3.1 Meaning and Scope

Structural Reforms as used by politicians is a very convenient term, which is however not clearly defined. A substantial gap exists between how researchers use the phrase and how it is used in the political arena. Unless terms are clearly defined beforehand, proposed policy intentions may be totally distorted in the process of debate and realization, producing unintended results. Experts on the economy have come to a general consensus that structural reform is to correct problems such as the national economy's overdependence on public sector demand, or to facilitate the transfer of financial and human resources from low productivity sectors to high-productivity ones by terminating support to the former (OECD, 1988). Issues that need to be addressed by structural reform are very complex and cannot be explained by a simple, one-dimensional theory. And this is exactly why structural reform is so named, i.e. the reform of "structure." However a policy mechanism involving consistent logic and practicability has to be undertaken in order to tackle with the problems faced due to structural failures. Obviously the main ingredients in the process of structural reform are: structure and reform. Which is the structure and what does the reform change?

1 According to the World Bank's 1997 World Development Report The goal of structural reform is to create a favorable policy environment for accountable, transparent government with a well-defined public and private sector working in mutual reinforcing ways to promote prosperity and sustainable development. The chief functions of a modernized system of governance include five key tasks: (WDR, 4) Establishing a foundation of law, Maintaining a non-distortionary policy environment, Investing in basic social services and infrastructure, Protecting the vulnerable, Protecting the environment.
Structural reform consists of improvements made to institutional frameworks, regulations and government policy so that ‘behind-the-border barriers’ to regional economic integration and improved economic performance are minimized. Structural reform helps foster an economic environment that supports the efficient functioning of markets; contributes to macroeconomic stability, productivity and economic growth; and ultimately enhances living standards in a sustainable way (OECD 2005). There are numerous benefits that efficient and well-functioning markets can produce. Well-functioning markets allocate resources to their most valued use and facilitate competition. This leads to better quality products and services at lowest possible prices and better choice for consumers. Increased competition also encourages innovation and productivity gains and sustainable economic growth, improving the wellbeing of citizens.

Structural reform consists of improvements made to institutional frameworks, regulations and government policies such that the economic environment supports the efficient functioning of markets, and ultimately enhances living standards in a sustainable way. Thus, the immediate goal is to create markets that are stronger and more efficient. Ultimately, the goal is the sustainable improvement of the well-being of citizens. Structural reform is an evolutionary process that can provide ongoing benefits for all economies. While sweeping reforms may at times be necessary, even economies with highly efficient markets can benefit from precisely targeted reforms.

In an increasingly globalized world, structural reform has benefits that spill across borders. Structural reforms in one economy can enhance economic outcomes in other economies. This results from reductions in costs and prices, increasing competitive pressures and rationalizing supply chains. The existence of these spillover effects is a good reason for structural reform to enter the agenda of multilateral forums. Why are structural reforms so difficult to implement?

Moreover, given resistances to structural reform, many reforms end in either outright failure, or in diluted versions that have impacts that are reduced or negligible relative to
what were originally planned (Fernandez and Rodrik 1991). Also, the prospect of conflict can often deter even the attempt at structural reform. Therefore, successful structural reform needs political support from the highest levels and a well-planned strategy. A significant element of any structural reform strategy often involves conflict management. This can include either galvanizing support for reform by educating people about its benefits and building broad coalitions to support it, or by undermining resistance by developing transition programs and assisting the adjustments of those who stand to lose immediately (Fernández and Rodrik, 1991).

In the world of politics, it is important to take an initial step somehow by trying out one proposed policy option, and then correcting or trying out another option if the first does not work. In doing so, however, clarity about which policy option is being implemented is of utmost importance. In reality, it is rare that policy proposals are correctly translated into actual policy measures. As such, although policy packaging obviously needs to be logically consistent, the reality is that proposed policies are prone to distortion, tainted by a political power game and/or driven by the internal logic of an administrative organization. The results of policy implementation often run counter to what was intended by those advocating the policy.

It is thus all too obvious that policy principles must be presented in a clear and explicit way. The question is to what extent things should be simplified. In designing policies, policymakers try to analyze the areas to which the policy will be applied. And in the process, they inevitably need to simplify matters and frame them into simple models. Such simplification, in itself, should not be criticized. If analytical models are to hold true, there is a need to be conscious of the conditions under which those models relate to reality. But it is both long-winded and unappealing to say “this is how things will turn out under these circumstances” and “that will be the result under another set of circumstances.” Thus, usually, only the conclusions of analysis are presented.

The fact that policy proposals inevitably take on a political nature the moment they are proposed further complicates matters. In the world of politics, it is impossible to stop
relationships from being interpreted as friend or foe. In fact, it is fair to say that such relationships are the very foundation upon which the world of politics stands. Once in the political arena, policy proposals - simplified conclusions from analysis - begin to develop on their own irrespective of the conditions under which the policies were formulated and the specifics of the model used for formulation. By this stage, proposed policies, regardless of the intentions of their authors, become subject to arbitrary interpretation by each of those advocating them, for whatever reason (Heinemann, 2004).

One effective way to distinguish between “policy conflicts due to clashing interests” and “policy conflicts due to differing views on the correct policy” is to prevent proposed policy measures from getting blurred as a result of simplification. By explicitly specifying the cause of policy conflict, a common understanding can be reached. Policy implementation costs money. Therefore, by specifying the costs associated with each policy, the structure of policy conflicts can be pictured to some extent. The comparison between trust based on rules, and assurance based on personal relationships, provides a good picture of the conflicting interests facing the modern social system especially in Japan. In interpreting such conflicts politically, however, it is more appropriate to focus on the competition between trust and assurance as a means through which government policy changes society, rather than assuming that the social system inevitably changes from an assurance-oriented one to a trust-oriented one (Giavazzi and Tabellini, 2005).

The same competition mechanism applies to political conflicts. Political parties should compete with each other based on different value systems, to make democracy work. In order to better understand a particular policy proposal, it is necessary to first specify the realm of correctness with respect to the policy, and then expand the realm of clashing interests (Maurice Duverger, 1954). In order to do this, there is a need to create a sub-track in the political debate by clearly defining the terms used. What approaches and senses of value lie underneath the policy debate is of crucial importance. Hence the relationship between the correctness of a policy and the clashing interests surrounding it in the debate on policy has to be clearly identified and differentiated or connected based on the structural situation (Wakatsuki, 2001).
Policy analysts are often confronted with the gap between a policy outcome shaped in the policymaking process and policy knowledge they supply, and hope to have such knowledge more utilized so that this gap could be bridged. They are required, consequently, to actively sell their products (viz., knowledge and information) to politicians, consumers of those products. The emphasis on political initiative, moreover, is considered to give policy analysts a good chance to sell their products. A limited number of producers of knowledge and information used to be allowed to enter the policy information market, such as bureaucrats. Such a regulation has been eased now; more various producers including policy analysts can supply their products of knowledge to customers of policy makers (Noritada, 2007).

### 3.2 Structural Reform and Economic Development

Structural reform and economic development are closely linked. Economic development generally involves substantial and sustained increases in private sector investment in physical capital and increases in output. The benefits of development then radiate out to all sectors of society. The private sector, however, reacts to the economic environment. Well designed and implemented structural reform can bring forth an unleashing of the private sector which strongly supports economic development. Indeed, those economies that have implemented substantial structural reform in the past tend to be the most developed, and those that are undergoing the most rapid sustained growth have engaged in significant structural reform in recent years.

All economies face constant challenges from many different directions. Structural reforms are implemented every day, either to grasp the benefits of globalization and technological change, or to avoid foundering on unaffordable welfare systems or the rise of new economies (Sapir, 2005). Despite this flurry of reforms, many of their effects are insufficiently understood. A series of issues arise are entangled in the concept of structural reforms. So talking of structural reforms there is no single definition to explain it. Moreover the same reform strategies may have different results for different countries. Hence the governments must consider the effects of each reform on all sectors of the
economy. The government’s approach to reforms has been very different across time and across countries. A government’s approach depends on local institutions, on the nature of the opposition, and on the scope of the reform under way. But they do have alternatives. Often, there are ways to tailor reforms so as to protect specific parts of the population; and there are ways to experiment gradually, to avoid costly policy mistakes (Pitlik and Wirth, 2003).

3.3 Factors driving Structural Reforms

While the factors or changes in any economy which are the key drivers of structural reforms may be broad and diverse, three distinct trends are clearly discernable: trade and investment have continued to be liberalized; technology has advanced at an ever accelerating rate; and economies have increasingly been subjected to economic shocks that originate beyond their borders (IMF, 2004). The fact that opposition to reform is often grounded on complexities related to the costs and benefits of policy changes and the trade-offs between economic and other objectives, suggests that comprehensive and transparent explanations are essential elements of successful structural reforms (Boeri, Conde and Galasso, 2004). The various stakeholders should have a clear understanding of the problems and of the solutions including the involved costs and benefits in both the short and the long run. To this end, use of outside expertise may bolster the case for structural reform.

Sequencing and synergies between structural policies may significantly facilitate reform (Ostry, 2009). Context matters a lot when devising strategies to grease the wheels for change. For instance, demographics have a bearing on reform. Ageing generations wary of their retirement may support changes in financial services and healthcare, and it may be easier to make labour markets more flexible in countries with relatively large young populations or active immigration (Conde and Galasso, 2004). Getting the sequence right with consistent, mutually reinforcing policies is the key. In the political economy of reform, judgment and timing are vital (Beetsma, and Ribeiro, 2005). For instance, changes to income support are more likely to work during upswings when public
momentum is upbeat. People will swing behind reforms as their beneficial effects become more apparent. In short, steady, persistent and coherent change is better than no change at all. And not reforming causes fractiousness, a loss of confidence and weaker economic performance. It can also end in a crisis. A morose economy eventually forced Japan’s hand on reform (Cowling and Tomlinson, 2000).

3.4 Implementation of Structural Reforms

3.4.1 Initial Structural Conditions

Initial conditions determine the scope for structural reform to enhance economic performance and when this is wide, pressure and desire to undertake reform might be thought to be greater. On the other hand, a wide gap probably also strengthens the resolve of rent seeking beneficiaries of regulation to maintain the status quo by for example forming coalitions to block reforms (Blundell and Bond, 1998). Economic crises can promote reforms because bad economic conditions make it clearer that existing policies are no longer sustainable, neither for individual citizens nor for the economy. Crises introduce a degree of urgency in the decision-making process, weaken opposition to reform, and raise the cost associated with pre-reform institutional arrangements (Drazen and Easterly, 2001).

The uncertainty surrounding the benefits of reforms is often larger than the uncertainty surrounding their costs, even when the expected aggregate gains are substantially larger than the expected collective losses (Fernandez and Rodrik, 1991). The costs of implementing structural reform tend to be upfront, while the associated benefits take time to materialize. Therefore, politicians (particularly with short time horizons) are hesitant in implementing reforms as there is a risk that the electorate will only experience the costs of reforms during the legislature (Olson, 1965).
3.4.2 International influences

Domestic reforms may be affected by international influences in a variety of ways: through competitive pressures, peer pressures and imitation, and binding agreements or treaties. Competitive pressures from openness to trade and FDI strengthen incentives for domestic firms to seek the reform of policies in labour and product markets that put them at a competitive disadvantage vis-à-vis foreign suppliers (Blanchard and Giavazzi, 2003; Pitlik and Wirth, 2003).

Monetary policy may play a role in the promotion of structural reform. The implementation of structural reform may be affected by fiscal policy insofar as measures to compensate the losers of reform or to accommodate any temporary effects on aggregate demand relative to supply need to be (Saint Paul, 2002). Conversely, if the initial budget position is sound, reforms that are expected to increase the economy's structural rate of employment, may create room for compensating or accommodating fiscal measures by improving the cyclically-adjusted budget balance. On the other hand, the process of fiscal consolidation may in itself exhaust the political capital available for introducing other reforms (Duval and Elmeskov, 2005).

3.4.3 Demographic Factors

Given the importance of coalitions, there is an empirical issue whether reforms are easier in smaller countries with homogenous populations than in larger heterogeneous countries, although empirical investigations of this issue have been very limited (Alesina et al., 2003). The age structure of the population may also affect reform attitudes. Older population segments may discount future uncertain benefits of reforms more heavily than younger segments. On the other hand old-age workers and retirees have a vested interest in growth-enhancing structural reform to secure the financial viability of pension and social security systems. Such reforms also boost their real incomes and the return on their capital holdings with negligible labour market consequences for the retirees (Boeri, Conde-Ruiz, and V. Galasso, 2003).
3.4.4 Political institutions

Institutional features of the political decision-making process may be important for the ability to implement structural reform (Boeri, 2006). Presidential political systems and majoritarian electoral rules often seem to empower large and homogeneous constituencies as compared with the outcomes in parliamentary systems and under proportional electoral rules (Persson, 2003). Thus, they should in principle be better at overcoming the resistance of relatively small interest groups to structural reform.

The political orientation of the government is perceived to determine the government's position regarding ideologies and implementation. The government's tenure of office may also affect the reform process (Martinelli and Tommasi, 1993). If a general election is approaching; the government may refrain from implementing structural reform with high short-term costs. On the other hand, newly-elected governments should be more prone to implement reforms whose expected gains during the legislature are substantial (Haggard and Webb, 1994). However, this argument relates mostly to the moment when governments initiate the reform process. Taking into account political and administrative obstacles, it is likely that there is a considerable time lag between the beginning of the reform process and the actual implementation of reforms (Castanheira, 2006).

3.4.5 New Technologies

Technical progress has historically been a powerful disruptive force in product markets by undermining existing natural monopolies inter alia through a reduction of scale economies, capacity constraints and sunk costs (Bassanini and Ernst, 2002). The resulting lowering of entry barriers and development of new products tends to increase the political leverage of potential new entrants and reduce consumer concerns as to the outcomes of reforms, leading to a strengthening of the pro-reform constituency. New technologies may also change firms' perception of costs and benefits of existing structural policies, with for example the emergence of new information and communication technologies (ICT) leading to a more uncertain technological paradigm and thus increasing the costs of
mobility-reducing labour market policies (Arthur, 1989). Indeed, ICT is a prominent example of disruptive technical progress, with a particularly prominent impact on telecommunications, initially by enabling cheap international call-back services that unsettled the system of administratively determined accounting rates for settling international communications and subsequently by introducing competition from mobile telephones, raising a whole set of new regulatory challenges (Boylaud, 2000).

The last few years has seen a fundamental transformation in understanding what activities should be undertaken by government, and how those activities that continues to be performed by government (Caprio and Hanson, 1999). Structural policies with emphasis on privatization, deregulation, liberalization of product, capital and labour markets, especially in the sectors of telecommunications, energy, financial services and transport, as well as in specific policy areas such as the pension system, are at the core of mainstream policies followed in many countries (Blanchard and Giavazzi 2003). At the same time, they constitute very controversial issues both from a theoretical and practical perspective. Preparing a clear vision and a plan for the implementation of a structural reform within the economy is of crucial importance for its success. Hence, defining structural reform is ambiguous and the few definitions that exist in the political rhetoric, media and specialized publications are diverse in their interpretations.

3.5 Main Structural Reform Policies

The goal of structural reform is to create a favorable policy environment for accountable, transparent government with a well-defined public and private sector working in mutual reinforcing ways to promote prosperity and sustainable development. Structural reform programs usually consist of a package of inter-related policy correctives designed to improve both the external and internal policy environment. Improvements in the external policy environment are designed to enhance the country's ability to reap the gains of trade and enable access to foreign capital. Improvements in the internal policy environment are designed to improve the efficiency and equity of government functioning and to improve regulatory and oversight capacities with respect to the maintenance of a policy environment for private economic activity.
Standard components of a structural reform program include an assessment of the country's internal and external sectors. Macroeconomic functioning is considered to be at the core of the package of proposed changes, but microeconomic, governance, and even non-economic factors that might impact substantially on the success of the proposed policies are also included (IMF, 2004). The government's program will typically be stated in the form a policy matrix with timetable benchmarks. The priorities for the structural reform agenda will depend upon the country's situation, but will typically include: improved governance, including strengthened state capacity, transparency, and competition policy; improved balancing of public and private sectors through privatization; bank and financial sector restructuring; land reform, and energy sector reform (OECD, 2003). Governance measures often also include reform of the treasury system, the establishment of a single independent auditing agency to control the efficiency of public finances and eliminate redundant inspection rights, control over quasi-fiscal operations of the central bank, prevention of unjustified intervention by public officials in the operation of private enterprises, and public procurement reform.

The goal of privatization is to raise productivity and support growth targets, as well as aid in the achievement of fiscal goals by bolstering revenues and lowering direct or indirect subsidies (Li, Qiang, and Xu 2001). The goal of bank restructuring is to increase the stability of the banking system.

3.5.1 Price Adjustment and Liberalization

Structural consequences of pricing issues are of utmost importance as they have stabilization corollaries. One of the important obstacles to efficiency in many transition and developing countries is the bureaucratic administrative control over prices. When price controls lead to distortions and resource misallocation, authorities will need to implement structural reforms. Besides raising administered prices to cover costs, if not to bring prices to world market levels, authorities may need to reconsider whether controlling these prices is desirable. Although there is a strong case for government regulation of prices set by monopoly producers, market forces, possibly supported by
government policies to promote competition, should be sufficient to set prices for other goods and services, including those produced by state enterprises in a competitive environment. Thus, governments should liberalize prices where considerations of monopoly do not apply. This explains why price liberalization has played a major role in the transformation of the former centrally planned economies (Levine 1997, 2005). It remains relevant for economies that still have widespread price controls.

3.5.2 Tax, Expenditure, and Budgetary Reforms

In many countries complex tax laws and inadequate systems of tax administration make it hard to raise sufficient revenue to finance important government services without large budget deficits and their attendant macroeconomic consequences (Li, 2001). Governments faced with problems such as major overhaul in the tax structure, weak revenue monitoring and expenditure control systems inefficient procedures for developing government budgets etc contribute to fiscal imbalances and keep the government sector from providing the education, health, and other services needed to support private sector activity and facilitate growth (Saint Paul, 2002). Tax reform, for example, can raise revenue by removing exemptions, requiring advance payments of estimated tax liabilities, imposing license fees or presumptive taxes on hard-to-tax groups such as farmers and small businesses, simplifying rate structures and payment procedures, and eliminating nuisance taxes.

3.5.3 State Enterprise Reform, Privatization, and Restructuring

In many countries large state enterprise sectors contribute to low productivity and slow economic growth. Because they are more subject to political influence and often face little competition, state-owned enterprises are frequently less efficient than private firms, and they experience higher costs and lower profits or sizable losses that contribute to higher fiscal deficits. The lower efficiency of state enterprises can also lead to poorer quality goods and higher prices for consumers. A large state enterprise sector can mean government control over prices for a wide array of goods and services, causing major distortions and resource misallocation in the economy. An extensive state enterprise
sector can also mean less innovation, because the incentives facing managers encourage the pursuit of the "quiet life" rather than changes in products and production processes that can bring political difficulties or labor unrest. To address these problems, adjustment programs in countries with large state enterprise sectors often include measures for state enterprise reform. Many countries have adopted privatization programs, returning factories and other facilities to private ownership while yielding one-time increases in revenue to the government budget (Cook, Kirkpatrick and Nixson, 1998). Restructuring programs have also been adopted for enterprises not privatized, including such measures as closing inefficient or money-losing production units, streamlining management, and establishing performance contracts for top executives. A key objective has been to "harden the budget constraint" for state-owned enterprises, so that they are forced to operate efficiently. Thus, in some countries the automatic recourse of state enterprises to budgetary subventions or loans from state-owned commercial banks has been terminated.

In many countries, reform has also included selling company-owned housing and transferring responsibility for child care and medical facilities to the government. At the same time, restructured enterprises have sometimes been granted autonomy in setting prices.

3.5.4 Rationalizing Social Safety Nets

The need for economic adjustment often reveals the inefficiency and ineffectiveness of existing social safety nets, government programs to ensure a minimum standard of living to the most vulnerable members of society. Different types of countries typically have different kinds of safety net programs, with different problems. For example, in many transition countries, social security programs (which provide pension and health benefits) have high costs and are typically funded through heavy payroll taxes on employers, sometimes discouraging foreign investment (Galasso and Profeta, 2002). In addition, unemployment benefits are often low and poorly administered, making it hard to develop the political support for implementing privatization and restructuring programs at state enterprises (Blanchard and Philippon 2004). In many developing countries subsidy programs are poorly targeted, providing small benefits at high fiscal cost to persons at all
income levels and doing little to relieve poverty among the lowest income groups. By contrast, the main problems in many industrial countries involve public pension programs designed as pay-as-you-go schemes.

Many of these programs have large unfunded liabilities that could exceed several times the level of GDP during the next few decades, as aging populations reduce the number of working persons per beneficiary. Further, high unemployment benefits and stringent employment regulations are thought to contribute to high unemployment rates in many Western European countries (Galasso and Profeta, 2002). To ensure support for adjustment efforts and assist low-income households while containing fiscal expenditure, policymakers must give careful attention to social safety nets in any adjustment program. Where large social security systems threaten to impose heavy expenditure burdens, governments must develop programs that will bring benefits in line with projected revenues. Because the tax burden of most pay-as-you-go public pension systems is already substantial, averaging 15–30 percent of payrolls in most industrial and transition countries, and will be hard to increase further, program reforms will likely include changes on the expenditure side (Gruber and Wise (eds.), 1999).

Measures may include rising the general retirement age, refocusing disability programs, eliminating early retirement programs for women and workers in hardship industries, and transforming pay-as-you-go systems into prefunded or multi-pillar systems to allow savings-based resources to cover a much larger share of total retirement benefits (Conde Ruiz and Galasso, 2004). Similar concerns involve public health care programs, where costs have risen with the aging of populations and the development of new and expensive treatments. Subsidy programs can be made more effective through better targeting. Many countries can achieve substantial fiscal savings while increasing benefits to the most needy by implementing measures to permit access only to low-income groups.
3.5.5 Financial Sector Reforms

During the past two decades weak financial systems have been a source of serious macroeconomic problems in a growing number of countries (Bekaert, Harvey and Lundblad, 2005). In Japan from 1991 through 2000, heavy loan losses have constrained the ability of the banks to fund new loans, slowing growth and leading to calls for massive bank restructuring. The unsustainable investment booms and an eventual economic collapse, when net capital flows turned negative and the resulting depreciations in exchange rates triggered widespread bankruptcies, declines in output, and unemployment (Duval, 2005). The many adverse consequences of weak financial systems and banking crises have led economists to make financial sector reform a prime element in many recent adjustment programs (Auerbach, 2002).

3.5.6 External Sector Reforms, Trade Liberalization, and Convertibility

In recent years trade liberalization has assumed greater importance (IMF, 1998b). Many developing countries have reduced both tariff rates and nontariff trade barriers. Although trade restrictions remain an issue in many countries, the current frontier for policy reform is capital account convertibility. Considerable research supports the view that countries benefit from liberalizing capital markets and that the effectiveness of capital account restrictions declines quickly over time (Dooley, 1996). The events of the Asian and Russian crises of 1997–98, however, have shown the importance of an orderly approach to liberalizing capital markets, with the strengthening of domestic financial markets as a prerequisite to successful liberalization. Thus, in many countries, reforming domestic financial markets is under way not only for its own sake, but also to permit eventual capital account liberalization (McKinnon, 1993).

3.5.7 Improved Governance and Transparency of Government Operations

Questions of governance and transparency are among the structural issues that have received growing attention in formulating economic adjustment programs. Until recently, little systematic research had been done on the effects of government inefficiency,
corruption, and lack of transparency on economic performance, although many anecdotal reports document how these factors have harmed economic activity and discouraged investment (Henry, 2005). An important aspect of improving governance involves strengthening public institutions. Because institutions have a dramatic impact on a country’s economic climate, institutional reform can play an important role in increasing productivity and raising a country’s growth rate (Rodrik, 2000). Such institutional elements as administrative structures, court systems, and commercial laws need careful review in any comprehensive adjustment program. Institutional reform usually requires considerable time to implement, however, particularly if laws and regulations need rewriting and staff must be retrained. Hence, although it is important to introduce reform measures early in an adjustment program, full implementation of these measures and the regulatory benefits are likely to come over a period of years.

3.6 Factors Slowing Structural Reforms

The uncertainty surrounding the benefits of reforms is often larger than the uncertainty surrounding their costs, even when the expected aggregate gains are substantially larger than the expected collective losses (Fernandez and Rodrik, 1991).

The costs of implementing structural reform tend to be upfront, while the associated benefits take time to materialise. Therefore, politicians (particularly with short time horizons) are hesitant in implementing reforms as there is a risk that the electorate will only experience the costs of reforms during the legislature.

Some regulations tend to create rents, which are shared among the beneficiaries of regulation in many ways. Generating consensus for reforms suffers from the “collective action” problem that the costs of reforms are concentrated on relatively small and well organised target groups, while the benefits tend to be thinly spread – at times to such a degree that the beneficiaries have difficulties in observing them - over a much larger and less organised electorate (Olson, 1965).
When it comes to reforms, each country should naturally devise its own strategies based on its own circumstances, but there are some general lessons for policymakers to bear in mind.

First, reforms work better with proper sequencing and co-ordination within and between policies, even though in practice this may be a luxury. Also, co-operation between countries may yield benefits, whether in building a fair and open international trade regime or a services market for suppliers and consumers (Hauner and Prati, 2008).

Second, is to promote supportive macroeconomic policies. If these keep aggregate demand close to potential output, they will oil the reform process by minimizing the fear factor associated with structural change. In this context, whereas fiscal laxity may entail painful corrective action later on, sound public finances can create the wherewithal required for the introduction of reforms by providing confidence and room for manoeuvre (Bean, 1998).

And third, they should always be transparent about the costs and benefits of reform, and be ready to communicate in the face of well-drilled opposition. Outside expertise has been shown to be useful here, as policymakers embark along the bumpy road of reform (Heinemann, 2004); given the difficulties, political leaders understandably worry about losing popularity, or votes. However, as experience demonstrates, by marshalling the political economy of reform, (very different) governments can make decisive breaks with the past, and still look forward to winning the next election as well (Beetsma and Ribeiro, 2005).

The reasons for such mixed progress are several. Vested interests, worried staff, or deep-rooted institutional arrangements that are hard to budge can clutter the road to reform. In the end, economics rarely clinches the reform battle, whereas politics holds the key. This is because reform challenges the status quo. It brings into play notions of fairness, job security and dependability on the likes of medical cover or unemployment benefits.
Though reforms tend to exact costs on particular groups, they may find allies in the wider community.

3.7 Structural Reform in Japan

Faced with economic stagnation and financial crisis since the end of the bubble economy in the early 1990s, referred to as the bursting of the bubble, with a dramatic collapse in both stock and property prices, observers expected Japan would bounce back – it always had, notably in its remarkable resurgence following the first oil (1973) crisis (Drazen, 2000).

In fact, Japan did not bounce back: it entered its first “lost decade”, which was followed, in spite of a couple of ultimately ephemeral signs of recovery, by a second lost decade, and then the third. From colossus, Japan became (and remains, even in this global crisis period) the “sick man” of the global economy. Though some of Japan’s companies remain global leaders, the macro economy has been stuck in the doldrums (Easterly, 2001). But, it is often said with regret that the 1990s was a lost decade for Japan. Japan was stuck in sticky post-miracle doldrums and that Japan could not change easily (Iwata, and Miyagawa, 2003). The forces of inertia, complementary linkages, and unstable political system repeatedly thwarted reform attempts. Yet, just as the idea of a paralyzed Japan was taking hold, a wave of structural reforms began to sweep Japan. The government had to step in to facilitate the process of “creative destruction.” Years later, despite deep linkages and opposition to change, it is clear that significant reform has taken place in Japan. The significance of these structural reforms is considerable because they aim at undoing the very features of the Japanese political economy that

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2 The 1973 oil crisis started in October 1973, when the members of Organization of Arab Petroleum Exporting Countries or the OAPEC (consisting of the Arab members of OPEC, plus Egypt, Syria and Tunisia) proclaimed an oil embargo “in response to the U.S. decision to re-supply the Israeli military” during the Yom Kippur war; it lasted until March 1974. OAPEC declared it would limit or stop oil shipments to the United States and other countries if they supported Israel in the conflict. With the US actions seen as initiating the oil embargo, the long-term possibility of embargo-related high oil prices, disrupted supply and recession, created a strong rift within NATO; both European nations and Japan sought to disassociate themselves from the US Middle East policy.
were once recognized as the foundations of the three-decade long economic miracle (Epstein and Gintis, 1995).

Japan has increasingly focused on structural reforms as a driving force for growth. Since the mid-1990s the government has initiated a wide-ranging series of measures aimed at promoting reforms in Japan's economy, society, and government (Molteni and Corrado, 2001). The need for reform has been further emphasized by fundamental changes taking place in the social and economic environment in the early years of the new millennium, changes such as: even-faster-than-expected aging of the Japanese population, worsening environmental problems, acceleration of the information technology revolution, and evolution of the industrial structure due to economic globalization.

The new world economic order is supported by such principles as competition, transparency, accountability, and self-responsibility. Nations, corporations, and individuals accept these principles as a prerequisite for survival and victory. The problem for Japan is the fact that agreeing to these principles would mean an almost complete turnaround, or an almost complete denial of the traditional Japanese principles. The content of what most people refer to as 'reform' is nothing but an incredibly wide-ranged, and therefore extremely difficult endeavor, and this should be recognized thoroughly. In fact, in the heartbreaking "lost decade," almost every Japanese has become aware that something must change, but there is almost complete lack of recognition that changing that "something" would be a formidable task (Hayashi and Prescott, 2002).

Despite its bitter experience in the "lost decade," Japan is delayed in transforming itself into the new order. This is partly because its transformation is a formidable task for Japan. But more fundamentally, Japan lacks the sense of crisis and also lacks logical thinking for the necessity and the purpose of reform, as it has failed to complete such processes as the solution of firms' excess debts, excess equipment and excess employment, the write-off of banks 'bad loans, the consolidation and privatization of public corporations, the reform of budgetary planning, improvements in the education
system, complete deregulation, etc. Hence the only solution to this ongoing malaise was to structurally reform the whole system.

Figure 2: Fiscal Indicators for Japan
Source: OECD Economic Outlook, Japanese MOF

The above figure shows that the government debt was below 100% in 1997, which crossed above 120% in 2001. The interest rates which was above 13.5% in 1997 had a downward trend till 2000 (11.4%), and again reached 12.6% in 2001.

Reforms are extremely difficult to implement in any country. Even if reforms do increase effectiveness and enlarge the overall economic pie, this does not ensure their implementation. This is because the benefits will not necessarily be distributed evenly and there will be people who benefit and those who will not. Owing to this, as the phrase “in theory but not in practice” goes, relevant parties may support the reforms in principle, but when it comes to specific issues, those who have something to lose will oppose them. This is the reason why structural reform programmes do not proceed as planned.
As this shows, while the “theory” is an argument based on the benefits of society as a whole, the “practice” of it are arguments based on partial benefits from the viewpoint of individual interest groups. While economists, who place priority on efficiency, always support reforms, there are many politicians who are passive toward change out of consideration of income distribution, including respect for vested interests. People who oppose reforms are criticized as being resistant forces, but when we consider that interest groups and the politicians who represent them are only acting, just like other economic players, to maximize their own interests based on institutions such as existing laws (in other words, the rules of the game), it is not necessarily appropriate to conclude that they are bad.

Reforms that do not harm anyone and bring benefits to all are the easiest to implement because no one will object. These are called “Pareto Optimal” reforms, or reforms without pain. Therefore, it is not an exaggeration to say that respect for vested interests is a fundamental rule for carrying out reforms smoothly. Such respect may seem to be the enemy of economic reforms, but respecting vested interests and reforming the economy can be consistent with each other if those who are put at disadvantage through the reforms are compensated for their losses (Overholt, 2002). While this can be done in a clear-cut manner through the state budget, it may also be achieved by making efforts to foster a new system while preserving the old regime.

3 Pareto efficiency, or Pareto optimality, is a concept in economics with applications in all areas of the discipline as well as engineering and other social sciences. The term is named after Vilfredo Pareto, an Italian economist who used the concept in his studies of economic efficiency and income distribution. Informally, Pareto efficient situations are those in which it is impossible to make one person better off without necessarily making someone else worse off. A state of affairs where it is not possible to improve the economic lot of some people without making others worse off; a mercantilist view. The implications of this view in welfare economics are that, once an economy has ceased to grow, it is impossible to increase the wealth of the poor without opposing the Pareto criterion; in other words, without making the rich worse off. This then becomes an argument for retaining the status quo, even if the distribution of income in society is very uneven. A Pareto improvement, however, occurs if resources can be better utilized so that one group’s prosperity increases, but not at a cost to another’s.
3.8 Overcoming Short-Term Adjustment Costs

Structural reform can create short-term adjustment costs, but in the longer term these costs should be more than offset by the benefits that well targeted reforms can create. An initial challenge for economies undertaking reforms is to generate enough support and commitment to ensure that the wider benefits of reforms are allowed to become apparent. Some economies maintain social safety nets, which ensure that individuals who lose their jobs, for example, do not fall into extreme poverty. Moreover, time-limited employment insurance schemes and job retraining programs can assist individuals with their transitions. In some cases, whole physical regions within economies could lose significant employers. In such cases, regional governments or regional economic development institutions could be financially supported in determining alternative viable strategies. While all of these programs might require financial support from central governments, it is important that these programs be temporary in nature and not create dependency, and the incentives should always be to support the transition.

The design of reforms may be able to mitigate some of the short-term cost of reforms (Lindert, 1996). There may be many potential reforms, or ways to sequence the implementation of the elements that can create the same desired end result. By giving consideration to the costs that each option may generate, an economy may be able to reduce the short-term costs associated with a proposed set of reforms, which in turn can help to alleviate any resistance to the reforms that may exist. Some economies have created policies to accompany reforms that help to reduce any residual costs. Explicitly addressing these costs can help to guarantee the success of reforms (Fernandez and Rodrik, 1991).

In order to make structural reforms work, the most important thing, from the strategic point of view, is to foster a new regime rather than break down the old one (Cowling and Tomlinson, 2000). When applying these hints to Japan’s reforms, we should turn our eyes to up-and-coming industries rather than mature ones, and venture businesses rather than major companies. In addition to this, more active use should be made of direct investment by foreign firms. The inflow of direct investment can invigorate the Japanese economy.
through the introduction of technology and business management know-how, development of job creation and skills, and the improvement of productivity and consumer benefit through increased competition.

However, it is apparent that in the framework of a globalised technological race economic success is closely linked to continuous change with regard to many economic and social relations. Societies which appear able to implement changes are also able to achieve high economic and social performance, in contrast to societies which are negative or hesitant to deal with the new problems and to implement necessary changes. However, the question as to what kind and what policy mix of changes are necessary and appropriate is an issue of tense debate.

The management of change appears a necessary tool for both the evolution of developed economies and the development of less advanced economies, even if for different considerations. Why is it so? What are the arguments and the contra-arguments for the main policy issues which are debated? What kind of questions and issues are raised in implementing structural policies such as those mentioned above? What economic and social policy options are at stake? (Boltho and Corbett, 2000).

The new international context in which the current economic evolution takes place, its specific characteristics, the delineation of ‘structural policies’, their socio-economic and political implications according to the economic environment in which they are implemented and a critical presentation of theories of structural change, constitute the main theme of structural reforms (Haggard and Webb, 1994).
3.9 Whole-Of-Government Approaches to Structural Reform

3.9.1 The Importance of a Whole-of-Government Approach

A whole-of-government\(^4\) approach to structural reform can benefit society. Structural reforms span the public sector, affecting numerous departments and agencies. The barriers to trade that exist in practice are often determined not by a single department, but by the interaction of several different departments. The benefits of removing these impediments and improving policy coherence can include a reduction in uncertainty, increases in public sector productivity, and a reduction in the cost to the government which can lead to stronger economic growth (Hubbard, 2002). A whole-of-government approach requires an overriding strategy, or roadmap that defines the direction that structural adjustments will take in order to achieve an economy’s long-term goals. A well formed and credible strategy can signal to both the public and private sectors what changes may be necessary in future. Defining how each part of the public sector contributes to this overriding strategy can boost public sector productivity. Clear accountabilities create a defined area for which each department is responsible. Accountable departments can then work to streamline processes within their area and be recognized for their results. This encourages public sector productivity gains.

Mapping out clear accountabilities across the public sector also allows economies to identify policy overlaps and conflicting work agendas. Policy overlaps create waste as work is replicated across numerous public sector departments, while conflicting work agendas reduce the effectiveness of public policy as departments expend scarce financial resources working against other departments. By removing these overlaps, departments

\(^4\) In 2005, the OECD Development Assistance Committee’s (DAC) Fragile States Group (FSG) developed a draft set of Principles for Good International Engagement in Fragile States. These Principles highlight the fact that successful development in a fragile environment depends, at least in part, on well sequenced and coherent progress across the political, security, economic and administrative domains. Working effectively across these domains requires donor countries to adopt a ‘whole-of-government’ approach (WGA), involving departments responsible for security, and political and economic affairs, as well as those responsible for development aid and humanitarian assistance. An OECD DAC work stream on policy coherence and WGAs in fragile states was initiated to produce an agreed DAC framework or guidance on good practice for WGAs in fragile states that would inform international donor country practice.
can specialise, thereby allowing them to work together to implement an economy's strategy. This can reduce government budgets and private sector uncertainty.

3.9.2 Case Study: Japan's Council on Economic and Fiscal Policy

The Council on Economic and Fiscal Policy (CEFP) is a consultative organ placed within the cabinet office, whose purpose is to facilitate full exercise of the prime minister's leadership while sufficiently reflecting the opinions of private-sector experts in economic and fiscal policy formation. The CEFP is chaired by the prime minister, and its members include the Chief Cabinet Secretary, the Minister of State for Economic and Fiscal Policy, other relevant ministers, and private-sector experts. The CEFP deliberates on and drafts the basic policy of economic management including structural reform, fiscal management, budget formulation and other important issues in economic and fiscal policy, which then become the government's formal policies after the adoption by the cabinet (Shiroyama, 2003).

There are three chief advantages of the CEFP:

(i) It enhances the consistency and comprehensiveness of economic policy making. The CEFP has promoted the establishment of a new budgeting cycle, in which the linkage between economic policy and fiscal policy is strengthened, and the direction of major issues of structural reform is decided. Also, there has been an innovation in government policies because the private-sector experts of the CEFP have proposed various policies, making full use of their management know-how.

(ii) It enables policy achievement evaluation and feedback to new policy making. Following managerial methods used in private companies called PDCA (Plan-Do-Check-Action) cycles, clear and concrete numerical targets and timetables have been set up in formulating these policies. This makes it possible to evaluate the achievement of individual policies and to feed back the results to new policy making.
It increases the transparency of the decision-making process. Transparency of the decision-making process has been improved significantly because the results of the discussion are open to the public immediately. (Almost all of the materials used in the meetings are disclosed on the day of the meetings. The minutes are released three days after the meetings.) In this way the CEFP has drastically changed the decision-making processes related to Japan's structural reform and acted as a driving force to promote the structural reforms of the Koizumi Cabinet.

3.9.3 Whole-of-government commitment

Whole-of-government commitment is essential if any short-term adjustment costs are to be minimized and overcome. This commitment can ensure that the longer-term benefits of stronger economic structures are allowed to become apparent. Uncertainty accompanies reforms in the short term as many sectors of an economy adapt to changing prices and increased competition. In the long term, however, the benefits of reform become clearer and public support for the reforms grows. According to one study, well-targeted structural reforms can increase growth within two to three years.

3.10 Transparency

Transparency can assist in generating the public support that economies require to successfully undertake reforms at a much earlier stage in the process. On balance, well-targeted reforms should produce net economy-wide benefits that far outweigh the initial adjustment costs of implementation. Transparency can also highlight what measures that have been taken to reduce the cost of reforms. Transparency can mobilize the support of the population who stand to gain from the proposed reforms.
3.10.1 Japanese Financial Sector Reform

By the mid 1990s, many Japanese financial institutions were faced with high levels of non-performing loans and instability of the financial system became the largest concern of the time. As a first step, the newly created Financial Supervisory Agency (FSA, now called the Financial Services Agency)\(^5\) let the banking sector improve their disclosure of balance sheet information, with widening coverage of non-performing loans (Masami Imai, 2005). Then, it was found that the non-performing loans problem was more severe than expected and it was recognized that rapid disposal of bad loans by banks was fundamentally important in order to restore confidence in the financial system (Cabinet Office, 2001). However, significant capital injections accompanied with the failures of some banks allowed financial institutions to take a step-by-step approach rather than drastic reform of their management. Partly because of deflation, non-performing loan problems had not improved for a couple of years (Uchida, 2003).

Finally, the FSA urged banks to take a number of measures to effect a prompt and complete resolution of the problem. These included placing sufficient reserves, securing adequate levels of capital and improving the corporate governance of the banks. The Industrial Revitalisation Corporation of Japan\(^6\) was set up, parallel with the enhancement of the Resolution and Collection Corporation to facilitate efforts to revitalize borrower companies through the purchase of these loans. Consequently, the Japanese financial sector re-established its resilience. The non-performing loan ratios of the major banks

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\(^5\) The Financial Services Agency is a Japanese government organization responsible for overseeing banking, securities and exchange, and insurance in order to ensure the stability of the financial system of Japan. The agency operates with a commissioner and reports to the Minister of Finance (Japan). It oversees the 'Securities and Exchange Surveillance Commission' and the 'Certified Public Accountants and Auditing Oversight Board'. Its main office is located in Tokyo.

\(^6\) Based on the Industrial Revitalization Corporation Act ("the act"), the IRCJ was established on April 16, 2003 and began operations on May 8, 2003. The Industrial Revitalization Corporation of Japan (IRCJ) was supposed to help banks to overcome the non-performing loans crisis by rehabilitating poorly performing companies. Since then the IRCJ has made decisions to support 41 corporate groups (supported companies) and provided them with support for business revitalization. On March 2, 2007 the IRCJ made the final exit decision for the final supported company, and subsequently sold the equity it held in that company. As this signified the full completion of its business operations as prescribed in Article 19, Clause 1 of the act, on March 15, 2007 the IRCJ disbanded on completion of its operations, based on Article 43 of the act.
were lowered from 8.4 percent (March 2002) to 1.8 percent (March 2006) which allowed the banks to expand their business. Also, full deposit guarantees for possible bank failures were removed in March 2005.

![Total Nonperforming Loans](chart)

**Figure 3: Total Non-Performing Loans**
Figures 3 and 4 show the amount of bad loan problem in Japan. In the year 1999, it was more than 30 trillion yen, which reached 45 trillion yen in 2002. Then on, thanks to Koizumi’s reform efforts the percentage was reduced from 8.4 in 2002 to 4.7% in September 2004.

3.10.2 Japanese Special Structural Reform Zones

Structural reform is hard work. Not only is it analytically difficult, it is also politically difficult. Given the difficulties involved, special mention should be made regarding innovative new approaches. The Special Zones for Structural Reform that went into

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7 Japan’s Special Zones for regulatory reform were established in 2003 as an endeavor to enhance nationwide regulatory reforms based on local government initiatives. These Special Zones are not like the free trade zones inviting foreign capital that have been taken on as national projects in Ireland or China. In
effect in Japan in April 2003 is just such an approach (See appendix-I, figure 18). According to this initiative, a special zone for structural reform is to be created where a local government and the private sector have a proposal to except the region from one or more specific regulations. In this way, the region becomes a pilot project for a particular initiative, and the overall economy becomes a giant structural reform laboratory with multiple experiments. Moreover, the specific proposals arise from the local level and not from a centralized authority, which allows those who are closest to the issue to develop the ideas, and also support the building of a diversity of experiments. Where a proposal is shown to have good results, the experiment is studied for broader implementation.

With the rebound in the global economy, economic policymakers in industrial countries have increased the attention they devote to structural policy issues. Impediments to competition, labor market and price flexibility, and innovation are a primary concern in this regard, given their adverse effects on growth in investment, employment, productivity, and, therefore, output. Policymakers’ emphasis on structural reforms is, of course, not new. Reflecting a broad consensus about the substantial benefits of structural reforms, a general, worldwide trend toward more market-friendly regulatory frameworks and policies has prevailed since the early 1980s. The scope and speed of structural reforms has, however, differed widely across countries and sectors (OECD, 2003).

The discrepancy between the widely accepted notion of beneficial structural reforms and the mixed implementation record in industrial countries highlights the importance of understanding the obstacles to reform. The basic conjecture of is that reforms can lack political viability, which, as the growing literature on the political economy of reforms suggests, arises from the uneven distribution of the aggregate benefits of reforms across the economy and time (Tommasi, and Velasco, 1995). In particular, reforms typically involve costs to those who benefited from the pre-reform structural policy regime. As a result, policymakers who would like to pursue structural reforms to advance welfare and

fact, this scheme acts to stimulate regulatory competition between municipalities to attract new business activities by both foreign and domestic firms in the local areas. This approach is a significant step towards mobilizing local government initiatives under a highly centralized administrative system in Japan, and marks a shift toward a more market-based economy.
improve prospects may be confronted with a status quo bias, a situation where reforms are not supported by a majority or strongly opposed by a key constituency. Nevertheless, the broad trend toward regulatory reform over the past two decades shows that the status quo bias is not insurmountable even when considering the differences in the scope and speed of reforms across countries.

3.11 Importance of Structural reforms in Japan’s overseas relations

Structural reform stimulates the domestic economy and is also important in the process of deriving benefits from globalization. In other words, the major objectives of structural reform are to ensure that the market mechanism fully functions, broadly enhance productivity and move labor and capital, among others, from low productivity areas to high productivity areas. This will also allow Japan to reap benefits from closer economic ties with overseas economies (Batini N’Diaye and Rebucci, 2005).

In cases where regulations on investment, employment and production activities remain and structural reform is insufficient or in cases where human resource development cannot deal with technological innovation, sometimes it will be impossible to derive benefits from globalization. Far from it, the economic situation may become increasingly severe, characterized by stagnating investments, factories moving overseas, rising unemployment and widening income disparities (GOJ, 2004).

Moreover, in addition to structural reform in Japan, it will be necessary to standardize products and regulations in cooperation with other countries and regions in order to promote global trade and investment. It will be also important to abide by contracts, protect intellectual property and strengthen competition policy, etc. in order to boost economic activity through the advancement of the international division of labor.

To begin with, the following discussion will outline the situation after 1973 when Japan made the transition to a floating exchange rate system and identify the characteristics of globalization that have been evident in the Japanese economy particularly since the 1990s (Belke, Herz, and Vogel 2005).
3.12 Economic Development since 1990s

There are four characteristics of globalization in the Japanese economy especially in the period after the 1990s, as explained below.

The first characteristic is the changes in exchange rates and their economic impact. After making the transition to a floating exchange rate system, Japan was faced with a steep appreciation of the yen in the late 1980s as well as experienced a long-term appreciation of the yen, albeit modest, in the early 1990s. These exchange rate changes had a substantial impact on the Japanese economy (McKinnon and Ohno (2001)).

![Real Effective Rate of Japanese Yen](image)

**Figure 5: Real Effective Rate of Japanese Yen.**

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8 In 1973, major countries including Japan shifted from the fixed exchange rate system to the floating exchange rate system. Since then, these countries have employed a system where exchange rates are decided in a foreign exchange market. The reason these countries shifted to the floating exchange rate system was because the trade imbalance in advanced countries had not been rectified and the circulation of speculative funds intensified, based on the assumption that exchange rates would change, which frequently led to cases of international currency instability. As such, it became difficult to maintain the fixed exchange rate system.
One of the causes as observers point out for the lost decade was the yen depreciation. In the year 1996 the value of yen was 130, which reached its peak in 2000, due to zero interest rate policy. From then on the value of yen has been decreasing and was almost 90 in 2007. In the year 2009 it was just above 100.

Secondly, with the advancement of Japan’s industrial and trade structure, the focus on the US as a trading partner and direct investment destination gradually shifted to the East Asian region. These developments are the result of vigorous corporate activity which took place as Japan’s relations deepened with overseas economies. (Cabinet Office, 2004)

Thirdly, regarding Japan’s financial and capital transactions, equity investments from abroad have recently increased, but it cannot be said that Japan’s international financial and capital transactions have accelerated, except in the bubble economy period. Financial and capital developments have been stagnant compared to those on the trade front (Hanazaki and Horiuchi, 2000).

Fourthly, the Japanese economy’s international ties are not as deep as those of European and North American countries. This means that even though globalization in Japan is

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9 One of the distinctive changes in trade in the past 30 years is that the biggest trading partner shifted from being the US to the East Asian region behind this shift is the rise of the Association of Southeast Asian Nations (ASEAN) and China. With respect to merchandise trade, or the total of exports and imports, Asia surpassed the US as a trading partner after 1988 and China by itself exceeded the US with respect to imports in 2002.

10 The liberalization of international current transactions and capital transactions advanced after Japan acceded to the OECD in 1964. Meanwhile, the liberalization of short-term money markets and capital markets, which leads to the lifting of bans on lending and borrowing in foreign currency, was delayed about 20 years and progress was finally achieved between the 1980s and 1990s. Nonetheless, it appears that international financial and capital transactions have not been fully activated in Japan except during the bubble economy period in the late 1980s due to lack of overseas asset management, high interest rate of borrowing from overseas and weak fund demand in the corporate sector international activity appeared to be dwindling overall domestic institutional investors including life insurance companies who refrained from conducting international capital transactions

11 Japan has continued to be generally flat at around 15% since the 1990s. Although the level of financial openness in Japan surpassed the level in the US during the bubble economy period in the late 1980s, economic activity was not as dynamic in Japan compared to European and North American countries after the collapse of the bubble economy. It appears that foreign bond investment in European and American
presumably advancing, it may not be the case when compared to the European and North American countries.

3.13 Conclusion

At the end of analyzing Japan's economic crisis the following causes have been identified:

**Surplus in Savings**

Japan has traditionally enjoyed an unusually high savings rate and a comparatively low consumption rate. During the decades of recovery and high-speed growth, this "savings surplus" supplied sorely needed capital to private industry in the form of bank loans. This money was used to build and expand Japan's industrial infrastructure and to achieve the rank of a world-class manufacturing power. However, during the 1990s, the "savings surplus", once the indispensable fuel for high-speed growth, became a serious, structural impediment, leading to a severe slump in demand and causing a heavy drag on Japan's economic recovery.

**Liberal Democratic Party (LDP) and Vested Interest Groups**

LDP support from interest groups representing protected, inefficient sectors of the Japanese economy has contributed to Japan's economic malaise but has also made it difficult for the Japanese state to implement the reforms necessary to get back on track. Focused on staying in power, the LDP has been reluctant to implement far-reaching

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12 It is said that Japan's saving rate was one of the highest in the world. The rate in the 80s and the early 90s had been over 10% steadily and higher than any other developed country. A number of academic studies have addressed why the saving rate in Japan was so high: Hayashi (1986) shows that prevalence of the extended family and bequests are singled out as probably the most important factor contributing to higher saving, while Horioka and Watanabe (1997) points out that the net saving for retirement and precautionary motives are of dominant importance.
reforms or tackle the tough issues, such as the ominous overhang of nonperforming loans (NPLs). The LDP’s coalition of interest group supporters, which supplies money and votes, has lobbied hard to sandbag or dilute reform measures. The unprecedented length of Japan’s asset deflation and liquidity trap is largely due to the absence of effective, far-sighted political leadership. Prime Minister Koizumi, who came up with a clear-cut electoral mandate to reform an outmoded economic system, had to spend most of his time and energy in crushing these opposition forces than concentrate on development.

**Policy Mismanagement**

The lack of political will and effective leadership are reflected in serious policy mistakes. These include: the consumption tax hike in 1997, which stifled nascent signs of recovery; the unparalleled slowness in disposing of NPLs; and the heavy-handed reliance on interest rate cuts, to deal with the deflationary impact of sharp yen appreciation following the Plaza Accord. (Satoshi Shimizutani, 2005) While it would be unfair to blame the bubble, asset deflation, and the liquidity trap solely on Japan’s politicians and policymakers, it is accurate to say that policy mismanagement has aggravated the problems and prolonged the processes of recovery.

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13 The Bank of Japan pursued a very expansionary monetary policy during the so-called "bubble" period, and an extremely restrictive monetary policy since 1991. From 1987 to 1989, reserve money grew by 11.5% a year, and broad money by 10.9%. This expansive monetary policy financed growth of nominal GDP of more than 7% a year from 1988 through 1990. In 1991-92, the monetary base was actually reduced by 2.8% a year, which was quite remarkable. Broad money then grew at only a 1.2% rate. Growth of nominal GDP slowed to 2.8% in 1992 and to less than 1% from 1993 to 1995. Just before the big tax increase of 1997, Japan had experienced a year of unexpectedly strong recovery, after its long recession of 1991-95. Japan’s growth fell to only 1.4 per cent in 1997 and this slowdown was followed not by the expected acceleration, but by a GDP collapse of minus 1.9 per cent. Not only did this slump in economic activity represent one of the deepest recessions suffered by any advanced economy since the Second World War; it also triggered a financial crisis across Asia that brought down almost every government in the region.

14 Japan’s nonperforming loan (NPL) problem should be regarded as being inextricably linked with structural changes both in the financial sector and corporate sector. While the problem was previously characterized primarily as the negative legacy from the bursting of asset price bubbles, recently it has increasingly become more a question of the disposal of NPLs newly generated in the transformation of industry and individual businesses.
As we are aware of the seriousness of non-performing loan and problem of deflation in Japan, the above figure shows that the NPL problem which was almost 13 trillion yen in 1993, reached its peak in 2001 with 33 trillion yen, and the consumer price index has been seeing ups and downs, which was just above 1% in 1993, reached its peak in 1997, and from then on has declined is negative in the year 2001. (-0.3%).

**Structural Impediments**

The complex structure of Japan’s political economy - particularly the close, symbiotic ties between the economic bureaucracies, like the Ministry of Finance (MOF), and the corporations under their regulatory jurisdiction, like banks and insurance companies - has also contributed to Japan’s problems (Hubbard, 2002). The interests of the Banking Bureau of MOF and the banking industry are interdependent. There is little transparency...
or public accountability. Information is hoarded about the actual scope of bad loans. Old methods of crisis management (specifically, administrative guidance) prevail. These elements help to explain why it took the government so long to deal with the massive hemorrhaging of Japan's financial system (Frankel, 1991). Although Japan has made progress toward developing a more transparent, rules-based system, the problems of no transparency and weak accountability have not disappeared.

As explained previously, the intensity of bad loan problem was another major cause of the recession in Japan.

*Yen Appreciation*

Another underlying cause of the bubble, sustained asset deflation\textsuperscript{15}, and the liquidity trap is the steep, long-term appreciation of the yen relative to the dollar\textsuperscript{16}. For Japan, yen

\textsuperscript{15} Deflation in Japan started in the early 1990s. On March 19, 2001, the Bank of Japan and the Japanese government tried to eliminate deflation in the economy by reducing interest rates (part of their 'quantitative easing' policy). Despite having interest rates down near zero for a long period of time, this strategy did not succeed. Once the near-zero interest rates failed to stop deflation. Some economists, such as Paul Krugman,
appreciation has been a chronic problem (Buiter and Panigistzoglou 1999). Exchange-rate factors have limited the effectiveness of certain policy tools that might have cleaned up Japan's financial mess (Hayashi and Prescott 2002). Caught in a classic liquidity trap, for example, the option of designing monetary policy to hit specific inflation targets would be difficult, in part because a sudden, sharp devaluation of the yen would put enormous pressure on South Korea and Taiwan to devalue their currencies. In an era of global capital flows, the constant national need to make adjustments in the value of key currencies, and the costs of overshooting, misalignment, and potential speculative attack have enormously complicated domestic macroeconomic management.

Global Capital Flows

Japan's rapid growth from 1955-1975 and its steady growth from 1975-1991 can be understood as part of a global expansion of trade. But if postwar Japan has benefited from the globalization of trade, it has profited less from the globalization of capital flows. Neither the public nor private sector has handled the liberalization of capital movements as adroitly as the liberalization of global trade. Japan has received surprisingly low returns on its massive dollar assets abroad (Conway and Nicoletti, 2006). Moreover, the

and some Japanese politicians spoke of deliberately causing (or at least creating the fear of) inflation. In July 2006, the zero-rate policy was ended. In 2008, the Japanese Central Bank still has the lowest interest rates in the developed world, deflation has still not been eliminated and the Nikkei 225 has fallen over approximately 50% (between June 2007 and December 2008).

16 In the decades following World War II, Japan implemented stringent tariffs and policies to encourage people to save their income. With more money in banks, loans and credit became easier to obtain, and with Japan running large trade surpluses, the yen appreciated against foreign currencies. This allowed local companies to invest in capital resources much more easily than their competitors overseas, which reduced the price of Japanese-made goods and widened the trade surplus further. And, with the yen appreciating, financial assets became very lucrative. With so much money readily available for investment, speculation was inevitable, particularly in the Tokyo Stock Exchange and the real estate market. The Nikkei stock index hit its all-time high on December 29, 1989 when it reached an intra-day high of 38,957.44 before closing at 38,915.87. Additionally, banks granted increasingly risky loans.

17 The concept came to prominence in misconception in the 1990s when the Japanese economy fell into a period of prolonged stagnation and deflation despite the presence of near-zero interest rates. While the liquidity trap as formulated by Keynes refers to the existence of a vertical demand curve for money at some positive level of interest rates, the liquidity trap invoked in the 1990s referred merely to the presence of zero interest rates, the assertion being that since interest rates could not fall below zero, monetary policy would prove to be impotent in those conditions, just as it was asserted to be in a proper exposition of a liquidity trap.
Asian financial crisis\textsuperscript{18} between 1997 and 1998 crippled the country's efforts to shake off its stagnation. Japanese manufacturing industries were better prepared to take advantage of the globalization of trade than Japanese financial institutions were to utilize the opportunities created by the globalization of capital flows (IMF, 2004; Nicoletti, 2005).

Many groups in Japan have benefited from the existing configuration of the economic system and are very reluctant to embrace change (Schoppa, 2001). Farmers and those living in rural areas more generally, workers with lifetime employee guarantees, bureaucrats, construction firms and their employees, workers in small firms, and homeowners all benefit from the current system. Although each of these groups is a minority in the society, and feels particularly protective about only those parts of the system that benefit itself, in total they represent a majority of the population. The extensive nature of vested interests provides much of the explanation for why the democratic political process has not driven economic reform more vigorously.

\textsuperscript{18} Japan was affected because its economy was prominent in the region. Asian countries usually run a trade deficit with Japan because the latter's economy was more than twice the size of the rest of Asia together; about 40% of Japan's exports go to Asia. The Japanese yen fell to 147 as mass selling began, but Japan was the world's largest holder of currency reserves at the time, so it was easily defended, and quickly bounced back. GDP real growth rate slowed dramatically in 1997, from 5% to 1.6% and even sank into recession in 1998, due to intense competition from cheapened rivals. The Asian financial crisis also led to more bankruptcies in Japan. In addition, with South Korea's devalued currency, and China's steady gains, many companies complained outright that they could not compete.