Japan's Financial Policies since the 1980s with Special Reference to the Bank of Japan

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Introduction

Financial reforms including measures of supervision of the banking sector have been earnestly discussed since the G20 Summit meeting in Washington D.C. in November 2008. In the course of the discussions to combat the global financial crisis, many policy makers and academicians have paid attention to Japan's similar experience in the 1990s, the "Lost Decade" after bursting of the "Bubble Economy" in the late 1980s.

In this background, the objective of this research note (hereafter called Note) is to make a survey of financial policies with special reference to the Bank of Japan (BoJ) for its supervision of the banking sector. The period in question is that before and after the 1990s. An important period included in the Note is that after the Lehman Brothers' bankruptcy in September 2008. The analytical method is basically a survey of literature and publications. It is supplemented by responses to a questionnaire which the author sent to BoJ in March 2009. The net contributions of this Note are the analyses of the following subjects:

1) All financial sectors/markets/agents/policies in a comprehensive framework;
2) Administrative setup (relationship between BoJ and Financial Services Agency (FSA), system of evaluation of BoJ's activities); and
3) Political economy of financial reforms with attention to external pressures, especially those from the United States.

1. Achievements of Financial policies before the Current Global Financial Crisis

1.1. Structure of Japan's financial sector and its developments

1.1.1. Structure of Japan's financial sector after World War II and its developments until the "bubble economy" in the late 1980s

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To restart her economic development as a developing country after World War II, Japan took a government-led strategy. Financial markets together with other markets were regulated so that savings of households could be channeled into enterprises through banks. Though private banks were regulated, all of them were allowed to survive in their designated markets under the patronage of the Ministry of Finance (MOF). Several public banks including a postal bank were also established by the government.

The above policies produced tangible results. Many enterprises also protected by other ministries like MITI[2] expanded their activities with financial loans provided by banks, and gained international competitiveness. The banks themselves also deployed their activities in other countries. Top ten banks in the world were occupied only by Japanese banks in 1988. Japanese economy overcame the difficulties caused by Nixon shock and two oil shocks to recover first from the recessions in the industrial world in the 1970s. [3]

But a turning point came in the second half of the 1980s. After the Plaza agreement in 1985, Japanese yen appreciated against US dollar substantially, leading to serious recession. The government took reflationary policies. In particular, the Bank of Japan governed by MOF at that time lowered interest rates substantially. The discount rate went down to two and half percent in 1987 (see Table 1). [4]Those policies were also taken under pressures from the United States.

[2] In fierce negotiations on trade talks, the Ministry of International Trade and Industry (MITI) was called a "notorious MITI" by the American counterpart. MITI is now the Ministry of Economy and Industry. MOF, most powerful of the bureaucracy in Japan, protected the financial sector.

[3] Vogel, E.F., professor of Harvard University, published a book entitled "Japan as Number One," in 1979. Japan's supremacy reached its peak in 1989, when the Institute for Management Development (IMD) ranked Japan as number one in its first country ranking. Twenty years later, Japan's rank is the 17th in 2009.

[4] Since March 1995, a money market rate has been used as a policy rate by BoJ.

Table 1 Economic and Financial Trends

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
MACRO INDICATORS															
GDP real growth	0.6	0.1	0.6	2.3	3.1	3.3	0.9	0.1	0.9	1.8	2.7	1.5	−2.2	0.0	2.8
(% change over prec. yr)															
CPI	0.6	0.1	0.6	2.3	3.1	3.3	1.7	1.3	0.7	−0.1	0.1	1.8	0.7	−0.3	−0.7
(% change over prec. yr)															
Exchange rate	168.5	144.6	128.2	138.0	144.8	134.7	126.7	111.2	102.2	94.1	108.8	121.0	130.9	113.9	107.8
(yen/US$, average)															
FINANCIAL INDICATORS															
(Period averages)															
Share prices (2005=100)	104.3	154.3	168.0	202.4	171.0	145.2	107.5	120.1	126.0	108.8	126.5	109.9	92.9	109.2	121.9
Money market rate	4.961	3.669	3.835	5.117	7.398	7.525	4.660	3.059	2.196	1.213	0.470	0.484	0.371	0.059	0.108
Discount rate	3.000	2.500	2.500	4.250	6.000	4.500	3.250	1.750	1.750	0.500	0.500	0.500	0.500	0.500	0.500
M3 growth	8.8	10.0	9.4	11.1	7.0	5.3	3.4	4.0	4.0	3.6	3.1	3.2	−5.1	2.6	0.9
(% change over prec. yr)															

	2001	2002	2003	2004	2005	2006	2007	2008	2009
MACRO INDICATORS									
GDP real growth	0.2	0.3	1.5	2.7	1.9	2.0	2.3	−1.2	
(% change over prec. yr)									
CPI	−0.8	−0.9	−0.2	0.0	−0.3	0.2	0.1	1.4	−1.4
(% change over prec. yr)									
Exchange rate	121.5	125.4	115.9	108.2	110.2	116.3	117.8	103.4	93.6
(yen/US$, average)									
FINANCIAL INDICATORS									
(Period averages)									
Share prices (2005=100)	94.1	77.2	72.3	88.1	100.0	128.2	131.1	93.5	68.4
Money market rate	0.058	0.011	0.001	0.001	0.001	0.125	0.473	0.461	0.105
Discount rate	0.100	0.100	0.100	0.100	0.100	0.400	0.750	0.300	0.300
M3 growth	0.8	0.9	−0.2	0.8	0.4	−0.4	0.8	0.8	
(% change over prec. yr)									

Source:The author based on IMF's International Financial Statistics online data on 28 March, 2010.
Note: GDP growth is based on 1985 indices for 1986−1990, and on 1995 thereafter.

These long reflationary policies led to tremendous jumps of stocks and commodity prices, eventually properties. What is called the "bubble economy" emerged. Despite introduction of some deflationary policies, those prices did not stop. Nikkei (stock) average index reached 38,957 yen on 29 December, 1989 against 18,701 yen at the end of 1986 (see Table 2). The following reasons for the property bubble have been cited by many observers: too much liquidity, optimistic outlook of asset prices by all major players of the markets, and lax supervision of financial markets.

Table 2 History of Economic and Financial Policies

		JAPAN					
	American administration and other	Administration of LDP	Economic situation	Economic policy	Financial policy General	BoJ	FSA
1980							
1981	Reagan						
1982	Reagan	Nakasone					
1983	Reagan	Nakasone		Yen-$ committee			
1984	Reagan	Nakasone		(1983-84)			
1985	Reagan	Nakasone		Plaza agreement			
1986	Reagan	Nakasone					
	Big bang in UK						
1987	Reagan	Nakasone					
1988	Reagan	Takeshita					
1989	Bush	Takeshita,others	Nikkei avr. 38957	Japan-US SII			
1990	Bush	Kaifu					
1991	Bush	Kaifu,Miyazawa					
1992	Bush	Miyazawa					
1993	Clinton	Oppositon		new SII			
1994	Clinton	Oppositon					
1995	Clinton	Murayama	79yen/$				
1996	Clinton	Murayama,other			Japan's big bang		
1997	Clinton	Hashimoto	Freeze of interbank markets	another SII	Japan's big bang		
			Bank,securitiy company bankrupt				
1998	Clinton	Hashimoto	Long-term banks bankrupt		Japan's big bang	New BoJ Act	FSA set up
1999	Clinton	Obuchi	Injection of tax to 15 large banks		Japan's big bang	Zero-interest-rate policy	
					Injection of tax to		
					15 large banks		
2000	Clinton	Obuchi,other			Japan's big bang	Lifting of zero-rate policy	
2001	Bush	Koizumi		another SII	Japan's big bang	Zero-interest-rate policy	new FSA
					Reform of public	Quantitative easing	
					financial institutions	(2001~2006)	
2002	Bush	Koizumi				Zero-interest-rate policy	
2003	Bush	Koizumi	Nikkei avr. 7604			Zero-interest-rate policy	
					IRCJ established		
2004	Bush	Koizumi				Zero-interest-rate policy	
2005	Bush	Koizumi				Zero-interest-rate policy	
2006	Bush	Koizumi				Zero-interest-rate policy	
2007	Bush	Abe			Prv. of postal bank		
2008	Bush	Fukuda				0.1% interest rate (Dec.)	
2009	Obama	Aso, opposition(LP)	Nikkei avr. 7021				
2010	Obama	Oppositon (LP)				Zero-interest-rate policy	

Source: Author.
Notes: LDP: Liberal Democratic Party
LP: Liberal Party
IRCJ: Industrial Revitalization Corporation of Japan
SII: Structural Impediments Initiative

1.1.2. Developments after the "Bubble Economy" in the 1990s and lessons of the "Lost Decade"

The bubble economy ended in the early 1990s, plunging the economy into deep recession. Despite the government stimulus measures, it lasted until the early 2000s. In addition to the fiscal policies, important financial policy measures were taken to combat the recession. Those financial policies are cited as Japan's lessons, most of which have been actually taken for the current financial crisis since September 2008.

Concretely speaking, BoJ which duties were dictated by the Ministry of Finance until 1997 lowered interest rates repeatedly. After the new Bank of Japan law effective in 1998, BoJ finally took a zero-interest-rate policy and a quantitative easing policy (see details in Section 1.4), both of which were unprecedented measures.

Another important lesson is related to a first large-scale freezing of money markets which has been a phenomenon of the financial crisis after the Lehman bankruptcy. It happened in Japan in 1997 as presented below.

In the long recession since the early 1990s, a rumor of a financial problem in Sanyo Security Company, a medium-size in the sector, led to sudden withdrawal of funds from the money market. This triggered the consecutive bankruptcies involving large financial institutions. Sanyo Security Company went bankrupt on 4 November, 1997. Hokkaido Takushoku Bank, 13th largest bank, went into liquidation on 17 November. Finally, Yamaichi Securities, one of the four biggest security companies, was obliged to wind up its operations on 24 November.[5]

To escape from the chilling economic recession, BoJ supplied a large amount of liquidity to the markets, and the government injected public funds into most of large banks in 1998 and 1999. But the financial difficulties and economic recession continued. Two long-term banks went bankrupt and nationalized temporarily in 1998. It was only when the government set a clear time table in which banks should clear up their non-performing loans (NPLs) in 2002 that Japan could start getting out of the long tunnel.

This is an important lesson. Dr. Takenaka, then Minister of Finance and Economy for 2001-2006, made a reference to this issue in an interview with a correspondent of UK's Financial Times on Oct. 27 2009. After he had pointed out that Japan's experience was that of a banking crisis, while the current US's that of a money market crisis, a common lesson is that an accurate assessment of assets is important before the government injects public funds, he said. [6] With its introduction, Japan could head for recovery from the crisis which had lasted for more than ten years.[7]

In actual fact, the comprehensive program for reducing NPLs announced in 2002 were

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[5] At that time, there were four large security companies, namely Nomura, Nikko, Daiwa and Yamaichi. Only Nomura and Daiwa have survived the period of the 1990s and the period before and after the Lehman Shock. Nikko has been merged into joint ventures with foreign financial institutions, though the name of Nikko still exists. Nomura Securities took over Asian and European branches of Lehman Brothers after its bankruptcy.

[6] "Heizo Takenaka on lessons from Japan's banking crisis," Short view (video), Financial Times. http://www.ft.com/cms/bfba2c48-5588-11dc-b971-0000779fd2ac.html (watched on 11 April,2010)

[7] This point is also made in IMF's evaluation on Japan (2008) as follows:
"without steps to fully recognize losses and address the capital shortage, the functioning of the markets can be distorted and delay needed restructuring. Weak accounting practices and regulatory forbearance masked the NPL problem for many years and limited incentives for action such as seeking out new capital and merging with other institutions." (p.3)

supported by protection of deposits, establishment of an institution for NPLs and strengthening of capital. The government requested major banks to accelerate the disposal of NPLs within two to three years by selling them directly to the market. The other loans were sold to the Resolution and Collection Corporation and to the Industrial Revitalization Corporation of Japan (IRCJ) established in 2003.

1.2. Financial reforms and administrative structure

The financial sector of Japan was guided by the almighty Ministry of Finance (MOF) until the late 1990s. Its policies coincided with those of other ministries. The bureaucrats took a very strong initiative in formulation and implementation of policies for the development of Japan since the end of World War II. This was possible under political stability as most of the periods were governed by one party, the Liberal Democratic Party (LDP).

The basic approach of the MOF was to foster the financial sectors with protection against domestic rivals and foreign agents. The system was established to channel domestic savings into enterprises through private banks and public financial institutions, in other words, indirect financing. The concrete guidelines/contents were as follows: separation of banking from securities; separation of short-term finance from long-term; more emphasis on public finance than on private finance. Even within each of the private banking sectors, the market was segmented so that both of large and small financial institutions could continue to operate. This is what is called Gosousendan-houshiki, or a"convoy" banking system.

With development of the Japanese economy and introduction of economic liberalization around the world led by United States and United Kingdom, the above system reached a point at which it could not push forward the economy in the future. Financial reforms started in the 1980s and much more vigorously in the 1990s. As explained in Section 1.3, pressures from the United States on a shaky political structure of Japan were another important factor leading to rapid liberalization of financial markets.

Concretely speaking, a basic strategy for financial reforms was decided by Yen Dollar Committee in the early 1980s. Major reforms were included in a package of policies under Japan's Big Bang announced in November, 1996. [8] Most of important

[8] The word, big bang, was used when Thatcher administration started its financial reforms in 1986.

liberalization measures were taken by 2001 except privatization of the postal bank in 2007 (see Table 2).

In addition, the financial reforms also included institutional reforms as well. A new administrative setup for regulation and supervision was established: new Bank of Japan Act in effect and Financial Supervisory Authority (FSA) established in the same year, 1998. This authority was replaced by Financial Services Agency (FSA) in 2000, which included a planning function of the Ministry of Finance. Finally, the Agency was upgraded to be a new FSA of the Cabinet Office and took over the duties concerning failed financial institutions in 2001.

1.3 Political Economy of Financial Reforms

Many experts and scholars have made many analyses of Japan's experience of financial reforms in the 1990s and beyond. Most of Japanese scholars and practitioners cite as the background to introduction of financial reforms the following reasons: inefficiency of government regulation since the end of World War II; protracted deep recession, competition with other financial markets in the world; scandals of MOF officials.

However, a most important lesson not drawn by most of them is that financial reforms/liberalization should not have been implemented in the post-bubble deflationary period. This lesson is rarely taken because the analysts have not been able to examine the historical events in a comprehensive framework. So the author will analyze the political economy of the financial reforms in the historical context. This point corresponds to an important rule among G20/G7 leaders after the Lehman bankruptcy that financial reforms should be implemented after the economic recovery.

What is important for Japan's experience in the 1990s is that the government took those policies in the post-bubble deflationary period under the pressures from the United States. It was necessary to reform the financial sector to strengthen competitiveness of Japan's markets. But the author of this Note argues that the drastic reform measures were introduced in a short time when the economy was thrown in a most serious financial crisis and that its schedule had been set by American officials. The Government of Japan did not introduce the financial reform measures with its own determination.

To explain the concrete events, Japan had serious negotiations with the United States which demanded comprehensive liberalization of the Japanese economy. After a series of trade liberalization talks starting in 1970, Yen Dollar Committee was convened in the early 1980s, which produced a report on a strategy for financial reforms in Japan. In addition, more comprehensive approaches were taken in Japan-US Strategic Talk in 1989 and the Japan-US Framework for a New Economic Partnership in 1993. Those talks were followed by subsequent similar talks.[9]

Negotiations on liberalization of financial markets were completed in 1995 under the above negotiation (financial services agreement). Its concrete schedule for implementation in the second half of 1990s must have been set at that time. Though the post-bubble recession reached the worst levels in the same period, the schedule was not changed because of the then political situation in Japan together with stubbornness of the American administration.[10]

The Liberal Democratic Party (LDP) which had governed Japan since the end of World War II was faced with declining popularity. As presented in Table 2, none of the governments from 1988 to 2000 had lasted more than two years. The first government of the opposition coalition came into power in 1993 and lasted till 1994. Though the opposition government was toppled down in 1995, the new government was composed of LDP, Japan Socialist Party (JSP) and another party which had taken part in the opposition coalition in the preceding two years. LDP which continued to govern afterwards did not have a power to resist the American pressures.

Even some politicians of LDP pushed the liberalization strategy to gain and maintain their own political power, acting as a reformer.[11]With their initiatives, therefore, the drastic reforms were implemented as scheduled despite the continued deep recession

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[9] The first talk was Japan- U.S. Enhanced Initiative on Deregulation and Competition Policy (Enhanced Initiative) under the Japan- U.S. Framework for a New Economic Partnership (Framework) in 1997. It was developed to be the Regulatory Reform and Competition Policy Initiative (Regulatory Reform Initiative). The latter was established by President Bush and Prime Minister Koizumi on 30 June, 2001.

[10] The details of the negotiations were not fully disclosed, even with a little reference by mass media. There were a few publications which criticized American pressures on liberalization of the Japanese economy.

[11] Only Takeshita was a mainstream politician backed by the biggest Tanaka faction of LDP. On the other hand, Nakasone and Hashimoto were key figures to take the liberalization policies in collaboration with the American counterparts. In particular, Nakasone from a small faction, though backed by the Tanaka faction, established a very good personal relationship with President Reagan and took a leadership for liberalizing the Japanese economy in the early 1980s.

In sum, the implementation of reforming measures or an Anglo-Saxon model for liberalizing markets was imposed with little consideration for the deflationary cycle in the second half of 1990s. It must also be noted that the implementation was taken so quickly that the financial institutions like banks could not cope with rapid changes in the financial markets, thereby protracting economic recovery. After the implementation of liberalization of financial markets, the problems of non performing loans (NPLs) were solved only after Koizumi administration with strong leadership had been established in 2001. Then, he appointed Dr. Takenaka as Minister of Finance and Economy, who took decisive action to get out of a financial predicament.

1.4. Policies of the Bank of Japan (BoJ)

1.4.1. Overall System

First, BoJ's administrative setup and the environment surrounding the Bank are explained. Many scholars and practitioners point out the following reasons for the new BoJ Act in 1998: movement of independent central banks in the developed world, inefficiency of the system backed by the Ministry of Finance, and continued financial crisis.

The author emphasizes the first point, though from a different angle: the financial reform package imposed by the United States included an establishment of a new system. The American move was of course backed by a movement of institutional reforms going on in other major industrial countries, especially UK. The essence of the system was a separation of financial policies from fiscal policies. In addition, the new system was equipped with good governance in terms of transparency and accountability.

The new law, the Bank of Japan Act, was passed in the Diet in 1997 and put in force in April 1998. The new Bank established an equally high stature comparable to central banks of other major industrial countries. Independence of the Bank was warranted. That is, the government which appoints a governor, two vice-governors and other external Policy Board members with consent of the Diet, can no longer sack them and give them directions about the Bank's policies and activities.

The second new characteristics of the Bank were introduction of a system of transparency and accountability of its policies and measures. Monetary policies and other measures are determined in a discussion among the Policy Board members composed of a governor, two vice-governors, and six members from institutions and enterprises outside the Bank. The policy decisions can be made with votes of the nine members. The discussion results including those of voting are disclosed through press conferences and publications.

This governance issue is thoroughly analyzed in a study of Financial Stability Assessment program (FSAP) conducted by IMF in 2003. Regarding 'D. Central Bank Responsibilities in Applying the Core Principles (CPs),' the IMF mission makes the following two statements:

"95. The Bank of Japan largely meets its responsibilities in applying the Core Principles to the systems that it operates and oversees."[12]; and

"108. Given that the BoJ observes or broadly observes the practices of the MFP Transparency Code, the assessment does not call for a recommended action plan to address shortcomings in transparency." [13]

In short, IMF appreciated the new BoJ and did not make any significant recommendations for further improvement in its governance.

1.4.2. Achievements of Monetary policies

Although the post-bubble recession was protracted until early the 21st century, BoJ made all it could to overcome the problems, even introducing unconventional measures which have been taken by major industrial countries in the current global financial crisis since 2008.

Kang, K. and Syed, M. of IMF's Asia and Pacific Department (2008) present their analytical results about the overall system of BoJ's policies as given below.

"Reflecting the breadth and gradual unfolding of the crisis, Japan's strategy evolved over a number of years, at first centering on innovative and exceptional measures by the BoJ to provide liquidity, including expanding the range of collateral, direct purchases of

[12] IMF(2009),p.59
[13] IMF(2009),p.63.

assets, and quantitative easing under a zero-interest-rate policy. "[14]

Concretely speaking, faced with the protracted recession, BoJ had no alternative but to adopt a zero-interest-rate policy in February 1999 (see Table 2). [15] In August 2000, reflecting signs of recovery, BoJ's Policy Board lifted the policy after voting against a request to postpone the decision by MOF officials present at the meeting as an observer.

However, it was introduced again in March, 2001. The Japanese economy was caught in a liquidity trap. It was not until July, 2006 that the zero-interest-rate policy was abandoned. The policy was taken for the long period from 1999 to 2006 except a short period from 2000 to 2001 (only seven months)

Another unconventional policy, quantitative easing, was introduced in March 2001 and lifted in March 2006. In the current financial crisis, almost zero interest rate was reintroduced in December, 2008 in cooperation with other major industrial countries represented by the United States. So the normal interest period lasted only from 2006 to 2008.

However, as IMF analysts point out, those macro policies were not sufficient, various prudential policies were taken as discussed below.

1.4.3. Achievements of Prudential policies

First, BoJ's overall administrative setup for prudential policies is explained. In the institutional reform in the late 1990s, Financial Services Agency (FSA) became a regulatory authority of all financial institutions. The Ministry of Finance had taken this responsibility before the year. FSA was given an authority to inspect even public financial institutions under the administrative control of the respective Ministries, including the postal bank. In addition, FSA conducts inspection of banks including foreign ones as an executive order. The Agency can also make a request BoJ to submit its information.

BoJ does not serve as a regulatory authority under the Banking Law enacted in 1997, but it conducts on-site and off-site examinations in order to maintain a safe and sound

[14] IMF (2008), p.2.

[15] The zero interest-rate policy was named by Governor Hayami in February 1999.

financial system. These examinations are based on bilateral agreements between the BoJ and financial institutions that have current accounts with the Bank under the Bank of Japan Act.[16]

While the BOJ has no planning function, it does cooperate with the FSA for supervision of the banking sector. In the event of a crisis, moreover, the Ministry of Finance and FSA has a joint responsibility for formulating corrective policies.

With respect to BoJ's structure, the most important section of BoJ is the Policy Board. The members except the governor and two vice-governors are six external members who belonged to other organizations than the Bank.[17]

As regards relationships with the government, the Minister of Finance or the Minister of State for Economic and Fiscal Policy or officials appointed by them can attend the Policy Board meeting, but cannot discuss the financial policies and measures for bank supervision. The governmental officials can ask the Board members to postpone implementation of policies to be decided by the members.[18]

The Bank conducts on-site examinations of financial institutions by dispatching its examiners to institutions, and off-site monitoring through meetings and telephone interviews with their executives and staff, and analysis of various documents and financial data. Findings from on-site examinations and off-site monitoring help facilitate the smooth settlement of funds and the proper exercise of the lender of last resort function. They also provide valuable information for the conduct of monetary policy.

In sum, a very effective system for monetary policy implementation and bank supervision was established in 1998 when FSA was born and that BoJ Act was put into force in the same year. FSA was then strengthened to be a new FSA in 2001 (see Section 1.2). As explained in Section 1.4.1, IMF endorsed the system in 2003.

[16] Japanese Bankers' Association, "BANK SUPERVISION: (1) Bank Supervision and Inspection." http://www.zenginkyo.or.jp/en/banks/banking_regulation/ (viewed on 17 January, 2010)
[17] Iwata (2009) argues that six external members may be allocated as follow: academician, banker, representative of a security company, representatives from two non-financial enterprises. There may be a rule to select a female member and a member from a foreign institution.
[18] Article 19 (Attendance of Government Representatives) , Bank of Japan Act (Act No. 89 of June 18, 1997).

With respect of achievements of prudential policies, BoJ took unconventional policies in line with the government in the following environment:

"While (innovative and exceptional policies like quantitative easing were) necessary, this liquidity provision proved insufficient for fixing the financial system. When the crisis intensified, the authorities turned to restructuring banks, pushing them to recognize problem loans and raise new capital, and in some cases seek out public funds or exit the sector. "[19]

To look at actual events, BoJ decided to buy stocks owned by private banks in 2002 to support the government's comprehensive program for reducing NPLs. This unprecedented measure was followed by further purchases of ABS and CP possessed by the banks.

2. Achievements of Financial Policies during the Current Global Financial Crisis

2.1. Structure of Japan's financial sector and its developments

To look at the situation of the financial sector just before the Lehman shock, financial reforms did not change the sector significantly. According to Financial System Council, advisory body of FSA, the banking sector still occupies a large share of financial flows as follows:

1) Shares of deposits in individual financial assets are about fifty percent (fifty-two percent in FY1998 to fifty-three in FY2008);
2) Shares of borrowings from the banking sector in all funds raised by companies are more than thirty percent (forty-one percent in FY1998 to thirty-six in FY2008);
3) Shares of corporate bonds held by the banking sector are nearly fifty percent (thirty-two percent in FY1998 to forty-eight in FY2008); and
4) Shares of commercial paper (CP) held by the banking sector are more than thirty percent (forty-seven in FY1998 to thirty-five in FY2008).[20]

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[19] IMF (2008), p.2.
[20] FSA's Report by the Roundtable Committee on Fundamental Issues of the Financial System Council-Designing the Japanese Financial System in Light of the Global Financial Crisis-December 9, 2009.

In addition, public sector still occupies a lion's share of banking activities (see Table 3). The postal bank is the largest bank in the world.

Table 3 Private Deposit by Institution (as of 31 March, 2007)		
	Trillion yen	% share
Domestic Bank	344.8	47.5
Foreign Bank	3.0	0.4
Agricultural Financial Institutions	76.2	10.5
SME Financial Institutions	117.2	16.1
Postal Bank	185.1	25.5
Total	726.2	100.0
Source: Bank of Japan, Flow of Funds Statistics.		

2.2. Financial Reforms and Administrative Structure

Fuchita (2009),[21] who worked for Nomura Securities, a Gulliver in the sector, for thirty years made a detailed analysis of Japan's financial reforms with reference to those of Western countries in the past and during the current global financial crisis. His main message of the book is that Japan's system of monetary and prudential policies was well established before the Lehman Shock and produced successful results in the crisis and afterwards.

FSA has been very successful in supervision of banks and other financial institutions. Branches of many foreign financial institutions located in Japan have received from FSA strong recommendations for improvement in their financial conduct. The examples are City Bank, UBS, Credit Suisse, and BNP Paribas. One fraud of City Bank was so grave that the bank withdrew its activities from Japan for some period. His praise for BoJ will be explained in Section 2.3.3.

In addition, the lesson from Japan's "Lost Decade" that drastic financial deregulation was implemented in a serious recession for a short period was overlooked by most of analysts and observers (discussed in Section 1.3). In the current financial crisis, financial reforms which are financial regulation this time have been envisaged for a medium-term after the economies recover.

[21] His book is published in December 2009 and drew much attention from the interested parties. Huchita is a director of the institute of capital markets of the company. He is also a member of Monetary Policy committee organized by FSA.

2.3. Policies of the Bank of Japan (BoJ)

2.3.1. Overall System

As explained in Section 1.4, financial reforms were implemented despite the serious recession under the pressures from the United States. But the new system for financial policies and measures of regulation and supervision made significant achievements. BoJ policies have been successful since the Lehman shock.

Now, the author can raise two new points for further improvement in the system. They are issues of BoJ's governance. First, as argued by Professor Iwata, BoJ's transparency and accountability are not perfect.[22] The author of this Note has also made an extensive review of literature including information and academic papers available in BoJ homepage. Then, based on the survey, the author sent a questionnaire to BoJ and discussed the issue with a BoJ official by phone in March 2010.

The analytical result is that there is an evaluation of the Bank's activities in its annual publication, Annual Review. The same contents are also given in a "policy review" report of the Ministry of Finance. But the evaluation deals only with organizational management like budget and personnel. It is made by internal auditors' office of the Bank.

There is no explicit system of an evaluation of monetary policies and measures for supervision of banks within the Bank. [23] BoJ may argue that policies are discussed at meetings of the Policy Board with final decisions made by voting and that the discussion results are disclosed and published. But the post-evaluation of their activities should be made by themselves and presented in front of the interested parties for better governance.[24]

Second, a more comprehensive administrative framework should be set up. Though FSA covers activities of all banks, securities firms and insurance companies, commodity

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[22] Iwata (2009), pp.9-10.

[23] BoJ submits a half-yearly report on its activities to the Diet session as stated in Article 54. This is an approach to accountability which BoJ regards as important.

[24] IMF established the Independent Evaluation Office in 2001 after strong criticism against its policies at the time of Asian financial crisis for 1997-1998.

markets are dealt with by the respective Ministries like the Ministry of Economy and Industry. This problem is important as banks which are also examined by BoJ have a portfolio of financial assets including commodities.

2.3.2. Achievements of Monetary policies

As Professor Iwata argues, setting of monetary policy targets given to BoJ in 1997 Act resulted in the problem of accountability of the Bank's activities.[25] The Bank has not adopted an inflation targeting regime against many requests even from abroad. Professor Iwata thinks that if a clear setting of prices cannot be made in the current system of BoJ, this executive power should be removed from BoJ and that inflation rates should be set by the government which takes into account all the relevant policy measures including those of BoJ. Even if an inflation targeting regime is not adopted, this argument is worth noting.

This point was also discussed in IMF's evaluation of BoJ policies in the framework of Article IV consultation. In its consultation report in 2009, BoJ resisted IMF's proposal on clarification of the time horizon for the medium-term understanding of price stability expressed by the Policy Board members, referring to "considerable uncertainty about the outlook." [26] The clarification of the time horizon means a more concrete forecast of inflation which comes closer to an inflation targeting regime.

The new development, however, is that the board members of the Bank releases more clearer price forecasts after the Policy Board meeting.

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[25] Iwata (2009), pp.144-148.

[26] IMF staff statement:
"15.Communication has also been enhanced by the publication of two-year forecasts for growth and inflation and more comprehensive discussion of risk factors. However, a gap has emerged between the BoJ Policy Board's two year inflation forecast and its medium-term understanding of price stability. In the current deflationary environment, clarifying the time horizon over which inflation is expected to return to a range consistent with this understanding could help anchor medium-term inflation expectations in positive territory."(underlined by the questioner (Sakamoto))
Source: IMF, *"JAPAN: Staff Report for the 2009 Article IV Consultation,"* July 2009, p.18.

The (Japanese) Authorities' Responses and Policy Intentions:
"18. The BoJ noted that with considerable uncertainty about the outlook, longer-term definitive forecasts that attempted to reconcile current projections of deflation with the 0–2 percent understanding of price stability would not be reliable and could deviate significantly from actual outcomes, reducing public confidence in the central bank's assessment of economic trends." (underlined by the questioner (Sakamoto))
Source: IMF, *"JAPAN: Staff Report for the 2009 Article IV Consultation,"* July 2009, p.19.

2.3.3. Achievements of Prudential policies

As analyzed in the preceding sections, BoJ was newly established in the Bank of Japan Act in 1998. Together with FSA which started their duties in the same year, Japan's system for financial sectors both at monetary policy level and at that of supervision was one of the best system as appreciated in IMF's FSAP assessment (see Section 1.4.1). It had been well set when the current global financial crisis hit the Japanese economy.

Having the bitter experience in the "Lost Decade," the Japanese financial sector and its economy have weathered the current financial crisis. Concretely speaking, almost zero-interest-rate measures were taken. The return to the policy was formally announced in October 2010. The same extraordinary policies were adopted as prudential policies: provision of abundant liquidity by BoJ to money markets and to markets of CP and stocks. The Policy Board may introduce measures to purchase financial products related to REIT and ETF in November 2010.

Based on the Japanese experience, IMF made a similar proposal to its member countries to tackle the current global financial crisis. Namely, "a comprehensive strategy to address the broader challenges—restructuring troubled assets and facilitating consolidation—has yet to be fully fleshed out."[27] The strategy includes BoJ's measures of supervision of the banking sector as well as unprecedented macro-financial policies.

The same effective supervision by FSA and BoJ followed the post-bubble period. The examinations of banks by BoJ together with inspection by FSA must have contributed to stability of the banking sector. Fuchita (2009) who knows actual exercises of examinations by BoJ in detail appreciates BoJ's supervision for stability of financial markets.[28]

On the contrary, it should be noted that public financial institutions are not well supervised in the current system. Privatization of postal agencies started in 2007 and planned for completion by 2017. The postal bank occupies one quarter of individual

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[27] Kang, K. and Syed, M. (IMF) (2008), p.4.

[28] Fuchita (2009), p.106. He states that BoJ's measures responsive to liquidity risks by off-site monitoring and on-site examination are a good lesson for other central banks. For example, BoJ's officers are appointed for the respective banking institutions to make a daily check of their finances, and make frequent consultations with the counterparts of the banks.

deposits (see Table 3). The postal sector is still controlled by the Ministry of Internal Affairs and Communications, not FSA, nor BoJ. The new administration of the Liberal Party established in September 2009 takes a position against the measure of the privatization (see Section 3.3).

3. Conclusions and Agenda for the Future

3.1. Conclusions and Lessons from Japan's Experience

The author produced this Note, making an extensive survey of literature and using responses to a questionnaire sent to BoJ in March 2010. Based on the analyses in the preceding chapters, the major conclusions and lessons from Japan's experience since the 1980s are presented below.

1) Setting a clear time table to solve non-performing loans (NPLs), especially collection of accurate information on NPLs, is a key to restructuring of the financial sector and economic recovery. As IMF (2008) puts it, the markets do not start functioning well without steps to fully recognize losses and address the capital shortage.[29]

2) (Japan's) financial reforms/liberalization should not have been implemented in the post-bubble deflationary period. The measures were taken in a schedule set by American officials before the crisis. This corresponds to a rule among G20/G7 leaders for the current global financial crisis that financial reforms should be implemented after the economic recovery.

3) Though there has been significant progress in BoJ's administrative setup including transparency and accountability, more improvement is needed. First, an internal evaluation system should be introduced. Second, who sets price targets and how should be reconsidered with reference to organization of BoJ's Policy Board.

3.2. Japan's response to current discussions about bank supervision

Measures to solve non-performing loans were taken with strong leadership of the government and FSA in the early 2000s. Since that time, there has not been any difficult period for bank supervision. So the cooperation between BoJ and FSA has not

[29] IMF evaluation (2008), p.3.

been an issue by now. Financial experts appreciate the administrative setup for supervision of the banking sector by the two institutions.

In relation to discussions in international scenes, as one of the best systems for implementation of monetary policies and measures for supervision of the banking sector was established by the early 2000s as praised in IMF's FSAP, the Japanese authorities including BoJ have not taken any significant initiatives for reforms of the global financial markets after the Lehman bankruptcy.

There are other reasons for passive attitude toward changes in the global financial order. First, one should pay attention to peculiarity of Japan's financial sector. As pointed out in Section 2.1, despite drastic financial liberalizations in the late 1990s, the financial markets have not changed much and that the banking sector has occupied a large share in all the financial markets until now. A new Basel regulation discussed seriously among Western countries is not appropriate for Japan because the banks still depend on borrowings with the result of low capital adequacy ratios. With higher ratios expected, Japan's banking sector may reduce liquidity again in the face of the fragile economy.

Secondly, Japan has had a very long history of zero-interest-rate policies, namely introduction in 1999 until now except 2000 and 2007-2009. The Japanese economy, markets and agents have got used to this level and have not been responding to these low interest rates. In this regard, BoJ's examinations of banks have already been so demanding that any drastic changes in regulation coming from abroad may cause negative impact on the Japanese economy affected severely by the global financial crisis.

3.3. Policies of the new administration since September 2009

In this section, the author points out changes in policies made by the new administration of the Liberal Party (LP) since September 2009. It has tried to change the reform policies taken by the preceding governments of the Liberal Democratic Party (LDP).

First, regulation by FSA has been changed. A small party which has a coalition with LP demanded that banks should postpone repayment by small- and medium-size companies (SMEs). The bill for "Act concerning Temporary Measures to Facilitate

Financing for SMEs, etc." was passed in the Diet in December 2009. Consequently, the Inspection Manual and Supervisory Guidelines have been revised in line with the enforcement of the Act in April 2010. The financial inspection and supervision focus on checking the efforts of financial institutions for enhanced financing and support for business improvement of SMEs.[30]

The Minister in charge of FSA at that time, representative of the small party, demanded the staff of FSA that the system of supervision should be changed accordingly. This may worsen financial positions of banks which lend much to SMEs.

Second, the counter measures against reforms of the postal bank have been initiated by the small party and decided by LP. Though the Party almost decided to postpone the passage of the law in November 2010 because of resistance by opposition parties, the contents of the new measures are as follows:

1) to raise a limit of deposit in the postal bank from 10 million yen to 20 million yen per person[31] and to raise a limit of the postal insurance company from 13 million yen to 25 million per person.

2) more than one third of stocks of those two institutions will be held by the government which can keep a strong executive power.

3) removal of limitations on their entry in other private financial markets like credit to individuals and new insurance products.

These measures mean that public financing will keep high shares in financial markets and have negative impact on private financial institutions. IMF expressed concern over the proposal in its Article IV consultation report in 2009.

In sum, LP took over the power for the first time in September 2009 and have introduced policies to reorganize the regime led by LDP and bureaucracy, status quo during the post World War II era. The policies include initiatives by politicians and removal of the power from the bureaucratic corps. As a result, little leadership has been taken to further improve the financial system and resist the moves to weaken the

[30] FSA homepage http://www.fsa.go.jp/en/refer/diet/173/01.pdf (viewed on 11 April, 2010).
[31] The limit of deposit in private bank is 10 million yen.

financial markets and the economy in the current global financial crisis.

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