DEVELOPED COUNTRIES OF THE REGION

Australia, Japan and New Zealand

Overview and prospects

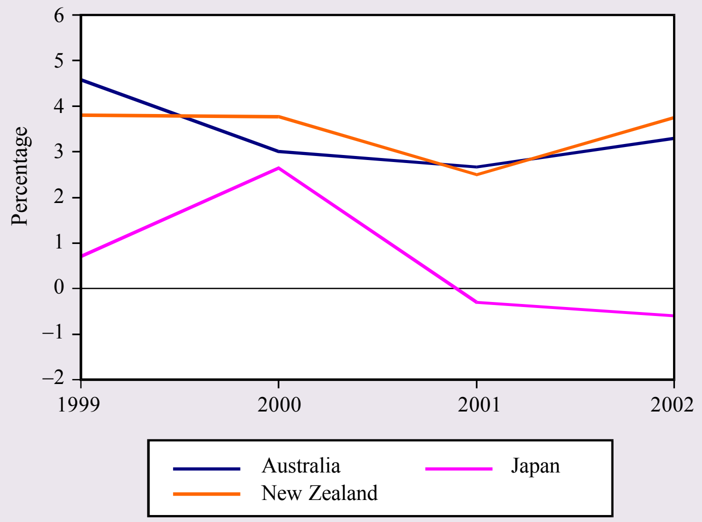
Japanese economy contracts again while Australia and New Zealand show stronger growth in 2002

In 2001, Japan experienced its third and most severe recession of the last decade. Its economy had shown unexpected strength and appeared to have turned the corner into positive growth in the first quarter of 2002. However, the pace could not be sustained as growth was narrowly based on net exports and public spending amid continuing weak domestic demand. Along with the deterioration in the external environment after the first quarter, particularly in the United States of America, Japan's GDP growth slowed markedly among the course of 2002, when the country once again experienced a contraction in output, as in 2001. In sharp contrast, following a slowdown in 2001, the Australian and New Zealand economies bounced back smartly in the first half of 2002, only for growth to lose some momentum in the latter part of 2002 as the external environment deteriorated. In Australia, drought was also a negative factor in the overall economic performance in 2002. However, largely on the basis of continued buoyancy in domestic demand, both countries were able to raise their total output in 2002 in line with their recent trend rate of 3 to 4 per cent a year (figure II.36).

With regard to consumer prices, Japan experienced its fourth year of deflation and the rate of price decline in fact intensified somewhat in 2002. In Australia, inflation came down sharply, from 4.4 per cent in 2001 to 2.5 per cent in 2002, while New Zealand saw a nominal decline in the inflation rate from 2.7 to 2.6 per cent in the same years (figure II.37). The benign infla-

Figure II.36. Rates of GDP growth in developed countries in the ESCAP region, 1999-2002

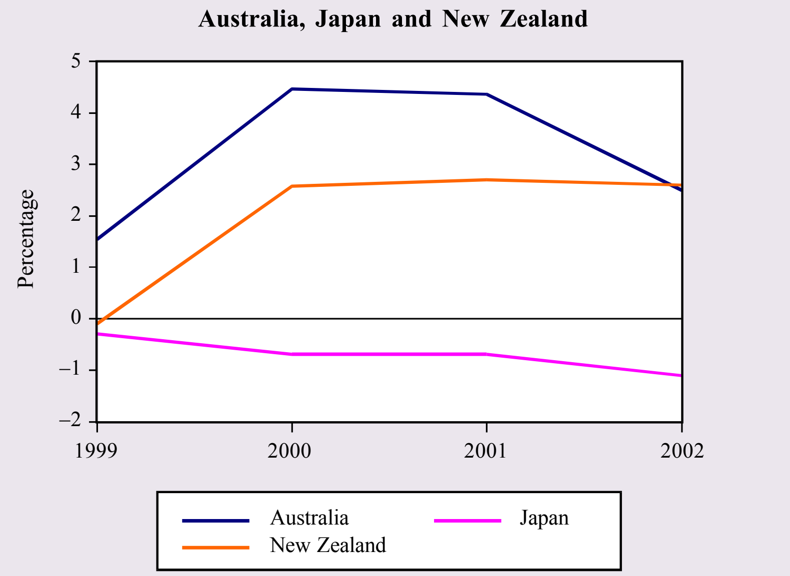
Australia, Japan and New Zealand



Sources: ESCAP, based on IMF, *World Economic Outlook* (Washington, September 2002); and Economist Intelligence Unit, *Country Forecasts* (London, 2002), various issues.

Note: Data for 2002 are estimates.

Figure II.37. Inflation in developed countries in the ESCAP region, 1999-2002[a]



Sources: ESCAP, based on IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); and Economist Intelligence Unit, *Country Forecasts* (London, 2002), various issues.

Note: Data for 2002 are estimates.

[a] Percentage changes in the consumer price index.

tionary environment facilitated the maintenance of a liberal monetary environment, notwithstanding some minor fluctuations in interest rates between late 2001 and mid-2002. In both Australia and New Zealand, for example, monetary policy was eased following the events of 11 September 2001 (table II.43). At the beginning of 2002, however, the easing was partially reversed as growth appeared to be more robust than had initially been forecast. Interest rates resumed their downward path subsequently as the external environment weakened perceptibly and by mid-2002 the rates stood at the same level as in the last quarter of 2001. Easier monetary conditions in Australia resulted in a rise in the investment-to-GDP ratio of 0.7 percentage points in 2002. In Japan, despite unchanged interest rates in nominal terms, deflation means that real interest rates are significantly positive (the typical lending rate of interest being close to 2 per cent) with deleterious consequences for the burden of debt service on both corporations and households. As interest rates cannot be reduced to below zero, this debt-service burden can be eased in part through a rise in the price level that increases corporate cash flows.

Inflation remains benign in Australia and New Zealand; Japan experiences the fourth year of deflation

In Japan, despite appreciation in the trade-weighted exchange rate of the yen, the current account balance-of-payments surplus widened, while in Australia and New Zealand the deficits widened with broadly unchanged trade-weighted exchange rates.

The consensus view is that the Japanese economy appears to have bottomed out at last and could therefore grow by around 1 per cent in 2003 should the external environment improve. However, as in 2001 and 2002, there are significant impediments to sustained economic

Table II.43. Developed countries of the ESCAP region: short-term interest rates and money supply growth (M2), 1999-2002

(Percentage)

	1999	*2000*	*2001*	*2002*[a]
Short-term interest rates				
Australia	5.0	6.2	4.9	4.8
Japan	0.2	0.2	0.1	0.1
New Zealand	4.8	6.5	5.7	5.7
Money supply growth (M2)				
Australia	11.7	3.8	13.2	11.9[b]
Japan	3.4	1.1	2.2	5.2[c]
New Zealand	8.2	0.9	14.7	5.2[c]

Sources: ESCAP, based on IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); and *OECD Economic Outlook,* No. 72 (December 2002).

[a] Estimates.
[b] January-March.
[c] January-August.

growth, including weak private consumption, weak corporate investment, persistent deflationary pressures and the still unfinished agenda of financial and corporate sector reform. Most observers agree that, for Japan, the medium-term growth path depends less on the external environment and more upon radical measures that address the long-standing problems of falling prices and bank and corporate sector reform. There is also the newer, and serious, issue of rising public debt. Progress in dealing with these problems would have a favourable impact on business and consumer confidence in the economy, stimulate higher corporate and household expenditure and provide a fillip to the momentum of growth in the economy in the coming years. Urgent action is needed, particularly in dealing with Japan's massive public debt, which, after several years of spending in excess of revenues, is projected to reach 160 per cent of GDP in 2003.

The Japanese economy has bottomed out; prospects for Australia and New Zealand for 2003 are positive

In Australia and New Zealand, the overall prospects for 2003 are, on balance, considered broadly positive. Domestic demand in the two economies is sufficiently strong to counteract the negative influences of an external environment beset by significant geopolitical and economic uncertainties and higher global downside risks (see chapter I). In the short term, a consistent policy approach based upon prudent macroeconomic policies should preserve the current momentum of growth.

GDP performance

As is well known, the Japanese economy has been in the throes of a decade-long period of lacklustre growth following the collapse of the "bubble economy" in the early 1990s. This has been countered, though with little success, with a series of spending packages by the Government, raising public debt to a very high level. But higher public spending has been offset by lower private spending so that whatever growth was achieved between 1998 and 2002 came largely from net exports. The economy was therefore affected by the sharp downturn in the ICT sector in the United States, for which several Japanese companies are suppliers of components. In many quarters it was felt that the 2001 recession had ended with the resumption of growth in the first quarter of 2002. However, in hindsight, this expansion was essentially driven by a temporary surge in net exports to the United States, with a heavy preponderance of ICT and related products. External demand, especially from the United States, weakened sharply from the second quarter of 2002 onwards and, although this was offset to some extent by higher demand from within the region, the Japanese economy is estimated to have contracted by 0.6 per cent in 2002 as a whole (table II.44). This outcome is, however, an improvement over expectations at the beginning of 2002, when it had been predicted that the economy would contract by 1.2 per cent in that year.

As in the last few years, specifically from 1997 onwards though briefly interrupted in 2000, the principal drag on Japan's economic performance has been weak domestic demand, notwithstanding the many

Table II.44. Developed countries of the ESCAP region: rates of economic growth and inflation, 1999-2002

(Percentage)

	1999	*2000*	*2001*	*2002*[a]
GDP growth rates				
Australia	4.6	3.0	2.7	3.3
Japan	0.8	2.6	−0.3	−0.6
New Zealand	3.8	3.8	2.5	3.8
Inflation[b]				
Australia	1.5	4.5	4.4	2.5
Japan	−0.3	−0.7	−0.7	−1.1
New Zealand	−0.1	2.6	2.7	2.6

Sources: ESCAP, based on IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002) and *World Economic Outlook* (Washington, September 2002); and Economist Intelligence Unit, *Country Forecasts* (London, 2002), various issues; and national sources.

[a] Estimates.
[b] Percentage changes in the consumer price index.

Weak domestic demand remains the main drag on Japan's economic performance

fiscal measures taken by the Government. Weak domestic demand, as stated earlier, had its origins in the collapse of the bubble economy in the early 1990s. It was driven by low consumer confidence compounded by the deflationary pressures that began in 1999; together these have undermined consumer spending and aggravated the burden of real debt. Furthermore, in the face of sluggish retail sales, high levels of excess capacity have built up in the Japanese economy. As the present Government has initiated some tentative steps towards fiscal consolidation with the 2002 budget (bond issues having been limited to 30 trillion yen), the problem of excess capacity could actually worsen in the next few years if growth and consumer confidence do not revive.

Excess capacity implies that corporate debt burdens have either remained largely unchanged or risen relative to equity in corporate balance sheets in the last few years; the latter had a direct impact on the financial sector in the form of NPLs. At the same time, wealth reduction has continued with falling equity and land prices. On the plus side, however, the pace of decline in fixed investment by corporations appears to be moderating and the profits of major corporations are beginning to show an improvement. More significantly perhaps, unemployment has stabilized at around 5.5 per cent, at least for the present. These are mildly encouraging signs but much more remains to be done, as is discussed in the section on policy issues.

Strong private consumption drives growth in Australia and New Zealand

In Australia, growth was primarily driven by private consumption in 2001 and 2002, with net exports playing a supporting role. Strong private consumption demand translated into a major spurt in gross fixed investment in 2002, mainly, but not exclusively, in private housing. There was considerable new investment in major resource projects. Although adversely affected by drought in 2003, Australia achieved one of the highest GDP growth rates, 3.2 per cent, among the major OECD economies. It should be stressed that domestic demand will need to grow further if the present momentum is to be sustained in the face of a weaker external environment in 2003. There is an expectation that such growth might not be forthcoming on both the investment and consumption sides; investment growth is likely to moderate as weaker equity markets dent business confidence and there is a cooling-off in the booming housing sector. Household consumption may experience a similar fate as consumers seek to reduce the household debt built up over several years of high spending. A further question mark hangs over the unemployment situation, which appears to have stabilized at the rather high level of 6 per cent or more despite several years of robust growth.

In New Zealand, the GDP growth rate rose by more than one percentage point in 2002. As in Australia, this was the result of buoyant growth in private consumption, chiefly in housing, aided by an increase in exports. New Zealand, as a small and open economy, was even more exposed to the state of the global economy in 2002, especially the sharp slowdown in the United States after the first quarter and the generally poorer sentiment in capital markets around the world. In the near term, this was mainly reflected in a flattening of investment expenditure in the second half of 2002 as New Zealand imports capital to finance its current account deficit. With a slightly less favourable year for some agricultural exports and some appreciation of the New Zealand dollar exchange rate, the current account deficit widened in 2002. However, it is estimated that overall GDP growth would have eased to a more sustainable level towards the end of 2002 and therefore the increase in the current account deficit is regarded as a temporary phenomenon that should pose no significant policy issues for the time being.

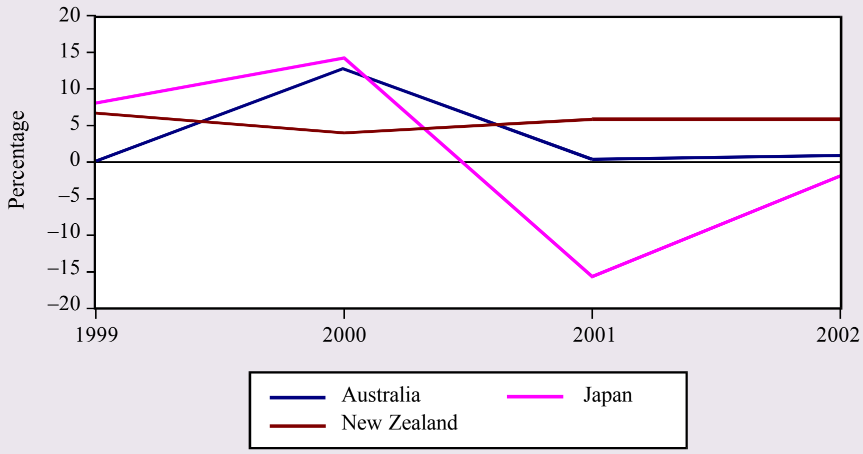
New Zealand's strong economic performance over the last few years is reflected in the low rate of unemployment, which is at a 14-year low; participation rates are also very high and labour shortages are becoming serious in certain skill categories. Even so, pressure from an upward drift in wage rates has essentially remained subdued and inflationary pressures are moderate.

Foreign trade and other international transactions

The yen appreciates in the face of strong fundamentals

Following an increase of over 14 per cent in exports and over 22 per cent in imports in 2000, Japan's trade surplus narrowed substantially; the surplus on the external current account narrowed slightly from 2.6 to 2.5 per cent of GDP (figures II.38 and II.39). These trends intensified

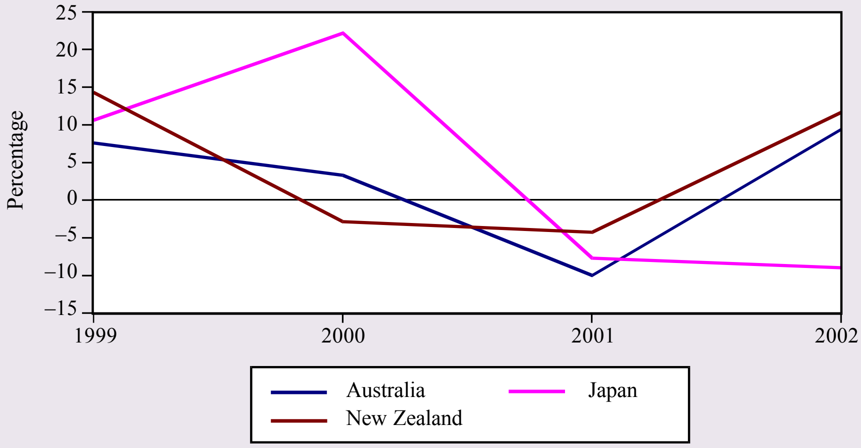
Figure II.38. Growth rates in merchandise export earnings of developed countries in the ESCAP region, 1999-2002



Source: IMF, *Direction of Trade Statistics* (CD-ROM), January 2003.

Note: Data for 2002 refer to January-August.

Figure II.39. Growth rates in merchandise import spending of developed countries in the ESCAP region, 1999-2002



Source: IMF, *Direction of Trade Statistics* (CD-ROM), January 2003.

Note: Data for 2002 refer to January-August.

subsequently and the surplus narrowed further to 2.1 per cent in 2001. Exports, mainly of ICT components, were once again lower in 2002, but imports declined at an even faster pace as the economy contracted; as a result, the current account surplus widened to 2.8 per cent of GDP. Consequently, by July 2002 Japan’s foreign exchange reserves had reached the staggering level of $446 billion. The upward trend in surplus accumulation has a clear bearing on the yen exchange rate, tending to push it upwards. The weak yen policy favoured by some as a means to revive growth through higher net exports is thus constrained by the relevant economic fundamentals, irrespective of Japan’s sovereign credit rating or the credit rating of Japanese corporations. It is no surprise, therefore, that, instead of depreciating, the yen’s trade-weighted exchange rate actually appreciated by around 4 per cent in 2002.

Such has been the weakness of the Japanese domestic economy that the appreciation of the yen exchange rate on a trade-weighted basis was paradoxically accompanied by a decline in overall Japanese imports in 2001 and 2002. The Japanese economy has provided little stimulus to global growth in the last two years through increased imports. This was in sharp contrast to its performance in 1999 and 2000, when, taking the two years together, imports went up by a third. The weak overall import demand from Japan has major implications for the region. All the subregions experienced reductions in exports to Japan in 2001 and 2002. However, some individual economies, such as China and Thailand, nonetheless managed to increase their exports to Japan.

Australia's export growth slows in 2002

In Australia, following the boom in exports in 2000, export growth was marginal in both 2001 and 2002 on the back of weaker or flatter commodity prices (table II.45). There was a decline in imports in 2001 so that the current account deficit, measured as a ratio of GDP, narrowed considerably compared with the previous year by 1.6 percentage points (table II.46). In 2002, however, the strong growth in consumption led to higher import growth, which, combined with weaker tourism receipts, widened the current account deficit to 3.8 per cent of GDP (table II.47). Australia's foreign exchange reserve position since 2000 has remained broadly constant at around $20 billion, and the trade-weighted exchange rate barely moved over the 12 months to December 2002. During that period, however, the Australian dollar appreciated significantly against the United States dollar. As roughly 10 per cent of Australian exports are destined for the United States, this development does not presage difficulties on the export front per se. However, Australia is also a significant exporter of commodities that are priced in United States dollars. An appreciation of the Australian dollar vis-à-vis that currency could indicate problems with competitiveness and market share in 2003.

Table II.45. Developed countries of the ESCAP region: merchandise exports and their rates of growth, 1999-2002

	Value (millions of US dollars)	Exports (f.o.b.) Annual rate of growth (percentage)			
	2001	1999	2000	2001	2002 Jan.-Aug.
Australia	63 357	0.1	12.7	0.4	0.9
Japan	403 383	8.1	14.1	−15.6	−1.9
New Zealand	13 456	6.6	4.0	5.8	5.9

Source: IMF, *Direction of Trade Statistics* (CD-ROM), January 2003.

Australia's external deficit has, on the whole, been comfortably financed by capital inflows given the traditional interest rate differential favouring the Australian dollar. Moreover, the Australian stock market declined much less than other markets in 2002 (by only 2.6 per cent in terms of the United States dollar compared with 16.8 per cent for the Dow Jones and 31.5 per cent for NASDAQ in the United States). At the same time, however, the relatively thinly traded nature of the currency, the

Table II.46. Developed countries of the ESCAP region: merchandise imports and their rates of growth, 1999-2002

	Imports (c.i.f.)				
	Value (millions of US dollars)	Annual rate of growth (percentage)			
	2001	1999	2000	2001	2002 Jan.-Aug.
Australia	66 851	7.6	3.3	−10.0	9.4
Japan	349 056	10.5	22.1	−8.0	−9.3
New Zealand	13 353	14.3	−2.9	−4.3	11.7

Source: IMF, *Direction of Trade Statistics* (CD-ROM), January 2003.

fluctuations in commodity prices and shifts in global financial market sentiment make the Australian dollar vulnerable to bouts of volatility; such volatility could become a source of uncertainty and disruption in business planning and longer-term investment decision-making.

Current account deficit widens in New Zealand

New Zealand missed out on some of the buoyancy displayed by world trade growth in 2000. However, exports grew by around 6 per cent in 2001 and by the same amount in 2002, in sharp contrast to the

Table II.47. Developed countries of the ESCAP region: consumption and investment as a percentage of GDP, 1999-2002

(Percentage)

	1999	2000	2001	2002[a]
Consumption as a percentage of GDP				
Australia	78.4	78.2	78.3	78.5
Japan	72.6	72.5	74.2	75.2
New Zealand	80.6	78.3	76.7	76.8
Investment as a percentage of GDP				
Australia	23.5	22.5	21.3	22.0
Japan	26.2	26.4	25.8	24.2
New Zealand	20.4	20.7	20.1	20.3

Sources: ESCAP, based on United Nations, "Project LINK Global Economic Outlook Forecast Tables" (October 2002); and Economist Intelligence Unit, *Country Forecasts* (London, 2002), various issues.

[a] Estimates.

experience of Australia during that period. As New Zealand's imports declined in 2001, the external current account deficit narrowed by a substantial 2.5 percentage points of GDP (table II.48). However, import growth and outgoings on services outpaced export growth in 2002 and the current account deficit widened to 3.5 per cent of GDP in 2002. New Zealand actually runs a modest surplus in merchandise trade; it is its deficit in services and a large gap in income from investments that contribute to the overall deficit. New Zealand's external position deteriorated to some extent in 2002 with the appreciation of its currency, which made imports more attractive.

Table II.48. Developed countries of the ESCAP region: budget and current account balance as a percentage of GDP, 1999-2002

(Percentage)

	1999	*2000*	*2001*	*2002*[a]
Budget balance[b] as a percentage of GDP				
Australia[c]	0.9	0.9	0.2	0.1
Japan	−7.0	−7.3	−7.1	−7.2
New Zealand	0.4	0.8	1.4	1.5
Current account balance as a percentage of GDP				
Australia	−5.9	−4.1	−2.5	−3.8
Japan	2.6	2.5	2.1	2.8
New Zealand	−6.3	−5.3	−2.8	−3.5

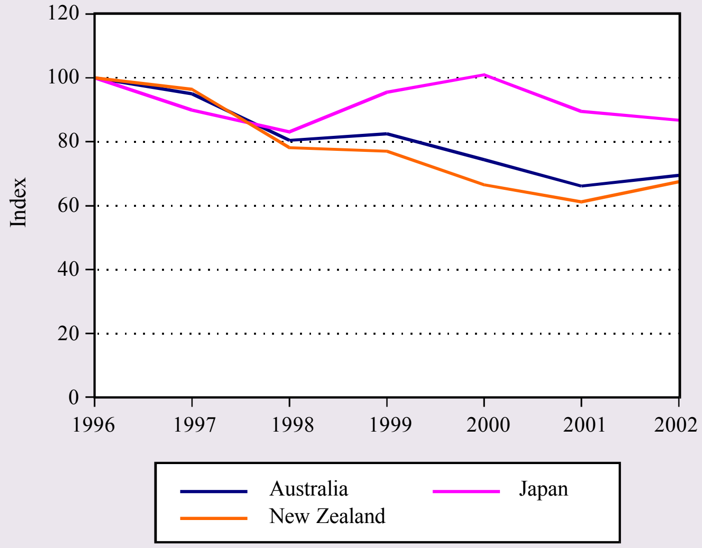
Sources: ESCAP, based on IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002) and *World Economic Outlook* (Washington, September 2002); and Economist Intelligence Unit, *Country Forecasts* (London, 2002), various issues.

[a] Estimates.
[b] General government fiscal balance.
[c] Data exclude net advances (primarily privatization receipts and net policy-related lending).

However, as in Australia, the external deficit is not a major policy issue. The interest rate differential makes it easy to finance the deficit and over the years New Zealand has succeeded in denominating the majority of its external liabilities in its own currency, thus removing the exchange rate risk. The exchange rate therefore has only a marginal bearing on the management of the external debt. The appreciation of the New Zealand dollar against the United States dollar in 2002 is considered to be temporary and a reflection of United States dollar weakness rather than any inherent upside potential in the New Zealand currency. Nevertheless, the exchange rate could be a source of uncertainty in the months ahead with some negative implications for investment expenditure (figure II.40).

Figure II.40. Index of exchange rates against the United States dollar of developed countries in the ESCAP region, 1996-2002

(1996 = 100)



Sources: IMF, *International Financial Statistics,* vol. LV, No. 12 (December 2002); and *Far Eastern Economic Review,* various issues.

Note: Data for 2002 are estimates.

Key policy issues

Banking reform, deflation, fiscal consolidation and corporate sector restructuring remain key policy issues for Japan

As the second largest economy in the world and the largest in the region, Japan exercises a major influence on developments in its trading partners. Therefore, the need for Japan to address its decade-long slump is of vital importance from both Japan's own national perspective and international and regional perspectives. The present Government has recognized the need to take radical action in the areas of banking reform, deflation, fiscal consolidation and other structural issues in the corporate sector. However, implementation has been slower than initially expected or, indeed, hoped for. Broadly speaking, there are four interrelated policy issues that the Japanese authorities have to tackle and in the following paragraphs an attempt is made to highlight the complexities involved in dealing with the underlying dilemmas.

Without meaningful progress in dealing with the chronic problems of the financial sector, the credit crunch in Japan will continue to deprive productive companies of access to financial resources that would enable them to restructure and grow. Despite loan write-offs equivalent to 16 per cent of GDP in the last 10 years, NPLs remain stubbornly high.

From official estimates, Japanese banks carry on their books some 47 trillion yen of NPLs, or roughly 8 per cent of GDP, although some observers consider this figure to be an underestimate. In fact, there is a clear risk that NPLs could rise dramatically given the extraordinary combination of falling output and deflation in Japan. Weak profitability constrains the provisioning capacity of banks, so that there would appear to be no respite available to them were they to be left to their own devices to tackle their balance-sheet problems. Japan's strategy for the financial sector has consisted of stricter loan classification, accelerated loan disposals through the Resolution and Collection Corporation and reduction of exposure to equity price risk through the Bank Shareholding Purchase Corporation. The strategy was given sharper focus by the appointment of a new head of the Financial Services Agency, who assembled a task force to propose a reform package. The task force has announced a plan that calls for halving NPLs by March 2005. Much will depend on how aggressively the Agency can exercise its discretionary powers in implementing this plan (see box II.9).

Box II.9. Banking reform in Japan

Despite write-offs amounting to 16 per cent of GDP over the last decade,[a] the lingering NPL problem in the Japanese financial sector continues to be aggravated by asset-price deflation and contracting GDP. The recent deterioration in economic conditions in Japan further increases the risk that more loans could turn into NPLs. Arguably, a resolution of the NPL problem holds the key to renewed and durable economic growth in Japan.

The NPLs of all deposit-taking institutions amounted to ¥43.2 trillion ($355 billion) as at the end of March 2002, an increase by ¥9.6 trillion, or 28 per cent, from a year earlier. While the increase is partly due to the application of stricter criteria for the classification of NPLs, it primarily reflects steady deterioration in the business conditions of borrowers, despite the removal of ¥9.2 trillion from the balance sheets of banks.

To halt this vicious cycle, at the end of 2002 the Japanese Government announced a reconstruction programme called the Programme for Financial Revival, including a schedule for action plans designed to resolve the NPL problem through halving bad loans by March 2005.

Framework for a new financial system

The framework has several elements. Its overall objective is to channel resources to productive companies and develop a viable and robust financial system within a realistic time frame. To maintain public confidence, the framework proposes postponement of the complete abolition of the blanket deposit guarantee scheme to the end of March 2005. In the interim, a task force on financial issues will be established to monitor the status of NPLs with a view to resolving the problem by the end of fiscal year 2004, that is, early 2005.

The NPL problem manifests itself in its starkest form in the parlous financial condition of SMEs. Here, high levels of borrowing have come up against declining collateral values, low demand and falling prices. As one of the measures to provide a safety net for SMEs, the framework suggests encouraging the entry of new lenders into the market who can better assess and cater for their financial needs, participate in their long-term rehabilitation and strengthen the monitoring of their operations in the future.

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[a] *Japan: Staff Report for the 2002 Article IV Consultation; Staff Statement and Public Information Notice on the Executive Board Discussion* (IMF Country Report No. 02/175).

Above all, to halve the volume of NPLs by March 2005, the framework proposes a support system for troubled financial institutions which includes the provision of additional liquidity through special loans by the Bank of Japan, the injection of public funds based on the current Deposit Insurance Law and the assignment of resident inspectors to sit on the boards of troubled financial institutions. Through the latter, pressure for reform would be given a boost in financial institutions under the special support scheme. The framework also suggests establishing a new public funds scheme whereby the Government would inject funds into a troubled financial institution more promptly and thus ensure the stable functioning of the financial system.

New framework for corporate rehabilitation

A key element of the plan is the enhanced role of the Financial Services Agency. The Agency is expected to promote and carry out structural reform, in particular in those financial institutions that come under the ambit of the special support scheme. It includes sales of bad loans to the Resolution and Collection Corporation and the injection of corporate reconstruction funds, plus others measures, such as the possible introduction of a credit guarantee system for Debtor-in-Possession finance. It also suggests strengthening the role of the Resolution and Collection Corporation in the rehabilitation of troubled institutions, enhancing cooperation with corporate reconstruction funds and developing a debt market involving the greater securitization of loans.

In order to facilitate structural reform by the Financial Services Agency, the planned framework proposes a stricter assessment of banking assets, improved capital adequacy and strengthened governance. In particular, it suggests tighter criteria for the classification of assets; such criteria should be more consistent with the market valuation of the assets. In this connection, the market valuation system is to include the use of discounted cash flow methods for calculating asset values and likely future provisions and a review of the period within which weak banks have to improve their capital-adequacy ratios. These measures are broadly in line with what constitutes international best practice as laid down by the Bank for International Settlements.

More fundamentally, a tax reform proposal for the improvement of capital adequacy includes a new scheme to recognize the provisions as tax losses, the removal of a freeze on the refund carry-back system and consideration of the extension of the carry-over period for tax liabilities. Finally, it suggests a strengthened role for external auditors in the assessment of the condition of troubled institutions, the conversion of preferred stock held by the Government into common stock in accordance with operational guidelines and enhancing the effectiveness of an early warning system through the careful monitoring of indicators such as overall profitability and liquidity in the banking system as a whole.

Market response

By and large, the plan has been received with some disappointment by market participants. There was an expectation that the Government would undertake a more aggressive restructuring programme in the financial system and deal more decisively with the NPL problem. In particular, it is felt that the Government has failed to set a target for the amount of deferred tax assets that the banks can include in their Tier 1 capital.[b] Markets had seen this as one of the more effective measures for compelling banks to make new capital injections and maintain their capital-assets ratio at the required level.

In addition, the reform plan includes measures that will initially lead to an increase in NPLs and consequently impair the banks' capital-adequacy ratios, for example, through the proposal to adopt the discounted cash flow system for the evaluation of NPLs. There are also to be special inspections of the banks by the Financial Services Agency and such inspections would, in all probability, reveal additional impaired assets. The successful implementation of these policies is thus likely to be a major challenge for the Government and markets, hence the fear of some policy slippage. Finally, there is scepticism about the significance of the reform plan as it focuses primarily on the NPLs of major banks. This leaves aside a far larger amount of "grey" liabilities held in the non-banking financial sector.

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[b] Banks set aside reserves to offset potentially bad loans but the reduction in taxable income occurs only when the borrower becomes insolvent. Currently, the expected future reduction in taxable income can be recognized in the profit and loss account as an expected refund and included in core capital, significantly boosting the banks' capital-adequacy ratios.

There is general agreement that deflation poses a critical threat to sustained improvement in GDP growth over the medium term. Thus far, the Bank of Japan has concentrated on expanding liquidity in the economy and the base money had increased, on a year-on-year basis, by 30 per cent by mid-2002. However, this policy has not yet succeeded in ending deflationary pressures in the economy. There is growing acceptance that the Bank has to take more innovative action and not rely on monetary policy alone to counter deflation. Since deflationary expectations can be as difficult to shift as inflationary expectations, one suggested approach is to alter the public's expectations in this regard by, say, announcing a commitment to end deflation within 12-18 months. Whether this would produce the desired effect is subject to some doubt.

While there is no formal fiscal consolidation programme, the present Government has initiated a move in that direction by putting a limit of 30 trillion yen on bond issuance in the current fiscal year. The twin problems of the public debt and fiscal consolidation reveal the dilemmas that the Japanese Government is facing in this area of policy. On the one hand, given the weakness in growth, it would be inappropriate to push too aggressively with fiscal consolidation in the near term; on the other, the ballooning public debt cannot be left adrift without some official commitment to end it over a credible time frame. Some degree of consolidation is needed to stabilize the debt, say, by 2007 and further measures will be needed thereafter to reduce it if Japan is to make public debt manageable at some point in the future. Given the lack of growth in the economy, this would be a very tall order. However, the Government could set broad objectives for its tax, expenditure and social security policies and initiate a public debate on the subject as a way of building consensus in society on this critically important issue.

Corporate restructuring has to be pursued to reduce the excessive leveraging of most companies, particularly SMEs. It is also necessary to enhance labour mobility and "sunk" capital needs to be salvaged from non-viable enterprises and reallocated to companies where the chances of long-term survival are better. In this context, the banking system has to deal with the problem of company debt, how it might be restructured and/or converted into securities, how sales of impaired assets to third parties might be financed and how the quality of decision-making might be improved in the banking system as a whole. Significant reform of the regulatory regime governing corporate enterprise is also needed and a more strategic approach is necessary in this regard. Entry barriers are still rather high in some sectors, notably telecommunications and electricity, and business start-ups are hampered by a complex process of official approvals. Accelerated disposal of property used as collateral is another area needing reform.

Australia and New Zealand face broadly similar policy challenges: tax reform, welfare spending and incentives for production and employment

In comparison with Japan, both Australia and New Zealand face essentially straightforward policy issues, namely, managing relatively sophisticated economies in a rapidly changing global environment, preserving competitiveness and the momentum of growth in a framework of macroeconomic stability and managing the trade-offs between taxation, welfare spending and incentives for production and employment. Notwithstanding signs of reform fatigue in Australia, as reported in the *Survey 2002,* the Government is examining afresh the matrix of taxation, labour market reforms, media laws, competition policy and welfare. The present Government has stated that it does not favour budget deficits; this constrains it in its desire to lower taxes over the long term. Indeed, the currently weaker international economy could reduce the projected fiscal surplus in fiscal year 2002/03. The Government has also put on hold plans to dispose of its remaining stake in Telstra. This suggests perhaps that more radical reforms of taxation might be deferred for now, that is, until the overall resource situation improves, the global environment stabilizes and the higher spending on defence, security and border protection, to which the Government recently committed itself, can be assessed as either temporary or permanent.

In New Zealand, similar tightening of the budget situation is on the cards despite the recent run of fiscal surpluses. Lowering the tax-to-GDP ratio in the near term appears problematic, however, given the unfunded liabilities in the New Zealand Superannuation Fund and the Accident Compensation Corporation and political commitment to boost spending on health, social security, public housing and education. The Government's preference is to allow some deterioration in the fiscal situation in the short term and maintain spending on key strategic priorities, so as not to disturb the current high momentum of growth. A longer-term issue facing the country is its relative underperformance compared with Australia since the mid-1980s. This comparison raises a host of difficult issues related to levels of capital intensity in the two economies and the negative impact of large net outward migration from New Zealand in recent years. New Zealand's small size and physical distance from its trading partners provide some explanation for its inability to reap economies of scale. However, this also suggests that any policy interventions would pose major problems.