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Economic Policy Recommendations and Economic Policy of the Koizumi Administration

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ABSTRACT:

This article argues that the Koizumi administration implemented not only structural reforms to strengthen the supply-side of the economy, but also economic policies to stimulate the demand-side, and that the economy recovered in ways that differed from what was initially expected. As regards fiscal policy, in both 2001 and 2002 the Koizumi administration first formulated austere budgets despite economic recession. However, economic sluggishness forced the administration to compile supplementary budgets in order to boost the economy. As the economy recovered thanks to increased foreign demand, though, the administration was able to return to its austere budget policy from 2003 onwards. As regards policies to accelerate the disposal of non-performing loans, it paid particular attention to small and medium-sized enterprises and regional financial institutions in order to prevent a decrease in domestic demand. Moreover, as it injected public funds into Resona, the shareholders were not held responsible in that they did not suffer a full loss of their investment. This raised stock prices by encouraging moral hazard among foreign investors. This increase in stock prices, in addition to the export-led economic recovery, helped to solve the non-performing loans problem of financial institutions.

1. Introduction

In the 1990s, Japan underwent a prolonged recession, which has been called a “lost decade.” Many economists proposed various economic policies intended to end the recession and policy controversy was sparked. The main issue was whether the recession was due to supply factors (a decline in productivity of the Japanese economy) or demand factors (a lack of demand).

Prime Minister Junichiro Koizumi, who took office in April 2001, insisted that “there can be no economic recovery without structural reforms” and undertook

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supply-side reforms: fiscal reconstruction, regulatory reforms, and accelerated disposal of bad loans. He stated that the Japanese economy had not recovered during these ten years in spite of both increased public spending and easing of monetary policy to the fullest extent, and that the economy would not recover as a result of the issuance of additional government bonds in order to revive demand.¹⁾ His policy was criticized by many economists who attributed the deep recession to a lack of demand. They argued that fiscal restraint and accelerated disposal of non-performing loans during a period of deflation would aggravate the downturn. Koizumi acknowledged that reforms would be accompanied by “pain.” The “Basic Policies for Economic and Fiscal Management and Structural Reforms,” published by the Council on Economic and Fiscal Policy (CEFP) in June 2001, stipulated that the next two or three years were positioned as a period of intensive adjustment and that low economic growth should be accepted in the short term in exchange for achieving medium- to long-term economic growth.

As expected, the economy worsened, though the economy recovered slightly from February 2002. Financial system instability also led to a fall in stock prices. Share prices started to rise and economic recovery was evident, though, after public funds were injected into Resona Bank in May 2003. Koizumi declared that his cabinet had achieved self-sustaining economic growth not by fiscal stimuli, but by structural reforms, the center of which was bad debt workout.²⁾

Did the Koizumi administration revive the Japanese economy by implementing only supply-side policies? In this article, I will answer this question by analyzing the decision-making process as well as the content of fiscal policy and policies to accelerate the disposal of non-performing loans under the Koizumi administration.

This article is organized as follows. In the second section, I will explain the content of supply-side policy recommendations, which were implemented under the Koizumi administration. In the third section, I will look at fiscal policy and argue that stimulative fiscal policy was implemented in times of recession, even though Koizumi disagreed with this policy. In the fourth section, I will discuss the policies to accelerate the disposal of non-performing loans. I will show that the radical disposal of bad loans was realized through a different pathway from the one that proponents of the policies expected and that the policies took into consideration the demand-side of the economy. In the fifth section, I will close the argument by explaining a problem that often arises when social scientists recommend policies.

1) Koizumi stated this opinion in the debate between party leaders in the Diet on October 30, 2002. *Asahi Shimbun*, October 31, 2002.

2) In his policy speech to both houses of the Diet in January, 2006.

2. Supply-side Policy Recommendations

At present, standard macroeconomics says that supply factors determine long-term economic growth. Thus, some macroeconomists argue that the causes of the prolonged recession in Japan in the 1990s are supply factors. The most prominent article focusing on supply factors says that this protracted Japanese recession can be explained by two factors. One is that the growth rate of total factor productivity (TFP), which reflects the development of technology, declined in the 1990s. The other is that labor hours per week were reduced from 44 hours to 40 hours between 1988 and 1993 because of revisions to the Labor Standards Law in 1987.³⁾

Why did the growth rate of TFP decline in the 1990s? Some explanations are given below.

First, economic policies protecting inefficient and declining sectors have been in place in Japan for a long time. To remain in power, the Liberal Democratic Party (LDP) had supplied funds to low-productivity sectors such as small businesses, agriculture and the construction industry through subsidies, loans from government-affiliated financial institutions and public works spending. The LDP has also regulated economic competition to protect inefficient and declining sectors. The best known example is the Large-scale Retail Stores Law. On account of these policies, low-productivity sectors expanded too much and the productivity of the Japanese economy as a whole declined.⁴⁾ If this is true, the policies required to revive the economy include cutting back government spending (cutting back public works spending and subsidies to agriculture), scaling back public-sector financial institutions (reforms of special public corporations, including government-affiliated financial institutions and postal service privatization), and regulatory reforms (privatizing publicly owned entities and deregulating entry into the medical sector, agricultural sector and so on).

Second, rigid employment practices in Japan have prevented workers from smoothly moving from low-productivity sectors to high-productivity sectors.⁵⁾ If this is the case, deregulating labor markets and enhancing the mobility of workers are required. To put it concretely, the employment pattern should be diversified by

- 3) Fumio Hayashi and Edward C. Prescott, "The 1990s in Japan: A Lost Decade," *Review of Economic Dynamics*, vol.5, no.1 (2002): 206-35.
- 4) Richard Katz, *Japan: The System That Soured* (Armonk, N.Y.: M. E. Sharpe, 1998).
- 5) Tsutomu Miyagawa, Yukie Sakuragawa and Miho Takizawa, "Productivity and the Business Cycle in Japan: Evidence from Japanese Industry Data," *The Japanese Economic Review*, vol.57, no.2 (2006): 161-86.

making it easier to dismiss regular employees and increase the use of part-time and temporary workers dispatched by employment agencies.

Third, because banks were burdened with bad loans, the entry of high-productivity firms was blocked. By continuing to lend money, banks prolonged the life of companies that could not repay their debts and had little hope of recovery because the banks feared their non-performing loan problems would come into the open. These low-productivity firms remained in operation though they should have been driven out of the market. As a result, the entry of new, more competitive businesses into the market was blocked.⁶⁾ If this is the case, driving “zombie firms” out of the market by clearing away non-performing loans, assisting the establishment of new businesses, and removing entry barriers are required.

Moreover, some economists emphasize that the non-performing loans of banks suppressed the financial intermediary function. Banks were reluctant to lend money because of a need to maintain capital adequacy ratios. As most small and medium-sized enterprises (SMEs) depend on indirect finance, this caused a lessening of demand through deterioration in capital investment.⁷⁾ From this point of view, the early disposal of bad loans is necessary to revive the economy.

As stated above, supply-side policy recommendations are composed of regulatory reforms, fiscal structural reforms, and the accelerated disposal of bad loans. Koizumi proclaimed in his policy speech to both houses of the Diet in May 2001 that his cabinet would address these policies.⁸⁾ And his administration did implement these policies to a considerable extent.

First, the Koizumi administration advanced regulatory reforms. I will give some typical examples of these reforms. In 2002, the government eased the regulations on taxi companies, specifically entry regulations and regulations on the number of taxies (to ease regulations restricting competition). In 2003, in addition to creating a special deregulation zone for structural reforms, the government made it permissible to establish a company with a nominal ¥1 in capital (to assist the establishment of new businesses). In 2004, the Worker Dispatch Law was revised,

6) Kyoji Fukao and Hyeog Ug Kwon, “Why Did Japan’s TFP Growth Slow Down in the Lost Decade? An Empirical Analysis Based on Firm-Level Data of Manufacturing Firms,” *The Japanese Economic Review*, vol. 57, no.2 (2006): 195-228.

7) This argument seems to be supply-side based as it focuses on the supply of investible funds. However, it can also be regarded as demand-side based because it focuses on demand deficiency.

8) Heizo Takenaka, *Kohzo Kaikaku no Shinjitsu: Takenaka Heizo Daijin Nisshi* [The Truths of Structural Reforms: The Diary of Minister Heizo Takenaka] (Tokyo: Nihon Keizai Shimbunsha, 2006), 27-29.

allowing manufacturers to use dispatched workers and extended the permitted period contract for dispatched workers from 1 year to 3 years (to enhance the mobility of workers). In 2005, the Post Privatization Law was passed. In 2006, the government decided that it would abolish, privatize, or merge public-sector financial institutions and reduce by half their balance of money loans (to scale back public-sector financial institutions).

Second, the Koizumi administration undertook fiscal structural reforms. In particular, the government trimmed public works spending by 10% in the fiscal 2002 budget and continued to reduce it by more than 3% each following year. In the end, it was reduced from ¥9400 billion (in the fiscal 2001 budget) to ¥7200 billion (in the fiscal 2006 budget).⁹⁾

Third, the non-performing loans problem was resolved. From September 2002 to September 2004, Minister of State for Economic and Fiscal Policy Heizo Takenaka as also became Minister for Financial Services. Takenaka formulated the “Program for Financial Revival” in October 2002 and stated that bank inspectors would tighten asset assessments at major banks and that he would not hesitate to inject public money into banks if necessary. The government decided to inject capital into Resona Bank in May 2003 and nationalize Ashikaga Bank in November 2003. Moreover, as a result of strict financial inspection, the Financial Services Agency (FSA) forced UFJ Holdings, Inc. to merge with Mitsubishi Tokyo Financial Group, Inc. in 2004. Facing pressure from Takenaka, major banks increased capital on a large scale and accelerated the writing off of bad debt. As a result, the goal of the “Program for Financial Revival”, halving the ratio of non-performing loans of major banks by the end of fiscal 2004, was reached.

As stated above, the Koizumi administration steadily implemented supply-side policy recommendations. However, in this article, I will analyze the decision-making process and the content of fiscal policy and of policies to accelerate the disposal of non-performing loans and make two arguments. One is that under the Koizumi administration, supply-side policy recommendations were certainly carried out, but demand-side policies were also implemented. The other is that the economic recovery followed a significantly different pathway from the one that proponents of supply-side policies predicted.

9) Yu Uchiyama, *Koizumi Seiken: 'Patosu no Shusho' wa Nani wo Kaetanoka* [The Koizumi Administration: What did the ‘Prime Minister of Pathos’ Change?] (Tokyo: Chuo Koron Shinsha, 2007), 25.

3. Fiscal Policy

It is generally thought that the Koizumi administration implemented a program of fiscal austerity despite the economic stagnation. In fact, the Koizumi administration provided additional public spending during recessions in order to stimulate the economy. Supplementary budgets were formulated in fiscal 2001 and 2002 and Koizumi had to renege on his pledge to limit government bond issues to ¥30 trillion in fiscal 2002. Moreover, in 2003, the government started to cut taxes for corporate R&D expenses and IT-related investments, and these cuts amounted to ¥1.8 trillion per year. After 2002, the issuance of government bonds amounted to more than ¥30 trillion every year until fiscal 2006, when the government was able to limit government bond issues to ¥30 trillion. Therefore, the total amount of outstanding bonds rose substantially during the Koizumi administration.¹⁰⁾

The supplementary budget formulation processes in fiscal 2001 and 2002 are outlined below. It is evident that Koizumi was forced to permit formulation of a supplementary budget as a demand management policy even though he stuck to fiscal austerity as an overall goal.

3.1. Formulating the Supplementary Budgets in Fiscal 2001

After Koizumi became prime minister in April 2001 the economy had worsened. However, Koizumi compiled an austerity budget in order to realize his promise to limit government bond issues to ¥30 trillion. On August 10, guidelines for budget appropriation requests that reduced public works spending and general policy spending by 10% were approved at a cabinet meeting.

Furthermore, Koizumi presented a policy to restrain government bond issues to ¥30 trillion. In the initial budget for fiscal 2001, the amount of government bonds to be issued was ¥28.318 trillion. To limit government bond issues to ¥30 trillion, governmental spending which would be used practically (the so-called “real water”) in formulating a supplementary budget would amount to less than ¥1.7 trillion. The ruling parties’ legislators who demanded economic pump-priming measures claimed that the government should not adhere to the ¥30 trillion cap. On the other hand, the Ministry of Finance (MOF) objected to formulating a supplementary budget in the light of sound public finance.

The Minister of State for Economic and Fiscal Policy, Heizo Takenaka, regarded the cause of economic stagnation not as a temporary demand deficiency but as supply-side problems, such as the non-performing loans problem. Thus, he

10) The total amount of outstanding bonds increased from ¥367.6 trillion (at the end of fiscal 2000) to ¥526.9 trillion (at the end of fiscal 2005).

thought that expanding public works spending would do nothing but enlarge the fiscal deficit. However, he also thought that trying to achieve fiscal soundness too rapidly would cause an economic slowdown. He determined that the government should remain committed to fiscal reconstruction, but that it should also formulate a supplementary budget on an appropriate scale in order to reduce the risk of an economic slump.¹¹⁾ Therefore, he stated that the government aimed to limit government bond issues to ¥30 trillion but that he, personally, considered ¥30-33 trillion a reasonable amount for the current fiscal year. Nonetheless, Koizumi stuck to the ¥30 trillion cap.¹²⁾ It was reported that in September he ordered Takenaka not to make unnecessary statements since he had promised to limit the issuance of new government bonds to ¥30 trillion.¹³⁾

Business and stock prices continued to decline. On October 3, Takenaka informed Koizumi that an extra budget was necessary. He explained that it would be very hard to limit the issuance of new government bonds to ¥30 trillion in fiscal 2002 if nothing was done because the economic downturn would decrease tax revenue.¹⁴⁾ Consequently, negotiations regarding an extra budget began. Takenaka insisted that ¥2-3 trillion of government spending was necessary. However, Minister of Finance Masajuro Shiokawa wished to adhere to the ¥30 trillion cap. In the end, a supplementary budget worth ¥1 trillion was formulated.¹⁵⁾

On October 16, the real growth rate of the government's economic forecast was revised downwards from 1.7% to about -1.0%. Although executives of the governing parties claimed that negative growth should be avoided, Koizumi restated his firm commitment to fiscal reconstruction. He said, "Do we have to increase the issuance of government bonds, trying to turn the growth rate to positive by any means?" and "We have to accept some negative growth to advance structural reforms."¹⁶⁾ Takenaka, who was troubled by Koizumi's stubborn attitude, said that currency redenomination had the effect of changing the economic mood on October 21. On October 23, he offered a personal opinion that "convertible government bonds" could be issued to facilitate fund-raising by the government when the fiscal 2002 budget was being formulated. "Convertible government bonds" are bonds which can be converted to state-held equity shares in the future.

11) Takenaka, *Kohzo Kaikaku no Shinjitsu*, 266-67.

12) *Asahi Shimbun*, August 31, 2001.

13) *Nihon Keizai Shimbun*, December 28, 2001.

14) Takenaka, *Kohzo Kaikaku no Shinjitsu*, 267.

15) Takenaka, *Kohzo Kaikaku no Shinjitsu*, 269-70.

16) *Asahi Shimbun*, October 20, 2001.

He suggested that the convertible government bonds could be convertible into shares of Nippon Telegraph and Telephone Corporation (NTT) held by the government. He conceived that they could be issued irrespective of the ¥30 trillion cap since they could be characterized as a type of security different from normal government bonds. However, the expected profit on the sale of NTT shares was already allocated to redeeming government bonds that had been earlier issued to provide for fiscal stability. For this reason, Takeshi Noda, the leader of the New Conservative Party, which was one of the ruling parties, harshly criticized Takenaka for suggesting what could not be done and suggested that he should implement standard economic policies.¹⁷⁾

On the other hand, the Minister of Economy, Trade and Industry, Takeo Hiranuma, stated that formulating a supplementary budget worth about ¥5 trillion was necessary.¹⁸⁾ Takenaka also indicated he thought a second supplementary budget would be needed.¹⁹⁾ One of four private-sector experts who were members of the CEFP said that all private-sector experts agreed that the government should not limit government bond issues to ¥30 trillion in the current fiscal year.²⁰⁾

Koizumi still stated that it was wrong to regard new bond issuance equal to ¥30 trillion to be part of an austerity budget as tax revenue was slightly more than ¥50 trillion.²¹⁾ However, on November 18, Secretary-General of the LDP, Taku Yamasaki, and a former Secretary-General of the LDP, Koichi Kato, who were Koizumi's political allies, advised him to formulate a second supplementary budget. On the following day, he decided to do so.

Koizumi held firm on the ¥30 trillion cap, though, and the MOF used "invisible debts" as financial resources. That is, it used the proceeds from sales of NTT shares, which were held in a special account for government debt consolidation funds and should have been allocated to redeeming government bonds and paying interest on the bonds in principle. The second supplementary budget amounted to ¥2.5 trillion of government spending. This amount was calculated by working backwards from the available proceeds of the sales of NTT shares.²²⁾

The budget bill for fiscal 2002 was decided by the cabinet on December 24. The total budget amounted to ¥81.23 trillion, which was reduced by 1.7% from the

17) *Nihon Keizai Shimbun*, October 24, 2001.

18) *Nihon Keizai Shimbun*, October 25, 2001.

19) *Asahi Shimbun*, October 18, 2001.

20) *Asahi Shimbun*, October 17, 2001.

21) *Nihon Keizai Shimbun*, November 14, 2001.

22) *Asahi Shimbun*, November 22, 2001.

initial budget for the previous fiscal year, and the general-account expenditures amounted to ¥47.5472 trillion, which was reduced by 2.3%. Despite economic stagnation, an austere budget was compiled. Since “invisible debts” of about ¥1.5 trillion were also incurred, the amount of bond issues totalled just ¥30 trillion.²³⁾

3.2. Formulating the Supplementary Budget in Fiscal 2002

Takenaka, who was acting as both Minister for Financial Services as well as Minister of State for Economic and Fiscal Policy after the Cabinet reshuffle on September 30, 2002, considered abandoning the ¥30 trillion cap unavoidable because accelerating the bad-debt disposal would aggravate the economic slump. He tried to change Koizumi’s line of policy, and hoped to help Koizumi save face by using the term “*Seisaku Kyoka*” (policy enhancements) that he coined.

On October 4, Minister of Finance Shiokawa, who had remained committed to the ¥30 trillion cap, remarked that he was not going to change the line of policy (the ¥30 trillion cap) and was not going to formulate a supplementary budget, but that he did not know what could happen when the disposal of non-performing loans was accelerated because the economy was dynamic in nature.²⁴⁾ His statement was interpreted as meaning he would tolerate the abandonment of the ¥30 trillion cap. A MOF executive also said that some fiscal aftercare would be necessary, depending on how the Financial Services Agency (FSA) proceeded with the disposal of bad loans.²⁵⁾

Koizumi again opposed fiscal stimulus. On October 4, he stated that increasing public spending in a time of recession had become a habit, but that carrying out public works projects by issuing government bonds was typical of old-style electioneering.²⁶⁾ On October 7, Takenaka tried to persuade him to formulate an extra budget, but at a meeting of the CEFP shortly afterwards Koizumi announced that he would not abandon the ¥30 trillion cap in fiscal 2002.²⁷⁾

Politicians in the ruling parties voiced desires to formulate an extra budget. On October 8, Takenaka discussed the issue with the Chief Cabinet Secretary, Yasuo Fukuda, and the Chairman of the LDP Policy Research Council, Taro Aso. They agreed to prepare to compile an extra budget. Takenaka was concerned, however, regarding the sources of financial resources for the extra budget since Koizumi

23) *Asahi Shimbun*, December 14, 2001; *Nihon Keizai Shimbun*, December 25, 2001.

24) *Nihon Keizai Shimbun*, October 5, 2002.

25) *Nihon Keizai Shimbun*, October 5, 2002; October 8, 2002.

26) *Nihon Keizai Shimbun*, October 5, 2002; October 8, 2002.

27) *Asahi Shimbun*, October 19, 2002.

appeared determined to adhere rigidly to the ¥30 trillion cap. Takenaka thought that Koizumi would never accept an extra budget, as he hated to be overpowered by “forces opposing structural reforms.”²⁸⁾

The Administrative Vice Minister of Finance, Toshiro Muto, then let Koizumi know that it would be extremely hard to stay within the ¥30 trillion cap as tax revenue was expected to drop significantly. Subsequently, Koizumi adopted a position that he would determine whether an extra budget was necessary when an estimate of tax revenue was made in mid-November.²⁹⁾ He would then be able to agree to an extra budget for the reason that the government had to cover tax revenue shortages, and would still be able to insist that he did not compromise with “forces opposing structural reforms.”

In November, it became apparent that an extra budget was needed and additional government bonds would have to be issued because the tax revenue shortfall was about ¥2 trillion. On November 12, Koizumi permitted an extra budget and additional public works projects. On November 14, he told Aso that he would leave the specific content of the extra budget to the ruling parties.³⁰⁾

Negotiations began between the government and the ruling parties to compile the extra budget. The ruling parties demanded ¥3 trillion for public works projects and ¥2 trillion to consolidate social safety nets. Shiokawa insisted on holding the issuance of government bonds to below ¥35 trillion, meaning that the additional issuance of government bonds would be limited to ¥5 trillion. Aso pointed out that ¥36 trillion was not so different from ¥35 trillion and requested that Shiokawa step up public works spending. Shiokawa remained unyielding. Eventually, they agreed that ¥1.5 trillion was to be spent for public works projects and ¥1.5 trillion was to be spent to consolidate social safety nets. In addition, it was necessary to cover the tax revenue shortfall and the increase in mandatory expenditures. The MOF limited additional government bond issuance to about ¥5 trillion by trimming budgetary expenditures.³¹⁾

The government asserted that public works spending was consistent with structural reforms because it would be used to promote investments for urban development, infrastructure development to revive urban areas as well as regional cities and towns, and infrastructure development to promote a recycling-oriented society and deal with environmental problems. However, infrastructure

28) *Asahi Shimbun*, October 9, 2002; October 19, 2002.

29) *Nihon Keizai Shimbun*, November 5, 2002.

30) *Asahi Shimbun*, November 22, 2002.

31) *Asahi Shimbun*, November 22, 2002.

development for reviving urban areas included expansion of the Tokyo International Airport, maintenance of belt highways, laying power lines underground, and so on; activities that did not differ greatly from old-fashioned public works projects.³²⁾ During Diet deliberations, an opposition party member pointed out that spending on the construction of prison buildings was included in the expenditures for environmental measures. Shiokawa was compelled to admit that old-fashioned public works spending was included in the supplementary budget.³³⁾

While the Koizumi administration's decision to formulate a supplementary budget that included public works spending in order to stimulate the economy seemed a case of "*Seisaku Tenkan*" (policy shift), Koizumi never admitted to changing his policy. He persisted in saying that this was "*Seisaku Kyoka*" and that he would not change his reformist policy.

3.3. Export-led Economic Recovery

As stated above, although Koizumi had initially stuck to the ¥30 trillion cap, he was forced to take fiscal action and abandon the cap in fiscal 2002. However, the economy recovered very gradually from February 2002. Share prices started to rise in summer 2003 and the economy was clearly recovering. Therefore, calls by the ruling parties for public spending to stimulate the economy faded away.

Why did the economy begin to recover in 2002? The recovery depended mainly on increased overseas demand, especially demand in China. Resolving the growth rate of aggregate demand into the part due to domestic demand and that due to exports, Takao Komine found that the latter was larger when the economy started to recover in 2002 (**Table 1**).³⁴⁾ Consistent with this, Akira Sadahiro shows that China-bound exports rose rapidly during this period (**Table 2**).³⁵⁾ In other words, the Japanese economy might have been righted not by the policies implemented by the Koizumi administration, but by the fortunate increase in foreign demand, especially that of China. Continuing economic stagnation could have obliged the government to compile an extra budget and increase public works spending a third time if overseas demand had not increased.

32) *Asahi Shimbun*, November 22, 2002.

33) *Asahi Shimbun*, January 30, 2003.

34) Takao Komine, *Nihon Keizai no Shin-Kyokumen* [A New Phase of the Japanese Economy] (Tokyo: Chuo Koron Shinsha, 2006), 118-20.

35) Akira Sadahiro, *Sengo Nihon no Makuro Keizai Bunseki* [Macro-Economic Analyses of Postwar Japan] (Tokyo: Toyo Keizai Shimpasha, 2005), 26-27.

In sum, in both 2001 and 2002, the Koizumi administration initially formulated austere budgets, but economic sluggishness created a demand for supplementary budgets to boost the economy. Koizumi was unable to adhere to his policy line. He was able to maintain his austere budget policy in 2003 and afterwards, though, as the economy recovered because of increased foreign demand.

Nonetheless, the Koizumi administration also implemented policies that provided real domestic support for the economy. The improvement in stock prices since summer 2003 was mainly due to stabilizing financial markets. This stabilization occurred because the administration accelerated the disposal of non-performing loans. However, this also did not proceed as initially expected.

4. Policies to Accelerate the Disposal of Non-performing Loans

4.1. Policy Process

In 2001, Takeshi Kimura, a financial consultant, pointed out through various media that the most significant cause of financial instability was about 30 large borrowers from each major bank. Loans to some general construction companies, big retailers, and real estate companies that were burdened with excessive debt and suffering from a severe slump in business were classified not as bad loans, but as loans to “normal borrowers” or “borrowers requiring attention”. Major banks had not set aside sufficient loan-loss reserves against loans to these companies. Investors feared that major banks’ own capital would be rapidly eroded and a financial crisis would occur if these companies fell into bankruptcy. Kimura insisted that the FSA should inject public funds into major banks and make them set aside sufficient loan-loss reserves against these companies. The Minister for Financial Services, Hakuo Yanagisawa, remained adamant that the inspection of financial institutions by the FSA was sufficiently rigorous and no injection of government funds was required.

Financial instability continued and Koizumi demanded Yanagisawa achieve results so that the public would recognize that the disposal of non-performing loans was advancing.³⁶⁾ Koizumi indicated his policy was to speed up the bad-loan disposal. When Aoki Kensetsu, a construction company with excessive debts, went bankrupt, he said it was a sign that structural reforms were proceeding at a good pace.³⁷⁾ Investors saw that other companies with excessive debts would probably be

36) *Nihon Keizai Shimbun*, November 15, 2001.

37) *Asahi Shimbun*, December 7, 2001.

forced into bankruptcy, and the share prices of these companies fell sharply. Investors also feared that a financial crisis would occur in the coming March, and this was called the “March Crisis.”

Koizumi made the prevention of such a crisis his top priority. The restructuring plan for Daiei, a major supermarket chain which was considered a typical company with excessive debt, was formulated in January 2002. The Ministry of Economy, Trade and Industry (METI) and the FSA supported this plan and banks wrote off ¥520 billion in Daiei loans. Koizumi accepted this plan without reservation. He said that Daiei’s failure would have an enormous influence on the economy and that this plan could be formulated because related organizations perceived the determination of the Cabinet to prevent Daiei’s bankruptcy.³⁸⁾

This plan was seen as the outcome of procrastination on the part of the administration, however, and financial unrest continued. Koizumi reshuffled his Cabinet in September 2002, replacing Yanagisawa as Minister for Financial Services by Takenaka, who would also continue as Minister of State for Economic and Fiscal Policy. Since the Cabinet’s inauguration in April 2001, Takenaka had demanded that the inspection of financial institutions by the FSA become more rigorous and that public funds be provided to banks if necessary. In October 2002, Takenaka formulated the “Program for Financial Revival”, stating that bank inspectors would tighten asset assessments at major banks and that he would not hesitate to inject public money into banks if necessary.

The fear of being nationalized caused major banks to increase their capital on a large scale. Mitsubishi Tokyo Financial Group, Inc., confident of its financial strength and highly rated by the market, increased its common equity capital through a public offering. It had planned a capital increase of ¥350 billion, but a sharp fall in its share price meant that it ultimately raised only ¥270 billion. Sumitomo Mitsui Financial Group, Inc. issued preferred shares worth up to about ¥500 billion. Goldman Sachs bought ¥150.3 billion of these preferred shares at a dividend rate of 4.5% (a fixed rate over a 25-year period). Because of the very high rate, it was said that Sumitomo Mitsui had been unfairly disadvantaged. UFJ Holdings, Inc. established a subsidiary in which Merrill Lynch & Co., Inc. took a ¥120 billion stake through preferred shares. This subsidiary specialized in the disposal of non-performing loans and UFJ Holdings transferred its bad debts from loans to SMEs to the subsidiary.³⁹⁾ However, UFJ itself did not issue new equity

38) *Yomiuri Shimbun*, January 19, 2002; January 20, 2002; January 25, 2002.

39) Atsuo Yamaguchi, *Risona no Kaikeishi wa Naze Shindanoka* [Why did the Accountant for Resona Die?] (Tokyo: Mainichi Shimbunsha, 2003), 161-62. Nihon Keizai Shimbunsha,

and did not promote the disposal of bad loans made to large firms with excessive debts. Subsequently, UFJ had difficulty surviving.

In contrast, Mizuho Financial Group, Inc. was seen as the most probable target of nationalization because its audits were done by Kenichi Meguro, who was known to be a particularly strict bank inspector. In fact, the finance director reported to the management board that the firm would have no choice but to apply for public funds. If it proceeded with the disposal of non-performing loans as the “Program for Financial Revival” demanded, it would post a loss of ¥2 trillion and be ¥1 trillion short of the minimum capital adequacy ratio that international banks had to maintain.⁴⁰⁾ Moreover, a foreign financial institution, with which it had negotiated without informing the public, demanded a “surprisingly high dividend rate” to take up its shares. As an alternative, Mizuho asked loan customers, from big companies to SMEs, to take up preferred shares worth a total of ¥1 trillion.⁴¹⁾

This plan of capital expansion was criticized as an “abuse of a dominant bargaining position”⁴²⁾ and as verging on a violation of the Securities and Exchange Act.⁴³⁾ Still, Mizuho was able to eventually increase its capital by ¥1.083 trillion, and consequently wrote off bad loans worth ¥2 trillion.

Takenaka and Kimura apparently did not expect major banks, with the exception of Mitsubishi Tokyo, to increase their equity on their own. For example, in his book, Kimura wrote that banks should have thought more favorably about applying for public funds instead of paying the excessive cost necessary to increase their capital.⁴⁴⁾ It can be inferred Takenaka and Kimura intended to speed up major bank’s disposal of non-performing loans by injecting public money into them and shaking up their management.

Takenaka’s hard-line policies were seen to be stymied at this point since the injection of public funds was not necessary due to the major banks’ capital

UFJ Mitsubishi Tokyo Togo: Supa Megabanku Tanjo no Butaiura [Merger of UFJ and Mitsubishi Tokyo: Behind the Scenes of the Birth of the Super Megabank] (Tokyo: Nihon Keizai Shimbunsha, 2004), 175.

40) Nihon Keizai Shimbunsha, *UFJ Mitsubishi Tokyo Togo*, 173.

41) Nobukatsu Ono, *Takenaka Heizo no Senso: Kin-yu Saisei ni Idonda 730 Nichi* [Heizo Takenaka’s Battle: To Tackle Banking Reform in 730 Days] (Tokyo: PHP Kenkyujo, 2005), 116-18.

42) Yamaguchi, *Risona no Kaikeishi wa Naze Shindanoka*, 162.

43) Nihon Keizai Shimbunsha, *UFJ Mitsubishi Tokyo Togo*, 174-75.

44) Takeshi Kimura, *Takenaka Puran no Subete: Kin-yu Saisei Puroguramu no Shinjitsu* [All about the Takenaka Plan: The Truths of the Program for Financial Revival] (Tokyo: Aski Komyunikeshonzu, 2003), 112.

expansion.⁴⁵⁾ Furthermore, falling stock prices put him in a difficult position. He and Kimura reiterated their determination that they would not adopt a policy of “too big to fail” and would drive troubled companies out of the market regardless of their size. This, combined with the major banks’ efforts to increase capital, caused share prices to continue plunging and Takenaka was harshly criticized. Under the circumstances, he felt pressed to raise share prices in any way possible.

In February 2003, he asked cabinet ministers to purchase the Nikkei 225 Exchange Traded Fund (ETF). He told journalists that he would buy the ETF and was absolutely certain it would be profitable to do so. The opposition parties insisted that this statement was a violation of the Securities and Exchange Act, because it was insider trading if it had any foundation or it was “spreading of rumor” if there was no foundation. Some members of the ruling parties also criticized him for his careless remark. He was forced to give excuses and apologize.⁴⁶⁾

At a May 8 meeting of the CEFP, private-sector experts recommended aggressively investing the funds of postal savings, postal life insurance and public pensions in the stock market as a means to revitalize it. This looked like a stock price-keeping operation (PKO), so the Minister of Economy, Trade and Industry, Hiranuma, and the Minister for Internal Affairs and Communications, Toranosuke Katayama, voiced objections. They explained that they wanted to increase the proportion of the funds that could be invested in stocks in the long and medium terms and this was different from a “PKO.” A senior official of the Cabinet Office, however, said that he did not think the difference could be sufficiently explained.⁴⁷⁾ In most cases, the recommendations of private-sector experts were prepared by Takenaka and his close advisers. On May 11, speaking on a television program, Takenaka himself stated that private banks invested 4 to 5% of their funds in the stock market, but only 1% of the funds of postal savings was invested in stocks.⁴⁸⁾ This statement was interpreted as a demand that more money from postal savings be invested in the stock market. This suggested he felt pressed by low stock prices because the “PKO” was notorious as a stopgap measure implemented in the 1990s as an alternative to undertaking structural reforms.

In addition, Takenaka tried to enable the infusion of public funds into banks by using audit corporations in order to break the deadlock. The Chairman of the

45) *Asahi Shimbun*, April 26, 2003.

46) *Asahi Shimbun*, February 15, 2003; February 18, 2003; February 20, 2003.

47) *Asahi Shimbun*, May 7, 2003; May 9, 2003.

48) *Asahi Shimbun*, May 12, 2003.

Japanese Institute of Certified Public Accountants, Akio Okuyama, who was a member of the “Takenaka Team” that had formulated the “Program for Financial Revival”, sent a Chairman Notice dated February 24, 2003 to certified public accountants.⁴⁹⁾ To release a Chairman Notice was very rare, and in this case it urged certified public accountants to calculate major banks’ deferred tax assets strictly, taking into account each bank’s earnings forecast and the underlying business environment.⁵⁰⁾ If they followed this notice, it would be difficult to allow Resona to claim the allowed maximum of five years of profits, for it had been in the red for three consecutive accounting periods.⁵¹⁾ Resona’s auditing firm allowed it to claim only three years of profits. As a result, the capital adequacy ratio of Resona Bank was calculated as 2.3% and that of Resona Holdings, Inc., the bank’s holding company, was calculated at 3.8%. As their capital adequacy ratio fell below the 4% level required by domestic standards, the infusion of public funds was required.⁵²⁾

On May 17, the Financial System Management Council met and it decided to inject ¥1.96 trillion in public capital into Resona Bank. The bank was not regarded as having excessive liabilities, though, because the auditing firm permitted deferred tax assets to be estimated over a three-year period. If it had not, Resona Bank would have been judged insolvent. Rather than applying Item 3, Article 102 of the

49) Afterward, Takenaka says that he asked the Japanese Institute of Certified Public Accountants to send a letter to all certified public accountants. Heizo Takenaka, *Takenaka Heizo Chugoku de Nihon Keizai wo Kataru: Pekin Daigaku Tokubetsu Kogi yori* [Heizo Takenaka Talks on the Japanese Economy in China: From Special Lectures at Beijing University] (Tokyo: Daiwa Shobo, 2008), 71-72.

50) In Japan, except when a borrower liquidates and the accounting loss is confirmed or it is objectively judged that the loan cannot be collected, loan-loss reserves are not recognized as tax losses. After it is confirmed that they are impossible to collect because of the borrower’s bankruptcy and so on, loan-loss reserves are recognized as tax losses and the amount is reduced from taxable income. This means that banks in effect prepay tax. Thus, it is permitted that banks record the amount of tax which is expected to be returned as a deferred tax asset on their balance sheets in advance. According to guidelines set by the Japanese Institute of Certified Public Accountants, banks were exceptionally allowed to record deferred tax assets within the limits of the estimated future taxable income for approximately five years because of the government’s policy to accelerate the disposal of non-performing loans.

51) Ono, *Takenaka Heizo no Senso*, 85. Yamaguchi, *Risona no Kaikeishi wa Naze Shindanoka*, 166-67.

52) Japan Center for Economic Research, “Financial Situation and Management of Banking Sector,” *Japan Financial Report* No.9, “The Profitability of Japanese Industries: Non-financial Sectors, Banks and Life-Insurance Companies,” (October, 2003): 15-28. <http://www.jcer.or.jp/eng/pdf/kinyuE9-3.pdf>.

Deposit Insurance Act (nationalizing banks as special public management), though, the government then applied Item 1 (in order to restore the soundness of banks, injecting public money into those that are not insolvent). Therefore, Resona's capital stock was not reduced and shareholders did not suffer the loss that they would normally be expected to realize from such a corporate failure.⁵³⁾

After the injection of public money into Resona Bank, share prices, especially those of banks, turned upward and this rapidly enhanced the financial strength of banks. This rise in share prices was attributed at the time to foreign investors, who had made profits through rising share prices in the United States and were now buying shares of Japanese companies which seemed relatively undervalued.⁵⁴⁾ The prime reason, however, was that shareholders of Resona Holdings escaped paying any penalty for the bank's misadventures and instead gained as Resona's stock price rose. Foreign investors rushed to buy the stocks of banks and related companies because it became clear that Takenaka was being unexpectedly generous to banks receiving public funds.⁵⁵⁾ In fact, securities analysts received numerous inquiries about the next major bank expected to apply for public fund injections.⁵⁶⁾ Some foreign hedge funds obtained a list of regional banks with poor financial characteristics and bought shares of these banks in anticipation of a second or a third present from the Japanese government.⁵⁷⁾ In sum, the stock prices of banks recovered because the belief that the government would protect bank shareholders created moral hazard.

As stock prices recovered, criticism of government economic policies from "forces opposing structural reforms" in the LDP and opposition parties calmed down. After that, the FSA, as an initiative of the Inspection Bureau, conducted stringent inspections of financial institutions. In November 2003, Ashikaga Bank, a regional bank, was judged insolvent because its auditing firm did not permit the estimation of deferred tax assets. It was nationalized temporarily under Item 3, Article 102 of the Deposit Insurance Act, and the stock of Ashikaga Holdings Co., which was the bank's holding company, became almost worthless. In this case, shareholders were not protected from loss caused by the bank's insolvency.

In 2004, after UFJ bank tried to thwart the inspections of the FSA in the previous year, the FSA implemented extremely strict inspections of the bank.

53) Yamaguchi, *Risona no Kaikeishi wa Naze Shindanoka*, 171.

54) *Asahi Shimbun*, July 9, 2003.

55) *Asahi Shimbun*, September 19, 2003.

56) *Asahi Shimbun*, October 1, 2003.

57) *Nikkei Kin-yu Shimbun*, December 1, 2003.

Consequently, it was forced to merge with Mitsubishi Tokyo Financial Group to avoid bankruptcy. Daiei, a large borrower from UFJ, was obliged to seek aid from the Industrial Revitalization Corporation of Japan (IRCJ).

By the end of fiscal 2004, the target of the “Program for Financial Revival,” which was that the non-performing loan ratio of major banks would be decreased by half, had been achieved and financial uncertainty had eased.

As explained, the fundamental disposal of non-performing loans was realized in ways different from what Takenaka and Kimura had expected. First, they had thought that huge infusions of public funds into major banks would be required. In fact, many major banks raised capital on their own and succeeded in clearing up their bad debts. Only Resona Bank and Ashikaga Bank applied for public fund injections. At the time, Mizuho’s capital expansion was criticized as “the worst” and the outcome of an “abuse of a dominant bargaining position.” Today, though, the “courageous decision” made by management is highly praised. Second, Takenaka’s threat to nationalize major banks caused them to make serious efforts to clear away bad loans, a problem they had been slow to deal with, and the radical disposal of non-performing loans was realized. However, we should recognize that the Japanese economy recovered because of the good fortune that foreign demand, especially in China, unexpectedly increased. This enabled ailing companies whose debts had been classified as bad loans to regain their financial footing and their debts could be restored to normal loans. As a result, the amount of bad loans rapidly decreased.⁵⁸⁾ Third, when the government injected public funds into Resona Bank, the FSA did not assess the bank’s assets and took at face value the auditing firms’ assertions that it was not insolvent. The shareholders did not realize the losses that would normally result from an investment in a company that became insolvent. Therefore, stock prices turned sharply upward – not because of progress made in structural reforms, but because of increased moral hazard – and a financial crisis was averted. The economic recovery was a significant factor in the increase in stock prices.

4.2. The Contents of the Policies

In this section, I will review the contents of the policies that were applied to

58) Of course, through the radical disposal of bad loans, the financial system was stabilized and in part this supported the economic recovery. That is, both the economic recovery and the radical disposal of bad loans decreased bad loans; both the decline in bad loans and the increase in stock prices improved banks’ management and stabilized the financial system; this caused a business upswing and a further upturn in share prices.

accelerate the disposal of non-performing loans and show that they took the demand-side of the economy into account. In general, the radical disposal of bad loans is said to make banks reluctant to extend loans and cause the bankruptcy of firms, thus leading to economic stagnation. In fact, these side-effects were observed. The government then applied economic counter-measures by increasing public spending and lowering investment taxes. Moreover, the “Program for Financial Revival” itself included measures which minimized the side-effects.

In this program, the section of “Due consideration to loans to small- and medium-sized enterprises (SMEs)” described the following measures. First, the FSA would swiftly approve the banking licenses of new lenders who would try to meet SMEs’ financial needs. Second, to support the revival of SMEs, the development of financial measures, including those utilizing trust and debt equity swaps, would be examined. Third, when a financial institution applying for public funds significantly failed to achieve its goal for lending to SMEs as given in its plan for sound management, the FSA would issue a “Business Improvement Administrative Order.” Fourth, the FSA would ensure that inspections would be properly conducted in a way that fully took into account each SME’s actual conditions. Fifth, the FSA would create a “Hotline for credit crunch and credit withdrawal” to receive fax and e-mail messages from SMEs and take appropriate administrative measures against a financial institution where serious problems were identified.⁵⁹⁾ In addition, the government announced that it would take measures to facilitate financing for SMEs, including the expansion of lending by government affiliated financial institutions and enhancement of the credit guarantee system provided by the Credit Guarantee Corporation in each area, as part of the “Comprehensive Measures to Battle Deflation”.⁶⁰⁾

The “Program for Financial Revival” was aimed at only major banks, and the bad loans of regional (that is, small- and medium-sized) financial institutions were initially passed over. In March 2003, the “Action Program concerning enhancement of Relationship Banking Functions” was released. In this program, it was emphasized that it would be difficult for small- and medium-sized financial institutions to take the same approach towards the disposal of non-performing loans and, in contrast to the case for major banks, no numerical targets were set for their disposal. In other words, a double standard was applied for the major banks and for the small- and medium-sized financial institutions.

These decisions show that Takenaka’s policies of accelerating the disposal of

59) The Financial Service Agency Website, <http://www.fsa.go.jp/en/policy/pfr.html>.

60) *Nihon Keizai Shimbun*, November 5, 2002.

bad loans were unexpectedly sensitive to the needs of SMEs and regional economies. We can better understand this by comparing his policies to Yanagisawa's policies.

First, Takenaka compelled financial institutions applying for public funds to achieve their targets for strongly expanding their lending to SMEs. The government forced banks to set these targets at the time the public funds were injected because the government had made commitments to members of the ruling parties who were supported by SMEs. However, some officials at the FSA thought that it was wrong for the FSA to compel financial institutions to expand their loans to SMEs in any way while at the same time demanding that they reinforce their financial and operating performance by raising lending rates.⁶¹⁾ Accordingly, under Minister for Financial Services Yanagisawa, the FSA took a soft stand against banks; that is, it did not always issue a "Business Improvement Administrative Order" when the target of lending to SMEs was not reached and it examined whether it should issue such an order only if the reasons for a bank not meeting its target were deliberate and malicious.⁶²⁾ In contrast, the "Program for Financial Revival" stated that a "Business Improvement Administrative Order" would be issued as a general rule when a financial institution failed to achieve its target to a serious degree.⁶³⁾ In fact, in January 2003, the FSA issued such an order to Mizuho Financial Group, whose loans to SMEs decreased by ¥5.569 trillion at the end of September 2002 despite its plan to increase the amount by ¥10 billion in fiscal 2002. This was a very rare action, for it was issued on the basis of semi-annual results (at the end of September 2002), not at the annual closing of accounts (at the end of March 2003).⁶⁴⁾

Second, Yanagisawa, who was criticized for being indulgent to major banks, was more severe with small- and medium-sized financial institutions than Takenaka. In preparation for terminating the unlimited guarantee of fixed deposit accounts in April 2002, he proceeded with the closure of failed small- and medium-sized financial institutions. From January 2001 to March 2002, 43 credit cooperatives, 13 Shinkin Banks (credit associations), and 2 second-tier regional banks failed and there were many mergers among them.⁶⁵⁾ On the other hand, under

61) *Nihon Keizai Shimbun*, November 5, 2002.

62) *Nihon Keizai Shimbun*, April 5, 2002; August 1, 2002; August 22, 2002.

63) The Financial Service Agency Website, <http://www.fsa.go.jp/en/policy/pfr.html>.

64) *Nihon Keizai Shimbun*, December 26, 2002. Other banks which applied for public fund injections decreased their lending to SMEs though not to the extent of Mizuho. Since the FSA issued the order to only Mizuho, Mizuho was seen as the most probable target of nationalization.

65) *Nikkei Kin-yu Shimbun*, March 14, 2002; March 18, 2002. Since the middle of October

Minister for Financial Services Takenaka, Ashikaga Bank was the only regional financial institution closed, because the “double standard” described above was applied.

Takenaka forced banks to lend to SMEs regardless of their productivity and was indulgent to regional financial institutions whose profitability was low. This seemed inconsistent with the idea of structural reforms. On the other hand, Yanagisawa announced a plan for the “final disposal of non-performing loans” which was aimed at “bankrupt borrowers,” “effectively bankrupt borrowers,” and “borrowers in danger of going bankrupt.” These categories included many SMEs. He clung to the plan to terminate the unlimited guarantee of ordinary savings accounts in April 2003, but this termination was postponed until April 2005 by Takenaka. Yanagisawa also proceeded in the disposal of regional financial institutions. As far as small business finance goes, he seemed to implement policies consistent with the idea of structural reforms.

Why did Takenaka treat major banks so severely, yet take a soft stance regarding SMEs and regional banks? I think this was to prevent a decrease in domestic demand. In addition, it was because he compromised with members of the ruling parties who opposed his plan to accelerate the disposal of bad loans since they were concerned about SMEs experiencing funding difficulties. Trying to propitiate these members by taking a soft stance against SMEs, he did not set numerical targets for the regional banks’ disposal of bad loans and compelled banks which accepted public funds to increase the amount of their loans to SMEs.⁶⁶⁾

5. Conclusion

As this article makes clear, as well as implementing structural reforms to strengthen the supply-side of the economy, the Koizumi administration also adopted economic policies to stimulate the demand-side.⁶⁷⁾ The article also makes

2001, failed financial institutions had been disposed almost every week.

66) In his memoir, Takenaka explained that it was important that he avoided needless political backlash by passing over small- and medium-sized financial institutions for a while. Also, he asserted that it was imperative to resolve the non-performing loans problem of major banks in order to stabilize the financial market. Furthermore, he stated that they had sufficient latent potential to resolve them in terms of human resources and financial strength, but regional, small- and medium-sized financial institutions did not. Takenaka, *Kohzo Kaikaku no Shinjitsu*, 70-71.

67) Likewise, it was postponed until April 2005 to terminate the unlimited guarantee of ordinary savings accounts, which was scheduled for April 2003. Koizumi was also eager to abolish, privatize and merge government-affiliated financial institutions in the early days of the

clear that the economy recovered in ways different from what had been initially expected.

The Koizumi administration proceeded with industrial structural reform by reducing spending on public works projects. As the economy worsened, though, the government applied fiscal stimuli. In time, the economy recovered through increased overseas demand and no further fiscal stimulus was necessary.

After October 2002, the government forced major banks to accelerate the disposal of non-performing loans and succeeded in stabilizing the financial system, though it also allowed some policies of forbearance, such as postponing the disposal of Daiei, which were inconsistent with structural reforms. However, when public funds were injected into Resona, which was the turning point for stabilizing the financial system, the shareholders were not held accountable. While this was contrary to fundamental market principles, it raised stock prices by encouraging moral hazard among foreign investors. This rise in stock prices helped solve the non-performing loans problem of financial institutions. Moreover, the government paid particular attention to SMEs and regional financial institutions in the process of accelerating the disposal of bad loans.

As stated above, although the Koizumi administration asserted that demand-side policies had no effect on the economic stagnation of the 1990s and that it would adopt supply-side policies, it was eventually obliged to implement policies that focused on the demand-side. In fact, Koizumi had to shift his policies when he faced continued economic stagnation and was forced to compromise with “forces opposing structural reforms.”

Unlike Koizumi, Takenaka paid attention to the demand-side, though he insisted on supply-side reforms. He argued that the economic stagnation of the 1990s was due to supply-side problems and that structural reforms to enhance the productivity of the Japanese economy were needed.⁶⁸⁾ At the same time, he argued for fiscal action to boost the economy in tough economic times, though he also insisted on fiscal restructuring. In accelerating the disposal of bad loans, he paid attention to the needs of SMEs and the regional economies. Regarding monetary policy, he asserted that deflation is a monetary phenomenon and called for the Bank of Japan to set an inflation target. This is evidence he considered the demand-side important.

government, but this was also postponed. In the end, both were carried out after stabilization of the financial market.

68) Heizo Takenaka, *Ashita no Keizaigaku: Kaikaku wa Kanarazu Nihon wo Saiseisaseru* [Economics Tomorrow: Reforms Revive the Economy Necessarily] (Tokyo: Gentoohsha, 2003), 36-43.

Some criticize his policy recommendations as inconsistent and question his ability as an economist.⁶⁹⁾ A consistent economist who insisted on structural reforms would deem fiscal and monetary stimuli unnecessary and only argue for the radical disposal of non-performing loans. A consistent economist who focused on economic recovery would have made looser monetary policy or increased public spending a priority, and the disposal of bad loans would have been postponed. However, Takenaka responded flexibly to changing economic circumstances by taking whatever measures were necessary at the moment, rather than by translating consistent economic ideas into economic policies and rigidly applying them in the real world. As things turned out, his flexible stance seems to have enabled economic recovery.⁷⁰⁾

This series of events illustrates a problem related to policy recommendations by social scientists. I will conclude this article by examining this problem.

Social scientists are generally trained that it is desirable to explain as much as possible by only one factor or as few factors as possible. Of course, they understand that it is an oversimplification to explain many results through only one factor since numerous factors combine to cause any given result in the real world. However, including many possible factors makes the process of explanation unworkable. Therefore, they oversimplify the real, complicated world in order to understand it better. In other words, to understand complex real world situations, they interpret them by focusing on only what seem the most important factors.

Thus, creating an analytic model that is internally consistent is sometimes more valued than accurately understanding the real world. This is because the model-

69) Satoshi Higashitani, *Dare ga Nihon Keizai wo Sukuerunoka* [Who can Save the Japanese Economy] (Tokyo: Nihon Jitsugyo Shuppansha, 2002). Satoshi Higashitani, *Ekonomisuto wa Shinyo dekiruka* [Can we Trust Economists] (Tokyo: Bungei Shunju, 2003).

70) The economic recovery under the Koizumi administration, after all, depended on foreign demand. As soon as the U.S. economy went into decline due to the collapse of the housing bubble, the Japanese economy also began to stagnate. The Koizumi administration was fortunate that the term of the Cabinet overlapped a period characterized by the housing bubble in the U.S. and the rapid expansion of the Chinese economy. In fact, economists who argued for structural reforms insisted that not only should low productivity industries, such as the construction industry, be allowed to diminish, but also that the conventional industrial structure centered on the manufacturing industry should be transformed into a new industrial structure centered on IT and the financial industry. Since the Yoshiro Mori administration, the government has had policies to promote the IT industry. However, the revival of heavy industries, such as the steel industry and the shipbuilding and heavy machine industry, which increased exports to China, was a notable part of the economic recovery phase from 2002.

makers realize the impossibility of giving a full and particular account of reality. Nevertheless, when making policy recommendations, they often forget this limitation. Their models are developed, focusing on only one or a few causal factors and with many conditions attached, yet they often insist that their policy recommendations derived from these analytic models should be applied to the real world without modification. If their policy recommendations are not followed, they sometimes criticize policy makers as lacking knowledge and ability in social science.

When a policy leads to a particular result, though, various factors other than the few focused on will have affected the result in unexpected ways. Consequently, even if a recommended policy is followed, a result contrary to expectations may occur. On the other hand, if a policy contrary to recommendations is implemented, a desirable outcome may occur despite expectations. Scientists cannot predict the future accurately even though they can analyze past phenomena brilliantly.

Several economic policies have been proposed by many economists with the aim of overcoming the economic stagnation that has prevailed since the 1990s. Most of these economists have interpreted the economic slowdown as having been caused by only one problem and have recommended that policies to solve the one particular problem be carried out. At first, Prime Minister Koizumi assumed that proceeding with structural reforms only would restore the economy. As it happened, both supply-side policies and demand-side policies were implemented and both types contributed to the economic recovery. This clearly demonstrates that the real world is more complicated than what is assumed by social scientists, who tend to explain everything with a severely limited set of factors. When policy recommendations derived from social science theory are applied to the real world, they do not always lead to the outcome hoped for and can sometimes have unforeseen consequences. Advisors from the fields of social science need to be conscious of these limitations when making policy recommendations.

Table 1. The ratio of contribution by domestic demand and by export to the growth rate of aggregate demand (%)

FY	Growth rate of aggregate demand	Contribution of domestic demand	Contribution of exports
1995	3.3	2.9	0.4
1996	3.4	2.7	0.6
1997	-0.3	-1.1	0.8
1998	-1.7	-1.4	-0.3
1999	1.0	0.5	0.5
2000	3.4	2.5	0.9
2001	-1.0	-0.2	-0.8
2002	1.4	0.3	1.1
2003	2.4	1.3	1.0
2004	2.3	1.1	1.3
2005	3.5	2.4	1.1

Source: Takao Komine, *Nihon Keizai no Shin-Kyokumen* [A New Phase of Japanese Economy] (Tokyo: Chuo Koron Shinsha, 2006), p.119.

Table 2. Japanese exports by destination region (%)

	Growth rate (per year) (2000-2004)	Percentage constituent		
		1990	2000	2004
The entire World	4.3	100	100	100
The U.S.	-2.8	31.5	29.7	22.4
EU	3.0	18.7	16.3	15.5
Asia NIEs	5.1	19.7	23.9	24.7
ASEAN	1.7	11.5	14.3	12.9
China	25.0	2.1	6.3	13.1
Others	9.6	16.5	9.4	11.4

Source: Akira Sadahiro, *Sengo Nihon no Makuro Keizai Bunseki* [Macro-Economic Analyses of Postwar Japan] (Tokyo: Toyo Keizai Shimposha, 2005), p.27.

