

Japan Takes on Challenges of Structural Reform

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Mr. Chairman, Ladies, and Gentlemen,

It is a great pleasure to be here today. I would like to talk about the challenges facing the Japanese economy and the progress of the structural reform the Koizumi administration has been pushing for.

1. Structural Problems Underlying the Persistent Economic Weakness

Last year, the global economy suffered from two unforeseen events. The first was the spread and continuation of the IT recession beyond all expectations. The second was the September 11th terrorist attacks in the U.S. These two unforeseen incidents have simultaneously exerted negative impacts on the global economy. The global economy has not as yet reached the stage where we can firmly anticipate its full-fledged recovery.

The Japanese economy began recovering from early 1999. But that recovery was lackluster, and in fact it was the shortest-lived recovery ever in the post-war period. Since the end of 2000, the Japanese economy has entered yet another recession.

This persistent weakness of the Japanese economy can be largely ascribed to structural problems, especially the non-performing loan problem. Non-performing loans of banks and excessive debts of the corporate sector have been dragging down the Japanese economy. The disposal of non-performing loans is necessary to reallocate the resources such as labor and capital from inefficient, unprofitable companies and sectors to more productive uses.

For the Japanese economy to get back on a growth path, it is also necessary to raise its potential growth by promoting structural reform, such as deregulation, fiscal reform, and reform of pension and medical insurance systems.

On top of the structural problems, the Japanese economy suffers from cyclical downturn due mainly to the slowdown of the global economy. Industrial production and business investment, especially in IT-related sector, have been significantly declining. The unemployment rate has reached a post-war record of 5.5% in November last year.

To cope with the worsening economic conditions, the government has formulated two economic policy packages that are backed by two supplementary budgets for the current fiscal year. The first is the “Advanced Reform Program” in October, which includes measures for new job creation, safety net formation concerning job security and SMEs, and measures addressing the NPL problems. In December, the government adopted the second package, the “Emergency Action Program for Structural Reform”, in order to accelerate structural reforms. The Action Program is accompanied by the second draft supplementary budget, which is to be deliberated by the Diet. 4.1 trillion yen (US\$34 billion) will be allocated to social infrastructures that will facilitate structural reforms. This demand increase is estimated to lift GDP by 0.9 percent over a year.

In line with the structural reform efforts of the government, it is hoped that the Bank of Japan will continue to adopt appropriate and flexible monetary policies to stem deflation. The government and the Bank of Japan will work together in fighting deflation.

With such efforts by the government and the Bank of Japan, the government expects that the Japanese economy will start a recovery driven by private demands sometime in the second half of the next fiscal year. However, economic growth in the next fiscal year will likely be as low as zero percent.

The much-hoped-for recovery will likely be fragile, unless economic fundamentals are strengthened. Structural reform is the key to fundamentally solving the problems besetting the Japanese economy. Now, I would like to discuss the Koizumi Administration’s strategy for structural reform.

2. The Koizumi Reform Under Way

(Japan's Policy-Making Process Has Changed)

Since its inauguration last spring, the administration of Prime Minister Junichiro Koizumi has been living up to its pledge to push through reform, buoyed by strong public support.

In understanding the Koizumi Reform, I think it is very important to realize that the policy-making process in Japan has changed to a considerable degree. In order to implement the structural reform, strong political leadership is essential to fight against vested interests. Before Mr. Koizumi took office, no one could imagine that the Japan Highway Public Corporation would be privatized, that the Government Housing Loan Corporation could be discontinued, and that expenditure on public corporations could be reduced by over 1 trillion yen in a year. The Koizumi Reform has progressed under the Prime-Minister's strong leadership.

His strong leadership is fortunately supported by the administrative reorganization introduced one year ago. The Council on Economic and Fiscal Policy (CEFP) was then created in the Cabinet Office, and has taken a key role in the formulation of economic and fiscal policies. The Council has provided him with "machines" for his leadership. The Council is comprised of economic ministers and 'wise men' from the private sector and presided by the prime minister. I am in charge of steering the Council to make sure that the Council underpin the prime minister's leadership.

(Moving Forward on Structural Reform)

Now, I would like to touch upon the topic of where our structural reform is headed. In June last year, the government adopted a key document setting out all the basic directions of the Koizumi reform. This document drafted by the Council is titled as the "Basic Policies for Macroeconomic Management". Its basic concept is "no growth without reform." To take forward the "Basic Policies", the "Reform Schedule" was formulated in September. The "Reform Schedule" is a road map for reform, putting in place a clear timetable for the specific contents of the "Basic Policies".

The Council is now finalizing another key document addressing economic and fiscal management over the medium term. This document titled as "Reform and Prospects" will lay out targets for fiscal consolidation and the medium-term policy framework focusing on structural reforms. It will also include a likely scenario for economic growth over the next decade.

The period of intensive adjustment over the next few years will be an important preparation for achieving private-demand-driven economic growth. During this phase, overcoming deflation will be of great importance. The government and the Bank of Japan will need to work in unison in fighting deflation. We expect that economic growth will stay low for the next two years or so, but subsequently the economy will pick up and approach a 2% growth for the rest of the next decade.

(Non-Performing Loan Problem)

Now, I would like to discuss the non-performing loan problem, which has been a drag on the Japanese economy. The “Reform Schedule” includes a set of measures for accelerating the disposal of non-performing loans and revitalizing the financial sector: the Financial Service Agency (FSA) has introduced special inspections, the purpose of which is to ensure adequate loan classification and secure enough loan loss provisions. The RCC will purchase NPLs more actively because the RCC is now allowed to purchase NPLs at market prices unlike before. The RCC and the Development Bank of Japan will support private investors in establishing deleveraging funds, which will facilitate the restructuring of debt-ridden companies. As a result of these efforts, the resolution of NPLs will steadily be attained.

(Deregulation and Public Corporations Reform)

Let me turn to measures to revitalize the economy. Demand creation by fostering competition and innovation is crucial for revitalizing the economy. In particular, the Japanese government has been undertaking deregulation in health care, social welfare, childcare, education, and other fields directly linked to people’s daily lives. It has often been considered that the market mechanism cannot work well in those areas. The Koizumi administration thinks differently. That is why these areas are chosen as target areas for deregulation as part of the Koizumi reform.

In December, the government also announced a plan for the rationalization of public corporations. Under this plan, 62 public corporations (or 40 percent of the total) will be, in principle, privatized or abolished. In particular, seven public corporations—which have been dependent on large governmental expenditures—are now slated to be privatized or prioritized ahead of other public corporations. In the next fiscal year’s budget, the government is set to cut spending for public corporations as much as one trillion yen, or a 20% cut.

(Fiscal Reform)

Fiscal reform is necessary. The draft budget for the next fiscal year is formulated with the principle of limiting the issuance of government bonds to no more than 30 trillion yen. Under this principle, the draft budget prioritizes spending, allocating greater funds to priority areas such as 1) measures for ageing society, 2) promotion of science, technology, and education 3) revitalization of the metropolitan region, and 4) regional revitalization with environmental consideration. On the other hand, public works expenditure is to be reduced by more than 10 percent while prioritizing projects. The draft budget also reduces ODA expenditure by 10 percent, cut back medical service compensations for hospitals and doctors. Total expenditures by local governments will be reduced as well.

Furthermore, the “Reform and Prospects” presently being deliberated will set the stage for improving the quality of government expenditures over the medium term, through better prioritization of budget allocations and the active use of private finance initiatives (PFIs). The government will keep in check expansion of government expenditures. With these policies being implemented, the Japanese government will achieve surplus in the “primary balance” of the central and local governments combined shortly after the year 2010. The ratio of government debts to GDP will start to decline at around the same time.

Eight months have passed since Mr. Koizumi took office. Over this relatively short period, his administration has successfully taken some powerful steps for structural reform. Yet, this journey of structural reform has only just begun. To move forward on these structural reforms, the Council will focus particularly on tax reform, new policies to rejuvenate Japanese industries and reform of public financial institutions.

3. Japan’s Role for the Future of Asia

Finally I would like to briefly address the role of the Japanese economy in Asia. While Asian economies are now facing difficulties amid economic stagnation, they have by no means lost their economic dynamism. Many IT products are produced in the region and IT literacy is very high in Asia. With the advance of globalization, goods, services, people, capital and technologies actively transcend national borders, resulting in higher levels of economic interdependence in this region. China’s entry to WTO will further accelerate the speed of globalization.

Asia’s economic dynamism will continue to be a driving force for the global economy.

Japan's solid recovery can contribute to the long-run growth of Asian economies. Strong Japan-US cooperation will provide conducive environment for the stability and prosperity for Asia.

As the Asian crisis in 1997 has highlighted, Asia economies must reinforce their economic fundamentals and improve their financial systems in order to achieve the best possible performance in the new era of globalization. Japan is ready to play an important role in the global economic management by helping reinforcement of Asian economies in the following three aspects.

Firstly, Japan's foreign direct investment (FDI) in other Asian economies is conducive to promoting their growth through transferring capital and technologies. Japan's FDI in Asia has been expanding rapidly, and it will contribute to raising potential growth of Asia. While there are concerns in Japan about industrial hollowing out, Japan must overcome such concerns by promoting domestic investment through its own structural adjustment.

Secondly, Japan is prepared to promote bilateral or regional arrangements for investment and trade liberalization in tandem with multilateral liberalization. Japan-Singapore Economic Partnership Agreement is a case in point. Another case is a meeting of IT ministers in the Asian region. I took the lead in organizing a first get-together of Asian IT ministers to share best practices and stave off digital divide. We are of the view that bilateral and regional arrangements will complement multilateral frameworks like the WTO, enhancing the prosperity of this region.

Thirdly, Asian economies need to implement structural reforms as the Asian crisis highlighted the importance of structural adjustment in each economy. We are hoping that the Japanese economy will set a new model of growth by creating a market-friendly economy through structural reforms in which the private sector, not the government, takes the lead.

Closing

Let me conclude by assuring you that Japan is changing with the Koizumi Reform, changing for the better.

Thank you very much.