



# Long March Back to the Future

Huge strides made in era of reform, scandal and intrigue, but more to do.

When I returned to the U.S. in 1986 after three years at the U.S. Embassy here, Japan appeared poised to dominate the global economy in the 21st century. Ezra Vogel's *Japan as Number One* was a best-seller in both countries. Japanese investors had purchased such U.S. icons as the Rockefeller Center in New York City and California-based golf course operator Pebble Beach Co. The Imperial Palace in Tokyo was said to be worth more than California! One senior official bluntly told me that Japan would soon be America's "elder brother."

The Japan model featured highly leveraged financing; lifetime employment; five-year "visions" for industrial development prepared by elite ministry bureaucrats; tight relationships among government officials, business leaders and politicians; legitimate cartels operating under "administrative guidance"; and cross-shareholdings that permitted management to concentrate on long-term strategies. It

rested on a rigorous examination-based education system and social values that emphasize what I call the four Gs – *gisei* (sacrifice), *gambaru* (hard work), *gaman* (perseverance) and *giri* (duty).

Twelve years later when I arrived back in Tokyo in 1998 to become ACCJ executive director, that confidence was badly battered. Flaws in the Japan model – most prominently the quasi-socialist finance system that allocated capital without reference to risk – had created a huge financial bubble in the 1980s. When the bubble burst in 1991, Japan plunged into deflation and economic stagnation that confounded attempts to reverse it by the Ministry of Finance and the then-Ministry of International Trade and Industry. The number of non-performing loans (NPLs) skyrocketed, and joblessness had reached unimaginable levels for a system predicated on lifetime employment.

It slowly became evident that the country could not continue to simply export its way out of difficulty. Although Prime Minister

Junichiro Koizumi had coined the phrase "No growth without reform," it was his predecessor twice removed, Ryutaro Hashimoto, who recognized that to resume sustained economic growth the country had to deal with two larger ineluctable issues: a rapidly aging population, and globalized financial markets driven by advances in information technology.

Under Hashimoto's direction, the Ministry of Finance published an unprecedented report in June 1997 that would fundamentally change the nation: "The major challenge for Japan in the 21st century is to maintain its economic vitality against the rapid aging of the population ... [and] the rapid progress of globalization and innovation in the information and communication technologies. To meet this end, it is necessary for Japan to undertake a structural reform of its social and economic system. In particular, financial systems, the artery of the economy, must be reformed [to] effectively support the economic activity in the coming century."

In November 1996, Hashimoto announced that Japan would carry out a financial “Big Bang” that would put the Japanese financial markets on a par with those of the U.S. and the UK. It endeavored to unwind a system that had been at the heart of the Japan model for four decades, threatened the interests of political and economic elites, and profoundly affected the lives of millions of ordinary people.

Unfortunately for Hashimoto, a hike in the consumption tax cost the LDP its Diet Upper House majority in the summer of 1998. Although described by the media as being about as exciting as cold pizza, Hashimoto’s successor, Keizo Obuchi, continued the shock treatment. A record-high emergency injection of public money staved off a collapse of the banking system, two major banks were nationalized, and in December the Diet passed the Financial System Reform Law. This paved the way for what could be called the fourth opening of Japan – following the opening to China in the 6th century, to the West in the 19th century and to democracy after World War II.

During its 1,500 years of recorded history, Japan had forbidden or tightly controlled the ability of foreigners to conduct business inside its borders, particularly in acquiring control of Japanese companies. In essence, foreigners were permitted to do business *with* Japan, but only in a limited fashion *in* Japan. The new law liberalized capital markets and led to an unprecedented expansion of foreign direct investment (FDI).

Such FDI, which would have been inconceivable a decade earlier, occurred in industries such as retailing, autos, banking, insurance, telecommunications and leisure. (Foreign companies became the largest owners of golf courses!).

#### **Pressure pays off**

The influx of FDI transformed ACCJ advocacy activities. Previously, most foreign companies shared one advocacy objective: greater market access. ACCJ advocacy now began to encompass the full spectrum of economic policy, including taxes, labor laws, standards, healthcare, financial-market regulations and education. In 2001, we changed the title of our periodic publication from *U.S.-Japan Trade White Paper* to *U.S.-Japan Business White Paper* to signal this evolution. As more firms began to operate “inside the castle,” the ACCJ advocacy strategy shifted from applying *gaiatsu* (outside pressure), often through the offices of the U.S. government, to a more subtle and direct *naiatsu* (inside pressure).

As full tax-paying and job-creating participants in the Japanese economy, ACCJ members became deeply concerned with the economic system itself – its principles, practices, laws and regulations. Our basic message: in a globalized economy, market-based policies, transparency, a level playing field for all participants, and rules-based decision-making offer the best approach to achieve sustained economic growth.

Protectionist anti-reform politicians charged that so-called vulture funds would engage in hostile takeovers of vulnerable Japanese companies, heartlessly jettison surplus employees, and sell the valuable pieces of the acquired companies at unfairly high prices. The old guard, however, was railing against the tide of history. After the untimely death of Obuchi, Koizumi – who had a reputation for being something of a maverick and had run twice previously – became prime minister on a wave of deep-seated voter dissatisfaction with mismanagement of the economy and insider, patronage-based politics.

#### **Maverick reform**

Using unusually colorful language, Koizumi announced sweeping structural economic reforms that would allow no “sanctuaries” for pork-barrel interests. Since Koizumi’s proclamations hit at the source of the power of the LDP factional bosses who depend on vast public works, he ran into tough sledding from the outset. For example, he was forced to compromise on plans for privatizing the four semi public highway corporations that had infamously built lavish highways and bridges in sparsely populated areas. After a while, pundits gleefully began to accuse him of practicing “NATO” politics – all talk, no action.

But Koizumi is nothing if not persevering (*gaman-zuyoi*). Counterattacking, he put privatizing the monolithic Japan Post system at the center of his program – with

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no fewer than 120 reforms! Japan Post contains the world's largest savings and insurance entities, holding nearly 30% of the nation's household savings, and more life-insurance policies than the top-four private companies combined. And most important politically, Japan Post also functioned as a kind of "off-budget budget" for financing pork-barrel public works. Not surprisingly, therefore, the Diet Lower House barely passed the privatization bill after a bitter intra-LDP fight, only for it to be rejected by the Upper House.

### Political gamble

In response, Koizumi took a gamble by dissolving the Lower House and calling on the electorate to give him a mandate to carry out structural reforms. Campaigning vigorously and handpicking 73 newcomer candidates, Koizumi led the LDP to its largest majority in history. It seemed that reform was well on its way to success, and Japan's long march through the depths of deflation, anemic economic growth, and anxiety over how to provide for an aging population with a shrinking workforce might soon come to an end.

In mid-2006, there are reasons for optimism. GDP has expanded in four successive quarters. The major banks have brought down NPLs to manageable levels and have resumed lending. Efficient large-capital companies have restructured, reducing costs to regain profitability and reinvest capital. Incomes and household

consumption have begun to rise. Deflation has abated.

How much economic reforms have contributed to the revival of the economy is open to debate. Certainly, zero percent interest rates and fiscal stimulation provide much of the story, but reforms requiring increased transparency and accountability, along with the creation of the Financial Services Agency (FSA) to enforce them, have been critical to bringing down the level of NPLs and spurring corporate restructuring that have restored profitability.

As even a quick perusal of ACCJ Viewpoint and Public Comment papers indicate, however, further steps are needed to fully embrace the principles for an open market-based economy, such as transparency, rules-based decision-making, equal access and a level playing field, regulations that facilitate healthy competition and restrain monopolistic behavior, and a legal system that provides recourse and encourages healthy competition.

Indeed, forward movement on reform seems to have stalled. Economic revival has lessened the sense of urgency for reform and enabled anti-reformists to regroup. Jockeying among candidates to succeed Koizumi in September and a series of scandals have diverted attention from economic reform. Anti-reformists have even charged that deregulation imposed on Japan by the United States led to the Livedoor Co., Ltd. scandal, and even the Aneha fake earthquake-data construction case.

### Could do better

Now is, therefore, no time to fall into complacency. The redesign of the Japan model has progressed at its own pace and in its own fashion, but it needs more work. It remains highly vulnerable to perturbations in its export markets, particularly those of the U.S. and China. Household savings have declined, but corporate savings have risen, leaving still troublesome the domestic savings/investment/consumption ratios. Stock prices have recovered, but foreign investors are the prime movers, and the Tokyo Stock Exchange badly needs an effective independent watchdog.

The loan spigot has been turned on. But it is unclear how much better the banks are today at assessing risk. A slew of new NPLs could again bring on a wave of bankruptcies and rising unemployment before a more comprehensive social safety net can be created.

Although the national debt of more than 150% of GDP is held largely by Japanese government entities, and is significantly lower on a net basis, it will be a serious burden on future taxpayers. Public spending has declined, but huge projects are still being built.

Nevertheless, whereas eight years ago, all was doom and gloom, as I leave Japan for the fifth time in the last 50 years (Can it be true?), the mood has turned almost euphoric. Mood swings are, of course, part of human nature – and market cycles. But compared to the mid-1980s, taking a measured optimistic

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outlook today rests, in my view, on much more solid ground.

Transparency in government and boardrooms has greatly improved, operating most visibly through a public-comment procedure, more robust corporate-shareholder meetings and a more responsive judiciary, but also in the form of stricter standards and enforcement by an independent and increasingly experienced FSA.

Privatizing government entities, such as Japan Post, so that the “private sector can do what it can do” – provided they don’t receive favorable treatment that gives them unfair advantages – will contribute substantially to creating more robust financial markets that can allocate resources to their most productive uses.

FDI – inward and outward – has become an important and normal feature of the Japanese economic landscape. Once considered almost a sin, M&As for strategic as well as rescue purposes have begun to occur among domestic companies. Business schools have proliferated

to create the skills necessary to succeed in a market economy, as have human-resources development and placement companies required for a flexible labor market and effective social safety net.

Finally, a consensus has emerged that Japan’s aging population and globalized markets give it no alternative but to move toward fuller integration into the global economy. Competing internationally forced companies such as Toyota Motor Corp. and Sony Corp. to become world-beating competitors. The protected sectors of the economy are being cautiously but inevitably opened to competition – and under increasingly effective regulation. Indeed, competition policy, including a more robust legal infrastructure is a major policy area.

In closing, some thoughts on the younger generation. I often hear from Japanese friends my age that the younger generation has lost the values (such as the four Gs) that enabled Japan to rise from the rubble of World War II to become the world’s second

most powerful economy. They cite as evidence freeters, who opt for short-term, part-time work over becoming salarymen (and women). But as any international employer can attest, young Japanese employees rank by any global standard among the world’s most hardworking, educated, competent and conscientious.

Moreover, young Japanese today are much more comfortable dealing with change and the outside world. Foreign companies – including the ACCJ – have no trouble finding graduates and mid-career people eager to work for *gaishi-kei* (foreign-capital) companies. Young voters responded favorably to Koizumi’s charismatic style, willingness to confront the LDP old guard and the bureaucracy, and determination to change the entire system if need be. Japan’s future will be in good hands – if the system gives them the opportunity to shape it.

**Donald B. Westmore is the outgoing ACCJ Executive Director**

## If it be so ...

Goodbye means “God be with you,” which is another way of saying “Have a safe journey,” for me a generally upbeat salutation. *Sayonara* means “If it be so ...” and for me has a tinge of sadness and resignation. On the other hand, it also has a vague, ephemeral quality – a fleeting moment in our lives, to be followed by other meetings sometime, someplace. So I am content to say to all my friends and colleagues at the ACCJ, sayonara after eight years serving as your Executive Director. It has been personally rewarding, challenging and a pleasure.

The ACCJ celebrated its 50th anniversary when I arrived. In two years it will celebrate its 60th – a special occasion called *kanreki* that marks a rebirth after five cycles of the 12-year Zodiac. I look forward to watching with admiration the ACCJ build on its venerable 58 years to reach new levels of vigor and influence. Since I hope to continue to help strengthen the ties of understanding and mutual benefits through cooperation across the Pacific, I am sure that we will meet once again, somewhere, sometime. *D.B.W.*