

# **Is There a Route to Realistic Reform?**

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## 10 year-long *big stagnation*

The Japanese economy grew at an average rate of just 1% in real terms per year throughout the 1990's. This was a marked decline of the growth rate from over 9% in the period of 1956 to the first oil crisis year of 1973, and slightly over 4% during 1975-1991 period.

The year 1991 was a symbolic year. In this very year, Japan's so-called economic bubble began to collapse, while we witnessed the U. S. economy hitting the very bottom after long stagnation, followed by historically the longest expansion leading to *new economy* in late 1990's. This was the year of *the Gulf War* and the implosion of the Soviet Union. India, also in this year, introduced new economic reform policies which successfully gave dynamism to her economy and began to attract good quality inward FDI (foreign direct investment).

All this means that the sudden stall or paralysis of the once miraculous Japanese economy happened in a rapidly changing global economic and political paradigm. This also means possibly this change in Japan must be seen in a broad global and historical perspective and framework.

What Japan is now facing is not a 10 year-long prolonged recession. It is a *big stagnation*. It is far more than simply cyclical. Actually she is in the midst of *compound adjustment pressure*.

Compound elements can be boiled down to:

- 1 Classical cyclical factors.
- 2 Disposal of financial institution's non-performing loans stemming from the burst of bubble economy.
- 3 Adjustment pressures, to business management in particular, resulting from the decline of the trend line growth rates.
- 4 The completion of the process of what is called *catching up* with advanced Western industrial countries that continued since the end of World War 2 (or for more than 100 years since the Meiji Restoration) and the need to engineer a new economic model for the *post-catch up* period.
- 5 Response to *global Mega-competition* with having *market economy domino*.
- 6 Shift of macro-economic framework from a savings shortage to a savings surplus economy.
- 7 Response to a drastic change in the population pattern resulting from an ever lower birth ratio and the aging of society.
- 8 A shift of the industrial technological paradigm from *Fordism* type of standardized mass production to more information, service intensive industries.

□□All of these mean that Japan's economic stagnation since the burst of the bubble economy is more than a simple cyclical phenomenon and

actually very much structural. The government, however, tended to take mostly fiscal stimulus policies of a counter-cyclical nature.

Since the first "emergency measure" of August 1992, the government has introduced some 10 emergency or "comprehensive" measures:

- 1, 1992.8.28 (Miyazawa Cabinet) 10.7 trillion yen fiscal package (additional deficit financing needed was 2.256 trillion yen).
- 2, 1993.4.13 (Miyazawa) 13.2 trillion yen (2.246 trillion yen).
- 3, 1993. 9.16 (Hosokawa) 6.0 trillion yen (3.616 trillion yen)
- 4, 1994. 2. 8 (Hosokawa) 15.25 trillion yen (2.182 trillion yen).
- 5, 1995. 4.14(Murayama) 7.0 trillion yen (2.826 trillion yen).
- 6, 1995.9.20 (Murayama) 14.22 trillion yen (4.702 trillion yen)
- 7, 1998.4.24 (Hashimoto) 16.0 trillion yen (6.118 trillion yen)/
- 8, 1998.11.16 (Obuchi) 23.9 trillion yen (12.325 trillion yen).
- 9, 1999.11.11 (Obuchi) 18.0 trillion yen (7.56 trillion yen).
- 10, 2000.11.19 (Mori) 11 trillion yen.

Even with these fiscal stimulus measures, the economic growth ratio remained on average only 1 % and the government's budget deficit continued to increase. Ministry of Finance declared a *Public Finance Crisis* in 1995. The Hashimoto government even increased consumption tax from 3 % to 5 % in April 1997. This turned out to be a terrible policy mistake killing economic recovery and creating an inter-bank market crash, leading to a series of collapses of financial institutions and credit contraction.

### Koizumi's Half-Reform

Prime Minister Junichiro Koizumi came to power on April 26, 2001 on an explicitly reformist platform by saying, " no growth without reform ". There is no doubt about the fact that he is really reform-minded. The main points of his administration's reform policy are: capping annual JGB (government bond) issuance at the level of 30 trillion yen from fiscal 2001 starting April of that year; forcing commercial banks to write off all non-performing loans within 2 to 3 years period; scaling down or abolishing special public corporations; accelerating all necessary structural economic reforms to revitalize the economy.

All these seemed to be very ambitious. But the combination of fiscal austerity by capping JGB issuance and writing off efforts of banks' non-performing loans are deflationary. Other reform measures, though they have been enthusiastically discussed within the government, have rarely been put in place. Actually, since the 1996 *Maekawa Report*, after the previous year's Plaza Accord, we had so many reports advocating structural reforms. Actual implementation of the reform plans has been almost nonexistent.

This was so mainly because Japan produced too many new

governments. Since the collapse of the so-called political 1955 regime, LDP's government party has had a 38-year monopoly. Japan produced 8 prime ministers including PM Miyazawa as the last prime minister under 1955 regime. Each prime minister tried to have their own structural reform plans by calling for ideas from outside advisors. However, as one government lasted on average just around one year, soon after the announcement of some reform plans, a new prime minister would come into power and shelve his predecessor's ideas.

As for Koizumi 's reform plan, very few of the ideas were implemented except for JGB issuance capping and special public corporations' reforms.

Reforms are too slow to come. Minister Heizo Takenaka refutes such criticism by saying the government is materializing indeed several hundred items of structural reform. I believe it is a big strategic mistake that government has such a large number of reform items. Devils live in details. Government seems to be creating resistance forces by going into too much detail. I will discuss in the latter part of this paper the strategic importance of choosing two or three areas of reform, which have a ripple effect and trigger some chain-reaction type of reform pressure on all other areas. They include information disclosure, promotion of effective capital markets on a massive scale.

Another concern about Koizumi's reform plan is that it stresses how to save tax expenditures, but puts much less importance on to how to create a tax basis, namely wealth. To spend tax money wisely is always necessary. But this approach only cannot create economic growth, new industry frontiers, new jobs, new technology, new culture or new wealth.

Japan's politics and government policy tended to focus on how to distribute tax money, or how to make income redistribution while having national income almost automatically growing during a catching-up period. It was, in retrospect, an easy task in the good old days for politicians and bureaucrats. But we now have a new situation of no growth or negative growth of the economy (income). It is that there is no new pie for redistribution. We need to encourage the creation of a bigger pie.

### Too Much Pessimism and an Insufficient Sense of Crisis

Bearishness or pessimism in Japanese society is now almost at an all time peak.

Recent bankruptcy level of companies is at an all time high. Since the peak of the bubble economy period up to now, Japan has lost more than two years of nominal GDP equivalent value of real estate and financial assets. More than half of the companies listed on the Tokyo Stock Exchange are now making no profit, and more and more

restructuring of employment is destroying long-lasting lifetime employment system and job security. More than 40 thousand Japanese commit suicide every year.

Ken Courtis of Goldman Sacks Asia bluntly says that the only way to be optimistic about Japan is to look at the charts upside down. Today's pessimism penetrating into every corner of Japanese society is just in contrast to irrational exuberance in the bubble economy period of late 1980's.

It is partly a reactionary sentiment.

For some time after the bubble economy burst, non-Japanese observers barely understood this much pessimism in Japan. Foreign media released special editions and programs about *Japanese Pessimism*. In other countries the afterimage of a super strong Japanese economy remained. Actually, from 1991 to around the summer of 1997, the year of Japan's market crash, overseas investors did make net investment into Tokyo Stock Market totaling some 23 trillion yen.

Pessimism. Yes. But very little sense of crisis exists in today's Japan. Financial Times' Lex column editor concluded, after staying in Japan for couple of weeks in 2001, that this is a *Golden Recession* for Japan. He never detected recession walking along the Ginza Street and seeing people well dressed and enjoying shopping.

I have a feeling that the real crisis of today's Japan is the shortage of a real sense of crisis or sense of urgency. What the Japanese have now is just pessimism, or helplessness. This feeling invites non-action. As is often the case, it can be even an excuse for non- action. It can be defeatism.

A sense of crisis is a driving force for change and action. For reforms to be implemented, we need a true sense of crisis.

### Paradox of Success

Why is it that Japanese society cannot bring about enough sense of crisis? This can be expressed as a *Paradox of Success*. In most of the latter half of the last century, Japan showed beautiful economic performance excepting the *lost decade* of the 1990's. Japanese management models, social models including the education system and employment practices all functioned really well. People don't want to give up easily on successful systems and practices as it gives them pain or psychological resistance. They may continue to want keep credit of the success stories. People, leadership people in particular, don't want to change management style or life style. It is partly because of natural inertia, partly because of not wanting to give up some vested interest.

In the case of the former Soviet Union, the failure of her system was too obvious for every body to keep it. Actually people easily changed religion to capitalism.

Another aspect of Paradox of Success in Japan is that we accumulated over time meaningful wealth and assets with which people can maintain a similar lifestyle by eating up the accumulated assets and forgetting about the reality of the crisis. As is often mentioned, 1400 trillion yen of individual financial assets' value deprives people of the needed sense of crisis.

### No-landing Flight?

Japan's economy is not making a hard landing. The policy of putting off or postponing all necessary but painful policy choices is also putting off a hard landing.

This is forcing the economy to continue to fly. The point is how long it can fly. And where. It can if it has enough fuel. Here the fuel is domestic savings surplus and current account surplus. Different from the case of the Asian crisis (basically capital-account crisis versus traditional current-account short term balance of payment difficulties) of 1997, Japan's crisis is all home made, not dependant on foreign borrowing. Resources needed to fix the problems all exist domestically.

Some are concerned about possible capital flight from Japan. Japanese individuals and company treasurers are still fairly conservative, keeping money at home, even as the banks' deposits yield almost no interest.

This basic picture may continue to be so if bearishness on Japan's economic future does not turn to just despair triggering real capital flight. As for external current account balances, the huge export surplus has been on the decline, a trend that is causing serious concern and hot dispute in Japan over deteriorating international competitiveness of Japanese export industries and the possibility of seeing a trade deficit in the course of time. Income (profit) transfer, remittance from oversea investment, however, is increasing and so far compensating the declining trends of trade surplus.

Domestic savings and an external surplus are making this Japanese airplane continue its flight. But this is a flight to nowhere and can be continued only until fuel depletion. It may be able to fly another 5 years or 6 years. Here time is not a friend. Necessary reforms must be implemented before the fuel depletion. That is the limit for reform. It is a race against time. For reform to be implemented, a true sense of crisis is deadly needed.

In the U.S. case, after having only pessimism, complaining and criticizing every body else other than themselves, with business leaders visiting not markets but Washington, trying to have political solutions for economic and management issues, her leadership people, both public and private, began to have a true sense of crisis from around the mid-1980's. Symbolical phenomena I now recall are: MIT (The

Massachusetts Institute of Technology) in 1989 published an influential report (*Made in America*) after a two-year comparative study about competitiveness with the interdisciplinary participation of many scholars and specialists; and Paul Kennedy's big volume book, *The Rise and Fall of the Great Powers*, which was published in 1989 and became a sudden best seller enthusiastically read by leadership people. It is just a brick-thick book that usually makes everybody sleep with the message of the danger of the country's decline by over-stretching described repeatedly and in so much detail. Though the U.S. decline was not mentioned in this book, U.S. leadership people must have overlapped her country's future with many historical examples of declined countries. The consequent emergence of a true sense of crisis pushed forward all types of necessary reforms in public policies as well as in the business management arena. *Restructuring* became a buzzword on everybody's lips and the new reality of U.S. society. After some years, this sense of crisis and consequent reforms made the U.S. economy and society, after some years, really rejuvenated, changing U.S. economic landscape after the 1990's fundamentally.

In Japan, people have pessimism and no more than that. Historically Japan has survived many serious crises. The Black Ship crisis produced the Meiji Restoration, which implemented fundamental system reforms in a short period of time without war. The discovery of this Meiji Restoration gave then young Peter F. Drucker too overwhelming an impression to resist his deep interest in Japan ever since.

Oil crises created enough sense of crisis overnight and business management style, people's lifestyle, have fundamentally changed with a sense of crisis leading the economy to be most energy efficient (marked decline of so called energy's *original unit*). Some years later, Japan's automobile industry produced dramatically improved fuel-efficient engines, which created ever greater international markets for Japanese cars. At that time the almost non-existence of a domestic oil supply gave rise to an acute sense of crisis.

A pollution crisis – air and water contamination – in the 1960's also brought about a sense of crisis that forced businesses to make technological innovations in order to have environmentally friendly technology and systems.

Why doesn't Japan have a similar sense of crisis leading to changes this time? There is a difference. The past crises Japan survived were all visible and easily perceived crises. In contrast the crisis this time around is a systemic and creeping crisis. People are beginning to recognize the crisis in an abstract and conceptual manner. People understand that some serious real crisis may happen unless we implement proper reforms quickly. But the crisis is not visible, not the crisis of today or tomorrow. Reforms accompany pains. If people can postpone pains, they prefer no change. Actually, people are eating up

accumulated assets instead. Past crises were immediate crises with immediate acute pains, which people understood could be cured only by immediate reforms.

In the 1990's big stagnation, though, Japan did have real pain in a real crisis. That was the case of the November 1997 market panic. Crisis was visible at that time. Many financial institutions, including Yamaichi Security House, went bankrupt, and banks suddenly began to be really hesitant in lending. This led to the macroeconomic disaster of credit contraction, or what economists call a liquidity trap, leading the economy immediately to acute recession. This crisis was visible enough to give people a sense of crisis and to make the government undergo fundamental policy changes.

If I remember correctly, one American economist sees Japan's situation in terms of *CRIC cycles*-- namely Crisis produces Reforms which produce Improvement leading to Complacency and a new C risis. This is the very pattern of recent Japan.

### Stealth Government and Disclosure Shortage

I do believe that the one of the most important and urgent subject for Japan to have meaningful reforms by consequence is to have *information disclosure*. With enough disclosure, the policymaking process will become transparent, making people well informed and giving the market a more reliable signal needed for effective resource allocation.

I can make a bit humorous comparison of some countries.

- In Germany, what is banned by law is actually banned.
- In Italy, what is prohibited by law is sometimes permitted.
- In the defunct Soviet Union, everything was banned except what was permitted by law.
- In U.K., the law refers neither to what is banned nor to what is permitted.
- In the United States, anything is permitted except what is banned by law.

Then, how about Japan? The answer is that people in Japan must consult the government (administrative government) in advance about what is permitted and what is banned. In other words, though what is banned by law is not permitted as a matter of course, people must still consult the government about every thing except what is clearly permitted by law. If you do something not banned by law without consulting the government, it may exact unexpected revenge on you one way or the other somewhere down the line, or at least so perceived by people. Japan is not necessarily an example of Big Government compared with the United States and many of European countries,

given the governments' size in terms of the ratios of tax burden or government expenditures to the size of the nation's economy. At least, not yet. Even so, as the late popular writer Shiba Ryotaro put it, "Japan has a *Heavy Government*", because people feel the existence of government about every thing and everywhere in daily life and daily management of business activities.

An American lawyer, Glenn Fukushima, one-time chief of the Japan desk of the USTR, described Japan's various regulations as being structured like an onion, with one regulation layered by another – at least seven layers; laws, cabinet orders, ministerial ordinances, notification, regulation, internal regulations and administrative guidance.

Official government documents disclose the fact that there are 20 types of regulations alone. They are *kyoka* (permit), *ninka* (authorization), *mennkyo* (license), *shounin* (approval), *shitei* (designation), *shodaku* (consent), *nintei* (recognition), *kakunin* (confirmation), *shoumei* (verification), *shinnsa* (investigation), *toroku* (registration), *todokede* (notification), *teishutsu* (filing), *houkoku* (report), *shinkoku* (statement), *kofu* (submission) and so on.

Nobody, including the regulators (bureaucrats), can have a clear definition of these bureaucratic jargons. For bureaucrats definition is just one thing. The important thing is they keep opacity or intransparency of administrative procedures or to keep people not enough informed.

These regulations deprive Japanese society of transparency. The 2001 edition of the *World Competitive Yearbook*, published by the Lausanne based business school, IMD, contains shocking statistics. In the global ranking of government transparency (a degree of how clearly the government informs the public of its policy intentions), Japan ranked at the very bottom, amongst the 49 countries covered by this survey. Indonesia, Venezuela and Argentina are all a bit better than Japan.

In Japan the nation's power is excessively concentrated in the administration. The Diet (legislature) makes laws, upon which the administration executes its rights. But most legislative bills submitted to the Diet are prepared by administrators, and the Diet approves most of them almost automatically without revision. Bureaucrats prepare bills to use at their convenience. They tend to incorporate discretionary rights for their convenience. And the bigger the discretionary rights, the less transparent the administration becomes for people, and consequently the more power and influence it gains.

Such discretionary policies create serious unpredictability in the economy and in business management in particular. To push up the trend line growth rate of the economy, Japan needs to encourage risk takers. Venture business tends to be discouraged by such nontransparent processes.

Corporate governance is getting more important in this increasingly

globalized world. As is often the case in Japan, under the main-bank system, many companies' governance is introduced by their main-banks. And corporate governance of banks is given by the regulator, the Ministry of Finance (MOF). But such a system has recently been forced to modify because the MOF lost credibility after a series of poor policies and scandals. MOF's governance is being tested, and banks have lost the governance provided by the MOF. The main-bank system is in the process of being dismantled.

The situation is thus quite messy and confusing. To reestablish a sound and viable system and practices, we do need more transparency through enough information disclosure. Information disclosure is a powerful tool to make government transparent, policy more predictable, business more self-disciplined and self regulated.

### Needed Capital Market

The financial system needs urgent and fundamental reform. The early bank-centric system lasted too long after Japan shifted from a domestic savings shortage economy to a savings surplus economy since around the second oil crisis. The failure of early enough transformation of the financial system toward a capital market-led economy was one of the fundamental causes of the bubble economy of the late 1980's. The bank-centric system tends to discourage risk takers, challengers to new frontier territories of business and technology. To create a better functioning capital market, bold incentive policies are needed while abolishing all incentive measures to banking business. For this we need to change our mindset and even our value system.

Information disclosure is also a key to a capital market. A transparent and less discretionary government is also a prerequisite for a good capital market. Karel van Wolfrén, in his *The Enigma of Japanese Power*, describes Japan's power system as something like a pyramid without a spire – a flat-topped pyramid.

This means there is a nonexistence of clear leadership that is accountable. But a transparent capital market can show strong leadership. Leadership for reform can come from a market that gives important signals. For the moment, the market signal is a *half-signal*. But it is better than no signal.

Transparency, information disclosure, an accountable capital market – mobilization of resources and policy measures toward such priority systems – should be the key to reform, pushing the trend line growth ratio of Japan's economy. Better-informed people can have a better understanding of reality and more readily have a sense of crisis. Japan's government district is *Kasumigaseki* area, which literally means foggy checkpoint, namely nontransparent regulation. Different from

Foggy Bottom, *Kasumigaseki's* discretionary and nontransparent over-regulation is choking the potential vitality of the economy.