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Introduction

At the turn of the millennium, the Japanese economy remained mired in a pattern of stagnation that had continued since the early 1990s. As this disappointing condition dragged on, some in Japan called for systemic reform as a central part of policies to restore economic health. Beginning in 1994, the government formally pursued an agenda of broad economic deregulation, a specific package of deregulation measures for financial markets, and administrative reform. The private sector, prompted by substantial excess capacity in some industries, has also carried out some restructuring. The casual outside observer might easily infer that substantial—and beneficial—systemic change was well under way by 2001. Having recognized their problems, the Japanese appeared on the surface to be charging forward to embrace practical market-oriented solutions.

That appearance is deceiving. The central conclusion of this study is that fundamental aspects of the economic system are not changing very much. Like a person with arthritis, the existing Japanese economic system has lost much of its nimbleness; its joints have become creaky and painful. Japan has been taking aspirin for its arthritis—partially alleviating the pain temporarily. Something more radical—like hip replacement—would restore some mobility on a long-term basis, but so far this is not happening. As is the case with arthritis, surgery and more powerful medicine will not return Japan to its youth; Japan is a mature industrial economy with a diminishing population of working age, so even reform will not restore the high growth pattern of the past. Nevertheless, more radical treatment would produce better economic performance than in the past decade.

To be sure, the formal policy of deregulation has been proceeding since 1994 and has increased competition in some markets. However, the nature of corporate governance, corporate finance, labor markets, and the role of government in the economy continue without much alteration. This conclusion will elicit some protest among readers. As reform was getting under way in 1997, *Wall Street Journal* editor Paul Gigot opined that the Japanese economic system had failed, proving that the American style of capitalism is superior and that Japan would now reform to be more like the United States.[1] Then–prime minister Keizo Obuchi published an op-ed in the *New York Times* in 1999 stating that his nation recognized the need for extensive reform and was pushing boldly ahead.[2] Even some outside observers believe that radical changes are under way that will propel the economy back on to a stronger growth path.[3] Careful analysis, however, leads to the conclusion that such views are incorrect and provide misleading expectations for American businesses and policy makers.

This conclusion has important implications. The economic stagnation of the 1990s was largely macroeconomic in origin, stemming from the rise and collapse of real estate and stock prices. Such asset bubbles can occur—and have—in any economy. However, the macroeconomic origin of the problems obscures the fact that structural flaws in the existing system contributed to the creation of the asset bubble. Furthermore, the failure to reform through most of the 1990s complicated and delayed the recovery of the economy. Therefore, robust economic recovery depends on further systemic reform and not just macroeconomic fixes. Cyclical macroeconomic developments and simple downsizing in the corporate sector should produce an upturn in growth over the next few years. However, Japan's moving to a sustained higher growth path and avoiding renewed recession or financial crisis over the next decade requires more substantial reform. Given the nation's grim demographics—decreasing population and a rapid increase of retirees relative to workers—acceleration of economic and productivity growth is crucial. Without reform, the economy will not achieve this acceleration.

Failure to change will result in a stumbling economy bedeviled by recession and financial crisis, a scenario that would be worrisome for Japanese society, the rest of the region, and the United States. Should the economy sink into recession and crisis—a distinct possibility—Japanese households will obviously suffer. In a larger perspective, Japan will not contribute much to global growth by sucking in more imports and investment. Furthermore, the politics of a disgruntled population could easily lead toward a more nationalistic stance in foreign policy.

None of this need happen. More extensive reforms that enhance reliance on freely operating and transparent markets for goods, services, and finance, with a concomitant decline in interference by the government, would underwrite a brighter future. Economic growth under the best of circumstances will not be high, given the decline in the working age population and the financial burden of handling the exploding share of retirees. A more vibrant economy is crucial to surviving these problems without incurring a decline in standards of living. With reform Japan might manage a growth rate of two to two-and-a-half percent annually in the next decade; without reform annual growth of one percent or less will be Japan's fate.

The record of the past 130 years in Japan since modernization began is one of a pragmatic people who dramatically and successfully transformed their nation into one of the leading industrial nations of the world. That record does not guarantee success this time. The obstacles to reform have been formidable, and success itself may have made society less flexible.

Background

All across the globe nations have been getting government out of the market place over the past quarter century. The United States began a process of deregulation during the Carter administration in the 1970s, and the process continues today. In Britain, Prime Minister Margaret Thatcher presided over the privatization of nationalized industries during the 1980s. China has permitted private corporations and markets to operate. Experiments with communism, socialism, and regulation, undertaken in many countries in the name of fairness and promotion of economic growth, failed to meet expectations, leading to this massive reversal in policy. Behind the reversal lay a strong intellectual movement based on theory and on empirical research concerning the inefficiency and failures of government when it meddles excessively with markets.[4]

On the surface, Japan would appear to conform to this broad global trend, as deregulation, administrative reform, and industrial restructuring have been the hot topics of discussion for most of the past decade. The 1990s were certainly a troubling decade for Japanese society. After a half century of rapid economic growth and successful transformation to an advanced industrial nation, the economy stagnated and a mountain of bad debt weighed down the financial sector. Economic growth in the eight years from 1992 (when the slowdown began in earnest) through 1999 averaged a relatively weak annual rate of 1.0 percent.[5] The general stagnation was accompanied by the first real recessions since 1974, with negative growth in calendar 1998 and in two consecutive negative quarters in the second half of 1999. This economic performance was hardly the disaster that it might have seemed from the exaggerated adjectives used to describe it in the media; Japan remains one of the most affluent nations of the world, and unemployment remains modest. Nevertheless, after such a long period of unusually successful economic performance, stagnation and bad debts left many Japanese dismayed and bewildered by their problems.

The proximate cause of this poor economic performance lay in the speculative asset price bubble in the stock market and real estate market during the second half of the 1980s. In five years both equity prices and urban real estate tripled in value. When a worried government finally raised interest rates to constrain this situation, the party came to an end. The collapse of asset prices from the beginning of the 1990s, wiping out all the price gains since 1985, had a serious negative effect on the economy, as it would on any economy. Banks were also left with massive amounts of nonperforming loans, secured by real estate collateral that was shrinking in value. Both poor macroeconomic performance and the bad debt problem were exacerbated by poor decisions within the Japanese government. Fiscal stimulus was an on-again, off-again affair for much of the 1990s, while the bad debt problem was allowed to fester unchecked until near the end of the decade.

Arguably, any market economy could encounter the problems Japan experienced in the 1990s. Speculative bubbles, driven by excessively positive expectations about the future, can occur anywhere. Collapse of asset prices of the magnitude experienced in Japan would have a negative macroeconomic effect in any economy and would produce massive amounts of bad debt in the banking sector. The record of policy on the nonperforming loans of the savings and loan industry in the United States during the 1980s amply demonstrates that poor policymaking is certainly not unique to Japan.

Even though the problems of the 1990s can be traced directly to the rise and fall of asset prices, the problems lay deeper. Why did the speculative bubble occur? Why did the bad debt problem fester so long without any serious effort at resolution? Why did low interest rates in the 1990s fail to encourage new business investment? Answers to these questions lay in structural flaws in the organization and operation of the economy rather than in just an unfortunate but understandable speculative mistake in asset markets. The existing Japanese economic system is a modification of capitalism involving, among other things, a strong indirect government intervention in markets that may have been well suited to the needs of a rapidly industrializing nation. The problems of the 1990s, however, demonstrated that this model did not suit the needs of an advanced industrial nation.

Poor economic performance in the 1990s, therefore, sparked a vigorous domestic debate over the need for government administrative reform, economic deregulation, new accounting rules, and other changes to spur more efficient corporate behavior. Beginning in 1993, all of these topics gained serious attention in government and the private sector. Over the course of the rest of the decade, government moved forward with a plan for general economic deregulation, a "big bang" deregulation of the financial sector, and government administrative reform. Corporations also began to cope with their own problems—bad debts, excess labor, and excess facilities—by late in the decade. By 2001, talk of change was very much in the air.

Is Japan really forging ahead with major economic restructuring, institutional reform, and deregulation? This study argues that the surface image of change is misleading. That "something" is changing cannot be denied, and the pace of change has clearly increased from the stasis of the preceding two decades. Nevertheless, a number of important and interrelated factors impede the reform process, and the result will be an economy that continues to differ in organization and behavior from that of the United States and most other industrial nations. The government will remain more intrusive in the economy than is the case in the United States or some other nations that have been deregulating. Mistrust of markets will continue, leading to constraints on the scope of their function. Corporate governance will not change to put shareholders in the driver's seat, and corporations will temper their drive for efficiency by other social considerations. Corporations might succeed in raising their return on investment relative to the dismal performance of the 1990s, but remain less profitable than their western counterparts.

All economies change over time. Economic institutions, the laws enabling those institutions, and regulations affecting economic behavior are all artificial constructs created by political systems and can be changed at any time. New technologies, experience gained concerning the success or failure of existing institutions and rules, shifts in macroeconomic variables (such as private-sector savings and investment), as well as shifts among growing and shrinking sectors all produce changes in laws, regulations, institutions, and economic behavior. In this basic sense, Japan is no different from other countries. Many changes have occurred in the past fifty years; new industries have been created, and some sectors have been deregulated.

What other kinds of changes have occurred? In just the past decade the number of franchise outlets (an American corporate organizational innovation of the 1950s) has increased four-fold, with convenience stores and fast food outlets popping up everywhere.[6] Franchised convenience stores have morphed into a distinctly Japanese format, providing a set of goods and services quite different from their American counterparts. Cellular telephones have come into widespread use since substantial deregulation occurred in 1994; the number of cellular telephone subscribers rose explosively from 2.1 million to 60 million in the seven years from 1993 to 2000.[7]

These rather dramatic changes in the context of a largely stagnant economy certainly suggest that economic vitality was not entirely lost. However, such examples do not offset the harsh reality of a stagnant economy and the need for broader reform. The fact is, Japan does not have enough examples of such successes to drive the economy back to health and needs further systemic change to provide a more receptive environment for them.

The Japanese are well aware of the trends in the rest of the world. They have been deeply interested in deregulation in the United States and in changes in other countries that have reduced the role of government in the economy. Much of the call for change at home has been driven by knowledge of these trends abroad. The continuing revolution in information technology and its explosive deployment in the United States have attracted particular attention. In many aspects of information technology the Japanese economy lags behind that of the United States, but it is moving forward quite rapidly (and leads in some areas, such as wireless communication). Japanese society is rich in technical expertise and generally has a pragmatic approach to new industries and technologies that will enable the economy to adjust reasonably quickly to the information revolution. Concern over lagging behind the Americans provides a powerful incentive to both corporations and government to push development of this sector of the economy.

However, this technical strength and the ability to respond to foreign trends should be kept in perspective. The Japanese economy has coped quite successfully in the past century with a constantly changing economic *structure*. Industries have emerged, grown, and died. A massive movement of people out of agriculture into modern industry occurred in the past century, and it was accompanied by a wholesale relocation of population from rural to urban areas. The textile industry, once a dominant exporter, has shrunk to insignificance. Much of the current news in Japan relates to restructuring—bloated corporations shedding capital and workers, banks recouping from disastrous amounts of nonperforming loans, and new industries taking off. *Structural* change is quite different from *systemic* change, however, and the big question is not restructuring, but systemic change. Are the basic rules and practices that constitute the architecture for economic behavior in Japan undergoing major reform? No. Is the economy moving toward greater reliance on freely operating markets for goods, services, labor, and corporate control? Not much. Will the Japanese economic system continue to appear distinctive when compared with that of the United States or other advanced industrial economies? Yes.

A decade from now the Japanese economic model or system will not have converged on the practices of the United States or other industrial nations. Why Japan will not adopt radical reforms and embrace a more market-oriented economic architecture is the central topic of this study. Japan's economic system will be somewhat *different* a decade from now, but it will remain *distinctive.* Government will remain intrusive in a number of areas of the economy, driven by a continuing belief that its guidance remains necessary for prosperity and to ensure the competitiveness of Japanese firms vis-à-vis their American and European competitors. Financial markets, labor markets, and corporate governance will experience some reform, without converging on American practices. Deregulation will unleash new competition in some markets, to the benefit of consumers, but the tendency even in those markets to temper competition with informal cartel arrangements will remain strong.

The terms American model and American standards have become quite faddish and are thrown around loosely in Japan. One could argue that Japan is not so different from European countries, but when people discuss reform that would move the Japanese economy to greater reliance on markets, it is the contemporary American system that they usually have in mind as a model. This study does not attempt to define an American economic model; it is, therefore, occasionally guilty of using the term rather loosely as shorthand for a system that relies heavily on markets for goods, services, and corporate control. Keep in mind that American institutions and behavior have also changed considerably in the past several decades, and they continue to change. Economic regulation in the United States has lessened or been eliminated in some industries, including transportation and telecommunications, but the economy is hardly a completely unregulated laissez-faire model today. American venture capital, and equity markets in general, play a larger role today than they did three or four decades ago. Shareholders—especially mutual funds and pension funds—exercise strong roles in corporate governance, representing another change from the past. Government plays less of a role than in the past in overt economic regulation, but retains a critical function in establishing ground rules for markets and monitoring them to combat fraudulent or other undesirable behavior. In summary, though, the contemporary American economic model relies more on markets with relatively freely determined interaction of demand and supply for exchanging goods, services, labor, corporate finance, and corporate control than is the case in Japan or even in most other advanced industrial nations.

The Japanese economy will not come to resemble the more market-dominated American model over the next decade. The comforting notion that it might, as expressed by Paul Gigot or Prime Minister Obuchi, is a misinterpretation of what is occurring in Japan. Despite the evident need for systemic reform, a set of powerful interconnected factors implies that change will not produce a clone of the American economy. The five main inhibiting factors emphasized in this study are:

—belief in the value of the existing system, which has been shaken but hardly destroyed by the events of the 1990s;

—the interconnected nature of the distinctive features of the existing system, implying that tampering with a few pieces of the system is not sufficient to change the whole;

—strong vested interests in the current system that may include a majority of the population;

—conformity of the system to broader social norms and expectations, representing values that society is loath to lose; and

—a weak process of deregulation and administrative reform, driven by the bureaucracy itself rather than by broad political pressures from voters, coupled with a corporate restructuring that emphasizes downsizing more than reforming the nature of the corporation.

These five factors are mutually reinforcing, and together they will shape the nature of change. A decade from now, the organization and behavior of the Japanese economy will certainly be different from that of today; as formidable as they may appear, these factors will not totally block systemic change. The resulting economic framework will still look quite distinctive from an American viewpoint, however.

The nature of change matters, for both Japan and the United States. For Japan, if the restraining factors identified here are too powerful, then very little systemic change will occur, and the economy will perform poorly for many more years. Renewed recession, dangerously rising levels of government debt, and generalized failure to meet the financial needs of a burgeoning retired population are clear possibilities. The Japanese public will be less well off than they could be.

This outcome matters to the United States and the rest of the world. With the Japanese economy just muddling through, it will not contribute much to regional or global growth, and U.S. officials will have to cope with the international consequences of recurring financial problems in Japan. Meanwhile, Japan is unlikely to adopt a more liberal stance on bilateral or multilateral trade negotiations because weakness at home will result in a continued defensive trade posture. Even security policy could be affected, including both the specifics of the bilateral alliance and Japan's broader participation in regional or global security issues. Self-absorption with domestic economic problems will leave Japan in a marginal role in security discussions among the major powers. In general, Japan's failure to produce more vigorous economic reform creates a series of challenges and problems for American policy.

Outline

Chapter 2 begins this study by defining the starting point: what distinguishes the organization and behavior of the Japanese economy from that of the United States or other industrial nations? Over the past half century, Japan adopted neither the American pattern of extensive use of independent regulatory agencies nor the European pattern of nationalized industries and extensive welfare. What Japan did adopt was:

—reliance on banking (rather than stock or bond markets) to move funds between savers and investors and, as a corollary, broad collections of firms (horizontal *keiretsu*) associated with the major banks from which they borrowed;

—a system of corporate governance that downgraded the role of shareholders in favor of banks and other stakeholders;

—long-term contracting in the corporate sector (vertical *keiretsu*);

—reduced price competition in the marketplace; and

—a heavy dose of indirect government interference in the operation of the economy (often called industrial policy).

When this system was working well—as it did during the first four decades after the Second World War—people felt strongly that they had created a kinder and gentler version of capitalism than that preached by neoclassical economists or practiced in the United States. Economic growth was high, unemployment was low, and rapid gains in personal income were broadly distributed through society.

Chapter 2 also articulates the first two problems for systemic reform. First, the Japanese have been proud of their system for the past several decades. Why tamper with a system that provided high growth, rising incomes, and low unemployment? The economic malaise of the 1990s certainly shook belief in the efficacy of the system, but hardly destroyed it. Many also see other benefits that they believe flow from their system—relatively low income disparities between rich and poor (in comparison with the United States) and lower crime levels than in other countries. Some in society believe the system is truly broken and must be radically reformed. Most in society, though, seem to be far less certain that the system is broken and are reluctant to abandon a model they firmly believed superior to their perception of American capitalism.

Second, the distinctive economic system involves a set of interlocking features. Changing or tinkering with one individual feature of the system without simultaneously addressing most or all of the others is not likely to be successful. At best, the piecemeal approach takes time, as alteration of one feature of the economy creates incompatibilities elsewhere, leading to further changes. At worst, the incompatibility that would result from tinkering with one piece of the economy would cause the proposed changes to be watered down or the resulting effect of the change to be minimized.

Chapter 3 explores why pressures have mounted for change and why reform should occur. As noted above, the main source of pressure for reform in the 1990s was the collapse of the asset bubble and the ensuing economic stagnation and nonperforming loan problems. In addition, evidence mounted concerning inefficiency or failure in some aspects of the economic system. Why, for example, has Japan needed the highest ratio of investment to gross domestic product (GDP) among OECD nations to sustain a virtually stagnant economy? Some flaw in the system led to continued high levels of investment in both private and public capital despite low rates of return or lack of social need.

Chapter 4 considers vested interests. Many groups in Japan have benefited from the existing configuration of the economic system and are very reluctant to embrace change. Farmers and those living in rural areas more generally, workers with lifetime employee guarantees, bureaucrats, construction firms and their employees, workers in small firms, and homeowners all benefit from the current system. Although each of these groups is a minority of society, and each feels particularly protective about only those parts of the system that benefits itself, in total these groups represent a majority of the population. The extensive nature of vested interests provides much of the explanation of why the democratic political process has not driven economic reform more vigorously.

Chapter 5 explores the compatibility of the economic system with broader social norms. Japanese society differs in many respects from that of the United States or the West more generally. It would be surprising if those differences did *not* affect economic institutions and behavior. In broad terms, those differences include a strong group orientation, a sense of hierarchy, reliance on personal relationships, avoidance of uncertainty, emphasis on facades, and preference for indirectness. The features of society are compatible with—and have helped shape—all of the distinctive aspects of the economic system. Change in social behavioral norms certainly occurs over time, and Japanese society today is rather different in some respects from fifty years ago. These changes generally occur slowly, however. As long as Japanese social behavior is visibly different from that in the United States, convergence on an American economic model is unlikely. Alteration of the existing overarching architecture for the economy is certainly possible, but whatever those changes might be, they must also be broadly consistent with social expectations.

Chapter 6 concludes the discussion of why reform will remain relatively weak by looking at the process of reform itself. At the governmental level, deregulation and administrative reform have been squarely in the hands of the bureaucracy itself. Unlike the United States or other countries where political dissatisfaction led to electoral outcomes that brought deregulation and a reduction in the economic function of government, in Japan the bureaucrats themselves have been granted the mandate for change. This is a rather weak means to achieve real reform. Deregulation has involved a bean-counting game, with bureaucrats emphasizing the number of regulations that have been eliminated or altered. Little attention has been given to reshaping the overall regulatory framework for particular industries. Meanwhile, administrative reform yielded a major reshuffling of the bureaucracy—moving pieces of various ministries around within the ministerial structure—without addressing the larger issue of the role of government in the economy. While the government has been touting deregulation and administrative reform, its involvement in the economy has actually expanded, and its schemes to promote various industries continue unabated.

In the private sector, structural change has been driven by stark necessity. Banks were burdened by massive amounts of bad debt, life insurance companies failed to earn promised returns for their policy holders, foreign financial institutions injected new patterns of behavior into the market, and many nonfinancial corporations experienced financial losses and increasingly stiff global competition. In the 1980s the high-flying economy caused some outside observers to believe that Japanese firms could defy normal economic rules—since they aggressively expanded market share without regard to profits. In any economic system, though, the bottom line matters. Japanese firms could get away with low profits for years, but a firm hemorrhaging money eventually either restructures or goes out of business. By the late 1990s parts of the private sector faced this dire constraint, and some restructuring was moving forward. The resulting restructuring has focused on the immediate causes of poor financial performance, however, without much alteration of fundamental aspects of corporate governance. Cutting employment through attrition and early retirements, for example, does not alter the underlying practice of lifetime employment. Nor have firms exhibited much alteration in the relationship between managers and shareholders. This approach should not be a surprise. The kind of financial pressures faced by Japanese firms lead necessarily to the restructuring that is occurring; any firm that wants to survive must cut costs. These pressures do not, however, lead logically to fundamental reform of corporate governance. What is occurring is more of a one-time slimming of bloated corporate structure, a delayed but normal response to stagnation and recession.

Thus neither government nor the private sector is embracing fundamental reform as enthusiastically as is commonly portrayed in the press. Unless or until the public exerts its democratic voice, more radical changes are unlikely. Optimists can point to the increasing integration of Japanese financial markets with the outside world, brought about by the recent inroads made by American financial institutions in Japan. Bringing with them western assumptions about corporate governance, these institutions are not shy about pressing firms in which they invest for changes in corporate behavior. Nevertheless, it remains unlikely that foreign financial institutions will be sufficiently powerful within the domestic Japanese market to bring about major change in corporate governance.

Chapter 7 concludes the study by asking what the weak process of reform means for bilateral relations. The starting point is simply to recognize that reform is not proceeding vigorously, that the organization of Japan's economy will remain distinctive, and that economic performance is likely to be disappointing. American government and corporate planning should begin from this premise. Adversity actually creates opportunities for some foreign firms, but for government the implications are more sobering.

To begin with, is there anything the U.S. government can do to nudge Japan toward reform and a return to economic health? American interests clearly lie with a healthy, growing Japanese economy. Bilateral discussion of how to restore health and growth should certainly be on the U.S. government's agenda, even though American options in encouraging a reform process that underwrites a healthy economic recovery are actually quite limited. Because Japan has a very large economy and is a large net creditor, opportunities to nudge it in desired directions are few. Discussion and advice are always desirable and should be pursued, but there is no guarantee that advice will be heeded. No official should enter into this process with unrealistic expectations about what American government policy can do to help fix the Japanese economic system.

On systemic economic reform issues, American trade policy will play a useful if modest role. Deregulation is central to many trade issues. Because foreign firms play a larger role in the Japanese economy as the result of negotiations that make the market more open, they can promote systemic reform from within. Foreign financial institutions, for example, have brought with them important financial innovations that help change broader corporate behavior. Even this possibility, however, should be kept in perspective. Foreign financial institutions play a larger role than they used to, but they are not important enough to bring major change on their own in either the nature of financial markets or broader corporate behavior. They will have an effect at the margin, but not much more. Still financial institutions and other foreign firms will have an increasing presence, which will help the reform process along, and that prospect should persuade the U.S. government to continue pursuing an active trade agenda with Japan.

More broadly, the Japanese will make economic reform decisions on their own, and U.S. government input will have relatively little influence. Americans are constantly asked for advice about what Japan should do, and supplying verbal pressure (known as *gaiatsu*, or outside pressure) has been a staple of bilateral relations since the time of Commodore Perry. In some cases, there may be opportunities, through government or even nongovernment settings, to supply *gaiatsu* that feeds into existing domestic pressures for change. However, most of Japan's economic problems are internal and for the most part will be worked out internally, without reliance on American or other foreign input. Japanese officials may seek advice and then ignore it. They may even choose to avoid bilateral arrangements in which the U.S. government can apply pressure; *gaiatsu* has become a pejorative term for many younger Japanese government officials who resent

American interference in what they deem to be domestic issues. There is no harm in seeking ways to advise Japan on what to do, but U.S. government policy must recognize that these issues are domestic, and that American influence will be small.

Even though *gaiatsu* may have little impact in general, times of approaching crisis (as when the Japanese banking industry was sliding toward wholesale collapse in 1998) justify strong pressure because of the potential international consequences of real economic crisis in Japan. Stronger public statements by senior administration officials at least get high visibility in the Japanese media, providing some input into policymaking. When necessary, that less diplomatic public pressure should be applied. American government officials should be aware that such crises will remain likely, given the weakness of reform, and they should monitor Japanese developments closely for warning of approaching problems.

The conclusion of this study is that Japan is unlikely to do more than muddle through even with American advice and occasional stronger pressure. Reform will probably be sufficient to prevent a serious collapse of the economy, but the most probable outcome is a weak growth rate, of zero to one percent, with recurring financial problems. In this scenario, the Japanese polity will remain absorbed with its domestic economic dilemmas for some time to come. Rather than thinking expansively about leadership on a global stage, Japanese political and bureaucratic leaders will focus heavily on domestic problems, and their behavior on international issues will reflect their domestic orientation. On economic issues, for example, the Japanese government will not be a progressive force within the World Trade Organization (WTO) and will work to undercut market-oriented policy proposals at the International Monetary Fund (IMF). The nation's relatively weak economic performance and bungling of reforms undermines the confidence of Japanese leaders on the global stage, and it undercuts the willingness of other nations to consider seriously international policy proposals from Japan. Even if American pressure were to lead to formal relaxation of the strict constraints on Japanese participation in peace-keeping operations (to include, for example, armed participation in collective security actions like the Gulf War), this lack of confidence and the predominance of domestic self-absorption would be likely to leave Japan a relatively passive actor in multilateral deliberations during security crises and a reluctant participant in policies that have been determined by others.

Continued weak economic performance could also affect the bilateral security relationship. A government concerned about the size of its rising debt levels will be less willing to increase budget expenditures related to American military bases. Furthermore, a Japan that feels less certain about its own economic performance could possibly adopt a more nationalistic approach to the rest of the world. Unable or unwilling to conform more closely to an American-style, market-based economic model, Japanese leaders might feel the time has come to distance the nation in other ways as well, pursuing a more independent or Asia-centric diplomatic and defense posture. Nationalistic attitudes and a desire for greater distance from the United States would be exacerbated should limited reform lead to a stumbling economy and financial crises that increase resentment of a more successful U.S. economy.

Could all of these predictions turn out to be wrong? One certainly hopes so. However, the probability of accelerated and more thorough economic reform that revitalizes the economy and yields a more confident global player is small. In fact, the downside risk—in which failure to reform creates worse problems—is higher than this upside possibility. While one may hope for a more optimistic outcome and for direct American policy encouraging Japan to move in that direction, the presumption should be that Japan's performance will be disappointing.