



Japan's Economic Woes: It's About Politics

By Yuko Kawamoto

The Japanese economy continues to suffer from vast unrealized potential. But the crux of the problem doesn't lie within the economy itself, but rather in Japan's failure to tackle the political reforms necessary to unleash the economy. This is the lesson of the current crisis, writes Japanese economist Yuko Kawamoto.

AS THE CURRENT GLOBAL FINANCIAL crisis weakens one economy after another, some Japanese feel that this time around Japan may be the least damaged and should emerge as the strongest among advanced economies. There are two reasons for this: first, the biggest impact of the slowdown will be where the bubble burst, namely in the US and Europe, and Japan is only indirectly affected through reduced market demand in those regions; second, Japanese financial institutions are less exposed to risky financial products than their American and European counterparts, so the credit tightening from over-exposure to these products will be less severe in Japan.

But in reality, this is sadly not the case. At least so far, the opposite has happened. For example, the fall in stock prices since the crisis began has been worse in Japan than in the US and Europe. This has been partly attributed to “fire sales” of equities by foreign investors whose share of the market has always been high on stock exchanges in Japan. It should also be noted that selling by Japanese companies of cross-shareholdings — which, by international standards, still remain relatively high — has also contributed to sharper falls in stock prices in Japan than elsewhere.

Although the potential of the Japanese economy remains impressive, what the current predicament underscores is that insufficient progress in tackling necessary structural reforms in the past — such as those involving cross-shareholdings mentioned above — is now keeping the Japanese economy from performing as strongly as it deserves to. In this sense, Japan's problem is not economic, but

rather political — a failure of the political system to face reality and tackle needed reforms.

It is easy to overlook the potential strength of the Japanese economy, particularly given the impressive recent growth of its Asian neighbors. But Japan is still the world's second largest economy and its domestic market is huge. Its manufacturing sector has achieved global technological superiority in a number of areas, and is very keen to sustain it. Japan's level of research and development investment by both the public and private sectors, measured as ratio of gross domestic product

to GDP, has been consistently high among Group of Seven (G-7) countries, exceeding that of the US. The fact that four Japanese-born scientists received the Nobel Prize this year demonstrates the country's scientific capability. Public investment in the past has given Japan some of the world's best basic infrastructure such as roads, railways, water works and IT networks. Accumulated household financial wealth stands at around 1,500 trillion yen (roughly \$15 trillion). Also, Japanese society is perhaps one of the safest and most peaceful in an ever-turbulent world.

However, for the Japanese economy to realize its full potential key problems need to be resolved, foremost among them is the public debt. Successive and vast fiscal stimulus packages adopted in the late 1990s, combined with sluggish tax revenue growth, have left Japan's public finances in by far the worst shape among advanced economies. Japan's total outstanding public debt as a ratio of GDP reached 170% in 2005, three times as high as that of US and much worse than that of Italy, a country notorious for chronic defi-

cits. Fiscal discipline implemented under former Prime Minister Junichiro Koizumi succeeded in stabilizing the growth of public debt, but it failed to reduce the accumulated level.

Moreover, Japan's aging population will require ever-larger public expenditures for social security in coming decades. With the country's consumption tax (the Japanese equivalent of a value-added tax, or VAT) at 5 percent, lower than many other countries, fiscal balance is unlikely to be achieved without raising taxes. However, whether it is public pensions or medical insurance, Japan's social

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security system has been riddled with problems in recent years — from lost or fabricated pension records to widening disparities in the working conditions and pay of doctors working in hospitals versus those in private practice, with the advantages enjoyed by the latter increasing. As a result, taxpayers cannot agree to tax increases unless the system is fundamentally reformed so that they feel their tax money will be usefully spent.

Reform, however, must also be carefully designed and thoroughly implemented. In the process, reformers will certainly run into stiff resistance from powerful vested interest groups such as the social security bureaucracy and doctors' associations. Successful reform will require competent administration and strong political leadership.

The Koizumi government from 2001 to 2006 started the reform process. Throughout the 1990s, Japan suffered prolonged economic stagnation, but after 2001 the government attempted to reign in fiscal spending and vigorously urged banks to dispose of their bad loans as quickly as possible. Resistance from government bureaucrats and industry inten-

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sified, but the government did not retreat. It was only after people were assured that their future tax burden would be reduced, and banks became confident enough to lend again to companies, that the economy at last returned to a growth path.

Koizumi appointed an economist, Heizo Takenaka, as minister in charge of economic reform and stood firm against the vested interests that opposed reform. His approach defied the traditional formula of party politics — that is, relying on the entrenched bureaucracy for policy planning, and governing based on a peaceful consensus among interest groups. Koizumi's defiance of the system largely worked, and he became extremely popular among the electorate.

The lesson is that strong political leadership committed to reform will give the economy the best chance to grow. Expectations of reduced tax burdens in the future and more business opportunities will encourage companies and consumers to invest and consume more. This, in turn, will result in faster actual growth and create expectations of even higher growth.

Nevertheless, while Koizumi's policies contributed to the Japanese economy's comeback, reform under Koizumi was neither perfect nor complete. The fiscal situation improved but is still far from balanced. The government succeeded in slowing the accumulation of debt, but is only halfway toward the stage where the stockpile of outstanding debt can be reduced. Furthermore, for the economy to grow faster, more competition and the entry of new businesses should be encouraged. Government regulations and private practices that inhibit such activities should be eliminated by regulatory reform, competition policy and privatization, while safeguarding the public interest. These are internationally accepted, standardized micro policy prescriptions, but their implementation has been generally weak and half-hearted in Japan, even under Koizumi.

Since Koizumi left office in autumn 2006 when his term as leader of the ruling Liberal Democratic Party ended, the prime minister's position has been passed to Shinzo Abe, then to Yasuo Fukuda and then again to the current prime minister, Taro Aso. Unfortunately, the reform that began with Koizumi's

cabinet has not been built upon by his successors. The political commitment to economic reform appears to have gradually weakened, and as a result, the economic recovery of the Koizumi era seems to have come to a halt. Indeed, a former economics minister commented that the loss of reform momentum has lowered the expected rate of growth and this has affected actual economic growth.

One reason for this is purely political. Under Abe, the LDP suffered badly in the Upper House elections in the summer of 2007. As a result, the opposition, led by the Democratic Party of Japan (DPJ), has controlled the Upper House since then. Legislation proposed by the ruling LDP coalition has been frequently frustrated and some key appointments requiring Diet approval have had to be withdrawn, notably the nomination of the governor of the Bank of Japan.

As the political power of the ruling parties has weakened, so too has the policy leadership of the prime minister. Moreover, political debate has been increasingly colored by a backlash against, and antipathy toward, the Koizumi reforms. Although analysis of opinion polls shows that the major reason for the LDP's defeat in 2007 was a succession of scandals involving cabinet ministers, as well as the government's ineffective response to the lost pension records mess, many in the LDP have pointed to the opposition's gains among the LDP's traditional supporters — farmers and local communities — as another key reason for the defeat. They argue that Koizumi's reforms went too far and exacerbated inequalities in society. They insist that fiscal discipline should be eased so that government expenditures can be increased to help farmers and local governments. The global financial crisis and the prospects of prolonged recession have strengthened the appeal of these arguments in the ruling coalition. As a result, the LDP seems to be going back to the policies of the old days, pleasing a whole range of vested interests.

At the same time, some of the reform commitment has been reversed by post-Koizumi administrations. For example, the government watered down judicial reforms by abandoning plans to increase the number of lawyers, despite the fact that the number of practicing lawyers per head

in Japan is still critically low compared to most European countries. Also, the government appears to have backed away from plans to reduce the barriers to entry to the taxicab industry, allowing local governments to implement entry restrictions. Agriculture remains heavily regulated, making it nearly impossible for new players to enter the business — for example, corporations still cannot own farmland. Continuing food safety scandals show that the competitiveness of Japanese agricultural products is diminished because of high levels of protectionism.

Regarding the participation of women in the workforce, the government's response has been too modest, and demonstrated an unwillingness to break from the current approach. Support for child-care should naturally be a priority, because unless demographic trends are reversed, the social security burden will continue to fall heavily on the shoulders of fewer and fewer working people as the population ages. The need for change on a whole range of fronts is necessary — corporate culture and practices, income taxation, labor regulation and openness to foreign workers in the nursing industry.

On the other hand, drivers of reform, such as the Regulatory Reform Commission, have been sidelined and are not receiving the political support they need. Inward-looking policies appear to be spreading in industries closely related to the government, where negative responses to foreign investment are rampant and cross-shareholding has been revived as a protection against hostile takeovers. Today's politicians and senior officials often seem to forget who saved Nissan Automobiles when it was on the brink of collapse — a foreigner, Carlos Ghosn, then president of French carmaker Renault. While the case for a friendly climate for foreign firms can be best demonstrated through a political commitment to foreign direct investment, or FDI, the cabinet ministers' meeting to promote FDI has been downgraded.

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As for the DPJ, its stance on economic reform still needs to be made clear. It appears hostile to anything associated with the name of Koizumi, proposing policies to support the LDP's traditional constituencies. At the same time, it has severely criticized the government's lack of accountability and efficiency, and some DPJ members have become very popular pursuing these issues. The irony is that these critical views of government bureaucracy are, in fact, close to those of Koizumi.

All this confirms that politics matters greatly for the Japanese economy. It is political support from the top that can create a climate for economic growth that taps Japan's full potential. As mentioned earlier, because the opposition now controls the Upper House, the dissolution of the Lower House, which is a prerogative of the prime minister, and an ensuing general election look imminent. This will present the Japanese electorate with a rare opportunity to decide which party and leader is most appropriate to meet the challenges facing Japan during this global financial crisis.

The need to address the crisis is unlikely to disappear in the coming months and it is understandable that this has made the decisions facing the country very difficult. But Japanese political leaders need to recognize that an effective response requires competent administration with robust political support. A general election can help consolidate the necessary political support needed to respond to the crisis.

Global attention will hopefully shift from short-term crisis management to the longer-term issue of fighting recession and bringing about economic recovery. The need for fiscal stimulus is now in the spotlight for good reason. But the purpose of fiscal stimulus should be seen as preventing the recession from spiraling downward, and no more than that. Japan's experiences in the post-bubble days of the 1990s show that fiscal stimulus alone cannot achieve sustained economic recovery. What

Japan needs are long-term solutions. For this, Japan must go back to the economics textbooks and restart the structural reform process to encourage the entry of new businesses, investment and competition, while sustaining a stable macro-economic environment through thoughtful fiscal and monetary policies.

Therefore, the political decisions taken in Japan in the near future will be crucial for the economy in coming years, as it emerges from the financial crisis. Whichever political party prevails, it would be wise to stand up firmly to vested interests, and to open up the government bureaucracy to make it accountable to the people. For the economy's sake, the Japanese people should welcome this opportunity.

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