Japan's Economic Doldrums:
A Potential Route to Real Reforms

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It has become abundantly clear that the Japanese economy has been in the doldrums for virtually a decade. Recent data indicates that recessionary forces continue to pervade the economy. Investment spending by corporations is either negative or non-existent. Consumers continue to refrain from consumption turning instead to increased rates of saving – and some private saving is now turning to foreign asset markets instead of domestic markets. Estimates of non-performing loans in the banking system continue to be raised and the addition of (net) new non-performing loans continues. Bankruptcies are growing in small and medium sized firms. While some large firms are beginning to restructure slowly, continued commercial bank lending is propping others up.

Clearly the domestic economy needs some sort of 'shock' to rekindle confidence on the part of consumers and business (and I would argue the government itself) and to kick start the economy. The question is what sort of shock will it take? Will the shock come after a serious financial crisis? Will the shock come from the failure of several large sized corporations? Will the shock come from a voter lead rejection of the LDP and its approach to economic reforms? Or will the shock come from outside Japan? And will it be a 'positive' or a 'negative' shock?

After more than ten years of significant underperformance in the Japanese economy, questions are being raised about whether or not there are any realistic policy options available to Japanese authorities that will put the economy on a sustained route to reform. Moreover, questions are being raised about the willingness of policymakers to accept the risks associated with needed policy change. Additionally some are wondering if the political associations of the LDP with ‘old Japan’ industrial and agricultural sectors will prevent it from being an agent of change in today’s economy.

It is clear that what have now become annual supplemental fiscal stimulus packages that continue to focus on public works spending have not provided sustainable growth stimulus to the domestic economy. Infrastructure expenditures that focus on highways, bridges, and airports are not helping. In fact, these expenditures have tended to postpone much needed structural adjustments in the excessively oversupplied construction sector. And it is clear that low – virtually zero – nominal interest rates have not successfully stimulated consumption or investment and hence the domestic economy. Though on the negative side, low interest rates have made it easier for banks to continue their past practices of supporting long-term corporate relationships with additional lending to high risk clients. And -- also on the negative side -- low interest rates have added to the pressure on consumers to increase savings as their return on assets have been very low, thus reducing the desired rate of asset accumulation.

The domestic economy is beset with strongly held, excessively negative views about the future. Consumers, convinced that the future is bleak are saving at high rates – and low rates of return compound the problem of amassing financial assets. Businesses, convinced that the future is dim, are not investing domestically, turning to overseas markets instead for the new investment plans. The press continues to focus on negative aspects of the economic situation and reinforces the low expectations. In the absence of some sort of positive ‘shock’ to the body politic, a fundamental change in both consumer and business expectations and confidence levels is not to be anticipated. Such a change in expectations must be the aim of policy efforts if one wants to successfully enter a period of sustained rates of real domestic growth in the Japanese economy.

Many observers argue that significant political constraints prevent authorities from undertaking the commitment to reform needed to restructure the domestic economy. Often the LDP is criticized for its deep connections in the agricultural and construction sectors of the economy – sectors which themselves are in need of fundamental restructuring. This financial connection between the ruling party and 'out of date' or 'old Japan' sectors in the domestic economy prevents significant change in the policymakers' approach to domestic reform agendas. The question is whether or not the LDP can be weaned from its past financial ties with the expectation of a fundamental change in the economic outlook for the economy.

This paper will argue that there is a policy choice available to Japan that could fundamentally alter the domestic political constraints and which would lead to serious and deep-rooted reform policies. Historically Japanese policymakers have responded slowly to the need for change. And typically they have only moved forward either in the midst of a serious crisis, or under significant pressure from the United States. It may be time for another round of economic and financial negotiations, which would exert external pressure for change. But unlike most earlier negotiation efforts, a new attempt needs to be based on an attempt to reach a legally binding trade agreement. Only the force of a legally binding (and therefore enforceable) agreement will be sufficiently convincing to the Japanese people to alter fundamentally the expectations of consumers and business. And without a fundamental improvement in the level of expectations by consumers and business, no new policy initiatives will produce the basic restructuring success that is so desperately needed in Japan. Of course, the negotiations would need to be of sufficient magnitude to make the results attractive to U.S. authorities as well. This means that all sectors must be on the table. There can be no holdbacks from the negotiations. The current state of the Japanese economy presents risks for the U.S.. And a weak Japanese economy presents security risks as well. The best weapon against terrorism that Japan can offer is a strong economy.

The recent spread of regional economic or trade blocs brings potential threats to the Asian Pacific Region – and in fact to the world economy. Japan, after decades of focusing exclusively on multilateralism as the corner stone of its trade policy approach, has started forming bilateral economic partnerships in Asia. With a completed arrangement with Singapore and the beginning of negotiations with South Korea, there is considerable momentum underway. And the United States continues to focus on strengthening relationships in the Western Hemisphere. A bilateral economic relationship between Japan and the United States would work to minimize the effects of regional bloc building. A trans-Pacific economic partnership would additionally provide potential pressure for progress on the next round of global trade negotiations.

It must be recognized that over the course of the past several decades, direct barriers to trade between the U.S. and Japan have been slowly reduced. Tariffs and non-tariff barriers have been eliminated or significantly eased with a few notable exceptions. It is fairly evident that the removal of the remaining border restrictions (tariffs and NTBs) would – with the notable exception of agricultural trade – not result in a significant restructuring of the domestic Japanese economy. Hence the negotiation of a basic U.S.-Japan Free Trade Agreement would not be sufficiently bold to reverse the negative confidence levels of consumers and business in Japan. Nor would it exert significant pressures on Japanese authorities for significant reform policies (again excluding the agricultural sector).

During the late 1980's and early 1990's a series of bilateral U.S.-Japan negotiations – called the Structural Impediments Initiative (SII) – focused on the barriers inside the Japanese (and U.S.) economy that impeded the international flow of goods and services. These negotiations resulted in the identification of a wide set of domestic policy areas, which were identified as being barriers to the operation (and creation) of efficient markets in Japan, and which hindered the forces of competition from being fully felt by Japanese firms and authorities. The topics ranged from land-use policies to the access of foreign lawyers to the business of practicing law in Japan – and much in between. The policy areas under discussion ranged from macroeconomics to tax policies to competition policies to standards and testing certification. No areas of the domestic economy were excluded from potential discussion.

Discussion of similar domestic restructuring issues continued during the Clinton Administration under the Framework talks. But none of the reports issued by the two sides were in fact legally binding and none have significantly altered policy formulation in either country. And the Bush Administration has continued these wide-ranging discussions in the new partnership discussions. However, the issues identified have been on target and the areas of discussion are exactly those that could help alter the fundamental economic landscape in Japan today. Perhaps incorporating the issues into a legally binding agreement that focused on a tight integration of the two economies would alter fundamentally the expectations of both consumers and business.

A U.S.-Japan Super Economic Partnership Agreement (SEPA)

The construction of a U.S.-Japan 'Super Economic Partnership Agreement' ('SEPA') may have the dynamic effects that are called for in today's economic environment. A 'SEPA' would take as its starting point the model of economic integration expressed in NAFTA. And it would be tailored to specifically fit into the NAFTA framework, which could provide the eventual basis for an expansion into both Canada and Mexico. Thus building a tight integration of the North American economy with that of Japan. But as noted above, a NAFTA like model is necessary but not sufficient to provide the momentum for changing domestic Japanese expectations. The sufficient condition for providing real momentum for change would come from the new areas to be included in the 'SEPA' which move beyond those already envisioned in the NAFTA documents.

The goal of a negotiated SEPA would be to integrate fully these two major industrial economies. It would produce a single market for goods and services which comprises more than a half of the worlds' GNP. It would produce investment incentives and growth forces, which could lift Japan from its current doldrums. Full integration necessitates that similar policy approaches be followed in each country for many internal economic regulatory issues. Microeconomic policies that are mutually supportive in the two countries would bolster growth opportunities and the efficient allocation of resources.

Firms need to be permitted to undertake similar business activities in both countries. They need to be able to 'export' their successful business model to the other country without undue regulatory barriers. U.S. firms could bring dynamic leadership to Japan with their management systems approaches and integration of IT systems into day-to-day business operations. U.S. focus on profits would alter the approach of Japanese firms towards the performance of their businesses. Labor management relations would be subject to new ideas with a full integration of U.S. management styles into the Japanese economy. Japanese successes in 'marketizing' R&D would provide American firms with business model examples worthy of close study. Japanese firms have successfully integrated policies of fast change, from design to production, that have kept the internationally competitive Japanese firms at world leadership levels.

Full commitment to unfettered market competition needs to be the goal of both governments. The integration of the economies would allow firms to maximize their efficient production and management techniques bringing enhanced competition to both nations. Adoption of corporate governance standards in Japan would increase stockholder rights and would tend to increase focus on profits and performance by corporations. It would increase transparency and strengthen confidence levels. Transparency in corporate practices would tend to add transparency to price structures in both commodity and labor markets.

For Japan it would mean that the forces of competition would result in cheaper products and higher technology for consumers and business, higher living standards, and greater growth in real incomes and GNP. It could mean a strengthened international competitive position for Japanese firms as well. Job creation would solve some of the current fears of the future for younger Japanese citizens. Lower priced goods and services inside Japan would unleash additional purchasing power by consumers, even from current income levels, and would stimulate domestic spending. Land-use reforms would increase the supply of useable land and would lower cost structures that would encourage foreign direct investors to enter the Japanese market. An internationally competitive IT market would enable Japanese firms to be global players in the B2B and B2C business. They could become part of the just-in-time global supply networks of international firms. And it would enhance the attractiveness of regional centers in Japan verses the current excessive focus on Tokyo and its nearby regions.

The increase in competition and efficiency in Japanese firms would tend to raise profitability of Japanese firms as well. Higher profitability – for those firms who adjust to the new environment – would strengthen their individual outlooks. It would also increase pressure for restructuring on those firms who failed to adjust. This pressure would tend to continue the recent trend away form *keiretsu* relationship and towards more efficient economic structures. Old cartel relationships would slowly disappear. As many have noted in the past these old cartel-like relationships have significantly burdened the economy with inefficient business forms and practices.

A 'SEPA' would move beyond the NAFTA model to include the following kinds of issues (what follows is only an illustrative list of areas for negotiation):

<u>Financial markets</u>. Full national treatment for all financial services firms. No restraints on the kinds of business offered. (This means regulatory focus on a negative list of restrictions.)

Mergers and Acquisition. Elimination of barriers to M&A activities in Japan. Change in regulations on the use of corporate stock in takeover bids.

Accounting Standards. Acceptance of agreed accounting standards, including the required use of outside accountants and auditors. Mutual recognition of trained accountants.

Corporate governance. Mutual acceptance of corporate governance principles ranging from outside directors to transparency to focus on stockholder rights.

Open skies agreement. Full acceptance of an open skies agreement with third country beyond rights for passenger and freight shipments.

Telecommunications competition. Opening of the telecoms market to full competition within the two nations. Deregulation of the communications market. Independent regulator, dominate carrier regulation, unbundled fiber optics and allow full competition, right of way deregulation.

Labor market flexibility. Focus on portable pensions, part-time worker rules, hiring and firing regulations, use of stock option compensation, competitive markets.

Labor mobility. Unimpeded movement of labor between the two economies for professional and skilled workers. At least five-year immigration status for workers hired by 'home' firms.

Professional Standards. Mutual recognition of professional standards for medical, accounting, lawyers, and related professional skill groups.

Product testing and standards. Mutual recognition of testing results for products, acceptance of agreed standards for product safety.

Competition policy. Agreed enforcement approach, use of fines, criminal statutes, arrest and conviction approaches, definition of terms and kinds of abuse of competitive practices.

Land use policies. Tax and regulatory change to encourage efficient use of land and old buildings. Accumulation and provision of 'sales' data and prices on real estate transactions. Building of database.

Housing Sector. Mutually accepted standards and testing for building products.

Distribution system. Further deregulation of delivery systems for package and freight. Opening to full competition.

Information Technology. Deregulation of e-commerce. Electronic authentication standards, electronic signature acceptance, intellectual property rights, trade in digital products.

Tax treatment of stock options, M&A activities, venture capital, stock transfers.

Health care services and medical equipment.

The above areas for negotiations are meant to be illustrative only. Clearly a fully constructed list of areas would entail negotiations between the two countries themselves. But the list is intended to highlight some of the potential areas for strengthening the Economic Partnership between the U.S. and Japan.

Fundamentally the goal is to deepen the economic integration of the two economic systems. One of the main tenants of the conceptual approach is to facilitate the spread of ideas and business perceptions between the two major industrial economies. Sharing of ideas and approaches can result in efficiency gains in both systems to the betterment of both countries. One of the key areas for investigation is the role of education in both economies. Some elites in Japan are currently engaged in discussions of the Japanese educational system focused on potential reforms for the 21st Century. University reforms in Japan might be stimulated in the new 'SEPA' if it included for discussion a freer exchange of students at undergraduate and graduate levels (focusing on visa policies in both countries), college exchanges of faculty and the building of consortiums between U.S. and Japanese universities. Some study of the approach to the integration of universities and business related research and consulting following U.S. models might be worth consideration as well. Current restrictions on Japanese faculty in terms of their ability to perform private sector consulting services might be reconsidered. Integration of the two approaches to education might offer significant benefits to both countries.