STRUCTURAL REFORM OF THE JAPANESE ECONOMY

LONG-TERM SLUMP IN THE 1990S & STRATEGIES FOR THE 21ST CENTURY

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The Japanese economy slipped into a recession after the “bubble” period of very high level of economic activities. In spite of various macroeconomic stimulus measures, the stagnancy persisted. The Japanese economy recorded a low average growth rate of 1%+ during the 1990s. The unemployment rate rose from 2% in 1990 to nearly 5% in 2000. During this period, several major financial institutions collapsed, the first experience since the World War II. Since 1998 Japan has also been experiencing a persistent price decline, causing concern that the economy may fall into a deflation or “deflationary spiral,” that the world after the WWII had never experienced.
Behind the low rate of growth are the following factors:

-- Adjustment of “excess” accumulated during the “bubble” period: medium- and short-run adjustment factors such as low investment, reduction of employment, debt reduction and mounting problems of non-performing loans.

-- Malfunctioning of the financial system: partly due to adjustments to the “excess.” Financial institutions continued to be cautious to supply new loans.

-- Lowering of growth expectation: businesses had become cautious about new investments in capacity, technology and human resources.

-- Long-run lack of confidence: increasing concern about aging of population and expected future tax burden to pay for the current budget deficit.

Adjustment of excess capacity proceeded partly in the first half of 1990s. Being assisted by ample investment opportunities centering on information technology, business-investment-induced economic recovery occurred in the middle of 1990s and in 1999-2000. However, adjustments of excess debt of businesses (over borrowing), excess loans and non-performing assets of financial institutions (over lending), and excess employment, were delayed. Expected rate of growth continued to decline, reflecting future uncertainty.

One reason for the delay in adjustments was a lack of the sense of urgency among business and household sectors as massive macroeconomic policy support (public expenditures) prevented the economy from collapsing totally. Employment adjustment was a typical example. Excess employment continued to be hoarded inside companies. This enabled positive growth in consumption expenditures and thus the positive growth of GDP during the first half of 1990s. However, as labor costs continued to be high, inaction in employment strategies kept corporate profitability at low levels.
Some “excess” problems were not simply of short-run and/or cyclical nature, but rather “structural”.

One example was the level of corporate profit ratio. Profit ratio on capital declined in the 1990s due to “excess” investment and excess employment accumulated during the “bubble” period. But even before the bubble, business investment were at a high level measured in a percent share of GDP and current profit ratios on capital were significantly lower than those in other industrial countries. This persistently lower profitability had been compensated by a rapid expansion of corporate size during the high-growth period. Necessary corrections to cope with the growth slowdown were much delayed.

The delay was brought about by the following factors: manager- and mainbank-ruled corporate governance that tended to neglect profitability, and high cost structure built in the economy brought about by public regulations and Japanese-style market practices. To the extent that return on corporate shares were increasingly emphasized, the low profitability itself has become an obstacle to new investments.

Another example is the relative size of banking loans in the economy. Before the bubble period, the outstanding amount of bank loans as a share of GDP were about 60%, far higher than the case of the USA where the ratio were between 30% and 40%. During the bubble period, the ratio in Japan reached 100%, and in the 1990s, in spite of efforts made by financial institutions to curtail loans, no significant corrections have been observed. As liberalization of the financial system proceeds, banks will have to improve their balance sheets and to raise profitability. Industrial finance relying heavily on financial intermediary (indirect finance) would face difficulty.
Expected rate of economic growth—expectation by business managers—continued to decline in the 1990s, not significantly influenced by high growth in the middle of the decade. To the extent that businesses expect lower growth, they would become reluctant to conduct long-term investment in production capacity, human resources and technology development. Thus the expectation tends to be self-fulfilling. Potential rate of growth of the Japanese economy is generally seen at around 2% annually. However, if low investment level continues, growth potential would likely to decline.

Japan’s potential rate of growth may not be as low as businesses believe. During the first decade of the 21st century, growth at a rate around two percent should be attainable. Increases in total factor productivity are likely to push up GDP by 1%+ annually. Accumulation of capital stock would contribute to growth by 1%, while slightly negative contribution will be expected from labor input.

In addition, recent contribution of information technology (IT) to the US growth suggests that Japan’s potential rate of growth at least for a few years from now, with deregulations in this sector, would be higher than the rate formerly estimated. According to a study in the EPA, IT is estimated to raise GDP by maximum 4% as a cumulative effect between 2000 and 2005. The calculation consists of 2% attributed to productivity gain in the IT sector (IT related machinery production, expansion of electronic commerce, etc.), and 2% from productivity gain in the rest of the economy through stimulated investment and higher level of capital stock.

For this growth potential to materialize, confidence in the future economy should be recovered. In addition, schemes and practices that could disturb IT and other technology development should be eliminated.
In 1997, the Japanese economy fell again into a deepest recession after the WWII. This downturn is often attributed to fiscal consolidation measures taken by the Hashimoto administration, including an increase in a rate of consumption tax from 3% to 5%, abolition of special tax break and reduction of public work expenditures. The total amount of fiscal drag was 10 trillion yen, or 2% of GDP. Asian financial and economic crisis was the other negative factor.

However, by far the largest factor of the fall was the breakdown of Hokkaido-Takushoku Bank and the Yamaichi Security, among others. Bankruptcy of large financial institutions was the first such experience for Japanese since the end of the war, and had massive psychological as well as real negative impact.

Consumer confidence, which had shown signs of recovery from the shock of the consumption tax hike, deteriorated sharply, leading to a reduction of consumption expenditures. Collapse of business confidence was even severer. Loan supply by financial institutions declined as banks tried to amend their balance sheets hurt by mounting non-performing loans.

The government changed its fiscal policy from consolidation to expansion and tried to stabilize financial sector by recapitalizing relatively sound banks and by resolving problem banks with a government fund totaling 60 trillion yen. The Bank of Japan provided massive liquidity to the market in order to support the financial system and the economy. Only at the end of 1998 when the concern of further meltdown of the financial system subsided, business and consumer confidence started to recover and the economy reached the bottom of a cycle.
(3) Role of macroeconomic policy to support the economy

General government budget balance
(as % of GDP)

To cope with the prolonged low growth and higher rate of unemployment, fiscal stimulus was frequently used. As a result, the budget deficit (general government) ballooned to 7% of GDP in 1999. In general government budget, the social security account still records a surplus of 2% of GDP. So the rest of the government sector (national and local governments) combined incurs a deficit of 8 to 9% of GDP. The part of the deficit attributable to the downturn of the economy (cyclical deficit) is estimated to be very small, or at most less than 1% of GDP. As such, the major part of the budget deficit is attributed to systemic factors and discretionary policy, or “structural” deficit.

On the other hand, a loosening of monetary policy was delayed at least in the first half of 1990s. The Bank of Japan actively reduced its discount rate and short term market rates, but the reductions were offset by rapid disinflation. As a result, real long-term interest rates were kept at high levels until 1995. In 1995, as yen’s rapid appreciation threatened the ongoing economic recovery, the BOJ stepped into with more loosening with its discount rate lowered from 2.5% to only 0.5%. As a result, even real long-term rates began to decline since 1996.
In order to cope with the persistent slow growth and occasional downturns, the Japanese government provided economic stimulus packages rather frequently. They usually included additions to public work expenditures, expansion of loan supply by public financial institutions, structural reform measures, and in some packages, tax reductions. For financing additional expenditures and tax cut measures, supplementary budgets were approved in the Diet.

Public work expenditures were the central part of stimulus packages. They were direct additions to GDP. They also provided additional demand and job opportunity for construction industries that consisted of 400,000 companies with more than 6 million jobs. There always existed (still exists) political pressure for more public work expenditures. As a result, the share of public investment in GDP were between 7 to 8%, as compared to 2 to 3 percent in other industrial countries.

Against this expansion trend, review and reduction of public works were occasionally attempted. In 1994, taking aim at a recovery in private sector demand, the government tried to shift the economic stimulus measures from public works to income tax reductions. (It failed as rapid yen appreciation triggered fear of economic downturn.) In 1997, substantial budgetary reform measures were implemented, including 8% reduction of public investment as well as consumption tax increase. (It was abandoned in 1998 when the Japanese economy fell into the worst recession since the end of World War II.)
As seen in Part 1, the Japanese economy has been under low growth in the 1990s, in spite of massive fiscal stimulus and monetary expansion. The persistent stagnation was brought about not only by traditional short-run business cycle, but by medium- and longer-run challenges.

- Excess piled up during the bubble period. Though excess capacity was mostly absorbed in the middle of 1990s, excess employment failed to diminish.
- Financial system malfunctioning. Loans outstanding by financial institutions to construction, real estate and non-bank industries amounted to 170 trillion yen, or one third of total amount of loans. A considerable portion of these loans turned out to be non-performing loans and hurt banking balance sheets. Bankruptcy of major financial institutions that Japanese had not experienced after the World War II, injured people’s confidence in financial system as well as confidence in the economy in general. Financial institutions have tried to fix their balance sheets, and have tended to reduce loan supply, very reluctant to provide new money to small businesses and to promising but risky businesses.
- Negative impact of structural problems. Various conditions that have supported rapid growth are changing. In the long run, rapid aging of population and resultant heavier burden of social security and tax payments causes concern among people. In the medium run, various structural change will occur. The Japanese-style market system, which is believed to have supported post-war rapid growth, helped raise manufacturing productivity to the extreme, but seems to have failed to facilitate new industries such as service, software and network architecture. Thus the ongoing industrial structure change ought to call for the reform of economic systems in Japan, but the future figure is unclear. This results in the lack of business and consumer confidence in the future development of the economy and employment opportunity. Under these “confidence crises”, the effect of traditional macroeconomic stimulus is limited and short-lived. Only structural reform policies would facilitate future development of the Japanese economy.

The chart above shows how the economies that had experienced “bubble” and resultant financial crises adjusted. Typically the economies allowed negative growth to reduce “excess” and to restore financial systems. In Japan, however, the growth rate was positive until the middle of 1990s. That is, Japan artificially delayed real adjustment by means of economic stimulus measures and Japanese style employment practices, thus made the ongoing adjustment process harder and more complicated.
Some examples of structural problems that the Japanese economy faces are:

(1) Public regulations--A lot of “economic” regulations (regulation on entry/exit, price setting, investment, and service contents) remain. Each regulation has its reasons for existence. However, in many cases, the scheme has become outdated due to technological development and economic globalization and just plays a role of protecting incumbents from tougher competition. Regulatory reforms would enhance consumers’ welfare and business opportunity for new entrants. On the other hand, consumers would be expected to behave on the basis of “self-responsibility”.

(2) Taxation--High marginal rate of tax discourages risk-taking behavior of businesses engaged in promising but risky activities, and labor supply behavior of medium- and higher income families. Reforms in tax system have been conducted in Japan, particularly to reduce marginal tax tare of corporate income tax. But the tax reduction has not been compensated by widening of corporate tax base, thus contributing to expansion of budget deficit.

(3) Japanese-style employment practices--Employment practices commonly seen in Japan’s large companies, such as “life-time” employment, seniority-based wage determination, promotion from “internal labor market”, intra-firm labor union, and on-the job training, gained success particularly in manufacturing, through sharing of information between companies and employees, employees’ faith in companies, and effective human investment of OJT. However, once growth potential of companies been lowered and high non-company-specific professional skills became the norm for majority of workers, the mechanism of “internal” labor market lost its advantage.

(4) Corporate governance--Japan’s corporate management has been conducted by managers who have promoted from employees. “Main banks”rather than the capital market have monitored the performance of the management. In reality, capital has been used in a less efficient manner as compared to other countries, and particularly during the “bubble” period, excessive and inefficient investments were piled up.
(5) Foreign direct investment into Japan—The level of activities by foreign companies in Japan has been very low. FDI into the Japanese market outstanding is less than one tenth of FDI by Japanese companies overseas. Internal FDI tends to enhance competition in the Japanese market and stimulates the business society with new/different corporate management strategies and ideas. Any obstacles to foreign business entry should also be common obstacles to domestic start-ups and entrants from other sectors. International comparisons show that the level of internal FDI and new business starts are significantly correlated.

(6) Trade practice Japanese style—Along with employment practices, close transaction among businesses in the same business groups, long-run stable transaction relationships between final assembly producers and parts suppliers (parts-supplier keiretsu), stable distribution channels (distribution keiretsu) and long-run stable transaction between business companies and financial institutions (main bank system) have been often referred to as characteristic to Japan. They are usually long-lasting stable transactions based on implicit engagements, but they are not fixed contracts. With possibilities of cancellation of the relations, participants are always under potential competitive pressure. Microeconomists have tried to rationalize the arrangements from the viewpoint of the asymmetry of information. Still, from the viewpoint of outsiders, these schemes lack transparency and impede new entries. Globalization and an expansion of electronic commerce are shaking the foundation of these schemes.

(7) Financial system—Besides the main bank system, Japanese financial system has centered on financial intermediation (indirect financing). Banking system has collected savings from household sector and provided fund to industrial sectors. The channel of direct finance through capital market has been underdeveloped, so the entire system has been a “single track”. At the time when new startups and other risk-taking business activities are called for, the existing system of financial intermediation has proved to be inadequate. “Multiple tracking” of the corporate finance is necessary.
The necessity for structural reform, or marketization, extends to wide range of the Japanese economy. Three sectors of the economy have their own reform agenda: i) business and financial sectors must reform themselves to enhance business and investment opportunity; ii) individuals or household sector must accept self-reliance discipline; and iii) the government sector must transform itself into a compact and efficient government respecting/utilizing market forces.

Changes in business and the government sectors must be compatible with (and accompanied by) those in household sector. Self-reliance of individuals involves shifts in lifestyle, from the traditional reliance on business community to self-decision-making and risk-taking in choosing jobs and careers that require investments in himself/herself. Self-responsibility should be nurtured in the business sector, not relying on protection through regulations and “convoy” type financial protection system.

Generally speaking, in the business sector, various reforms have already started in order to get out of the long stagnation of the 1990s. As for government sector, some reform initiatives have started in the areas overlapping with those in business sector such as regulatory reforms and partial tax reforms. However, for public-sector-specific reform areas such as administrative reform and decentralization of government, the process has been much delayed. Budgetary reform has just begun under Koizumi administration. As for household sector, it would take a long time for the majority of people to change their lifestyles and/or ways of thinking.
As an example of recent changes, let me take the case of FDI into Japan. Internal FDI stimulates domestic competition and corporate strategies, thus activates the economy. If internal FDI is obstructed by any rules or practices, those impediments should also be the one commonly disturbing domestic startups and growing companies, thus would bar dynamic economic development.

The chart (below right) shows this relation by a cross-country comparison. Japan ranked the lowest both by the level of FDI as compared to total domestic investment and by business startup ratio.

The other chart (upper left) shows that recently annual FDI inflows that has expanded significantly. Foreign capitals are entering the industries where FDIs were unimaginable in the past such as automobile and banking, suggesting possible future surge in new business startups.
However, up to the present, trends in business startups has been disappointing. Key conditions for active startups are fund availability and availability of human resources. Even in Japan, recently, a lot of venture capitals (VCs) were established. However, Japan’s VCs have tended to provide fund to businesses not just born but those developing and already establishing themselves. Comparison of newly listed companies in Japanese over-the-counter share market and those in the US NASDAC clearly shows the contrast between the VCs in Japan and the USA. In Japan’s case the management performance of newly listed companies are not very different from that of the average of already listed companies. Other statistics shows that Japan’s VCs provided the majority of their funds to companies with 10 or more years of existence, again in a sharp contrast to the US where the majority were provided to businesses less than 5 years old.

As for human resources, people with excellent talents/technology have tended to seek promotion in existing big businesses rather than gamble to start a new business. The chart (right) shows the survey result of intended career paths of newly graduates in 1993. After the survey was conducted, as new graduates continued to face difficulties in finding jobs in big companies, students’ sentiment may have somewhat changed.
Behind the successful and strong development of the Japanese economy was the so-called “market economy Japanese style”. It included, among other things; i) employment system such as long-term employment and seniority-based wage structure, ii) main-bank system, iii) corporate management controlled by managers who have been promoted from employees, iv) corporate groups combined with cross share holdings, v) long-run trade relationship between parts suppliers and assembly producers or between manufacturers and distributors, the so-called “keiretsu”, and vi) long-run relationship between the government and business sectors with industrial policies and public regulations.

These stable relationships contributed to the post-war development of the Japanese economy. From the viewpoint of microeconomics, the long-lasting trade relations diminish the problems associated with asymmetric information, such as agency problems between employers and employees, bankers and borrowers, etc. They also brought about a long-term view in corporate management and thus facilitated long-term strategic investment. However, with recent rapid changes in the economic environment, they seemed to have started to cause troubles such as the bubble economy of late 1980s and the persistent low growth of the 1990s.

The major challenges to the Japanese-style market system are: i) changes in industrial structure and in business environment brought about by information and telecommunication technology that call for more flexible and timely management and transaction; ii) shifts in paradigm into globalization and megacompetition; iii) aging of society; and iv) changes in people’s value. These factors had weakened the effectiveness of the traditional economic system, and in many cases, had become obstacles to further economic development.
(2) Mainbank system

 FUNCTIONS OF THE MAIN BANK SYSTEM

- Saving of costs associated with asymmetry of information
  - Screening and monitoring
  - Signaling to other financial institutions
  - Corporate governance
- Insurance to corporate management risks
- Information exchange

Finally, the main bank system often played a role of corporate governance in borrowing companies. Normally, shareholders and capital market ought to play that role. In Japan, however, with the existence of “stable shareholders” due to cross share holdings and a lack of monitoring capacity of the capital market, main banks had the best information of the borrowers and an incentive to urge sound management.
The main bank system which played an important role during the rapid growth period, has weakened its function since the 1970s. The background of this change were:

-- Financial liberalization. When the financial system was tightly regulated and protected, banks could easily enjoy interest spread between deposit and loan, and thus earn profit to cover “information production” costs. Since the middle of 1970s, however, deposit interest rates were gradually liberalized and the interest margin shrank accordingly. Also with liberalization of corporate bond issuance in a capital market, big businesses increasingly gained the opportunity to raise money from capital markets.

-- Strengthening of financial base of business companies. Big businesses have accumulated cash (retained earnings). The big manufacturing businesses’ amount of cash flow (operating surplus and depreciation allowance) as a percentage of sales rose from 30% in the middle of 1970s to 60% in the 1980s and 90% in the 1990s. Big businesses thus lowered their dependence on main banks, and as a result banks lost their best customers.

-- Globalization of banking and use of information technology widened the discrepancy of banks’ ability to respond to customers.

During the “bubble” period, business companies aggressively expanded equity finance and invested in financial instruments and business equipment, irrespective of future profitability of the assets. Banks, looking for new customers, tended to provided loans to risky projects such as those in construction and real estate sectors. Among these borrowers, lowering of the share of main bank in total bank loans and even changes of main banks often occurred. A lack or weakening of monitoring of borrowers by main banks and resulting weaker corporate governance led to the boost of the speculative bubble. Finally, in the 1990s, the “insurance” function of the main bank system also weakened. Main banks, rather than helping the troubled borrowers, tended to get rid of these troubled customers and selected borrowers utilizing their accumulated information.
(3) Cross share holding and corporate governance

- Lack of corporate discipline during the “bubble”
- Weak capital market governance due to cross holding
  - Long-term management perspective
  - Weak discipline imposed by capital market
- Rapid weakening of cross share holding

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Nippon Research Institute (adjusted for change in disclosure rules)

One cause of the “bubble” economy and persistent economic slump after the bubble collapse was the vacuum in Japan’s corporate governance. Formerly, the main bank system functioned well to discipline corporate management. That disciplinary role of the main bank system seemed to have stopped functioning fully in the middle of 1980s. Businesses as well as financial institutions rushed to collect low-cost money and invested in low profitability, high risk, questionable projects, just to compete each other to expand the size of businesses.

The lack of corporate governance was partly attributable to a lack of monitoring function of capital markets. And its major reason was the high percentage of “stable” shareholders, typically other companies and financial institutions. As a result, a major part of shares were held by organizations controlled by corporate managers.

Until the middle of 1990s, the “stable” shareholder ratio remained high, but in the latter half of 1990s it turned to a sharp decline, reflecting stagnant share prices and efforts to improve balance sheets of banks and corporate companies. This trend can potentially bring about a corporate governance system that relies more on capital market.
Potential problems embedded in the Japanese-style employment system are the following: (i) differentiation between regular employees and spot or part-time employees; (ii) potential undermining of the system due to changes in consciousness or value of younger-generation workers; (iii) the necessity of continuous growth of the size of a company to maintain the scheme, particularly the seniority-based promotion system; and (iv) rigidity of personnel set and slow adjustment of businesses to new business environment, and to an introduction of new technology and services.

The final problematic element of the old employment system is getting more and more important as industrial structure is rapidly changing from manufacturing to services, and as new technology industries such as IT industries and life-science industries require very quick introduction of newest technology and thus call for hiring of external experts rather than training workers internally. In the traditional manufacturing sector, the role of company-specific technology is important and technology transfer through on-the-job training and process innovation were the sources of competitiveness. In the knowledge-based sectors, technology edge as a front runner determines the competitiveness. Speed of innovation and uncertainty related to technological development are far higher. As companies are compelled to employ workers with professional skills directly from external labor market, a scheme for wage determination must reflect ability and skill of respective worker. Seniority-based wage determination thus becomes an obstacle. To facilitate quick restructuring of companies and branches, utmost flexibility of organizations is necessary.

Anecdotally, there have been many cases where the Japanese style employment practices were reviewed and/or weakened, but on a macro level, many schemes are still dominant. Schemes such as wage systems and corporate pension schemes are still in favor of long-term employment. A likely scenario in the future would be that, while traditional employment practices will survive among many manufacturing companies where company-specific technology and long-term job training and skill transfer are crucial, more flexible system will prevail among IT and service industries that rely on common technology and require timely decision making. Thus the both employment systems coexist according to comparative advantage of industries, to attain best performance through market competition between them.
A seniority-based wage determination has been seen as a strong incentive to stay in one company. A cross-country comparison of wage profile by age groups shows that Japan’s relative (indexed) wage level is a little lower than that in other countries, then significantly higher in the 30s through 50s of ages. Assuming that wage profile in the majority of countries reflects labor productivity by age, then Japan’s wage level has been kept lower than that warranted by productivity when workers are younger, then higher when the workers become older.

(Reference) Wage profile of college and university graduates (male workers)
Despite those changes in economic environment and confirmed needs for reforms in labor market structure, the actual wage structure is still largely seniority-based and is disadvantageous to workers who change jobs. The chart shows an average amount of workers’ lifetime earnings that include wages/salaries, retirement allowances, and corporate pension benefits. Compared to workers who work for one company until retirement, those who experience job changes incur losses in their life-time earnings significantly.

In addition to this basic wage structure, corporate pensions are designed company by company and thus lacks portability. A recent pension reform (an introduction of 401k investment) aims to increase this portability, and thus to increase labor mobility across firms and industries.
The key word in Japan’s economic reform is “marketization”, and its central policy issue is a regulatory reform.

Excessive government regulation on businesses and financial institutions tends to weaken their sense of risk, to narrow the room for competition, and to delay their adjustments to changes in business environment.

The number of regulations including both “economic regulations” and “social regulations” is a little more than 10,000, according to data produced by the Management and Coordination Agency. Recently, the number has actually been increasing. As a regulatory reform proceeds, a regulation tends to be unbundled into several regulations, particularly as a part of partial deregulation. In financial sectors, ambiguous regulations were changed to more specific regulations, and in the process, the number of regulations increased.

An estimate using the input-output table data shows that 41% of Japan’s production are under some kind of regulations (permission, approval, registration, etc.). Apparently, this figure overstates the current state of regulation because of limitations in data collection (if any part of an industry is under regulation, then the entire industry is assumed to be regulated). Still, a comparison with an experience of the US regulatory reforms reveals that Japan has not yet achieved a substantial reform. In the US, the percentage of regulated industries (output basis) declined significantly during Ford/Carter/Reagan administrations’ regulatory reform period, while in Japan no significant drop had been observed despite a long period of (slow) regulatory reform, at least until the 1980s.
The costs of regulation are diverse. Anecdotally,

1) Regulations bring about high-cost structure. This leads to price differentials between the Japanese and overseas markets. In 1998, consumer prices (in aggregate) were 41% higher in Tokyo compared to those in New York City (data source: Economic Planning Agency). High cost structure also put cost burden to tradable sectors and weaken their international competitiveness.

2) Regulations weaken regulated industries’ incentive to adjust to changes in economic environment. Tightly regulated industries tend to show lower performance when economic environment worsens.

3) Regulations restrict business opportunity and weaken their capacity for innovation. Japanese manufacturing sector has developed and commercialized various new products, such as facsimile, home-use video cassette recorder and lap-top personal computer. Non-manufacturing sector just introduced some new services developed in foreign countries, with an exception of rental video shops.
For a policy proposal, empirical analysis of policy effects ought to play a crucial role. In Japan, however, empirical analyses of regulatory reforms using microeconomic tools and data have lagged behind those in the US and UK. This delay partly reflected the fact that policy makers had not been familiar with economic analyses, and partly due to a lack of available microeconomic data. For a process of policy formation to become more open and transparent, discussions based on analytical findings would be much more important in the future. The tables shows an example of such empirical assessments.
Efficiency gains and resultant lower prices and demand expansion are rather a long-run positive effects of regulatory reform. In a short run, however, employment reductions and bankruptcies of incumbent businesses are of great concern. The analysis presented here is a trial to estimate both efficiency gains and employment losses using a microeconomic framework and data.

The retail trade industry used to be regulated in terms of required prior approval for startups (of branch stores) of large size retailers. In some regions, it took even 10 years for (potential) new entrants to negotiate with regional incumbent retailers to obtain such approval. In the 1990s the condition was substantially relaxed, and in the year 2000, the old law was substituted by a law with new relaxed regulations. Banking sector regulatory reform has been going on as a part of a “Big Ban” financial reform. Entry into the wholesale market of electric power was liberalized in 1995. In these three sectors, the effects of regulatory reform should fully emerge in the near future.

Assuming that the level of efficiency in all companies catches up to that of most efficient company in the same business due to competitive pressure after deregulation, efficiency gains should be on average about 28% in the case of the retail sector, implying a cost decline of the same percentage.

Assuming the efficiency gains and shifts in optimum combination of capital and labor reflecting their relative factor prices, in all three industries, labor input must shrink, suggesting job losses.
Japan’s regulatory reform process started at the end of the 1970s, mainly aiming at a compact government and to lighten people’s paperwork costs. In 1981, the Second Temporary Council of Research on Public Administration System (“Daini-Rincho”) was established. It emphasized private sector vitality, international harmonization and people’s welfare, and advised various administrative reforms. Among others, it advocated privatization of three public corporations, and they were reorganized to stock-based corporations (NTTPC in 1985, Japan National Railway in 1987 and Japan Tobacco Monopoly in 1985) and privatized, at least partially.

In the earlier 1980s Japan’s trade surplus ballooned and international claim for market opening and regulatory relaxation strengthened. The Japanese government tried to shift export-induced economy to domestic demand induced growth both macroeconomically and microeconomically.

Interest rate liberalization began in the second half of the 1970s, induced by an expansion of national bond issuance and by globalization of financial service. In 1984 the Joint US-Japan Ad Hoc Group on Yen/Dollar Exchange Rate, Financial and Capital Market Issues started and promoted financial sector regulatory reform. And in 1989, the Structural Impediment Initiative (SII) was initiated between Japan and the US, and discussed Japan’s market opening from the viewpoint of regulatory change and business practice reform.

After the bubble collapse, under deterioration of the economy and rising yen rate, regulatory reform was believed to vitalize the economy, through overcoming businesses’ and consumers’ lack of confidence, lowering relatively high price, and enhancing business opportunity for companies seeking domestic market.

In 1993, a government’ advisory group announced the “Hiraiwa Report”, advocating that economic regulation should be liberalized as a rule, while social regulation should be minimized with the rule of “self responsibility”. In March 1995, the government adopted a comprehensive action plan for regulatory reform. It addressed 1,091 items of regulations and put concrete time schedule to most of them. It was revised in 1998.

A new version of the action plan is under consideration (still ?), and a major focus is the area of telecommunications and IT related services.
(4) Characteristics of regulatory reform process in Japan as compared to that in the USA and the UK

- Japan has tended to avoid “trial and error” process
  - Even in the US, the airline case was exceptional
  - Privatization in UK lacked competition scheme
  - Price cap system in UK

- “Bottom-up” in the USA, “top-down” in Japan/UK

- Japan’s regulatory body is also an administrator of industrial policies
  - US, UK: independent regulatory commission
  - Check and balance with industrial policy administration, competition offices and local government

- Empirical analyses have not been utilized

Finally, let me explain some characteristics of Japan’s policy formation process for regulatory reform, as compared to the USA and UK, the front runners of deregulation.

-- The Japanese government seems to try to avoid a trial and correction process. So it takes long time to consider new schemes and to persuade all groups at stake. In case of network industry reforms where innovation proceeds rapidly, delay of reform can turn out to be a fatal mistake. The UK’s privatization process of national public utilities were a good example. Also its setting of the price-cap scheme was a typical trial-and-correction process.

-- In the USA, the deregulation processes were often triggered by new entrants, taking advantage of legal or administrative loopholes, without prior consent by incumbents and regulatory authorities. The typical case was the MCI’s entry in the long distance telecommunications market. In Japan, such loopholes are hard to find and businesses tend to avoid struggle with regulatory agencies, with a notable exception of door-to-door parcel delivery service and lower pricing by a few taxi cab companies.

-- In the USA and UK, half-independent regulatory commissions carry out actual regulatory administration, while different government organizations cover industrial policies and regulatory design. Also involved the judicial sector, antitrust authorities, and, in the USA, state governments. In Japan, both regulatory administration and industrial design, among others, are covered by a single government agency, and the competition authority hasn’t got enough influence. To cover both execution and planning in one organization is generally non-transparent and may cause conflict of interest.

-- As mentioned above, in Japan’s regulatory reform process, empirical assessment of existing regulation and its reform has been seldom utilized. Now, some cost-benefit analyses are going to be imposed for new regulation, but the process still lacks transparency.
STRUCTURAL REFORM OF THE JAPANESE ECONOMY

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