first FY2001 supplementary budget to reinforce the financial foundations of the safety-net guarantee and lending system. To promote more extensive utilization, credit guarantee corporations and government financial institutions shall be instructed to more thoroughly implement the system. Furthermore, the following measures shall be taken to expand and reinforce the system.

(a) Expanding and reinforcing safety-net guarantees

The eligibility of small- and medium-sized enterprises for the guarantee system shall be significantly expanded by easing the certification standards in the following cases: small- and medium-sized enterprises affected by restrictions placed on the business activities of counterparties (such as the closure of factories and stores of counterparties); and small- and medium-sized enterprises belonging to industries experiencing deteriorating business conditions.

(b) Expanding and reinforcing safety-net lending

The eligibility of borrowers shall be extended by easing the requirements related to declining revenues and to difficulties in discounting of bills. Furthermore, the system shall be expanded by creating a new lending facility in the Shoko Chukin Bank featuring unsecured loans of up to ¥30 million for small- and medium-sized enterprises experiencing funding difficulties due to the deterioration in the general financial environment.

[4] Greater flexibility in revising repayment terms under special guarantees

While a considerable degree of flexibility has been already permitted in revising the terms of loan repayment under the special guarantees, greater flexibility shall be added in view of the prevailing serious conditions.

Necessary measures shall be taken, in principle, upon application so that the terms of loan repayment under special guarantees by small- and medium-sized enterprises (such as those potentially eligible for safety-net guarantees) which have been affected by major bankruptcies, the failure of financial institutions or restructuring of counterparty companies shall be revised in line with the current conditions of the borrower.

(2) Implementing inspections corresponding to current business conditions

In order to avoid the mechanical application of the procedures of the financial inspections manual, the following pre-, concurrent-, and post-inspection measures shall be expanded and strengthened: instruction and training of inspectors; implementation of "inspection monitoring" for on-site confirmation of the appropriateness of inspections; and creation of an "appeals system" for post-inspection settlement of differences of opinion arising between financial institutions and the authority.

Furthermore, in order to enhance understanding of the current business conditions of borrowers, specific examples of how the provisions of the financial inspections manual should be applied in categorizing small- and medium-sized enterprises and small businesses shall be formulated and published.

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The fundamental requirement in overcoming deflation is the prompt creation of private demand. In line with the principle of "no growth without structural reform," the greatest possible effort shall be made to realize economic growth through implementing structural reform.

From this perspective, with regard to regulatory reform, in light of the recommendations submitted by the Council for Regulatory Reform, prompt implementation of regulatory reforms shall be undertaken wherever possible, including the submission of necessary legislative bills. Furthermore, the Three-Year Program for Promoting Regulatory Reform shall be revised toward the end of March 2002. As for tax reform, the Council on Economic and Fiscal Policy (CEFP) and the Government Tax Council have been engaged since the beginning of 2002 in comprehensive studies for the fundamental review of the tax system with emphasis on

economic revitalization, which is scheduled to conclude toward June 2002. In addition, in June 2002, the CEFPP is scheduled to present the basic directions for a broad range measures for economic revitalization.

Furthermore, comprehensive studies shall be undertaken to achieve greater accuracy in measuring price developments. In addition to examining the current framework of price statistics and methods of analysis, new methodologies shall be examined, including the use of price-indexed bonds, as is employed in the United States, Britain and other countries, thereby contributing to gauging how the markets are assessing future price developments.